Deloitte.
Access Economics

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

Essential Services Commission

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1 Shire of Pyrenees

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) which 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 also had 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 Shire of Pyrenees 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.

This 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 Essential Services Commission.

1.2 Overview

Pyrenees is a small rural council with a population of about 7,000 people. It successfully applied for an increase of 1.3% above the rate cap (of 2.5%) in 2016-17.

It has applied for a rate increase of 1.5% above the 2.0% 2017-18 rate cap. It has also applied for a rate increase of 3.5% for 2018/19 on the assumption that the rate cap for that year will be lower than this. It estimates that its proposed increases above the rate cap would generate additional revenue of $116,000 in 2016-17 and a further $120,000 in 2017-18 (assuming a rate cap of 2% in 2017-18). The increases would effectively be built into its rate base thereafter. It is proposing that if approved the additional revenue generated will be quarantined to apply exclusively for additional road infrastructure renewal.

Pyrenees is expecting to generate income of approximately $30 million (including from capital grants) in 2016-17. $9.1 million of this amount represents rates and service charges. Grants forecasts are abnormally high ($19.0 million) as a result in particular of receipt of $8.5 million in natural disaster restoration grants this year.

Its expenses for the year are forecast to be $22.8 million. It forecasts an adjusted underlying deficit for the year of $3.5 million and an adjusted underlying result ratio of -18%. (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 estimates in its long-term financial plan that its annual adjusted underlying deficit will improve but not be eliminated over the next 10 years (either with or without the increases above the rate cap now sought). Council's average rate increase over the last 15 years has been 5.72% and this highlights the challenges it faces in satisfying financially sustainable service level preferences.

The council has a large stock of infrastructure assets (particularly roads) and depreciation in 2016-17 was $6.9 million or 30% of total operating expenses. Pyrenees has invested heavily in asset management planning and analysis and it is a specified high priority in its current (2013-17) Council Plan (as updated Nov 2015) and the current draft update. It has had consultant input to inform its asset management decisions and believes that it is significantly underfunding annual asset renewal.

Pyrenees believes that it will need to progressively spend more over time on asset renewal if it is to maintain service levels and cost-effective asset management.

1.3 Assessment of financial performance, position and outlook

Pyrenees' rate cap variation submission indicates, as was the case last year, that it is very focussed on the need to spend more on road asset renewal and understands that in order to do so it needs to improve its long-run financial performance.

The Essential Services Commission in approving its application for 2016-17 emphasised the importance of Council taking steps to improve its long-term financial performance. This is a particular challenge for rural councils that often have limited revenue raising opportunities (e.g. a small ratepayer base) and considerable asset management responsibilities. 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. pps. vii and ix).

Pyrenees forward projected financial performance has improved compared with last year's forecasts. This is shown in Table 1.1 below.

Table 1.1: Pyrenees reported adjusted underlying result ratio

	2016-17	2017-18	2018-19	2019-20
Last year's projection	-23.9	-22.1	-21.2	N/A
This year's projection (as per Budget)	-18%	-6.4%	-14.6%	-14.3%

Pyrenees submission highlights a wide variety of initiatives it has undertaken or is pursuing to improve ongoing financial performance. Based on current projections and assumptions (i.e. with the rate increases proposed in its submission) it is forecasting only a very modest underlying operating deficit (about 5%) towards the end of the next 10 years.

Experience indicates that councils often find it hard to achieve the level of improvement in forward financial projections that they have previously forecast they will realise. Nevertheless Pyrenees clearly demonstrates a commitment to pursue this objective. If its performance continues to improve (even at a lesser rate than currently forecast) it will be in an ongoing better position (e.g. to spend as necessary, or at least spend more on warranted asset renewal).

Pyrenees should strive to achieve at least an adjusted underlying breakeven result over the longer-term. This may necessitate further efficiency improvements and/or cuts in service levels in future and/or possible additional rate increases beyond the cap. If it could achieve this on an ongoing basis then it would have the capacity to maintain service levels thereafter and undertake all asset renewal as required, including if necessary accommodating peak expenditure needs by use of debt.

Pyrenees currently has no debt. It correctly recognises that its prime focus for now should be to progressively reduce over time its adjusted underlying deficit and it is not planning to raise significant debt in future.

The council is currently spending on asset renewal at about 52% of annual depreciation but this has increased from 30% in 2010. It is predicting that asset renewal expenditure needs will rise in real terms over the current decade.

Deloitte Access Economics’ view is that it should not be assumed that asset renewal expenditure of the order of about 100% of the level of annual depreciation should necessarily be aimed for in any period (or even over the medium term). Asset renewal needs can be lumpy between periods and affordable service level preferences can change. Nevertheless, given Pyrenees’ operating circumstances, it is highly likely that it is currently materially underfunding asset renewal relative to what is cost-effective to do to maintain existing asset service levels.

Council has consulted with its community regarding its financial challenges including from survey data and believes that its community wants asset service levels maintained.

Pyrenees submission highlights that it is in the bottom 10% of council areas of the Victorian SEIFA Index for Socio-Economic Disadvantage and that its average rating levels are currently well below the Victorian state average.

1.4 Concluding remarks

Pyrenees projected future financial performance has improved considerably in the past 12 months. It is likely that this is a result of greater effort on its part to pursue financial sustainability by e.g. evaluating the financial impact of various options, seeking out further savings and producing more reliable forecast future financial projections. It nevertheless still faces financial challenges to maintain service levels and satisfy community expectations in future. Its forecasts demonstrate that the rate variation in its proposal if approved will help but current forecasts suggest more will still need to be done if it is to improve its underlying operating position and therefore ongoing financial sustainability over time.

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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