ESSENTIAL SERVICES COMMISSION

Overview

Decisions on applications for a higher cap 2017-18 to 2020-21

July 2017

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Contents

1. This year's decisions

Purpose

Five councils applied for higher rate caps to take effect from 2017-18. These councils sought approval to raise rates by a higher percentage than the cap set by the Minister for Local Government (the Minister). Three of the five applications sought rate increases for more than year. This overview paper summarises our decisions. Detailed reasons for our decisions in relation to each of the councils are found in the individual decision documents on our website.[1]

The overview is aimed to help councils intending to apply in coming years, to understand the key reasons for approving or not approving applications in the past two years. It may also help ratepayers and other members of the community to understand our decisions.

This section outlines the decisions we made this year. In later sections, we:

- describe our approach to assessing an application as required under legislation
- explain how other factors may influence an individual rate bill
- summarise the key reasons for our decisions
- highlight the relevant areas that may assist future applications from councils.

Applications and decisions

We assessed the applications under the Fair Go Rates system and made the following decisions.

Table 1 Summary of higher cap decisions

Council	Decision	Commentary
Pyrenees Shire Council	Approved	Average rate can increase by no more than 3.5 per cent in both 2017-18 and 2018-19[a]
Hindmarsh Shire Council	Approved	Average rate can increase by no more than 4 per cent in 2017-18
Borough of Queenscliffe	Not approved	Average rate can increase by no more than 2 per cent in 2017-18
Towong Shire Council	Approved	Average rate can increase by no more than 5.55 per cent each year in 2017-18, 2018-19, 2019-20 and 2020-21
West Wimmera Shire Council	Approved	Average rate can increase by no more than 3.5 per cent each year in 2017-18, 2018-19, 2019-20 and 2020-21

[a] The application from Pyrenees Shire Council was received in March 2017 and our decision was published in May 2017. This decision differs in terms of presentation; we followed the same approach in assessing all applications.

[1] Refer http://www.esc.vic.gov.au/project/local-government/53369-201718-higher-cap-applications/

2. How we assess an application

This section outlines the legislation that establishes the Fair Go Rates system and explains how we assess higher cap applications from councils.

Legislative requirements

The Fair Go Rates system is set out in the *Local Government Act 1989* (the Act). If a council considers it will need to raise rates by more than a cap set by the Minister, it can apply to the Commission to approve a higher cap. For the 2017-18 rating year — the second year of rate capping — the Minister set the cap at 2 per cent. For the first time, councils can apply for higher rate caps for up to four years.

The Act requires us to examine how a council's application addressed six legislative matters[2] when it applied for a higher cap. The legislation also sets out the Commission's objectives[3], to (i) promote the long-term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure; and (ii) ensure that a council has the financial capacity to perform its duties and functions and exercise its powers. Details of the six legislative matters and the two objectives are in Appendix A.

Structure of our assessment

Our assessments took into account the statutory objectives and legislative matters that applications must address. This approach ensured that the assessment included all relevant factors covered by the legislation that impacted on whether a council demonstrated a long-term financial need that should be funded through a higher cap.

First, we examined a council's financial position. We used the set of financial indicators that councils already report as part of the local government performance reporting framework. In general, it was reasonable to assume that if a council reported a deficit in its adjusted underlying result, there was an underlying financial need. An ongoing trend of adjusted underlying deficits would tend to confirm this was a long-term need rather than a one-off factor (such as a timing issue in the receipt of grant revenue).

Second, we examined the major causes of the adjusted underlying deficits and tried to understand the financial challenges faced by the council, including the need for the higher cap. An application that includes a long-term financial plan that comprehensively captures the council's financial challenges and their impacts is important.

