29/11/2022

RM/22/30926

The Hon. Melissa Horne MP
Minister for Local Government
Level 22, 1 Spring Street
Melbourne VIC 3000

Dear Minister,

Essential Services Commission advice on the rate cap for 2023–24

The Essential Services Commission is responsible for administering the Fair Go Rates system and providing advice to the Minister for Local Government on the average rate cap for councils. On 11 October 2022, you requested the commission's advice on setting the average rate cap for councils for 2023–24, under section 185D(3)(a) of the Local Government Act 1989 (the Act).

We recommend the average rate cap be set equal to the 2022–23 Budget Update forecast of the consumer price index (CPI) for 2023–24 from the Department of Treasury and Finance. We consider that this balances the needs of the community with the long-term sustainability of councils. Our reasoning is set out in attachment A.

The department will release its budget update with the relevant CPI forecast by 15 December 2022. We note that the department's latest CPI forecast for 2023–24, as published in the Pre-Election Budget Update on 10 November, is 4 per cent.

We also recommend that a uniform cap continue to apply to all councils in 2023–24. We consider that the higher cap application process remains an efficient, transparent and participative mechanism to deal with the varying financial circumstances of individual councils.

Councils that cannot, under the average rate cap, maintain the financial capacity to perform their functions and exercise their powers to achieve sustainable outcomes in the delivery of services and critical infrastructure, may choose to apply for a higher cap. We are required to have regard to a range of matters specified in the Act when assessing higher cap applications. We only approve higher cap applications we consider appropriate after having regard to these matters. A key consideration for the commission is whether a council can demonstrate a long-term funding need.

Adjustment to the December Budget Update CPI forecast – rate cap for all 79 councils

Our advice on setting the rate cap for 2023–24 is that there should not be an adjustment to the CPI forecast announced in the December Budget Update. For example, if the forecast is 4 per cent, then our adjustment is zero and our recommended rate cap is 4 per cent. If the forecast is 4.5 per cent, then our adjustment is zero and our recommended rate cap is 4.5 per cent.

If you have any questions regarding our advice, please do not hesitate to contact Angelina Garces, Senior Regulatory Manager, Local Government on (03) 9032 1337, or at [angelina.garces@esc.vic.gov.au.](mailto:angelina.garces@esc.vic.gov.au)

Yours sincerely

Kate Symons
Chairperson

Attachment A – rate cap rationale

On 11 October 2022, you requested the commission's advice on setting the average rate cap for councils for 2023–24, under section 185D(3)(a) of the Local Government Act 1989 (the Act), on the following matters:

- a recommendation for any adjustment(s) to be applied to the Consumer Price Index (CPI) in setting the cap for all 79 local councils, a grouping of councils or any individual council
- the rationale for and quantum of any such adjustment(s)
- should more than one option be recommended, indicate which is the preferred option.

We consider that the rate cap should be set to the forecast CPI announced in the 2022–23 Department of Treasury and Finance's December Budget Update. That is, there should not be any adjustments to the CPI in setting the rate cap for all councils. We arrived at this view in consideration of the financial sustainability of the sector, changes in council costs, expectations of future wage rises and recent economic forecasts.

Why the forecast CPI is an appropriate rate cap for 2023–24

The Victorian Pre-Election Budget Update, published on 10 November 2022, forecasts CPI to be 4 per cent in 2023–24. The pre-election budget update has provided us with a more recent CPI forecast than we usually have access to when providing this advice (which is typically the forecast from the May Budget). The recency of the forecast provides us with confidence that the December Budget Update CPI forecast will likely be close to 4 per cent.

We consider that a rate cap that is around 4 per cent reflects a reasonable increase for the average ratepayer and balances the needs of ratepayers and the community with the long-term sustainability of councils. A rate cap of around 4 per cent would be the highest average rate cap experienced by ratepayers since the framework was introduced. However, we consider that it is appropriate given our observations of changes in council costs and the impact expected future wage increases could have on council financial sustainability going forward.

A rate cap that is lower than the CPI forecast may be beneficial for ratepayers in the short term. However, a lower rate cap could deepen financial sustainability issues for councils, which would ultimately be borne by ratepayers and the community in the long term. Further, even with a 4 per cent rate cap, it is worth acknowledging that some councils are likely to see a continued impact on financial viability in the current economic environment.

Councils that cannot, under the average rate cap, maintain the financial capacity to perform their functions and exercise their powers to achieve sustainable outcomes in the delivery of services and critical infrastructure, may choose to apply for a higher cap. We are required to have regard to a range of matters specified in the Act when assessing higher cap applications. We only approve higher cap applications we consider appropriate after having regard to these matters. A key consideration for the commission is whether a council can demonstrate a long-term funding need.

Our advice is based on analysis of council finances and costs, inflation, and economic forecasts

In forming our advice, we analysed council financial data, price indices relevant to the sector, and economic forecasts, namely from the Reserve Bank of Australia and the Department of Treasury and Finance. We also met with stakeholders, including representatives from FinPro and the Municipal Association of Victoria.

Based on our engagement with stakeholders and analysis we consider that four key observations have informed our rate cap advice:

- Council cash reserves are decreasing.
- Council costs have increased at a slower rate than inflation during 2021–22, but at a higher rate than the current rate cap of 1.75 per cent.
- Construction costs are rising.
- Expected future wage increases will increase council costs in the future.

