MURRINDINDI SHIRE COUNCIL

Decision on application for a higher cap for 2016-17

May 2016

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Essential Services Commission 2016, *Murrindindi Shire Council — Decision on application for a higher cap for 2016-17*, May.

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1. OUR DECISION

The Fair Go Rates System (FGRS), established in the *Local Government Act 1989* (the Act), requires local councils to limit their average annual rate increases to a rate cap, determined annually by the Minister for Local Government (the Minister).[1] For the 2016-17 rating year, the cap has been set at 2.5 per cent.

Councils wishing to increase their average annual rates by more than 2.5 per cent in 2016-17 must first obtain approval from the Essential Services Commission (the Commission). We are responsible for approving, rejecting or approving in part the higher cap sought by council. This paper outlines our decision in response to an application by Murrindindi Shire Council (Murrindindi or Council) for a higher cap of 5.4 per cent (which includes the Minister's rate cap of 2.5 per cent) to apply in 2016-17.

In assessing applications, we are required to have regard to the six legislative matters[2] and the statutory objectives[3] of the FGRS (box 1).

The six legislative matters are:

- the proposed higher cap for each specified financial year
- the reasons for which the council seeks the higher cap
- how the views of ratepayers and the community have been taken into account in proposing the higher cap
- how the higher cap is an efficient use of council resources and represents value for money
- whether consideration has been given to reprioritising proposed expenditures and alternative funding options and why those options are not adequate and
- that the assumptions and proposals in the application are consistent with the council's long-term strategy and financial management policies set out in the council's planning documents and annual budget.

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1 Section 185B and 185C of the Local Government Act define rates for the purposes of the cap.

2 Section 185E of the Local Government Act.

3 Section 10E(7) of the *Essential Services Commission Act 2001* and section 185A of the Local Government Act.

BOX 1 OBJECTIVES OF THE FAIR GO RATES SYSTEM

- to promote the long-term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure
- to ensure that a Council has the financial capacity to perform its duties and functions and exercise its powers.

The Act also requires the Commission to have regard to a council's record of compliance with previous years' caps.[4] However, as this is the first year of the FGRS, this has not been a relevant consideration when assessing applications for higher caps in the 2016-17 rating year.

BOX 2 COMMISSION'S DECISION ON MURRINDINDI SHIRE COUNCIL'S APPLICATION

Murrindindi has applied for a higher cap of 5.4 per cent in 2016-17, that is, 2.9 per cent above the Minister's rate cap for 2016-17.

The Commission has assessed Murrindindi's application, and decided to approve the higher cap for infrastructure renewal (1.8 per cent) and not to approve the higher cap related to services (1.1 per cent). Murrindindi will be required to keep its average rate increase within a higher cap of 4.3 per cent.

The Commission is satisfied that the infrastructure renewal component relates to a long-term need that is consistent with Council's Long-term Financial Plan (LTFP). The Commission is not satisfied that the increase sought for the provision of services is a need that warrants a permanent increase to the rate base.

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4 Section 185E(6)(c) of the Local Government Act.

2. WHAT DID THE COUNCIL APPLY FOR AND WHY?

Murrindindi sought a 5.4 per cent higher cap in 2016-17 (inclusive of the Minister's rate cap of 2.5 per cent). Murrindindi estimated that this would result in additional revenue of $451 807.

Two reasons were specified for seeking the higher cap:

1. to fund the infrastructure renewal reserve ($282 000, 1.8 per cent) and
2. to maintain current service levels ($170 000, 1.1 per cent).

A copy of Murrindindi's application and its response to our request for information (RFI) is available on our website (www.esc.vic.gov.au). Appendix A shows the communications between the Commission and Murrindindi during the assessment period.

3. HOW DID WE REACH OUR DECISION?

Table 1 summarises our observations on each of the relevant matters specified in Murrindindi's application.