Third, we examined the robustness of the council's reasons for needing a higher cap. This is where we assessed the application to determine whether the council:

- was seeking to improve its finances in areas under its control (for instance, improving revenues and minimising costs) before seeking a higher cap
- had policies, plans and processes in place that gave us confidence that it had reasonably captured the key financial impacts and accurately estimated its long-term financial need

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2 Section 185E(3) of the Local Government Act.
3 Section 10E(7) of the *Essential Services Commission Act 2001* and s. 185A of the Local Government Act.

- engaged with its community to explain clearly the reasons for any higher caps, the impacts on services, infrastructure or finances of not receiving a higher cap, and what trade-offs might have to be made in different budget scenarios.

The matters defined in legislation guide this assessment. We reviewed the extent that the application adequately demonstrated how community views were taken into account, how the higher cap would be an efficient and value-for-money outcome, what trade-offs and funding options were considered, and whether the application was consistent with council's financial strategy and long-term plan. Two key considerations governed our assessment, namely, that our decisions did not compromise a council's financial capacity to perform its functions, and that our decisions promoted the long-term interests of ratepayers and the community.

In each of our decisions, our assessment approach as described above meant asking the following questions:

- What is the council's underlying financial position?
- What has been done to manage the underlying financial position?
- Are the plans, policies and processes in place sufficient to demonstrate the funding need?
- How were community views taken into account?
- What have we concluded?

Affordability

Affordability is an important consideration for a council when setting its rates. We expect that councils take this into account when they make their decisions about whether to apply for a higher cap.

We do not assess affordability in councils' higher cap applications. The legislation does not require us to do so, nor is it appropriate.[4] Councils are best placed to determine their community's capacity to pay after taking into account all major factors that may affect their communities. The decision on the appropriate trade-off between service impacts and the level of rates rightly sits within the council's jurisdiction.

Our role, as defined in legislation, is limited to ensuring that the higher cap application process undertaken by councils is robust and transparent.

[4] Affordability is not one of the matters listed in the legislation that councils must address in their applications — section 185E(3).

3. What higher caps mean to a ratepayer's bill

The four councils for which we approved a higher rate cap this year, as shown in table 1, can increase their **average** rates by the percentage shown in the respective year. The increase in each year is inclusive of the Minister's rate cap.

However, for a number of reasons, individual ratepayers may see their bills change by a different percentage.

A key reason is that, under the Fair Go Rates system, the cap applies to the average rate.[5] Within a municipality, individual properties can change in value — in percentage terms — by more or less than average. Ratepayers will see their rates increase by more or less than the average percentage accordingly, since rates are based on property values. But across its ratepayers in total, a council can only collect revenues consistent with the rate cap.

There are also other factors that impact on individual ratepayers' bills, such as:

- changes in municipal charges and differential rates that may affect certain ratepayers and not others,
- inclusion on the bill of special rates and charges, waste collection charges and fire service levy and other charges that are not subject to the cap.

Further details are also provided in appendix B.

Information provided on a rate notice

The information that must appear on a rates notice is defined by regulations.[6] Regulations require a notice of rates and charges to include the following:

- the relevant rate cap for the financial year
- whether the council has complied with the rate cap
- reasons why an individual ratepayer's rates and charges for that financial year may have increased or decreased by an amount different from that council's rate cap.

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[5] The average rate refers to the rate paid by the notional average ratepayer. This is calculated by dividing the total revenue required from rates by the total number of rateable properties in each local government area.

[6] Local Government (General) Regulations 2015, issued by Local Government Victoria as amended on 8 April 2016, which can be found at www.legislation.vic.gov.au.

4. Summary of our decisions and reasons

This section summarises our decisions on council applications. The individual decision for each council is published separately on our website.[7]

4.1. Pyrenees Shire Council

Pyrenees Shire Council (Pyrenees) applied for a higher cap of 3.5 per cent in each of 2017-18 and 2018-19, which is 1.5 per cent above the Minister's 2 per cent rate cap for 2017-18. Pyrenees has estimated that this would result in additional revenue of $116 000 in 2017-18.

