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

Essential Services Commission

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Contents

1 Hindmarsh 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 Hindmarsh 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

Hindmarsh is a small rural council located in the Wimmera region of western Victoria. It serves a relatively small population (about 5,500 people) and relatively large land area (7,527 km^2). It claims it has the second lowest population density in Victoria. Deloitte Access Economics considers councils like Hindmarsh Shire that have a low population density typically face above average financial sustainability challenges. Local governments are very asset-intensive (predominantly roads) and a lower population density means a smaller ratepayer base to spread large long-run infrastructure asset costs across. Like many rural councils Hindmarsh has a population older than the Australian average and with a lower average income.

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).

Hindmarsh Shire Council has applied for a rate increase of 4% which is an increase of 2% above the specified 2.0% 2017/18 rate cap. It estimates that its proposed increase above the rate cap would, if granted, generate additional rate revenue of $144,000 in 2017-18. This increase would effectively be built into its rate base thereafter.

Hindmarsh is expecting to generate income of approximately $17.4 million (including from capital grants and assuming a 4% rate cap) in 2017-18. $8.3 million of this amount represents rates and service charges. Its expenses for the year are forecast to be $17.9 million. It forecasts an adjusted underlying deficit for the year of $2.1 million and an adjusted underlying result ratio of -13%. (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.)

The Shire's long-term financial plan suggests that even if the increase sought is approved the Council will generate increasing operating deficits over the next 10 years as shown in Tables 1.1 and 1.2 below. Based on these projections it is likely to face ongoing challenges in satisfying its community's service level preferences without additional revenue in a financially sustainable way.

Hindmarsh Shire has a large stock of infrastructure assets (particularly roads) and depreciation in 2016-17 was $5.4 million or 29% of total operating expenses. Hindmarsh has undertaken considerable asset management planning work with consultant input and believes it is spending less on asset renewal than is desirable to cost-effectively maintain asset related service levels. Condition assessments and planning analysis suggests it already has an asset renewal backlog and that renewal needs will potentially increase over time.

1.3 Assessment of financial performance, position and outlook

Hindmarsh recognises the need to improve its long-term financial performance. Its projected forward net result (operating revenue less operating expenses) expressed as a percentage of total revenue (and sourced from p.15 of its application) is shown in Table 1.1 below. It assumes a 2% average rate cap.

Table 1.1: Hindmarsh Projected Net Result (as % of projected total revenue)

Year	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
Net result (%)	-3.8%	-4.2%	-6.0%	-10.7%	-9.7%	-11.3%	-13.3%	-15.5%	-17.4%	-18.6%

For reasons outlined in its '2016 Guidance Note', Deloitte Access Economics prefers to focus on the 'adjusted underlying result (%)' in assessing the long-term financial sustainability of a council. This is a performance indicator that Victorian councils are required to report performance against as a requirement of the 'Local Government Performance Reporting Framework'. It is similar to the 'net result' but excludes 'capital revenue' (funds received that are required to be spent on acquiring additional physical assets) from the calculation.

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).

Table 1.2 below show Hindmarsh's projected adjusted underlying result (sourced from the Excel spreadsheet of data supplied by Hindmarsh to ESC). It assumes a 4% increase in rates (i.e. a higher cap) in 2017-18.

Table 1.2: Hindmarsh Projected Adjusted Underlying Result (as % of projected total revenue)

Year	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
Adjusted underlying result	-13.3%	-6.3%	-8.1%	-12.8%	-11.7%	-13.3%	-15.3%	-17.5%	-19.3%	-20.5%

The trend results for both Tables clearly project an ongoing deterioration in Hindmarsh's future financial performance.

Hindmarsh itself has indicated it is mindful of the financial circumstances of its community and recognises that it needs to explore opportunities other than just rate increases to improve its ongoing financial performance. It believes its service levels are already modest and has indicated that it will strive to achieve further efficiency gains and actively seek more financial support from other spheres of government. It included evidence in its submission of considerable successful work it has already undertaken to achieve cost reductions (see e.g. p.16 of Hindmarsh's rate cap variation application) and has flagged other opportunities that it will explore.

Hindmarsh is highly dependent on grants. The Commonwealth committed to the annual re-indexation of financial assistance grants to local governments in its 2017-18 budget. Such grants are generally the largest source of grant support to local governments Australia-wide. This decision will at least mean that such grants will not fall further in real terms in the immediate future. All councils and especially small rural councils will however remain vulnerable to further cuts in grants from the Commonwealth or their state governments in the longer-term. There is for example no ongoing commitment from the Commonwealth for provision of currently significant 'Roads to Recovery' road grants to councils and the impact from a loss or reduction in this program could be significant. (It is not clear but appears that Hindmarsh Shire has assumed that such grants will be ongoing in its forward projections.)

Hindmarsh believes it is currently spending less on asset renewal than is warranted to maintain service levels and as such that its asset stock is aging and that its renewal needs are increasing. It believes it is spending about $0.5 million less on asset renewal each year (disregarding building assets) than is warranted. It has determined these needs by undertaking periodic condition assessment of its assets. It is projecting that it will spend on asset renewal over the next 10 years at about 80% of the rate of depreciation for this period.

Deloitte Access Economics' view is that it 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. 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. Notwithstanding the above comments it is quite possible that Hindmarsh Shire should ideally be spending more on asset renewal (as it so claims) to cost effectively maintain service levels.

Council needs to strive to achieve at least an adjusted underlying breakeven result over the longer-term. This is likely to require efficiency improvements, cuts in service levels or increases in rate or other revenue in future. If it could achieve this on an ongoing basis then it would have the capacity to maintain service levels and undertake all asset renewal as required, including if necessary accommodating peak expenditure needs by use of debt.

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

Hindmarsh has indicated in its submission that it has undertaken extensive community consultation regarding its financial challenges and ratepayers' preferences. It believes that a rate increase above the cap in order to better maintain overall service levels is consistent with community preferences.

Hindmarsh Shire's 2017-2021 Council Plan suggests its average residential rate levels are currently well below those of comparable councils (p.32).

1.4 Concluding remarks

On the evidence available Hindmarsh appears to be facing financial challenges that are not uncommon to smaller rural councils. It is heavily dependent on financial support from other spheres of government and is feeling the effects of declines in such revenue in recent years. 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 future in order to maintain current service levels. Its assets are aging and it is likely that it will need to spend more on asset renewal in future to offset otherwise declines in 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.