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Assistance with review of 2017-18 rate cap applications – Towong Shire Council

Essential Services Commission

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1 Towong Shire Council

1.1 Project background

Following the release of the Essential Services Commission's (ESC's) final report in October 2015 on the introduction of a rates capping framework for local government, the Victorian Government established the Fair Go Rates System (FGRS). This arrangement limits the maximum amount councils may increase rates by in a year without seeking additional approvals. The rate cap set by the Minister for 2017-18 is 2.0% for all councils.

Under the FGRS, councils can apply to the ESC for a higher cap in circumstances where the rate cap is considered insufficient for their specific needs. The ESC has engaged Deloitte Access Economics to provide assistance with the review of the rate cap variation applications that are submitted by councils to apply for 2017-18 in order to inform the ESC's decisions. Deloitte Access Economics undertook a similar process last year (for 2016-17 applications) and previously provided advice to the ESC in the development of the rate capping framework.

This report provides a summary of Deloitte Access Economics' review of the documentation submitted by the Towong Shire Council in its application for a rate cap variation. This includes:

- an overview of the Council's circumstances and their application;
- an assessment of the financial performance, position and outlook for the Council; and
- concluding remarks.

The review has been conducted having regard to key factors highlighted and discussed in Deloitte Access Economics' 2016 Guidance Note, 'Assistance with review of 2016-17 rate cap variation applications', prepared for the ESC.

1.2 Overview

Towong Shire is a small rural council located in the 'Alpine' region of north-eastern Victoria. It serves a relatively small population (about 5,800 people) and relatively large land area (6,675 km^2).

Deloitte Access Economics considers councils like Towong Shire that serve small resident populations and relatively large land areas typically face above average financial sustainability challenges. Local governments are very asset-intensive (predominantly for example road infrastructure) and a lower population density means a smaller ratepayer base to spread large long-run infrastructure asset costs across. Like many rural councils Towong Shire has a population older than the Australian average and with above average levels of social disadvantage.

The Victorian Auditor General's Office explicitly highlighted the additional financial sustainability challenges of rural councils in its recent 'Local Government 2015-16 Audit Snapshot' report (see e.g. pp. vii and ix).

Towong Shire Council has applied for a rate increase in 2017-18 of 3.55% above the specified 2.0% rate cap, that is, an increase of 5.55%. It has also applied for a rate increase of 3.55% above the (yet to be determined) rate cap for the following three years (2018-19 – 2020-21). The increase would generate approximately $230,000 of additional rate revenue in 2017-18.

Towong Shire applied for a rate increase of 3.84% above the rate cap of 2.5% for 2016-17. This increase was approved. Interestingly instead of passing on the full available rate increase of 6.34% in 2016-17 it elected to apply a smaller aggregate increase of 3.5%, that is, an increase of 1% above the cap. This may have reflected a decision to take a more cautious approach in the initial year of rate capping applicability having regard to its community's circumstances, and to first of all better assess longer-term needs and options.

Towong Shire is expecting to generate income of approximately $14.2 million (including from capital grants and assuming application of a 2.0% rate cap) in 2017-18. $7.9 million of this amount represents rates and service charges. Its expenses for the year are forecast to be $14.8 million. It forecasts an adjusted underlying result for the year of -12%. (The adjusted underlying surplus (or deficit) ratio is calculated as the underlying result expressed as a percentage of underlying revenue. Adjusted underlying revenue is total income other than non-recurrent grants and contributions used to fund capital expenditure; and non-monetary asset contributions.) It is forecasting to achieve adjusted underlying surpluses in 2016-17 and 2018-19. It is likely that the main reason for these fluctuating results is its assumed timing of ongoing grants (presumably in particular Commonwealth Financial Assistance Grants). Its longer term trend is however negative and this is discussed further in Section 1.3 below.

Towong Shire has a large stock of infrastructure assets (particularly roads) and depreciation in 2016-17 is forecast to be $3.7 million or 26% of total operating expenses. Towong is conscious of its asset management responsibilities and believes that over time, either service levels will fall or costs will unnecessarily increase if it doesn't maintain asset management related planned expenditure levels.