We assessed the Pyrenees application, and decided to approve its proposed higher caps for both years. We are satisfied that the higher caps are appropriate because the overall finances of Pyrenees are constrained. The council has demonstrated a long-term funding need in order to renew assets, particularly gravel roads.

However, in light of the ongoing financial challenges that Pyrenees faces in maintaining service levels and meeting community expectations, we have identified a range of necessary improvements to approaches to asset management, service reviews and community engagement at Pyrenees.

4.2. Hindmarsh Shire Council

Hindmarsh Shire Council (Hindmarsh) applied for a higher cap of 4 per cent for 2017 18 (inclusive of the Minister's rate cap of 2 per cent). Hindmarsh estimates this will generate $144 000 of additional revenue (above the Minister's rate cap) in 2017-18.

The Essential Services Commission assessed Hindmarsh's application and approves a higher cap of 4 per cent for 2017-18.

We are satisfied that the application shows a long-term funding need, and that Hindmarsh needs the higher cap to help manage assets and deliver services in the long-term interests of ratepayers and the community. In 2017-18, Hindmarsh will use the extra revenue to upgrade road assets. We are satisfied that the application shows a need to invest in road assets. This is supported by the council's long-term financial planning and community engagement.

[7] Refer www.esc.vic.gov.au/project/local-government/53369-201718-higher-cap-applications/

4.3. Borough of Queenscliffe Council

The Borough of Queenscliffe (Queenscliffe) applied for a higher cap of 4.5 per cent for 2017-18 (inclusive of the Minister's rate cap of 2 per cent). Queenscliffe estimates this will generate $150 000 of additional revenue (above the Minister's cap) in 2017-18.

The Essential Services Commission assessed Queenscliffe's application and does not approve its proposed higher cap of 4.5 per cent for 2017-18.

We are not satisfied that the higher cap for 2017-18 is appropriate because the application, as presented, does not provide sufficient evidence to demonstrate a long-term funding need.

4.4. Towong Shire Council

Towong Shire Council (Towong) applied for higher caps of 5.55 per cent for four years (2017-18, 2018-19, 2019-20 and 2020-21), which is inclusive of the Minister's rate cap. Towong estimates the extra 3.55-per-cent above the Minister's rate cap for 2017-18 will generate approximately $235 000 of additional revenue in 2017-18. It estimates the overall effect of the higher caps over the four years being approximately $2.5 million of additional revenue compared to the Minister's rate cap.

The Essential Services Commission assessed Towong's application, and approves the proposed higher caps of 5.55 per cent for each of the four years.

We are satisfied that the higher caps are appropriate because the application demonstrates a long-term funding need to deliver services at existing levels and maintain financial sustainability.

As the approval applies for four years, we expect council to continue to engage with its community on major service and financial trade-offs as part of its corporate planning and budget processes.

4.5. West Wimmera Shire Council

West Wimmera Shire Council (West Wimmera) applied for higher caps of 3.5 per cent for four years (2017-18, 2018-19, 2019-20 and 2020-21), which is inclusive of the Minister's rate cap of 2 per cent. West Wimmera estimates the extra 1.5 per cent above the Minister's rate cap for 2017-18 will generate approximately $97 000 of additional revenue in 2017-18. It estimates the overall effect of the higher caps over the four years being approximately $1.04 million of additional revenue compared to the Minister's rate cap.

The Essential Services Commission assessed West Wimmera's application, and approves the proposed higher caps of 3.5 per cent for each of the four years.

We are satisfied the higher caps are appropriate because the application demonstrates a long-term funding need and planning which includes engagement with the community. The application shows West Wimmera has a large asset renewal gap, while facing ongoing operating deficits.

As the approval applies for four years, we expect council to continue to engage with its community on major service and financial trade-offs as part of its corporate planning and budget processes.

5. Improving future applications

This section summarises key considerations for councils that may submit higher cap applications in future.