We have made general observations about these factors across the sector. The experience of an individual council will vary depending on its council's financial position and the specific challenges it might be facing.

Council cash reserves are decreasing

Over the past two years, councils have been using their cash reserves to maintain service levels as their own-source revenue was affected by low average rate increases relative to actual inflation and a decline in other revenue streams due to lockdowns and the coronavirus. Further, no councils have applied for a higher cap since 2019, and many councils limited their rate increases or offered rebates to assist households facing financial pressures as a result of the pandemic. While most councils working capital ratios are still in an appropriate range, the downward trend is not sustainable in the longer term.

Between 2018–19 and 2022–23, councils' cash reserves, as represented by the working capital ratio, decreased from an average of 320 per cent to 217 per cent. While still in a high range overall, the number of councils approaching a 100 per cent working capital ratio has increased. In 2018–19, only two councils reported a working capital ratio between 100 per cent and 150 per cent. In 2022–23, 28 councils are budgeting for a working capital ratio between 100 and 150 per cent. However, the deterioration in cash reserves is not uniform across the sector, with 35 councils budgeting to maintain a working capital ratio above 200 per cent in 2022–23.

We also note that the sector generally has low levels of debt. Debt finance can be a key element of a prudent and responsible long-term financial plan. Borrowing money to fund the construction of 'long-lived' assets can be a viable option for councils facing reduced cash reserves.

Council costs increased at a slower rate than inflation during 2021–22, but at a higher rate than the current rate cap

As the framework is forward looking, differences between the rate cap and actual inflation should be expected. However, in 2021–22 and 2022–23, these differences are larger than they have been in previous years (as shown in Table 1 below). For the Melbourne component of CPI, actual inflation was 4 per cent in 2021–22, compared to a 1.5 per cent rate cap. For 2022–23, the Victorian Pre-Election Budget Update, published on 10 November, forecasts a 7.25 per cent increase in CPI, compared to the current rate cap of 1.75 per cent .

We also observe that council budgets show a significant increase for services that are outside the rate cap, such as waste. Service charge revenue per property is increasing by an average 7.4 per cent in 2022–23.

The differences between the rate cap and inflation reflect how much and quickly circumstances changed since the rate cap was set in December last year. Councils that previously did not implement the full rate cap or provided rebates because of the pandemic would not have foreseen the cost pressures that they are now facing.

However, we note that the fuel and food components of CPI are some of the largest drivers of the overall increase in CPI. These are not core inputs for council operations.

To help understand the actual cost pressures councils are facing, we recalculated local government cost indices that are accepted in other jurisdictions (New South Wales, South Australia and Tasmania). All three indices, when updated with price inputs relevant to the Victorian setting, estimate that Victorian council costs increased by around 5.7 per cent from September 2021 to September 2022. Over the same period, headline inflation was 7.3 per cent.

Construction costs are rising

The cost indices take into account various components of CPI, as well as the wage price index and the producer price index. The inclusion of the producer price index accounts for changes in construction costs, which have increased over the past year. The roads and bridges construction component of the producer price index increased by 10 per cent from September 2021 to September 2022. Some council stakeholders have reported that the combination of supply constraints, cost increases and broader inflationary pressures may result in some councils deferring or reducing their capital works programs.

Wage increases are expected in the future

Employee costs are budgeted to account for 41 per cent of total council expenses in 2022–23. This does not include wage costs that would be captured by contractors performing work for councils. While wages have not kept pace with inflation, current forecasts show that they are expected to rise in the future. The Pre-Election Budget Update forecasts a wage price index increase of 3.5 per cent in 2023–24.

Many councils are currently renegotiating employment agreements that have expired or will expire by the end of 2022–23. Based on the Fair Work Ombudsman website, 41 councils will have expired employment agreements by the end of 2022–23. More broadly, the Fair Work Commission's minimum wage decision increased the minimum wage by 5.2 per cent in 2022.

In our view, the expectation of future wage increases presents a significant cost pressure on councils going forward. We consider that the increase in wage costs, alongside broader inflationary pressures, demonstrates why a rate cap in the range of the Department of Treasury and Finance's most recent CPI forecast of 4 per cent is appropriate.

1.1 Table 1 Rate cap, costs, and index numbers

	2018–19	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25
Rate cap	2.25	2.5	2.0	1.5	1.75	TBD	TBD
Actual inflation	1.7	1.7	1.4	4	-	-	-
Cost indices	2.6	0.2 to 0.3	2.3 to 2.7	5.6 to 5.8	-	-	-
CPI forecast*	-	-	-	-	7.25	4	2.75
WPI forecast*	-	-	-	-	3.25	3.5	3.25

*The CPI and WPI forecast are sourced from the 2022 Victorian Pre-Election Budget Update. The forecasts show that CPI is expected to peak in 2022–23 and that WPI is expected to peak in 2023–24.

Ratepayers and affordability

For ratepayers, the current environment highlights the role the rate cap and financial hardship policies have in addressing affordability concerns. While lower rate caps can decrease the overall rate burden on a community, it is a blunt tool and must also be balanced against the long-term sustainability of councils. In our view, well-functioning financial hardship policies and programs are more effective in targeting the affordability issues that ratepayers experiencing vulnerability are facing.