21/11/2025

CM/25/24526

The Hon. Nick Staikos MP
Minister for Local Government
2 Treasury Place
EAST MELBOURNE VIC 3002

Dear Minister

Essential Services Commission advice on adjustments for 2026–27 rate cap

On 24 October 2025, you requested the commission's advice on any adjustments to the Consumer Price Index (CPI) to assist you in setting the average rate cap for councils for 2026–27, under section 185D(3)(a) of the *Local Government Act 1989*.[1]

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

Our advice is that there should not be an adjustment to the CPI forecast for 2026–27 announced in the Department of Treasury and Finance's December Budget Update (See Attachment A for our reasoning).

For example, if the forecast is 3.0 per cent, then our adjustment is zero and our recommended rate cap is 3.0 per cent. If the forecast is 3.25 per cent, then our adjustment is zero and our recommended rate cap is 3.25 per cent.

We recommend the same cap be applied to all councils.

Recommended rate cap

The Department of Treasury and Finance (DTF) will release its Budget Update with the relevant CPI forecast in December 2025. We note that the department's most recent CPI forecast for 2026–

[1] The Consumer Price Index (CPI) is defined in the *Local Government Act 1989* as meaning the forecast Melbourne consumer price index, as published in the budget update prepared under the Financial Management Act 1994 or the pre-election budget update prepared under Division Six of Part 5 of that Act.

27, published in the State Budget on 20 May 2025, is 2.75 per cent. We also note that the Reserve Bank of Australia (RBA) projects inflation in Australia will remain above the target range of 2–3 per cent for some time before easing towards slightly above the midpoint of the range by late 2027.

In Victoria, inflation has continued to come down since its peak, with Melbourne's headline inflation recorded at 2.6 per cent as of September 2025.[2] Our analysis of council cost indices for the 2025–26 financial year also indicates that actual council costs rose by 2.7 to 3.3 per cent as of September 2025. These figures closely aligned with the DTF's forecast of 3.0 per cent for the 2025–26 financial year in the December 2024 Budget Update and are in line with the rate cap set for 2025–26. We note that in November 2025, the Reserve Bank of Australia (RBA) revised its CPI forecasts for 2026–27 to 2.95 per cent, up slightly from 2.75 per cent in August, reflecting stronger-than-expected headline inflation. We expect DTF's forecast inflation in the December 2025 Budget Update will be similar, at around 3.0 per cent.

For the 2026–27 rating year, we recommend no adjustment to the December 2025 Budget Update forecast of the CPI for 2026–27 from DTF. Our reasoning is set out in Attachment A.

Additionally, we recommend that a uniform cap continue to apply to all councils in 2026–27. 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. In 2025, two councils applied to us for a higher cap and were approved in full.

Effective support for ratepayers

Any increase in rates has the potential to raise concerns about affordability, making it important that councils provide effective support for ratepayers experiencing hardship. This becomes even more critical when councils are seeking a higher cap, as proactive measures can help ensure that affordability concerns are addressed while maintaining financial sustainability. Our experience from other sectors suggests that a proactive approach to supporting ratepayers experiencing hardship would benefit both ratepayers and councils. This is consistent with the advice we provided you on the hardship guideline in 2023. We note a draft guideline has been released for consultation and welcome the progress that has been made.

Councils can apply for a higher cap

The observations we make in forming this advice are broad by necessity and reflect the experience of the sector as a whole. The purpose of the rate cap is not to address the needs of individual councils. Councils can apply for a higher rate cap if they cannot maintain the financial capacity to

[2] Actual inflation for Melbourne is sourced from ABS data as of September 2025 (the latest data available). The ABS does not provide a statewide CPI, it publishes CPI data for the capital cities in each state instead. Accordingly, Melbourne CPI is used as a proxy for Victorian CPI.

perform their functions in the delivery of services and critical infrastructure. Councils that are concerned about their financial sustainability or their ability to adequately deliver services and infrastructure should be engaging with their communities about the need for a higher cap.