As stated in section 2, we examined the council's underlying financial position in every application. We reviewed whether the application demonstrated council has a long-term financial need that is best addressed through higher caps.

Councils can prepare for future higher cap applications drawing on the following:

- Our guidance on our website. This is the most comprehensive guide on our process and assessment approach. This guidance will be updated in late 2017 to align with next year's application process.[8]
- The key gaps we identified (subject of this section) when deciding not to approve certain applications over the last two years.
- Our detailed decisions on each application and the consultants' advice that informed our decisions.[9]

Councils intending to apply for higher caps should also take advantage of pre-application meetings with Commission staff to clarify any concerns or queries.

The following sections outline key considerations to assist future applications.

5.1. Demonstrating long-term financial need

A successful application demonstrates good long-term financial planning. This, in turn, means that the council:

- identified its major financial challenges and, based on the best information available, modelled them in its long-term financial plan
- showed that it consistently took action to manage its financial challenges — particularly those within its control to improve its revenues and reduce its costs
- established good policies, plans, processes and practices to give us confidence that it identified and quantified its financial needs reasonably
- engaged effectively over time, improving its community's understanding of its major financial needs, including
  - any major trade-offs (involving services, infrastructure or finances)
  - the reasons why these needs should be funded by a higher cap
  - the consequential impacts if the higher cap is not approved.

[8] Refer www.esc.vic.gov.au/document/local-government/36180-fair-go-rates-system-guidance-councils-2017-18/

[9] Refer http://www.esc.vic.gov.au/project/local-government/53369-201718-higher-cap-applications/

Issues with financial planning and community engagement

A key gap in some applications in the last two years was a lack of good long-term financial planning. Some councils in their applications did not:

- consider the council's major financial challenges systematically and reflect them in their financial plans,
- model alternative budget scenarios that aligned with good policies and financial sustainability
- explain their proposals or assumptions clearly enough
- ensure that financial plans were clear and consistent with other supporting material such as corporate plans, financial strategies and policies, and asset management plans.

Another key gap relates to addressing community engagement. Councils should promote the outcomes of good community engagement according to principles set out in our guidance. Sometimes, the applications did not adequately demonstrate:

- that the community received information on major trade-offs or the impacts of various decisions during the engagement process
- how the council took into account feedback received during the process.

Most councils now appear to provide their communities and ratepayers with information about the proposed higher cap and its purposes. However, in some applications it was still unclear whether councils had presented necessary and sufficient information on financial trade-offs and the potential impacts on services and service levels.

We continue to find some applications do not clearly explain how a council has taken into account the views of the community, in making the decision to seek a higher cap. The lack of clarity was most obvious where a council has received mixed — or largely negative — responses from those participating in engagement activities. It was not clear to us how councils weighed up such views, what additional information they may have relied upon in deciding to proceed with the application, or how they responded to the participants.

Overall, if a council has built good long-term financial planning and community engagement into its ongoing corporate and budgetary processes, it is well placed to demonstrate its long-term financial needs and the need for higher caps.

5.2. Financial sustainability of small rural councils

We note the Victorian Auditor General's view[10] of the financial sustainability of small rural councils, and recognise that many of them face major financial challenges. The Commission understands some of these major financial challenges, including:

- heavy dependence on grant revenue
- limited capacity to generate revenue from other sources
- significant road infrastructure network to maintain, relative to their size and capacity
- small rate base (and any additional cost of applying for a variation may prove to be prohibitive).

This year, we received five higher cap applications. All of them came from small rural councils. This demonstrates that, despite our expectations regarding the quality of applications, small rural councils can successfully apply for higher caps.

[10] Victorian Auditor General, 2016, *Local Government: 2015-16 Audit Snapshot*, November, p.12

For a higher cap application to be approved, councils must ensure their financial and community engagement processes meet the basic requirements of the Fair Go Rates system.[11] Successful applications in previous years showed that, with limited administrative resources, councils can continue to invest in sound long-term financial planning, exploit measures for cost reductions and efficiency savings, and effectively engage with their community.

