

30/11/2018

The Hon Adem Somyurek MLC
Minister for Local Government
c/o Local Government Victoria
Level 7, 1 Spring Street
Melbourne VIC 3000

Dear Minister

Essential Services Commission advice on the rate cap for 2019-20

The Essential Services Commission is responsible for administering the Fair Go Rates system, producing council compliance reports and providing advice to the Minister for Local Government on the average rate cap for councils.

On 18 October 2018, the former Minister for Local Government requested the commission's advice on setting the average rate cap for councils for 2019-20, under section 185D(3)(a) of the *Local Government Act 1989* (the Act):

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

In response to that request, we provide this advice under section 185D(4) of the Act.

We are of the view that our formula for establishing the average rate cap, as published in our final paper *Advising a local government efficiency factor* (March 2018), remains appropriate:

$$\text{Average rate cap} = ((1-\alpha) \times \text{CPI}_t) + (\alpha \times \text{WPI}_0)$$

The allowance made for labour costs in the average rate cap formula, through the Wage Price Index component, serves as a generalised acknowledgement that some costs, particularly direct and indirect labour costs, may be inflexible in the short to medium term.

This formula is revised from the original version published in *A Blueprint for Change – Local Government Rates Capping and Variation Framework Review* (September 2015), which has

underpinned our advice in previous years. The revised formula removes the efficiency factor and applies a decreasing weighting (α) to the Wage Price Index component of the rate cap. As proposed in our March 2018 final paper, for 2019-20, we apply a 90 per cent weighting to the forecast Consumer Price Index component for 2019-20 and a 10 per cent weighting to the forecast Wage Price Index component for 2016-17 ($WPI_0 = 3.25$).

The Wage Price Index component of our rate cap formula has been fixed at its value at the time the Fair Go Rates system was introduced (rather than being updated each year in our advice). This more accurately represents the prices of goods and services being purchased by councils under medium-term contracts at the time the rate capping regime was introduced.

The Department of Treasury and Finance will release its budget update with the relevant CPI forecast by 15 December 2018. Given our advice has been requested prior to the release of the budget update, this advice provides our recommended average rate cap for 2019-20 based on a range of possible forecasts of the CPI (table 1). For example, our formula would give an average rate cap of 2.58 per cent if the December CPI forecast from the Department of Treasury and Finance is unchanged from its May 2018 forecast.

Table 1 Recommended average rate cap for 2019-20 (per cent)

Based on a range of possible CPI forecasts

CPI forecast	2.00	2.25	2.50	2.75	3.00
Average rate cap	2.13	2.35	2.58 ^a	2.80	3.03

Note: The average rate cap results above include a 10 per cent weighting for the WPI component, using the Department of Treasury and Finance's December 2016 WPI forecast of 3.25 for 2016-17. ^a Average rate cap based on the Department of Treasury and Finance's May 2018 CPI forecast.

We recommend that a uniform cap should continue to apply for all councils in 2019-20. During our rate cap inquiry in 2015, we did not find any data that supported us recommending that a different cap should be set for different councils or council groups. We consider that the higher cap application process remains an efficient, transparent and participative mechanism for us to deal with the varying financial circumstances of individual councils.

Future estimates of the average rate cap using our formula

In addition to responding to your request, for information purposes only, we provide future estimates for the average rate cap based on our formula beyond the 2019-20 rating year. These forward estimates, set out in table 2, use the Department of Treasury and Finance's May 2018 forecasts, and provide an indication only of the trend in the resulting average rate cap.

Table 2 **Estimates of future average rate caps (per cent)**

Based on DTF forecasts of CPI as at May 2018

	2019-20	2020-21	2021-22
CPI forecast (May 2018)	2.50	2.50	2.50
WPI weighting	0.10	0.00	0.00 ^b
Efficiency factor ^a	None	None	None ^b
Average rate cap	2.58	2.50	2.50 ^b

^a In our 2015 report, we recommended an efficiency factor of zero in 2016-17 and increasing by 0.05 percentage points each year from 2017-18, subject to a detailed productivity analysis of the sector by the ESC. This analysis was completed in 2018, and our final proposal was to remove the efficiency factor from our rate cap formula and apply a decreasing weighting to the WPI component. ^b Subject to review. We anticipate undertaking another productivity analysis in 2020, to examine the longer-term opportunities for councils to pursue efficiencies and how these efficiencies might be shared with ratepayers.

As per the request from the former Minister, this advice will be published on our website following your announcement of the rate cap for 2019-20.

I would welcome the opportunity to discuss with you this advice and the commission's wider role in relation to the local government sector. Alternatively, your staff may contact Angelina Garces, Senior Regulatory Manager Local Government, on 03 9032 1337 to discuss any queries.

Yours sincerely



Dr Ron Ben-David
Chairperson

