Deloitte Access Economics

Assistance with review of 2016-17 rate cap variation applications

Murrindindi Shire Council

Essential Services Commission

Deloitte.

Contents

1 Murrindindi Shire Council

1.1 Project background

In 2015 the Essential Services Commission (ESC) was appointed by the Victorian Government to undertake an independent inquiry and provide advice on the introduction of a rates capping framework for local government.[1]

Following the release of the ESC's final report in October 2015, the Victorian Government established the Fair Go Rates System (FGRS) which limits the maximum amount councils may increase rates in a year without seeking additional approvals. The rate cap set by the Minister under the FGRS for 2016-17 is 2.5% for all councils.

Under the FGRS, councils can apply to the ESC for a higher cap in circumstances where the rate cap is insufficient for their specific needs. Ten local governments submitted applications for 2016-17 rate cap variations for the ESC's consideration.

The ESC has engaged Deloitte Access Economics to provide assistance with the review of the rate cap variation applications that have been submitted, to inform the ESC's decisions.

This report provides a summary of Deloitte Access Economics' review of the documentation submitted by the Murrindindi 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.

1.2 Overview

Murrindindi Shire Council is a small rural municipality on the outskirts of Melbourne. It has a population of about 13,500 and is expected to experience modest population growth averaging about 1% per annum over the next decade. It has applied for a rate increase of 2.9% above the 2.5% rate cap and this would generate additional revenue for the council of about $450,000 in 2016-17.

The council states that it is seeking the additional increase in order to assist it to maintain services and generate monies to 'cash back' the funding of reserves for future asset renewal. If its application is unsuccessful it proposes to spend $170,000 less in 2016-17 on service provision and not allocate $282,000 that it otherwise intends to place in an 'infrastructure renewal reserve' from income raised in 2016-17.

[1] State Government of Victoria, Local Government Rates Capping Framework Review, http://www.vic.gov.au/news/local-government-rates-capping-framework-review.html

1.3 Assessment of financial performance, position and outlook

Murrindindi budgeted for approximately $30 million in income in 2015-16, including $2 million in capital related grants and contributions. Budgeted rates and charges were $18 million.

Murrindindi's budgeted expenses for 2015-16 are $32 million. It effectively has budgeted for a not insignificant adjusted underlying operating deficit. In its 2015-16 budget it reported the following results and projections for its adjusted underlying result ratio (based on an assumed rate increase of 5.5% per annum):

Table 1.1: Adjusted underlying result ratio

	2014-15	2015-16	2016-17	2017-18	2018-19
Adjusted underlying result ratio	-23%	-10%	-12%	-9%	-8%

Rate increases of 2.5% per annum (as per the rate cap) would adversely impact on the above projections from 2016-17 onwards by of the order of 1.5% compounding per annum (assuming no other changes).

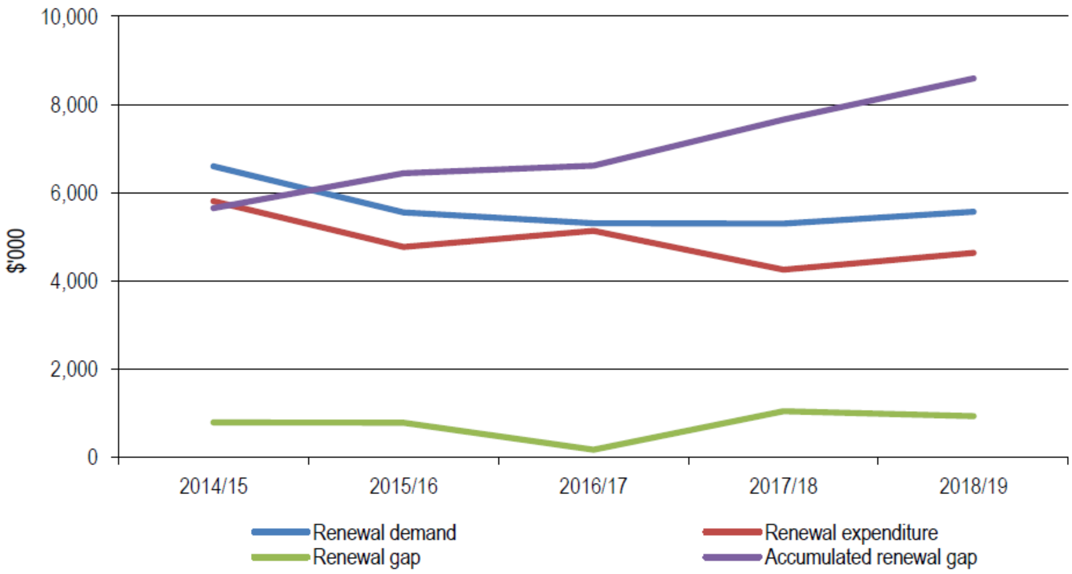
Murrindindi, like many small rural councils, faces greater challenges in operating in a financially sustainable manner compared with larger urban municipalities. These challenges have been compounded in Murrindindi's case as a consequence of the major 2009 bushfires. Those fires, amongst many other tragic and adverse consequences, have had a negative impact on council's revenue base. In addition, in some instances new gifted assets were provided to the council replace those lost in the fires and offered higher service levels that now impact negatively on its long-run operating costs.