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

Yours sincerely

Gerard Brody
Chairperson

Attachment A – rationale for our advice

On 24 October 2025, you requested the commission's advice on the following matters, under section 185D(3)(a) of the *Local Government Act 1989*, to assist you in setting the average rate cap for councils for 2026–27:

- 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).
- The commission's preferred option if more than one option is recommended.

Our advice for 2026–27 is that there should not be any adjustments to the forecast CPI announced in the Department of Treasury and Finance (DTF)'s December 2025 Budget Update in setting the rate cap for all councils.[3] We expect the forecast CPI will be around 3.0 per cent.

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.

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

In forming our advice, we analysed council financial data, price indices relevant to the sector, and economic forecasts from the RBA and the DTF. Over the past two years, the Municipal Association of Victoria (MAV) provided us with its calculations of council cost index, applying its own methodology.[4] We also reviewed the 2025–26 analysis of council budgets conducted by Local Government Victoria (LGV) alongside the results of 2023–24 audits of the local government sector conducted by the Victorian Auditor-General's Office (VAGO).

The following key observations have informed our advice:

- Actual inflation was below the rate cap in 2024–25, while increases in council costs were in line with the rate cap. These trends are expected to continue into 2025–26.
- Construction and wage costs are expected to rise faster than inflation. However, increases in these costs might be offset by slower growth in other cost components, keeping overall council cost increases in line with the rate cap.
- While cash reserves are declining for some councils, the sector is overall budgeting for an operating surplus and maintaining low levels of debt with stable borrowing levels.

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[3] The CPI is defined in the *Local Government Act 1989* as meaning the forecast Melbourne consumer price index, as published in the budget update prepared under the Financial Management Act 1994 or the pre-election budget update prepared under Division Six of Part 5 of that Act.

[4] The Municipal Association of Victoria's cost index is presented in Table 1.

- The RBA forecasts inflation to stay above target in the near term (2.95 per cent for 2026–27), but easing towards slightly above the midpoint of the target range by 2027.

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.

Actual inflation was below the rate cap in 2024–25, while council costs rose in line with the rate cap, and these trends are expected to continue into 2025–26

As the rate capping framework is forward-looking, differences between actual inflation and the rate cap should be expected. Over most of the observed period, actual inflation has been below the rate cap. The exceptions were in 2021–22 and 2022–23, when actual inflation exceeded the rate cap by a significant margin, largely reflecting the economic uncertainty and volatility associated with the impacts of the coronavirus pandemic. These years also saw notable gaps between actual and forecast inflation. In 2024–25, actual inflation again fell below the rate cap, and based on the latest available data as of September 2025, this trend is expected to continue into 2025–26.

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	2026–27	2027–28
Rate cap	2.25	2.5	2.0	1.5	1.75	3.5	2.75	3.0	TBD	TBD
Actual inflation[(a)]	1.7	1.7	1.4	4.0	6.9	4.0	2.0	2.6	-	-
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	3.1 to 4.0	2.2 to 2.8	2.7 to 3.3	-	-
MAV's cost index	2.42	0.48	2.07	5.68	4.81	3.64	3.04	3.3	-	-
DTF CPI forecast[(c)]	-	-	2.25	1.5	1.75	4.0	2.75	2.5	2.75	2.5
DTF WPI forecast[(c)]	-	-	3.25	1.75	2.0	3.5	3.5	3.25	3.25	3.25

[(a)] Actual inflation for Melbourne in 2025–26 is sourced from ABS data as of September 2025 (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 2025–26, due to data unavailability, cost indices were observed in September 2025 instead.
[(c)] Melbourne CPI and Wage Price Index (WPI) (Victoria) forecasts are sourced from the Department of Treasury and Finance's Victorian Budget in May/pre-election of the previous year. For example, forecasts for 2026–27 are observed in the DTF's May 2025 State Budget. Forecasts for 2027–28 are also from the DTF's May 2025 State Budget.

