24/11/2023

RM/23/26623

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 2024–25

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 16 October 2023, you requested the commission's advice on setting the average rate cap for councils for 2024–25, under section 185D(3)(a) of the Local Government Act 1989 (the Act).

The Department of Treasury and Finance (DTF) will release its Budget Update with the relevant CPI forecast in December 2023. We note that the department's CPI forecast for 2024–25, as published in the State Budget on 23 May 2023, is 2.75 per cent. We also note that a more recent average CPI forecast for 2024–25 from the Reserve Bank of Australia (RBA) on 10 November 2023 is 3.4 per cent.

Although there is general agreement that inflation has passed its peak, inflation rates have remained persistently high since the May forecast, with headline inflation in Melbourne being 4.9 per cent as of September 2023. Given the recency of the RBA's forecast, we anticipate that the CPI forecast announced in the 2023–24 Budget Update from the department in December 2023 will be similar to the RBA's. We note that RBA's forecast pertains to the broader Australian context, while the department's forecast specifically applies within the context of Victoria.

We recommend the average rate cap set equal to the 2023–24 Budget Update forecast of the CPI for 2024–25 from the DTF. Our reasoning is set out in Attachment A.

Additionally, we recommend that a uniform cap continue to apply to all councils in 2024–25. 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, can 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 average rate cap for 2024–25 is that there should not be an adjustment to the CPI forecast announced in the December Budget Update. For example, if the forecast is 3.2 per cent, then our adjustment is zero and our recommended rate cap is 3.2 per cent. If the forecast is 3.4 per cent, then our adjustment is zero and our recommended rate cap is 3.4 per cent.

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

Kate Symons
Chairperson

Attachment A – rate cap rationale

On 16 October 2023, you requested the commission's advice on setting the average rate cap for councils for 2024–25, under section 185D(3)(a) of the Local Government Act 1989 (the Act), and 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.

Our advice for 2024–25 is that the rate cap should be set to the forecast CPI announced in the DTF's 2023–24 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.

The RBA is forecasting a slower decline in inflation than initially expected

In the absence of knowing what the DTF's forecast in December 2023 will be, we have considered the RBA's most recent forecast. On 10 November 2023, the RBA released the CPI forecast for 2024–25, indicating a projection of 3.4 per cent, an average of December 2024 and June 2025 forecasts. According to RBA's statement on 7 November 2023, inflation in Australia has passed its peak but is still too high and is proving more persistent than expected a few months ago.[1] Considering the persistence of inflation in Australia, surpassing earlier expectations, the recency of the RBA's forecast provides us with an expectation that the DTF will likely form a similar view in setting its CPI forecast in the December Budget Update.

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

In forming our advice, we analyzed council financial data, price indices relevant to the sector, and economic forecasts from the RBA and the DTF. We met with stakeholders, including representatives from FinPro and the Municipal Association of Victoria. We also reviewed the 2023–24 analysis of council budgets conducted by Local Government Victoria (LGV) alongside the results of 2021–22 audits of the local government sector conducted by the Victorian Auditor-General's Office (VAGO).

[1] Reserve Bank of Australia (2023), Statement by Michele Bullock, Governor: Monetary Policy Decision.

Based on our review, analysis, and engagement with stakeholders, five key observations have informed our rate cap advice:

- While council cash reserves are declining, the sector maintains low levels of debt and stable borrowing levels.
- Council costs increased at a slower rate than inflation during 2022–23, but at a higher rate than the current rate cap of 3.5 per cent.
- Construction costs continue to rise but at a slower pace than last year.
- Expected future wage increases have the potential to raise council costs in the future.
- Major driving factors of the overall increase in CPI are not key council cost components.

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

While council cash reserves are declining, the sector maintains low levels of debt and stable borrowing levels

In recent years, councils have been utilizing their cash reserves to sustain service levels as their own-source revenue was affected by low average rate increases relative to actual inflation and other revenue reductions due to lockdowns and other impacts of the coronavirus pandemic. 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 because of the pandemic. While most councils working capital ratios are still in an appropriate range, the downward trend may not be sustainable in the longer-term.

Between 2018–19 and 2023–24, councils' cash reserves, as represented by the working capital ratio, decreased from an average of 320 per cent to 220 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 2023–24, 15 councils are budgeting for a working capital ratio between 100 and 150 per cent, and 4 councils are budgeting for a ratio below 100 per cent. However, the deterioration in cash reserves is not uniform across the sector, with 25 councils budgeting to maintain a working capital ratio above 200 per cent in 2023–24.

Though council cash reserves are deteriorating, the sector generally exhibits low debt levels. 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. Based on Local Government Victoria's 2023–24 analysis of council budgets, the sector's borrowing levels remained stable. Our analysis of council financial data shows that from 2018–19 to 2022–23, the proportion of council loans and borrowing relative to rates revenue decreased from 16.4 per cent to 13.7 per cent. However, councils are projecting an increase in borrowing over the next four years, with an average projected rate of 18.5 per cent.

Council costs increased at a slower rate than actual inflation during 2022–23, 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 were larger than in previous years (as shown in Table 1 below). For the Melbourne component of CPI, actual inflation was 4 per cent in 2021–22 and 7 per cent in 2022–23, compared to rate caps of 1.5 per cent and 1.75 per cent for the respective years.

Anticipated differences between actual and forecast inflation were also observed, as illustrated by historical data in Table 1.