Murrindindi cites examples of what it has done to improve efficiency and reduce operating costs. It is likely that in future it will need to further reduce costs (including through service level reductions), receive additional ongoing financial support from other spheres of government and/or increase rates significantly in order to progressively improve its adjusted underlying result ratio. It needs to do so in order to provide ongoing financially sustainable service levels.

Murrindindi recognises that spending on provision of new assets and upgrading of existing assets results in higher long-run operating costs and would further exacerbate its future asset management challenges. It therefore tries to ensure that a large proportion of total annual capital expenditure is devoted to asset renewal works. It is proposing that 84% of total capital expenditure in its 2016-17 budget be on asset renewal.

The council's 2015-16 budget highlighted that it expected its 'renewal backlog' would continue to increase over the 4-year planning period because it perceived that it was unable to spend on asset renewal at the required level to avoid this. This is demonstrated in the figure below, provided in their budget.

Figure 1.1: Renewal demand, expenditure and gap



Source: Murrindindi Shire Council Budget 2015 2016, page 47, 2016

Deloitte Access Economics has some reservations regarding the consistency and objectivity with which councils determine asset renewal 'gaps'. An accumulated renewal gap is a function of, amongst other things, preferred service level decisions and revenue raising and use of debt strategies. Whilst acknowledging that Murrindindi's operating environment is more challenging than that of many councils, the fact remains that a reduction in future planned service levels would help lower a 'renewal gap' and may be an important part of the mix that the council will need to consider in future.

Murrindindi has more than adequate current and projected ongoing liquidity and modest levels of debt. It has capacity to raise more debt in future if needed to accommodate large one-off (for example capital works) expenditure requirements providing it implements and maintains financial strategies that generate a satisfactory ongoing adjusted underlying operating result.

Like many other Victorian councils it would appear that Murrindindi bases its budget strategy decisions on raising funds for particular specific purposes. For example it budgeted to raise a loan of $0.5 million in 2015-16 to finance plant replacement while at the same time holding about $20 million in cash surplus to required outlays in that year. It is also currently allocating about $1.9 million over a 4-year period from revenue raised in its annual budget to fully 'cash back' its long-service provision.

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. For example if it was confident that it could successfully implement strategies over say a 5 or 10-year period that would enable the council to operate sustainably thereafter, then it could be appropriate to spend more on asset renewal to address perceived backlogs by reducing cash holdings.

1.4 Concluding remarks

There is scope for Murrindindi to improve its financial planning and financial management strategies and practices. Regardless it will need to generate more revenue and/or reduce service levels progressively over time in order to operate on a financially sustainable basis.

It could get by in 2016-17 without an increase in rates beyond the cap but this would only delay an improvement in its circumstances. Even if the requested increase is approved in 2016-17 the council will face significant (but manageable) future financial challenges and is likely to seek further rate increases beyond the rate cap in subsequent years.

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 2016/17 rate cap variation applications. You should not refer to or use our name or the advice for any other purpose.

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