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Dr R. Ben-David  
Chairman  
Essential Services Commission  
Level 37 / 2 Lonsdale Street  
Melbourne VIC 3000

Dear Dr Ben-David *Ron*

### **Local Government Rates Capping and Variation Framework Review – Draft Report**

The City of Port Phillip is proud of its leadership in delivering valued and affordable services to its community. While the City of Port Phillip has a strong focus on continually improving the efficiency and effectiveness of its service delivery, a rates capping framework that unreasonably restricts rate revenue may result in councils being forced to reduce the scope of services valued by the community, or to assume an inappropriate level of financial risk.

In this submission, the City of Port Phillip provides alternative recommendations to ensure a workable and effective rates capping regime. These include:

- setting the rate cap at a sufficient level to ensure councils' can cover reasonable cost increases and address the asset 'renewal gap' without applying for a variation
- implementing a variation process that is not unreasonably onerous and adequately considers each council's specific context and capability
- ensuring that the timing of the rates capping framework allows for sufficient consultation and consideration of annual budgets.

The City of Port Phillip welcomes the opportunity to inform the development of a rates capping framework that best supports its own objective of delivering services that are highly valued by our community and represent value for money.

Yours sincerely



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**SUBMISSION BY THE CITY OF PORT PHILLIP TO THE  
ESSENTIAL SERVICES COMMISSION  
LOCAL GOVERNMENT RATES CAPPING AND VARIATION FRAMEWORK REVIEW  
DRAFT REPORT**

**SUMMARY**

In its submission to the Essential Services Commission's (ESC's) Local Government Rates Capping and Variation Framework review consultation paper, the City of Port Phillip (CoPP) outlined principles by which rates capping framework should be developed. These principles best support CoPP's own objective of delivering services that are highly valued by our community and represent value for money. At the same time, it is critical that the rates capping framework avoids outcomes that compromise service delivery to the community and/or the financial sustainability of councils.

It is CoPP's view that many of the draft recommendations included in the ESC's draft report are consistent with the principles provided in CoPP's first submission. However, CoPP also has a number of significant concerns regarding the likely outcomes under a rates capping regime based on the draft recommendations.

In this submission, CoPP provides specific feedback on each of the ESC's draft recommendations and in some cases provides an alternative recommendation.

**ESC Draft recommendation 1**

The Commission recommends that there should be one rate cap that applies equally to all councils in Victoria.

CoPP acknowledges that the simplicity of one rate cap has benefits for administration and public understanding of rates capping. However, one rate cap will present difficulties given the diversity of the council rate and revenue practices across the sector. To mitigate these difficulties, the rate cap should be set a level that does not compromise councils' financial sustainability (refer to CoPP's position on draft recommendation 4). Notwithstanding this, the impact of one rate cap on the local government sector should be closely monitored.

**ESC Draft recommendation 2**

The Commission recommends that:

- revenue from general rates and municipal charges should be subject to the rate cap
- revenue from special rates and charges, 'revenue in lieu of rates' and the fire services levy should not be included in the rate cap and
- service rates and charges should not be included in the rate cap, but be monitored and benchmarked.

CoPP supports the rate cap applying to general rates only and supplementary rates being excluded from the rate cap in the year they occur.

It is CoPP's view that the framework should allow councils to transition future revenue from rates to service charges.

**ESC Draft recommendation 3**

The Commission recommends that the cap should be applied to the rates and charges paid by the average ratepayer. This is calculated by dividing a council's total revenue required from rates in a given year by the number of rateable properties in that council area at the start of the rate year.

CoPP supports this draft recommendation.

**ESC Draft recommendation 4**

The Commission recommends that the annual rate cap should be calculated as:  
Annual Rate Cap = (0.6 x increase in CPI) + (0.4 x increase in WPI) - (efficiency factor)  
With: CPI = DTF's forecast published in December each year and WPI = DTF's forecast published in December each year.