The DTF's Budget forecast in May 2023 shows that headline inflation in Melbourne is expected to be around 4.25 per cent in 2023–2024 and 2.75 per cent in 2024–2025. However, we note that CPI's fuel, electricity, and rent components 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 face, we recalculated local government cost indices adopted in other jurisdictions (New South Wales, South Australia and Tasmania). When updated with price inputs relevant to the Victorian setting, the three indices estimate that Victorian council costs increased by around 3.9 to 4.3 per cent from September 2022 to September 2023. Over the same period, Melbourne headline inflation was 4.9 per cent. We also note that rate caps in 2021–22 and 2022–23 were lower than increases in council costs, and this trend continues to hold for the 2023–24 rating year as of September 2023.

Table 1 Rate cap, actual inflation, cost indices, and forecasts (Unit: %)

	2018–19	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25	2025–26
Rate cap	2.25	2.5	2.0	1.5	1.75	3.5	TBD	TBD
Actual inflation[(a)]	1.7	1.7	1.4	4.0	7.0	4.9	-	-
Cost indices[(b)]	2.6 to 2.7	0.3 to 1.2	1.6 to 2.0	4.7 to 6.1	4.2 to 4.7	3.9 to 4.3	-	-
DTF CPI forecast[(c)]	-	-	2.25	1.5	1.75	4.0	2.75	2.5
RBA CPI forecast[(d)]	-	-	1.85	1.1	2.25	4.45	3.4	2.9
DTF WPI forecast[(c)]	-	-	3.25	1.75	2.0	3.5	3.5	3.25
RBA WPI forecast[(d)]	-	-	2.3	1.4	2.5	3.9	3.7	2.9

[(a)] Actual inflation for Melbourne in 2023–24 is sourced from ABS's data as of September 2023 (the latest data available).
[(b)] We recalculated local government cost indices that are adopted in other jurisdictions (New South Wales, South Australia and Tasmania), using Victorian data. Cost indices in Victoria were observed in June at the end of each financial year. In 2023–24, due to data unavailability, cost indices were observed in September 2023 instead.
[(c)] Melbourne CPI and WPI (Victoria) forecasts are sourced from the Department of Treasury and Finance's Victorian Budget Update in May/Pre-election of the previous year. For example, forecasts for 2024–25 are observed in DTF's May 2023 Update. Forecasts for 2025–26 are also from DTF's May 2023 Update.
[(d)] Australia CPI and WPI forecasts are sourced from the Reserve Bank of Australia's Forecast Table - Statement on Monetary Policy in November each year and are calculated as an average of the two relevant quarters. Forecasts for both 2024–25 and 2025–26 are sourced from RBA's Forecast Table on 10 November 2023.

Construction costs continue to rise but at a slower pace than last year

The cost indices take into account various components of CPI, as well as the wage price index (WPI) and the producer price index (PPI). The inclusion of the PPI accounts for changes in construction costs, representing around 25 per cent of total council expenses in 2023–24. The roads and bridges construction component of the PPI increased by 3.8 per cent from September 2022 to September 2023, compared to 10 per cent over the same period last year.

Using data from 2017–18 to 2021–22, VAGO reports that councils had a significant underspend trend for actual capital expenditure compared to their budgeted spending, which may indicate challenges with effective capital budgeting and ongoing management by the sector. Moreover, some councils face challenges in delivering planned capital works and often carry undelivered projects forward to the next financial year, which affects their ability to deliver the planned projects for that year. Some council stakeholders have reported that these challenges may stem from pressures related to the gap between the CPI and the rate cap, the inflationary environment, and the rising costs of delivering services and materials.

Wage increases are expected in the future

The inclusion of the WPI accounts for changes in employee costs, which are budgeted to account for around 40 per cent of total council expenses in 2023–24. From September 2022 to September 2023, the public sector component of the WPI in Victoria rose by 2.8 per cent. This applies to employees of councils and does not extend to wage costs that would be captured by contractors performing work for councils. While public sector wages have not kept pace with inflation, current forecasts show they are expected to rise. The Victorian May Budget Update forecasts a WPI increase of 3.5 per cent in 2024–25.

Our data shows that the average council enterprise agreements (EA) rate increase for 2023–24 was 3.5 per cent. However, many councils are renegotiating employment agreements that have expired or will expire by the end of 2023–24. Based on the Fair Work Ombudsman website, 33 councils will have expired EA by the end of 2023–24.

More broadly, the Fair Work Commission's minimum wage decision, which applies to contractors performing work for councils, increased the minimum wage by 5.75 per cent in 2023. Some council stakeholders have reported that councils are responding to the increased minimum wage and their renegotiated EAs by reducing the use of contractors and consultants, and councils are recognizing their limited capacity to absorb anticipated EA cost increases without affecting services and potentially reducing headcount.

Major drivers of the overall increase in CPI are not key council cost components

For the Melbourne component of CPI, electricity increased by 10.1 per cent, and gas rose by 19.1 per cent from September 2022 to September 2023. Based on our calculation of cost indices, these are among the largest drivers of council cost increases as of September 2023.[2] However, these cost components only represent 1.9 per cent and 0.1 per cent of total council expenditure in 2023–24, respectively.

In our view, the gap between the rate cap and inflation, rising construction costs, and the expectation of future wage increases have the potential to present major cost pressures on councils going forward. Given the combination of these cost pressures and a persistent inflationary environment, we expect the DTF's CPI forecast to land somewhere in the vicinity of the 3.4 per cent forecast by the RBA.[3]

[2] Other major drivers of council cost increases include insurance, motor vehicle parts, printing, publishing and advertising, and plant and equipment (furniture) costs as of September 2023.

[3] We also note that the bond-linked CPI forecasts within our relevant sectors, like water and energy, anticipate an inflation estimate of 3.31 per cent for the year 2024–25.

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 hardship policies and programs can be effective in supporting ratepayers experiencing vulnerability.