TABLE 1 LEGISLATIVE MATTER SUMMARY

Legislative matter	Summary
185E(3)(a) — proposed higher cap	The Commission verified that the higher cap was appropriately calculated.
185E(3)(b) — reason(s) for which the council seeks the higher cap	Council's application specified two reasons for seeking the higher cap: • to fund the infrastructure renewal reserve ($282 000, 1.8 per cent) and • to maintain current service levels ($170 000, 1.1 per cent). **The infrastructure renewal reserve** Following the 2009 bushfires, a total of $33 million in new and expanded assets were gifted to Council. This resulted in a substantial increase in expenditure to meet the ongoing costs associated with the operation, maintenance and renewal of the gifted assets. Council commissioned KPMG and CT Management to assist in analysing these ongoing costs, summarised in the table below:[a]

	Pre bushfires $/per year	Post bushfires $/per year	Increased cost to Council $/per year post bushfires
Operating	495 974	1 204 476	708 502
Maintenance	195 139	552 545	357 406
Renewal	349 766	1 046 798	697 032
Total	**1 040 879**	**2 803 819**	**1 762 940**

Council noted that, although renewal costs are shown on a per year basis in the table, this does not mean they are incurred on a per year basis. As the $33 million worth of assets were received virtually at the same time, this will have the effect of causing renewal requirements to spike significantly in years beyond the Council's Strategic Resource Plan (SRP) and Long-term Financial Plan (LTFP),[a] with forecast renewal expenditure of $7.75 million for 2026-27.

To meet future renewal expenditure, Council explained that it must make provision for these costs now, in addition to existing asset management liabilities, through its infrastructure renewal reserve. This will ensure Council is not faced with an unfunded burden in the years to come, when it will be unrealistic to raise the required revenue for renewal in a single financial year.[a]

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TABLE 1 (CONTINUED)

Legislative matter	Summary
185E(3)(b) (continued)	**Maintaining current service levels** Council's application did not provide sufficient explanatory information in relation to the need for a higher cap to maintain service levels ($170,000). We requested further information from Council through our Request for Further Information (RFI) In response to our RFI, Council confirmed that the requested funds are to maintain existing service levels to ratepayers and residents for the 2016-17 financial year. The most significant increase in costs for 2016-17 (compared to 2015-16) relates to the provision of expenditure for the general election of councilors to serve for the coming four years. The Victorian Electoral Commission gave Council an initial cost estimate of $120 848 for the October 2016 elections.[b] Council also noted that employee costs are a major component of its expenditure and that the current enterprise bargaining agreement is set at an increase of 3 per cent for 2016-17.
185E(3)(c) — how the views of ratepayers and the community have been taken into account in proposing the higher cap	In its application, Murrindindi provided a summary of its engagement with its community and ratepayers prior to the introduction of the Fair Go Rates System (FGRS): • 2010 — discussed its efforts to deal with the funding situation and the need for the community to appreciate the link between future recurrent costs and council rates. • 2011 — Council spoke to the community about conducting a service review to measure the impacts of the new and gifted assets and to identify efficiencies to meet new renewal and maintenance costs. • 2012 — Council resolved to implement a range of recommendations from the service review. It consulted with the community through letters, media releases, information sessions and meetings with community organisations. • 2013 — five community consultation meetings were held across the Shire to enable the community to provide feedback on the Draft Council Plan and Council's approach to addressing its longer-term financial sustainability needs. • 2014 — following advice from Government that Council would not receive any further assistance to help manage the costs associated with the new and gifted assets, Council embarked on a community engagement campaign to determine how best to maintain its financial sustainability. This funding advocacy project discussed with the community six options: 1. rate rises above Council's current forecasts in its LTFP 2. differential rating categories 3. asset sales 4. transfer of assets 5. review of capital expenditure and 6. review of services Council provides to the community. After receiving feedback from these consultations, Council reiterated its prior commitment to keep rate increases to no more than 6 per cent per annum and to focus on a mix of other options to address funding issues.