The efficiency factor will initially be set at zero in 2016-17 but increasing by 0.05 percentage points each year from 2017-18. The Commission will undertake a detailed productivity analysis of the sector to assess the appropriate long-term rate for the efficiency factor.

The rate cap proposed under these draft recommendations is set too low. At this level, there is a significant risk that the rate cap will compromise councils' financial sustainability and community service delivery.

In the ESC's draft report, it notes that a potential unintended consequence of the proposed rate capping and variation framework is that:

*"The cap is set too low and does not adequately represent council costs, creating negative impacts such as short-term budgeting, reductions in investment and maintenance of infrastructure, and reduced services contrary to the needs of the community."*

It is CoPP's view that this consequence is a *highly likely* outcome of the draft recommendations. The Consumer Price Index (CPI) and Wage Price Index (WPI), by themselves, are not satisfactory indexes to apply to the funding of local government service delivery. In particular, these indexes do not adequately address the significant asset 'renewal gap' that currently exists across the local government sector. The renewal gap can be defined as the difference between the funding councils need to renew existing assets and the funding actually allocated for asset renewals.

The significance of the local government renewal gap has been widely reported. The Victorian Auditor-General's Office (VAGO), in its 2014 report *Asset Management and Maintenance by Councils*, states:

*"The continuing growth in councils' asset renewal gaps remains of considerable concern."*

In the same report, VAGO identifies the renewal gap across the local government sector as \$225 million in 2012, double the renewal gap that existed in 1998. While this can be partially addressed through improved asset management practices in the sector, the proposed rate cap will be inadequate in allowing councils to close the renewal gap.

In response to this draft recommendation, CoPP proposes the following:

1. That no efficiency factor be incorporated in to the rate cap formula.

The rate cap will act as a sufficient efficiency target in its own right and impede the ability of councils to address the asset renewal gap. Where councils have the capability to achieve efficiency savings in addition to the rate cap, this should be done voluntarily and monitored within the framework. CoPP notes that it has identified \$5 million of permanent operational savings in the last two financial years.

2. That an allowance of 0.5% be added to the rate cap as a 'renewal gap factor'.

The 'renewal gap factor' would provide councils the means to close the existing renewal gap in approximately 10 years. This is based on the \$225 million renewal gap identified by VAGO and total sector rates revenue of \$4.0 billion in the same year (refer VAGO report *Local Government: Results of the 2011-12 Audits*), resulting in a rates funding deficiency of 5.6%.

Based on the current renewal gap trend, there will still be significant upward pressure on the renewal gap in the meantime, due to the continuing ageing of assets and other asset renewal related cost escalations. Councils would have to manage this through improved asset management practices and within conventional funding sources.

#### **ESC Draft recommendation 5**

The Commission recommends that the 2015-16 rates (general rates and municipal charges) levied on an average property should be adopted as the starting base for 2016-17.

CoPP supports this draft recommendation.

#### **ESC Draft recommendation 6**

The Commission recommends that the framework should not specify individual events that would qualify for a variation. The discretion to apply for a variation should remain with councils.

CoPP supports this draft recommendation, noting the wide variety of possible events that may give rise to a variation.

More generally, CoPP remains concerned that the resources required to make a variation application will be prohibitive, particularly for smaller councils. Despite improved governance within the sector, there remains a realistic risk that councils have a political aversion to making variation applications under certain circumstances. This will likely have the following unintended consequences:

- reductions in renewal investment in critical infrastructure
- reduced service levels contrary to the needs of the community.

This can be addressed by:

- setting the rate cap at a sufficient level to ensure councils' can cover reasonable increases in costs and address the asset renewal gap without applying for a variation
- implementing a variation process that is not unreasonably onerous and adequately considers each council's specific context and capability.

**ESC Draft recommendation 7**

The Commission recommends that the following five matters be addressed in each application for a variation:

- The reason a variation from the cap is required
- The application takes account of ratepayers' and communities' views
- The variation represents good value-for-money and is an efficient response to the budgeting need
- Service priorities and funding options have been considered
- The proposal is integrated into the council's long-term strategy.

