FPS Financial Performance Solutions.
ABN: 48299050496
41 Lily Street
Goodwood SA 5034
Mobile: [redacted]
Email: mark.fpsolutions@gmail.com

11 October 2022

Troy Edwards
Executive Director
Municipal Association of Victoria
GPO Box 4326
MELBOURNE VIC 3001

Dear Troy

State of Local Government Finances Report

Thank you for the opportunity to undertake a research project into the state of Victorian local government finances for the Municipal Association of Victoria (the MAV) and Local Government Finance Professionals (FinPro). I now provide details of the findings of my analysis and final report.

1. Background

In Victoria, following an inquiry conducted by the Essential Services Commission (ESC) in 2015, the Victorian State Government resolved to impose rate capping commencing on 1 July 2016, for the 2016-17 financial year. Since that time the Minister for Local Government has determined the rate cap for each financial year based on a recommendation by the ESC. In its 2019 report for the 2016-17 to 2017-18 years (the first two years of the cap) the ESC found that growth in the sector's total rate per property revenue reduced from an average of 5.1 per cent per annum in the three years prior to the introduction of rate capping, to 2.4 per cent in 2016–17 and 1.9 per cent in 2017–18. For the 2021-22 year the cap is 1.5%.

While the rate capping impacts on rates raised has been immediate since its inception, the ability of councils to respond with offsetting reductions in expenditure has been much slower due to the time required to undertake structural reviews and realise savings. This has put pressure on council capital works programs to balance the books in the short to medium term. Councils have also had to respond to the ongoing impacts of cost shifting and more recently the loss of revenue from COVID-19 shutdowns.

2. Requirements

The requirements were as follows:

- Develop a master set of financial data for the past five years and future five years that can be maintained by the MAV overtime for the purposes of regular monitoring and reporting, advocacy and campaigning, and strengthening the MAV's knowledge and capacity in this area
- Develop 3-5 indicators, measures and/or ratios for the purposes of monitoring and reporting the financial viability of the sector on a regular basis

- Undertake an analysis of the financial data with a view to preparing a 'State of Local Government Finances' report on the impact of rate capping, COVID-19 and other revenue impacts on the financial viability of the sector.

3. Approach

The following staged approach was undertaken to meet the requirements:

- Met with representatives of the MAV and FinPro to agree the scope, activities, roles, contacts and timeframe for key milestones and deliverables
- Sourced all data needs with support from FinPro, Local Government Victoria (LGV) and the Victorian Auditor-General's Office (VAGO) for each of the 79 councils including:
  - Past Five Years: Audited Financial Statements 2016-21
  - Future Ten Years: Financial Plans 2021-31
- Developed a master set of financial data based on stage 2
- Developed 3-5 indicators, measures and/or ratios to assess financial viability
- Prepared a 'State of Local Government Finances' report.

3. Analysis

3.1 Master Data Set

In completing the analysis, a master data set of financial information has been compiled for future use by the MAV based on audited Financial Statements from 2016-17 to 2020-21 and adopted 10 year Financial Plans from 2021-22 to 2030-31. The master data set consists of the following for each of the 79 Victorian local governments for the 15 years from 2016-17 to 2030-31:

- Indicators:
  - Local Government Performance Reporting Framework (LGPRF) financial indicators
  - VAGO financial sustainability indicators
  - Treasury Corporation Victoria (TCV) debt facility indicators
  - New South Wales (NSW) local government financial indicators
- Financial Statements:
  - Comprehensive Income Statement
  - Balance Sheet
  - Cash Flow Statement
  - Capital Works Statement
- Other Information:
  - Property assessments
  - Property valuations (Capital Improved Value)

The audited Financial Statement data for the 2016-17 to 2018-19 years was sourced from VAGO and the 2019-20 to 2020-21 years was sourced from LGV. The Financial Plan data was sourced from individual councils with assistance from FinPro. Definitions for the VAGO, TCV and NSW indicators are included in the attached appendix. Definitions for the key LGPRF indicators are included in section 3.2 below.

It is recommended that the MAV obtain a copy of the audited Financial Statement data set for each of the 79 councils from LGV annually to update the master data set. It is also recommended that forecast Financial Statement data be obtained on a 2-3 year cycle from individual councils.