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TABLE 1 (CONTINUED)

Legislative matter	Summary
185E(3)(c) (continued)	Council's application explains that, following the introduction of the FGRS its communication with the community was channelled through media releases, print media and local radio, focusing on the implications of rate capping for Council's LTFP. As part of its 2015 review of its Council Plan and 2015-16 Budget, Council endorsed the draft 2013-2017 Council Plan Review and Strategic Resource Plan for public consultation in accordance with sections 125 and 126 of the Local Government Act. Submissions were sought from the public and the documents were made available at Council offices and libraries, visitor information centres and on Council's website. Council's application stated that no submissions were received and the Council Plan and Budget were adopted in May 2015. [c] We noted that the engagement set out in Murrindindi's application appears to have primarily been one-way following the introduction of the FGRS. Further discussion about our assessment is provided in section 3.1 below
185E(3)(d) — how the higher cap is an efficient use of council resources and represents value for money	Council's application did not provide specific details about how the additional revenue raised from the higher cap (specifically the $170 000 related to service provision) represents value for money. However, it did provide a comprehensive list of service reviews that Council stated was incorporated into its LTFP over the past few years such as: • Economic Development Service Review • Library Service Review • Community Services Review • Parks and Gardens and Infrastructure Operations Service Reviews • Corporate Services and Finance Services Reviews • Waste Management Review • Review of Infrastructure Assets • Quarry Service Review • Review of Roads and Parks • Review of Roads and Parks Maintenance Service Levels • Organisational Structure Review — Business Services and • Age and Disability Services Review In addition to these service reviews, a range of organisational wide efficiencies estimated to total $613 000 were identified and implemented progressively from 2012, targeting the following areas: overtime and travel reimbursement savings, rationalisation of mobile device use and charges, streamlining insurance coverage, transition from paper-based to electronic document management, and use of aggregated procurement contracts. Council has also engaged in shared service arrangements with neighbouring councils and through local government bodies to deliver value for money. Some examples include sharing building surveyor services with Mansfield Shire Council, sharing resources to strengthen emergency management preparedness with Mitchell Shire Council, and participation in Municipal Association of Victoria (MAV) group procurement tenders for electricity, bulk fuel and insurance services. [d]

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TABLE 1 (CONTINUED)

Legislative matter	Summary
185E(3)(e) — whether consideration has been given to reprioritising proposed expenditures and alternative funding options and why those options are not adequate	Council's application explained that it had considered a number of avenues for alternative funding sources and reductions in expenditure since 2011. Council explained that the following funding options and service prioritisation areas have been continuously reviewed incorporated into its LTFP: • Rating Strategy Review • Advocacy program — maintained an extensive advocacy program for a more sustainable funding model in relation to the costs and lost revenue from the bushfires • Non-recurrent grants — dedicated part-time position established to source new grant funding opportunities • Fees & Charges Review and • Debt Strategy — borrowing strategies are reviewed as part of its budget and long-term financial planning each year. In 2015, Council adopted the principles of the Council Expenditure Review Project, which highlighted further opportunities for Council to manage its current and future costs and asset management responsibilities, such as: • considering new differential rating categories, following community consultation • reducing financial support for a range of assets by transferring support for those assets for which Council has no responsibility to the responsible body, and the sale of appropriate assets • discussing transferring the responsibility for managing and maintaining community assets to community groups in order to provide them with a greater say in how these assets are managed into the future and • developing a policy on asset renewal, which identifies the standards for asset renewal and ensures the level of service provided is appropriate to requirements.[e] Council's current debt level is broadly consistent with the median level of debt as a percentage of revenue for small rural councils in Victoria. Council explained that as a significant proportion of Council's current rate increases are aligned to Council's infrastructure renewal reserve, the use of debt would not represent sound financial management.
185E(3)(f) — that the assumptions and proposals in the application are consistent with the council's long-term strategy and financial management policies set out in the council's planning documents and annual budget	Council has demonstrated that the rationale for a variation to the rate cap is consistent with its 2013-17 Council Plan. We observed that the requested higher cap of 5.4 per cent, which includes both the infrastructure renewal reserve and service provision components, is aligned with Council's commitment to the community not to increase rates by greater than 6 per cent per year over the 10 year life of the Council Plan. Council provided an asset management plan and 10 year capital expenditure modelling that highlighted its need to secure funding to meet its longer-term asset renewal requirements. The requested amount of $282 000 to fund the infrastructure renewal reserve is consistent with, but slightly lower than, Council's Strategic Resource Plan, which proposed to increase the reserve from $6.51 million in 2016-17 to $6.86 million in 2017-18 (an increase of $352 000).