CoPP supports this draft recommendation.

**ESC Draft recommendation 8**

The Commission recommends that in 2016-17, variations for only one year be permitted. Thereafter, councils should be permitted to submit and the Commission approve, variations of the length set out below.

<b>First year of variation</b>	<b>Length of permissible variation</b>
2016-17	One year (i.e. 2016-17 only)
2017-18	Up to two years (i.e. 2017-18 only or 2017-18 and 2018-19)
2018-19	Up to three years (i.e. up to 30 June 2021)
2019-20 and beyond	Up to four years (i.e. up to 30 June 2023)

It is CoPP's view that that a variation for up-to four years should be available for councils from 2017-18, to align with the new council term that will commence in October 2016.

**ESC Draft recommendation 9**

The Commission recommends that it should be the decision-maker under the framework, but only be empowered to accept or reject (and not to vary) an application for variation.

CoPP supports the ESC, as the independent economic regulator, being the decision-maker under the framework.

**ESC Draft recommendation 10**

The Commission recommends that it monitor and publish an annual rates report on councils' adherence to the cap and any approved variation conditions.

CoPP supports this draft recommendation.

**ESC Draft recommendation 11**

The Commission recommends that it monitor and publish an annual monitoring report on the overall outcomes for ratepayers and communities.

CoPP supports this draft recommendation and emphasises the need for information that improves public understanding of council rating practices linked to service delivery outcomes. The impact of setting one cap across the sector, and the level of the rate cap, should be closely monitored for any unintended consequences.

**ESC Matter for consideration**

The Commission recommends that the Government consider making a formal review of the rates capping and variation framework a statutory obligation. The review should draw on any data and trends identified through the ongoing monitoring regime and all interested parties should have an opportunity for the sector to provide input to that review. The Commission considers a review period of 4 years to be appropriate.

CoPP supports this recommendation.

**ESC Matter for consideration**

The Commission recommends that the Government consider amending the *Local Government Act 1989* to require that service rates and charges must reflect the efficient costs of providing the underlying service.

CoPP requires further information before it would support such a recommendation. CoPP notes that there are many pricing and rating principles that councils use to achieve their policy objectives. For example, councils:

- set parking fees with (partial) reference to increasing the municipality's competitiveness by increasing visitation and trade
- are limited by statute in the setting of some charges, such as planning fees (which therefore creates a funding shortfall for those services)
- apply subsidies to user fees and charges for some services where a sound policy rationale exists, such as protecting the vulnerable, as opposed to recovering the full costs of those services.

These pricing and rating principles may not be consistent with a strict definition of 'economic efficiency', but may be legitimate with respect to achieving community driven policy outcomes.

**ESC Matter for consideration**

The Commission recommends that the Government consider initiating a periodic review to ensure that statutory fees continue to reflect councils' efficient cost of providing statutory services.

CoPP supports this draft recommendation. CoPP notes that, in many cases, statutory fees that are limited by their governing statute do not reflect councils' cost of delivering those services (for example, local government planning fees).

**ESC Proposed timing and process**

ESC announces cap	December 2015
All councils submit baseline data (budget)	January 2016
Councils notify ESC of intention to seek a variation	January 2016
Council applies for variation, submits baseline data (budget)	March 2016
ESC assesses council variation applications	March-May 2016
ESC notifies councils of decisions	May 2016
Councils consult on draft budget	May 2016
Councils formally adopt budget	June 2016

It is CoPP's view that the timing of the ESC's notification of a variation decision (May 2016) does not provide sufficient time for councils to consult on, and endorse, a budget within the statutory time frame and with sufficient time for councils to properly consider these outcomes.

This is a cause for significant concern for CoPP and may result in perverse outcomes such as councils preparing multiple budgets for public consultation (one with a variation approved and one without).

To address this, CoPP recommends that the ESC notify councils of a variation application outcome by April each year.