

27/11/2017

The Hon Marlene Kairouz MP
Minister for Local Government
121 Exhibition Street
Melbourne VIC 3000

Dear Minister

Essential Services Commission advice on the rate cap for 2018-19

On 2 November 2017, you requested the commission's advice on setting the average rate cap for councils for 2018-19, under section 185D(3)(a) of the *Local Government Act 1989*:

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

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

We are of the view that the formula for establishing the average rate cap, as published in our final report *A Blueprint for Change – Local Government Rates Capping and Variation Framework Review* (September 2015), remains appropriate:

$$\text{Average rate cap} = (0.6 \times \text{CPI}) + (0.4 \times \text{WPI}) - \text{efficiency factor}$$

The formula applies a 60 per cent weighting to the rate of increase in the CPI and a 40 per cent weighting to the Wage Price Index, less an efficiency factor. The allowance made for labour costs in the average rate cap formula serves only as a generalised acknowledgement that some costs, particularly direct and indirect labour costs, may be inflexible in the short to medium term.

We have applied an efficiency factor of 0.10 percentage points for 2018-19 as recommended in our 2015 report. This is based on an efficiency factor of zero in 2016-17, increasing by 0.05 percentage points each year thereafter. We are currently in the process of undertaking a productivity study, looking at options for setting a local government efficiency factor. This project has yet to be completed.

The Department of Treasury and Finance will release the budget update by 15 December 2017. The CPI and WPI forecasts may differ from those in the May 2017 budget. Table 1 provides the average rate cap for 2018-19 based on possible combinations of the CPI and WPI forecasts. For example, our formula would give an average rate cap of 2.35 per cent if the CPI and WPI forecasts from the Department of Treasury and Finance are unchanged from the May 2017 forecasts.

Table 1 Recommended average rate cap for 2018-19 (per cent)

Based on a range of possible CPI and WPI forecasts

	WPI = 2.25	WPI = 2.50	WPI = 2.75	WPI = 3.00	WPI = 3.25
CPI = 1.75	1.85	1.95	2.05	2.15	2.25
CPI = 2.00	2.00	2.10	2.20	2.30	2.40
CPI = 2.25	2.15	2.25	2.35 ^a	2.45	2.55
CPI = 2.50	2.30	2.40	2.50	2.60	2.70
CPI = 2.75	2.45	2.55	2.65	2.75	2.85

Note: The average rate cap results above include an efficiency factor adjustment of 0.10 percentage points. ^a Average rate cap based on the Department of Treasury and Finance's May 2017 CPI and WPI forecasts.

We recommend that a uniform cap should continue to apply for all councils in 2018-19. 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 2018-19 rating year. These forward estimates, set out in table 2, use the Department of Treasury and Finance's forecasts (as at May 2017), and provide an indication only of the trend in the resulting average rate cap.

We note that our productivity study will be completed in early 2018, and our future advice on the average rate cap for 2019-20 onwards is likely to incorporate our recommended approach to setting a local government efficiency factor from this study.

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

Based on DTF forecasts of CPI and WPI as at May 2017

	2019-20	2020-21
CPI forecast (May 2017)	2.50	2.50
WPI forecast (May 2017)	3.00	3.25
Efficiency factor ^a	0.15 ^a	0.20 ^a
Average rate cap	2.55	2.60

^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 (to be completed early 2018). We plan to apply the recommended approach resulting from the productivity study from 2019-20 onwards.

If you or your staff have any queries, please contact me on 9032 1316 or Andrew Chow on 9032 1323.

Yours sincerely

Dr Ron Ben-David
Chairperson

cc: The Hon Robin Scott MP, Minister for Finance