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TABLE 1 (CONTINUED)

Legislative matter	Summary
185E(3)(f) (continued)	Council is aware of the growing renewal gap, which is forecast to grow to $13.8 million by 2024-25, and the challenges this presents in the future. Following our RFI, Council explained that they are unable to allocate sufficient funding to meet all of its future asset renewal requirements. In order to address the issue, Council restructured the Infrastructure Asset Department in 2015 and formed a dedicated asset management unit to focus on addressing the renewal gap. Council noted that they are focused on working with both the community and the Victorian Government to return assets to either community or State Government management, which will ultimately reduce the maintenance and renewal requirements. Council's application also acknowledged that, in order to address the renewal gap, further reviews of the current services it provides to the community to determine the appropriate level will be required in the coming years.

[a] Murrindindi Shire Council 2016, *Application to ESC for Variation to Rate Cap for 2016-17*, 31 March 2016, p. 22. [b] Murrindindi Shire Council 2016, *Response to request for further information*, April, p. 2. [c] Murrindindi Shire Council 2016, Response to request for further information in relation to questions asked via email on 5 May 2016, p. 3. [d] Murrindindi Shire Council 2016, *Application to ESC for Variation to Rate Cap for 2016-17*, March, p. 39. [e] Murrindindi Shire Council 2016, *Application to ESC for Variation to Rate Cap for 2016-17*, March, p. 40.

3.1 ASSESSMENT

As required under the FGRS, we have examined each of the six legislative matters addressed in Murrindindi's application. The legislation also requires the Commission to (i) promote the long-term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure, and (ii) ensure that a council has the financial capacity to perform its duties and functions and exercise its powers.

Taking into account all of the relevant factors above, we consider that the infrastructure renewal component of the higher cap is appropriate because:

- there is an underlying funding need
- Council's renewal estimates are supported by expert reports and
- it appears appropriate consultation on renewal needs has been undertaken.

We do not consider that a higher cap for the maintaining service levels is appropriate because:

- the 2016-17 expenditure identified by Council that is related to this component did not reflect a long-term need for a permanent increase to the rate base
- it appears insufficient consultation on services was undertaken and
- while limited, Council has some financial flexibility to absorb a one-off shortfall in 2016-17.

These are discussed in more detail below.

INFRASTRUCTURE RENEWAL RESERVE

Murrindindi's forecasts of its financial indicators (under both 'with' and 'without' higher cap scenarios) show a negative adjusted underlying result in the short and medium-term (table 2). Based on this, we note that Murrindindi's financial capacity is constrained and it may face challenges to renew infrastructure in the longer-term.

The increase in expenditure to meet the ongoing costs associated with the operation, maintenance and renewal of gifted assets following the 2009 bushfires has been clearly identified and further substantiated by KPMG and CT Management. Murrindindi's demonstrated commitment to continually refine and update cost assumptions provides assurance about the accuracy of projections. Further, the need and practicality of utilising an infrastructure renewal reserve[5] is clearly shown by the uneven 20 year renewal requirements of the gifted assets following the bushfires forecast by Council. Figure 1 extracted from Murrindindi's application highlights a large renewal expenditure requirement of $7.75 million in 2026-27.[6]

5 The Future Capital Works Reserve represents funds reserved for future renewal of existing Council infrastructure, inclusive of additional gifted assets. Forecasts of the Council's Future Capital Works Reserve are shown in the 2013-17 Council Plan and estimated to be $6.5 million at the end of 2016-17.

6 Following the 2009 bushfires a total of $33 million in new and expanded assets were gifted to Council. These assets were received at the same time causing a spike in Council's asset renewal requirements in the future.