5.3. Multi-year applications need to be strengthened

A multi-year higher cap will necessarily result in a larger increase in a council's rate base.

It is reasonable for us to require a higher standard of documentation for multi-year higher cap applications. As a minimum, councils should:

- outline the key operating and financial assumptions underpinning the long-term financial plan
- identify and model viable alternative budget scenarios.

Over a longer period (say, for a four year higher cap) there is greater scope for longer term trade-offs that are often not possible in the short term. These trade-offs can include different service, infrastructure and financial options that may be available to a council and its community.

In these cases, we expect a council to explore trade-offs in more detail and model their financial and service impacts in a longer term plan. This process will also involve engaging effectively with its ratepayers and community along the lines described in section 5.1. Further, when we do approve a multi-year application, we would expect the council to continue to engage with its community on major service and financial trade-offs as part of its corporate planning and budget processes.

When multi-year applications fail to address these considerations fully, we may consider a partial approval of the duration of a multi-year higher cap, provided the immediate financial pressures are clearly shown. We may approve an increase reflecting the reasons that have adequate justification, as necessary, to take effect for one or more years of the period cited in the application.

5.4. Monitoring outcomes

Each year we report on each council's compliance with its rate cap, and every two years we report on outcomes from the Fair Go Rates system. When doing so, we will monitor and report on whether councils have spent the extra revenue from a higher cap in line with the expenditure needs cited in their applications. While we approve rates and not expenditure, it is important that the community and ratepayers receive confirmation that councils have met their commitments. If the extra revenue is redirected to other areas, we will seek and publish a council's explanation for the reallocation of those funds.

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[11] Refer http://www.esc.vic.gov.au/wp-content/uploads/2017/03/guidance-for-councils-higher-cap-applications-2017-18-updated-20170320.pdf. pp.35-38

6. Next steps

Fair Go Rates system — Guidance for Councils (2018-19) — October 2017

We will revise and reissue our Guidance to facilitate the 2018-19 higher cap application process. The revised document will provide greater detail of the matters that we would expect applications to address next year.

Community engagement conference — October 2017

Commission staff are planning a conference in Bendigo on community engagement. It will focus on sharing ideas and developing capacity for the sector on engagement.

Nearer the date, we will publish further details on our website and newsletter.

Workshops — November 2017

Commission staff intend to hold a series of meetings, following the release of the updated guidance, to assist council staff in understanding the requirements of the FGRS on higher cap applications and compliance reporting.

Early in 2018 Commission staff will be available for pre-application meetings with any council intending to apply for a higher cap, to clarify any issues they may have.

We will organise webinars and make the necessary technical arrangements for the convenience of those unable to attend the workshops or pre-applications meetings in person.

Appendix A: Legislative requirements

Legislative requirements

The Fair Go Rates system provides that, if a council considers it will need to raise rates by more than a cap set by the Minister for Local Government, it can apply to us at the Essential Services Commission, to approve a higher cap.

In arriving at our decisions, we must have regard to the statutory objectives of the Fair Go Rates system.[12] To meet these objectives, we consider how the council has addressed the six legislative matters that the Fair Go Rates system requires councils to address in their applications (box 1).[13]

Box 1 The Fair Go Rates system

The **legislative matters** are:

- the proposed higher cap for each specified financial year
- the reasons for which the council seeks the higher cap
- how the views of ratepayers and the community have been taken into account in proposing the higher cap
- how the higher cap is an efficient use of council resources and represents value for money
- whether consideration has been given to reprioritising proposed expenditures and alternative funding options and why those options are not adequate
- that the assumptions and proposals in the application are consistent with the council's long-term strategy and financial management policies set out in the council's planning documents and annual budget.

The **statutory objectives** are:

- to promote the long-term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure
- to ensure that a council has the financial capacity to perform its duties and functions and exercise its powers.