1.3 Assessment of financial performance, position and outlook

Towong demonstrated it recognised the importance of financial sustainability considerations in its 2016-17 application and its viewpoints and proposed responses were underpinned by a sound long-term financial plan. The financial projections Towong Shire has provided to support its 2017-18 application are broadly consistent with the data it provided in 2016-17. It is clear from its submission and supporting arguments that it understands the importance of planning to achieve long-term financial sustainability and the key factors it needs to consider (in particular service level preferences and their associated long-run costs relative to proposed forecast available funds and revenue raising decision options) in planning its way forward.

As it did last year Towong included in its application its projected performance for the Victorian Auditor General's Office (VAGO) 'financial sustainability risk' indicators assuming the options of both limiting rates to an assumed 2.0% cap over time and with a higher 5.5% ongoing increase. These projections are shown in Figures 1.1 and 1.2 below.

Figure 1.1: Projected performance against indicators assuming 2.0% pa rates cap

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Underlying result (1yr)	-6%	12%	-20%	-5%	-7%	-7%	-8%	-8%	-9%	-10%	-11%	-12%
Underlying result (4yr)	0%	2%	3%	-3%	-4%	-9%	-6%	-7%	-8%	-9%	-10%	-11%
Liquidity	5.61	6.44	5.06	4.42	3.99	3.21	2.39	1.40	0.35	(0.89)	(2.19)	(4.18)
Self financing	44%	56%	33%	36%	28%	25%	22%	22%	20%	20%	17%	18%
Indebtedness	7%	11%	30%	33%	38%	42%	38%	35%	31%	28%	23%	23%
Capital replacement (1yr)	1.86	2.58	1.71	1.46	1.19	1.28	1.07	1.21	1.16	1.30	1.25	1.39
Capital replacement (4yr)	1.68	1.89	1.89	1.89	1.71	1.41	1.25	1.19	1.18	1.19	1.23	1.27
Accounting Renewal gap (1yr)	0.61	1.82	0.88	0.94	0.99	1.03	1.07	1.11	1.15	1.19	1.24	1.29
Accounting Renewal gap (4yr)	1.08	1.17	1.03	1.06	1.14	0.96	1.01	1.05	1.09	1.13	1.17	1.22

Figure 1.2: Projected performance against indicators assuming ongoing annual 5.5% rates increase

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Underlying result (1yr)	-6%	12%	-18%	-1%	-2%	0%	1%	2%	3%	5%	6%	8%
Underlying result (4yr)	0%	2%	3%	-2%	-1%	-4%	-1%	0%	2%	3%	4%	6%
Liquidity	5.61	6.44	5.15	4.72	4.58	4.23	3.95	3.62	3.38	3.09	2.90	3.03
Self financing	44%	56%	34%	38%	31%	29%	28%	30%	29%	30%	30%	32%
Indebtedness	7%	11%	29%	31%	35%	37%	33%	30%	25%	22%	18%	17%
Capital replacement (1yr)	1.86	2.58	1.71	1.46	1.19	1.28	1.07	1.21	1.16	1.30	1.25	1.39
Capital replacement (4yr)	1.68	1.89	1.89	1.89	1.71	1.41	1.25	1.19	1.18	1.19	1.23	1.27
Accounting Renewal gap (1yr)	0.61	1.82	0.88	0.94	0.99	1.03	1.07	1.11	1.15	1.19	1.24	1.29
Accounting Renewal gap (4yr)	1.08	1.17	1.03	1.06	1.14	0.96	1.01	1.05	1.09	1.13	1.17	1.22

Deloitte Access Economics has some reservations regarding the VAGO suite of 'financial sustainability risk indicators' and suggested target range outcomes as a basis for setting and judging a local government's financial strategy and performance. Nevertheless in Towong's case the projected indicator results do provide a clear picture of the scenarios faced and their implications.

Data in Figures 1.1 and 1.2 above was sourced from page 11 of Towong Shire's submission. The annual underlying result outcomes shown above vary slightly, but not materially, from the Local Government Performance Reporting Framework adjusted underlying result indicator forecasts included in data submitted by Towong Shire with its submission. The trend nevertheless is unambiguous. Based on the assumptions made (which appear reasonable), Towong Shire is forecast to incur increasing annual operating deficits in future without an increase in rates beyond the cap.