Our calculation of local government cost indices for 2025–26 indicated that Victorian council costs rose by around 2.7 to 3.3 per cent from September 2024 to September 2025.[5] Over the same period, Melbourne headline inflation was 2.6 per cent.[6] We note that the numbers in the MAV's council cost index are generally positioned between the figures in the cost indices we constructed. We also note that these increases in council costs have tracked closely with the rate caps since 2023–24 and are expected to persist into 2025–26. This suggests that a rate cap within the range of 2.7 to 3.3 per cent would be appropriate, reflecting expected movements in council costs.

We expect the DTF's forecast inflation in the December 2025 Budget Update will be around 3.0 per cent.

Higher construction and wage costs are expected to be offset by slower growth in other council cost components

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 in the cost indices accounts for changes in council construction costs, particularly for roads and bridges, which represented around 25 per cent of total council expenses. From September 2024 to September 2025, the road and bridge construction component of the PPI increased by 3.5 per cent, up from 2.3 per cent over the same period last year.

The inclusion of the WPI accounts for changes in employee costs, which represented around 37 per cent of total council expense. From September 2024 to September 2025, the public sector component of the WPI in Victoria rose by 3.2 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. Current forecasts indicate that public sector wages are expected to rise at a higher rate than inflation. The DTF's May 2025 State Budget forecasts a WPI increase of 3.25 per cent for 2026–27, higher than the CPI forecast for the same period.

Many councils are renegotiating employment agreements that have expired or will expire by the end of 2025–26. Based on the Fair Work Ombudsman website, 41 councils will have expired enterprise agreements (EA) by the end of 2025–26. More broadly, the Fair Work Commission's minimum wage decision, which applies to contractors performing work for councils, increased the minimum wage by 3.5 per cent in 2025.[7]

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5 To help understand the actual cost pressures councils faced, we recalculated local government cost indices adopted in other jurisdictions (New South Wales, South Australia and Tasmania) by updating with price inputs relevant to the Victorian setting.

6 Actual inflation for Melbourne is sourced from ABS data as of September 2025 (the latest data available). The ABS does not provide a statewide CPI, it publishes CPI data for the capital cities in each state instead. Accordingly, Melbourne CPI is used as a proxy for Victorian CPI.

7 Fair Work Ombudsman (2025), [Minimum wages increase from 1 July 2025](#).

Future increases in wages and construction costs may push council cost indices slightly above inflation. However, historical trends suggest that slower movements or declines in other cost components tend to offset these effects. As a result, overall increases in council costs have generally remained aligned with the rate cap, as discussed above.

While some councils' cash reserves are declining, the sector is budgeting for an operating surplus and maintaining low levels of debt with stable borrowing levels

Our analysis of council financial data indicates that, between 2018–19 and 2024–25, councils' cash reserves (as represented by the working capital ratio) decreased from an average of 320 per cent to 256 per cent. While this remains within a high range overall, 6 councils are budgeting for a working capital ratio below 100 per cent, and 21 councils are budgeting for ratios between 100 and 150 per cent in 2025–26. These figures highlight a reduction in cash reserves for some councils compared to 2018–19, when no councils reported a ratio below 100 per cent, and only two reported ratios between 100 per cent and 150 per cent. However, the deterioration in cash reserves is not consistent across the sector, with 38 councils budgeting to maintain a working capital ratio above 200 per cent in 2025–26.