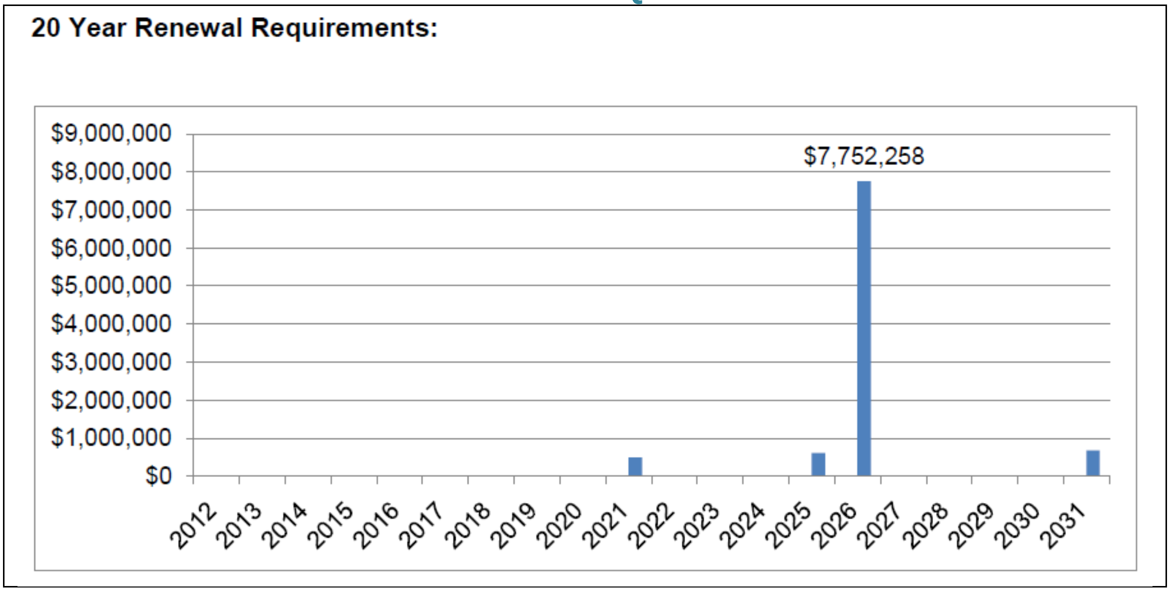
TABLE 2 LOCAL GOVERNMENT PERFORMANCE REPORTING INDICATORS

LGPRF indicator[a]	2014-15 (Actual)	2015-16 (Budget)	2016-17 (Forecast)	2017-18 (Forecast)	2018-19 (Forecast)
Operating position[b]					
Adjusted underlying result (%)					
pre FGRS	3.6	-7.3			
'without' proposed higher cap (a)			-8.2	-9.2	-10.2
'with' proposed higher cap (b)			-6.3	-5.3	-4.6
Difference (b-a)			1.9	3.9	5.6
Liquidity[b]					
Working capital (%)					
pre FGRS	397.6	326.3			
'without' proposed higher cap (a)			320.0	319.8	320.5
'with' proposed higher cap (b)			333.5	340.8	348.1
Difference (b-a)			13.5	21.0	27.6

Note: Under the Local Government Performance Reporting Framework (LGPRF), Councils are required to report annually on their performance against a number of financial and output measures. [a] table only includes LGPRF indicators considered in making our decision. [b] See Appendix B for definitions of these indicators.

Data source: Murrindindi Shire Council 2016, *Response to request for further information*, April.

FIGURE 1 20 YEAR ASSET RENEWAL REQUIREMENTS



We note that it would be unrealistic for Council to raise $7.75 million in a single financial year to meet its renewal needs. Therefore we consider that Murrindindi's approach to allocate funds to an infrastructure renewal reserve progressively over time would allow Murrindindi to responsibly address future renewal expenditure without rate shocks.

We are satisfied with the reported level of community consultation by Council in developing the 2013-17 Council Plan as shown in table 1. The requested amount of $282 000 to fund the infrastructure renewal reserve is consistent, but slightly lower than the Council Plan, which budgeted to increase the reserve from $6.51 million in 2016-17 to $6.86 million in 2017-18 (an increase of $352 000).

The information provided in relation to alternative funding sources demonstrated that Murrindindi is not solely relying on rate increases to fund future renewal expenditure and it has explored a number of other revenue sources, such as seeking additional non-recurrent grants and reviewing its Rating Strategy. Murrindindi also noted its aim to transfer the responsibility of managing and maintaining assets to community groups and sale of appropriate assets in order to reduce the future renewal burden. These past efforts and future plans highlight that Murrindindi appears to be acting prudently in considering available options alongside the proposed rate increase.

