

Assistance with
review of 2016-17
rate cap variation
applications

Shire of Pyrenees

Essential Services
Commission

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1 Shire of Pyrenees

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 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 report should be read in conjunction with the Guidance Note prepared for the ESC, which sets out the key factors that Deloitte Access Economics has considered in its assessments of the applications for rate cap variations for 2016-17 and the rationale for the basis of the analysis.

1.2 Overview

Pyrenees is a small rural council with a population of about 7,000 people. It has applied for a rate increase of 1.33% above the 2.5% rate cap. It estimates that the above the cap rate increase would generate additional revenue of \$98,000 in 2016-17.

Pyrenees budgeted for approximately \$19 million in revenue (including from capital grants) in 2015-16. \$8.5 million of this amount represented rates and service charges. Its budgeted expenses were \$20.7 million and it therefore had a budgeted deficit of \$1.6 million.

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

It is noteworthy that depreciation represented 40% of total budgeted expenses, a far higher share than is common for Victorian local governments. This suggests that the council has a large stock of infrastructure assets (in fact overwhelmingly roads) relative to its income level. It is not surprising therefore that Pyrenees emphasises in its submission that it is struggling to accommodate its road asset management needs and is seeking to generate more rate revenue in order to increase its level of asset renewal expenditure.

Generally, rural councils with large land areas often have relatively low ratepayer bases and large road networks to manage. Councils with such characteristics typically will face greater challenges in providing services in a financially sustainable manner. They are often more heavily dependent on grants and therefore more vulnerable to real reductions in grant levels.

In order to improve financial sustainability Pyrenees has been increasing average rate levels by about 5.25% per annum in recent years.

1.3 Assessment of financial performance, position and outlook

Pyrenees faces very significant financial challenges. The council is very focussed on the need to spend more on road asset renewal. Its submission and other related financial material gives far less emphasis to its large ongoing deficit. However, a strategy to progressively address its adjusted underlying operating deficit should be its first and prime priority. If it was able to operate on an ongoing break-even basis it would have the capacity to address its asset management needs to the extent required.

Pyrenees' 2015-16 budget and strategic resource plan projected an adjusted underlying operating deficit of about \$4.0 million per annum in 2016-17 to 2018-19. Eliminating a deficit of this magnitude solely through rate increases would require a progressive real rate increase of the order of 50% to 60%.

The fact that Pyrenees operates with a large adjusted underlying deficit is the reason why it is not able to spend on asset renewal at the rate that its assets are being consumed. In effect it is not generating sufficient revenue to fully offset the annual rate of depreciation of its assets.

The council is forecasting that it will spend on asset renewal during 2016-17 to 2018-19 at levels that represent between 60% and 70% of annual depreciation.

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 service level wishes can change. Nevertheless, given Pyrenees' operating circumstances, it is highly likely that it is underfunding asset renewal relative to its ongoing road asset service level preferences.

Despite its current preferences it is likely that the council will need to research the potential to revise downwards its asset-related service levels in future. Experience elsewhere suggests that some councils can achieve significant savings from this course of action

without major impact, through careful analysis of the options and implications and meaningful consultation with their communities.

Pyrenees has more than adequate current and projected ongoing liquidity. It also has very low levels of debt and expects to become debt free in 2017-18. It is not envisaging borrowing further in the near future. Greater use of debt to avoid rate increases beyond the cap is not an appropriate strategy for the council given its large forecast ongoing adjusted underlying deficit.

1.4 Concluding remarks

Unless Pyrenees receives considerable additional ongoing external financial support in future it will be likely to need significant rate increases. Even so, increases that its community can afford and is willing to pay may prove to be insufficient to avoid a significant decrease in services, and particularly road related service levels, in future.

It will be important for Pyrenees to carefully evaluate its options and the trade-offs going forward. The 1.33% increase in rates it has sought for 2016/17 can readily be justified. The fact that it did not seek a much larger increase this year may suggest it is not yet clear as to how best to respond to the challenges it faces.

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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