Generally, Deloitte Access Economics considers that councils need to achieve at least a breakeven adjusted underlying operating result over time in order to maintain financial sustainability and service levels (including by having capacity to replace/renew assets as required).

Towong Shire is likely to face ongoing challenges in satisfying its community's service level preferences in a financially sustainable way in future without additional revenue. For example, Figure 1.2 above suggests that even with the proposed increase in rates above the cap over the next four years it will still by then only realise an estimated breakeven underlying result (but further improve thereafter).

If Towong fails to generate sufficient revenue to offset operating expenses on average over the long-term this must inevitably lead to a reduction in service levels regardless of whether the council plans for this or not. At some point in the not too distant future it would simply not be in a position to undertake major asset renewal and replacement or other service related outlays as and when warranted.

Towong's current forecasts suggest that if it maintains spending and service levels as proposed in future it is likely to have a liquidity ratio of less than '1' by 2023/24 (refer Figure 1.1). That is its current (liquid) assets are expected to be less than its outlay obligations within the following year. That ratio is forecast to further worsen over time. Clearly such a scenario is untenable and one change or another (eg additional revenue and/or less expenditure) would need to occur.

Towong Shire has undertaken good forward planning and recognises its financial challenges and that without additional income that it may not be able to maintain service levels. It has indicated that it is mindful of the financial circumstances of its community and is committed to explore avenues other than rate increases wherever possible to improve its financial performance. It has documented a comprehensive range of initiatives it has already initiated to realise expenditure savings and has indicated that it will strive to pursue further opportunities. It rightly recognises though that further savings opportunities and efficiency gains are likely to be increasingly harder to realise in future without significant impact on service levels.

A reduction in Towong's asset renewal expenditure from current levels would effectively mean not intervening until assets reach a lower and degraded condition. It believes this is likely to lead to higher long-term costs as a result of premature asset failure and subsequent rehabilitation/replacement and higher risks and loss of service. Deloitte Access Economics' view is that even with comprehensive asset condition testing it is still difficult to determine optimal asset renewal timing outlays. It will inevitably depend in part on preferred and affordable service levels.

The council appears to have consulted extensively with its community regarding its financial circumstances and the options it faces and their implications. It believes it has the support of its community for the proposed rate increases in order to better maintain service levels now and into the future.

Towong Shire has very conservative debt levels (forecast to be $1.8 million at end 2017-18). It recognises that debt can be a useful and appropriate tool to finance acquisition of long-lived infrastructure and help maintain inter-generationally equitable rating and charging. It also recognises that its financial circumstances are such that it needs to focus on improving financial sustainability and that additional debt is unlikely to assist in this regard. Deloitte Access Economics broadly agrees with this approach although additional debt may be warranted in future to undertake asset renewal needs and meet cashflow needs if this is consistent with improving long-term financial sustainability.

1.4 Concluding remarks

Towong Shire has demonstrated a strong ongoing commitment to sound long-term asset management and financial planning. It has a good appreciation of the financial challenges it faces and is mindful of the community impact and preferences from the available options and their implications. It has taken many steps to improve ongoing efficiency but it is likely that it will need to generate rate revenue in excess of the cap in 2017-18 and beyond (or at least in the near future thereafter) in order to maintain current service levels.

Limitation of our work

Limitations

This work is not a substitute for independent financial modelling of scenarios with and without rate cap variations for each council. This work has been limited only to the review of application-related documentation submitted by councils seeking a rate cap variation and time available.

This work takes as given the financial and other data, calculations and analysis provided in the application-related documentation. It does not constitute an audit or test to verify the validity of the underlying financial data upon which the applications are based. We have not been given access to the underlying spreadsheet models, except to the extent that these have been provided as part of applications. Our analysis has not confirmed the calculations within the applications. We have not used or sought data from any other sources, except to the extent that this is cited as such in the report.

General use restriction

This report is prepared solely for the use of the Essential Services Commission. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for the purpose of assisting the Essential Services Commission with the review of 2017-18 rate cap variation applications. You should not refer to or use our name or the advice for any other purpose.

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