VAGO's 2025 report notes that the decline in cash reserves reflects councils drawing on cash to meet operating costs and capital expenditure. Despite this reduction, VAGO observes that cash reserves remain sufficient to meet short-term obligations, as many councils continue to generate cash inflows.[8] LGV's 2025–26 analysis of council budgets similarly indicates that overall council finances remain sound. In particular, 72 out of the 79 councils are budgeting for an operating surplus in 2025–26, while the remaining seven councils (mainly small shires) are forecasting an operating deficit. This suggests that the vast majority of councils are expected to generate sufficient revenue to meet their operating costs.[9]

In addition, the sector generally exhibits low levels of debt and stable borrowing 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 VAGO's 2025 report and LGV's 2025–26 analysis of council budgets, the sector's debt levels remained relatively low and borrowing levels remained stable. Our analysis of council financial data also shows that the proportion of council loans and borrowing relative to rates revenue decreased from 16.4 per cent to 15.4 per cent from 2018–19 to 2024–25. Over the next four years, councils project borrowing to average 16.2 per cent. The sector's levels of indebtedness are also expected to remain stable, compared to the past seven years.

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8 VAGO (2025), Results of 2023–24 Audits: Local Government.

9 Local Government Victoria (2025), 2025–26 Council Budget Summary.

Based on data from 2019–20 to 2023–24, VAGO's report highlights a significant underspend by councils on capital work programs, relative to their budgeted amounts. However, this trend has shown signs of slowing since 2021–22.[10] The underspend trend existed pre-pandemic and may indicate challenges with effective capital budgeting and ongoing management by the sector. It also indicates that spending on asset expansion, renewal, upgrade or replacement may not keep pace with community needs. VAGO reports that due to underspending in capital budgets and advance payments received in prior years, many councils have built up high cash balances, particularly in the interface council cohort.

Our observations were made across the sector as a whole, with an understanding that individual councils may face unique circumstances based on their financial position and specific challenges. We consider that assessing each council's unique circumstances is more appropriately addressed through the higher cap application process.

The Reserve Bank of Australia forecasts inflation to stay above target in the near term, but easing towards slightly above the midpoint of the target range by 2027

In November 2025, the RBA released its CPI forecast for 2026–27, projecting inflation at 2.95 per cent, the average of its December 2026 and June 2027 forecasts. This represents a slight upward revision from the 2.75 per cent projection published in August 2025. According to the RBA, headline inflation in Australia rose to 3.2 per cent over the year to the September quarter, a stronger outcome than anticipated in August. This increase was attributed to higher electricity prices following the partial withdrawal of household rebates, price increases in more volatile items such as fuel, and higher underlying inflation (which is expected to be temporary). The RBA expects both headline and underlying inflation to stay above the 2–3 per cent target range through much of next year, before easing towards slightly above the midpoint of the target range by late 2027.[11] We anticipate that the DTF will take these factors into account when providing the Budget Update.

Rate cap to align with CPI forecast

In our view, while the expectation of future increases in labour costs, slightly elevated inflation, and factors beyond councils' control may place some upward pressures on council costs going forward, the sector's overall financial position remains sound, supported by low levels of debt and borrowing. We also expect council cost movements to continue aligning closely with actual inflation through 2025–26.

[10] In 2023–24, 17 per cent of the sector's actual capital expenditure was below budget. In the prior year it was 26.2 per cent. VAGO (2025), Results of 2023–24 Audits: Local Government.

[11] Reserve Bank of Australia (2025), Statement by the Monetary Policy Board: Monetary Policy Decision; Reserve Bank of Australia (2025), Statement on Monetary Policy – November 2025.

Accordingly, we consider that the rate cap for 2026–27 should be set in line with the DTF's December 2025 Budget Update forecast of the CPI for that year, which we expect to be around 3.0 per cent.

Balancing council sustainability and ratepayer affordability

In providing our advice, we aim to strike a balance between the two objectives of the rate capping framework: supporting the long-term financial sustainability of councils and protecting the long-term interests of ratepayers. While a lower rate cap can help ease affordability pressures for the communities, it may also limit councils' capacity to deliver essential services and maintain infrastructure over time. On the other hand, higher rate increases can raise concerns about affordability. In our view, this highlights the importance of councils having well-functioning hardship policies and programs to support ratepayers experiencing vulnerability.