We must also have regard to council compliance with the Minister's rate cap or approved higher cap.[14]

[12] Section 10E(7) of the *Essential Services Commission Act 2001* and s. 185A of the Local Government Act.
[13] Section 185E(3) of the Local Government Act.
[14] Section 185E(6)(c) of the Local Government Act.

Appendix B: Rate caps and their effect on rate notices

As section 3 points out, many ratepayers in the state will see their bills change from 2016-17 to 2017-18. The actual percentage change they see, though, may not be the same as either the Minster's current 2 per cent cap for councils in general or their own council's approved higher cap. Some or all of the following factors may be relevant and move an individual ratepayer's bill up or down by more than the relevant cap.

Valuations change general rates

For every municipality, the Minister's cap, or an approved higher cap, limits the increase in total revenue that a council can receive from general rates and municipal charges (if any) in a year, when it send out the bills for the year.[15] In this context, *general rates* are calculated and billed as cents in the dollar value of a ratepayer's property.

All property values are reassessed every two years in a *general re-valuation*. If this results in an increase, say, in the total dollar value of rateable properties in a municipality, then the rating system eliminates the effect of the increase by requiring a corresponding decrease in the rates in the dollar (all other things being equal).

But over time, market forces can alter the relative value of many properties in the same municipality:

- Whole streets or districts may rise or fall in assessed value, reflecting changes such as urban renewal or improved access to transport and other amenities. Such changes would be reflected in the two-yearly general revaluation of the neighbourhoods most affected.
- An owner's actions can materially alter the value of one property, by renovation, subdivision or improvement. These changes may be reflected in a *supplementary valuation* and a change in billing between general valuations. .

Changes in valuation, relative to other properties in the same municipality, will mean that some rate bills will rise by more than the percentage cap; others, by less.

Councils change differential rates

All councils each year must declare and publish a general rate in the dollar of property value. Most properties in the state are residential and will be billed at 100 per cent of their council's declared general rate. But a council may also define a *differential rate* for each of several specific classes of property, as a percentage of the general rate — such as 70 per cent for rural property and 140 per cent for industrial property. Overall, the revenue from differential rates is included in the total revenue that will be capped in the Fair Go Rates system.

When a council announces a rate increase, it can at the same time introduce or alter differential rate percentages.[16] Such a decision is within the council's discretion and outside the scope of the Fair Go Rates system. The council can raise or lower the differential for any class of property, and so change the share of total rates payable for properties in that class. Other things being equal,

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[15] The general rate is a cents-in-the-dollar figure, to be multiplied by the rateable value (in dollars) of each individual property. The municipal charge is a flat dollar amount that the council may choose to include on all its ratepayers' bills.

[16] Councils must have regard to Ministerial Guidelines (which predate the Fair Go Rates system) when setting differential rates.

since the total revenue is capped, this means the share of the total rates for one or more other classes of property also needs to change in the opposite direction. The ratepayers concerned will see these changes in their bills, which will increase by more or less than the percentage cap.

Councils change municipal charges

Many councils include a *municipal charge* in their rate bills, as a standard dollar amount payable by all of its ratepayers. The council decides the amount of that charge.[17] The revenue from municipal charges is included in the total revenue that must be capped.

When a council announces a rate increase, it can also alter how much of that revenue will come from a municipal charge. Introducing a municipal charge or raising the proportion of revenue that comes from it will mean lowering the proportion from the rate-in-the-dollar component. This leads to reducing the relative burden on properties with high rateable value and transferring that burden to properties of lower value. The individual bills for lower value properties would also increase by more than the percentage cap (all other things being equal).

Other matters

Certain fees, charges and state levies for services such as waste collection or fire protection are not capped. The same is true of *special* rates (such as may be payable for a neighbourhood infrastructure project or service). All of these may appear on a rates notice.

[17] Total revenue from municipal charges must not exceed 80 per cent of total revenue from general rates.