3.2 Financial Viability Indicators

Section 4. of the attached report provides an assessment of the local government sector's financial viability based on the following key LGPRF indicators:

- **Adjusted Underlying Result**: Measures whether a council can generate sufficient adjusted revenue to meet total expenses. It is measured by comparing the adjusted underlying result to adjusted underlying revenue, expressed as a percentage. An adjusted underlying surplus indicates that a council can generate sufficient revenue to meet its expenses. The accepted target is greater than 0%.
- **Working Capital**: Measures whether a council can generate sufficient cash to pay its bills on time. It is measured by comparing current assets to current liabilities, expressed as a percentage. Higher current assets relative to current liabilities suggest that a council is in a strong financial position. The accepted target is greater than 120%.
- **Unrestricted Cash**: Also measures whether a council can generate sufficient cash to pay its bills on time but using unrestricted cash rather than current assets as the numerator. It is measured by comparing unrestricted cash to current liabilities, expressed as a percentage. Unrestricted cash is cash and cash equivalents that are available for use and free of obligations. Higher unrestricted cash relative to current liabilities suggest that a council can pay its bills on time. The accepted target is greater than 50%.
- **Debt Level**: Measures whether the level of debt and other long term obligations is appropriate to the size and nature of a council's activities. It is measured by comparing loans and borrowings to rates, expressed as a percentage. The level of debt should reflect the adopted borrowing strategy of a council. The accepted target is less than 60%.
- **Asset Renewal**: Also measures whether the level of debt and other long term obligations is appropriate to the size and nature of a council's activities but using capital expenditure as the numerator. It is measured by comparing asset renewal and upgrade expense to depreciation, expressed as a percentage. Higher levels of asset renewal compared to depreciation indicate that council assets are being renewed or upgraded as planned. An additional measure is to exclude upgrade expenses from the numerator. The accepted target is 100%.

It is recommended that the MAV monitor the financial viability of the Victorian local government sector using the above key LGPRF indicators with additional refinement within indicators where appropriate (for example EBIDA within adjusted underlying result). Targets should be refined over time by local government cohort as the recent move to own council target setting becomes more mature. It is also recommended that the LGPRF indicator 'Expenses per Assessment' be used to monitor changes in the local government cost base relative to the rate cap.

3.3 State of Local Government Finances report

An analysis of the financial data has been undertaken on the impact of rate capping, COVID-19 and other revenue and expense impacts on the financial viability of the sector. The findings of the analysis are presented in the attached report.

It is recommended that the MAV update the report on an annual basis, based on the most recent audited Financial Statements.

4. General

Thank you once again for the opportunity to undertake this analysis. If you have any questions or suggested changes regarding his report, please contact me on 0419 750 354.

Yours Sincerely,

Mark Davies FCA
Principal Consultant

Appendix: Financial Indicators

VAGO Financial Sustainability Indicators

Net Result Margin
Net result/total revenue.

Adjusted Underlying Result
Adjusted underlying surplus (or deficit)/adjusted underlying revenue.

Liquidity Ratio
Current assets/current liabilities

Internal Financing
Net operating cashflow/net capital expenditure

Indebtedness
Non-current liabilities/own-sourced revenue

Capital Replacement ratio
Cash outflows for the addition of new infrastructure, property, plant and equipment/depreciation

Renewal Gap Ratio
Renewal and upgrade expenditure/depreciation

TCV Debt Facility Indicators

Debt to Own Source Revenue
Debt means total interest bearing loans and borrowings on any date as shown by the latest Financial Statements for the 12 month period ending on that date. Own source revenue means the total revenue for the Council as shown by the latest Financial Statements excluding government grants, contributions for capital works and the value of assets received from the developers.

Interest Cover Ratio
The ratio is calculated by the ratio A:B where A equals EBITDA for the 12 month period ending on that date and B equals the total interest expense for the 12 month period ending on that date. EBITDA means the net profit of the Council for that period (including all forms of donations, grants and cash equivalent bequests by excluding non-cash developer contributions) before interest, taxes, depreciation and amortisation for the relevant period and before significant items.

NSW Local Government Financial Indicators

Operating Performance Ratio
The ratio is calculated by total continuing operating revenue (excludes fair value adjustments, net gain/loss on sale of assets, net share/loss on joint ventures) excluding capital grants and contributions, less operating expenses, divided by total continuing operating revenue (excluding capital grants and contributions).

Own Source Revenue
The ratio is calculated by total continuing operating revenue (excludes fair value adjustments, net gain/loss on sale of assets, net share/loss on joint ventures) less all grants and contributions divided

by total continuing operating revenue (excludes fair value adjustments, net gain/loss on sale of assets, net share/loss on joint ventures) inclusive of capital grants and contributions.

Unrestricted Current Ratio
The ratio is calculated by current assets less all external restrictions divided by current liabilities less specific purpose liabilities.

Debt Service Cover Ratio
The ratio is calculated by operating results (excludes fair value adjustments, net gain/loss on sale of assets, net share/loss on joint ventures) before capital, excluding interest and depreciation/impairment/amortisation divided by principal repayments (from Statement of Cashflow) and interest on loans.

Cash Expense Cover Ratio
The ratio is calculated by current year's cash, cash equivalents and term deposits divided by payments from the cash flow of operating and financing activities, multiplied by 12.