Overall, we are satisfied that the infrastructure renewal component relates to a long-term need that is consistent with Council's Long-term Financial Plan.

PROVISION OF SERVICES

Council identified a second reason for the higher cap as being to maintain existing services, it did not clearly identify in its application which services would be affected and it appears to not have consulted with the community about these service impacts before applying for a higher cap. In its application Murrindindi noted that the impact of any revenue shortfall if the higher cap was not approved would be finalised as part of Council's 2016-17 budget process.[7]

In response to our RFI, Murrindindi explained that the most significant increase in costs for 2016-17 relate to expenditure for the general election of councillors in October 2016. The cost estimate provided by the Victorian Electoral Commission is $120 848. As council elections are routinely held every four years, we would expect that Council would make provisions for this expense and account for that expense over a four year budget cycle. While Council has advised that this cost is higher than originally anticipated, we note that the annualised impact would be small when spread across four years. We note that other councils have not sought additional funds for this purpose.

Murrindindi's working capital ratio is projected to be above 300 per cent in 2016-17. This indicates that Murrindindi has some financial flexibility to absorb the service proportion of the higher cap in 2016-17 (table 2). This position is shared by Deloitte Access Economics which noted that:

> *Murrindindi has more than adequate current and projected ongoing liquidity and modest levels of debt.*
>
> *Murrindindi would be better off if it managed its funds holistically and based its revenue-raising strategy on progressively improving its underlying adjusted operating result.*[8]

[7] Murrindindi Shire Council 2016, Response to request for further information, April, p. 2.

[8] Deloitte Access Economics' advice provided to the Commission. In April 2016, the Commission engaged Deloitte Access Economics to assist the Commission in examining the underlying financial position of those councils that have applied for a higher cap.

Murrindindi’s application did not contain sufficient evidence to support a higher cap to maintain service levels or demonstrate that a higher cap for this reason would be in the long-term interests of its ratepayers and community.

MONITORING OF OUTCOMES

Under the FGRS framework, we are required to report annually on Murrindindi’s compliance with its rate cap and every two years on outcomes from the FGRS. When doing so, we will monitor and report on whether Murrindindi has spent the funds from a higher cap in accordance with the expenditure needs cited in its application. While we approve rates and not individual expenditures, it will be important that community and ratepayers receive confirmation that Murrindindi has fulfilled its expenditure commitments. In the event that those additional funds have been redirected to other areas of expenditure, we will seek and publish Murrindindi’s explanation for the reallocation of those funds.

APPENDIX A: SUMMARY OF COMMUNICATIONS WITH MURRINDINDI

Murrindindi submitted its application for a higher cap on 31 March 2016. In response to its application we sought additional information from Murrindindi (table 3). Murrindindi's application and its response to our request for further information can be found on our website.

TABLE 3 COMMUNICATIONS BETWEEN MURRINDINDI AND THE COMMISSION

Date	Nature of communication
31 March	Murrindindi submitted its application
18 April	Commission issued to Murrindindi a request for information (RFI)
27 April	Murrindindi submitted its response to the RFI
5 May	Commission sent follow-up questions related to Murrindindi's response to the RFI
11 May	Murrindindi responded to the Commission's 5 May request for some clarifications

APPENDIX B: LGPRF INDICATOR DEFINITIONS

a. **Adjusted underlying result** is adjusted underlying surplus (deficit) as a percentage of adjusted underlying revenue. A surplus or increasing surplus suggests an improvement in the operating position.

   Adjusted underlying revenue is total income less non-recurrent capital grants used to fund capital expenditure, non-monetary asset contributions and other contributions to fund capital expenditure.

   Adjusted underlying surplus is adjusted underlying revenue less total expenditure.

b. **Working capital ratio** is current assets as a percentage of current liabilities. It indicates whether a council has sufficient working capital to pay bills as and when they fall due. High or increasing level of working capital suggests an improvement in liquidity.