25/11/2024

RM/24/29327

The Hon Melissa Horne MP
Minister for Local Government
Level 16, 121 Exhibition Street
Melbourne VIC 3000

Dear Minister,

Essential Services Commission advice on adjustments for 2025–26 rate cap

The Essential Services Commission is responsible for administering the Fair Go Rates system and providing advice to the Minister for Local Government. On 11 October 2024, you requested the commission's advice on any adjustments to the CPI to assist you in setting the average rate cap for councils for 2025–26, under section 185D(3)(a) of the Local Government Act 1989 (the Act).[1]

The Department of Treasury and Finance (DTF) will release its Budget Update with the relevant CPI forecast in December 2024. We note that the department's CPI forecast for 2025–26, as published in the State Budget on 07 May 2024, is 2.50 per cent. The Reserve Bank of Australia (RBA) also notes that inflation in Australia has declined and is expected to head towards the target range of 2–3 per cent.

In Victoria, inflation has declined since its peak, with Melbourne's headline inflation recorded at 2.95 per cent as of September 2024.[2] Our analysis of council cost indices for the 2024–25 financial year also indicates that actual council costs rose by 2.6 to 2.9 per cent as of September 2024. These figures closely aligned with the DTF's forecast of 2.75 per cent for the 2024–25 financial year in the May and December 2023 Budget Updates.

[1] The Consumer Price Index (CPI) is defined in the Local Government Act 1989 as the Department of Treasury and Finance's forecast CPI under the Act.

[2] Actual inflation for Melbourne is sourced from Australian Bureau of Statistics (ABS)'s data as of September 2024 (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.

For the 2025–26 rating year, we recommend that there be no adjustment made to the December 2024 Budget Update forecast of the CPI for 2025–26 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 2025–26. 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. We note that no councils have applied for a higher cap since 2019–20, which marks the fifth consecutive year without any higher cap applications. A number of councils have approached us to express their consideration of applying for a higher cap next year.

Potential higher cap rate increases raise issues around how councils deal with ratepayers experiencing hardship. Balancing higher cap rate increases with effective hardship policies and programs is important to addressing ratepayer affordability concerns while ensuring council sustainability. Our experience from other sectors suggests that a proactive approach to dealing with ratepayers experiencing hardship would benefit both ratepayers and councils. This is consistent with the advice we provided you on the hardship guideline last year.

The observations we make in forming this advice are broad by necessity and reflect the experience of the sector as whole. The rate cap's purpose is not to address the needs 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. 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.

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 2025–26 announced in the December Budget Update. 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 2.5 per cent, then our adjustment is zero and our recommended rate cap is 2.5 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.

Gerard Brody
Chairperson

Attachment A –rationale for our advice

On 11 October 2024, you requested the commission's advice on the following matters, under section 185D(3)(a) of the Local Government Act 1989 (the Act), to assist you in setting the average rate cap for councils for 2025–26:

- 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 2025–26 is that there should not be any adjustments to the forecast CPI announced in the DTF's 2024 December Budget Update in setting the rate cap for all councils.[3] 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. We met with stakeholders, including representatives from FinPro and the Municipal Association of Victoria (MAV). This year, the MAV provided us with its calculations of council cost index, applying its own methodology.[4] We also reviewed the 2023–24 analysis of council budgets conducted by Local Government Victoria (LGV) alongside the results of 2022–23 audits of the local government sector conducted by the Victorian Auditor-General's Office (VAGO).

Based on our review, analysis, and engagement with stakeholders, the following key observations have informed our advice:

- Increases in council costs and actual inflation were in line with the rate cap in 2023–24, and this alignment is expected to continue into 2024–25.
- Increases in construction costs slowed down, while challenges in capital work delivery persist.
- Wage increases are expected in the future.
- Cash reserves are declining for some councils, but the sector maintains low levels of debt and stable borrowing levels.

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[3] The CPI is defined in the Local Government Act 1989 as the Department of Treasury and Finance's forecast CPI under the Act.

[4] The MAV's cost index is presented in Table 1.

- The RBA forecasts inflation to return to target range in 2025–26.

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.

Increases in council costs and actual inflation were in line with the rate cap in 2023–24, alignment expected to continue into 2024–25

As the framework is forward-looking, differences between actual inflation and the rate cap should be expected. Notably, substantial differences were observed in 2021–22 and 2022–23, as shown in the first two rows of Table 1. Anticipated differences between actual and forecast inflation were also observed in these two years, driven by ongoing economic uncertainty stemming from the impacts of the coronavirus pandemic.

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
Rate cap	2.25	2.5	2.0	1.5	1.75	3.5	2.75	TBD	TBD
Actual inflation[(a)]	1.7	1.7	1.4	4.0	6.9	4.0	2.95	-	-
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	2.6 to 2.9	-	-
MAV's cost index	2.42	0.48	2.07	5.68	4.81	3.64	3.04	-	-
DTF CPI forecast[(c)]	-	-	2.25	1.5	1.75	4.0	2.75	2.5	2.5
DTF WPI forecast[(c)]	-	-	3.25	1.75	2.0	3.5	3.5	3.25	3.25

[(a)] Actual inflation for Melbourne in 2024–25 is sourced from ABS's data as of September 2024 (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 2024–25, due to data unavailability, cost indices were observed in September 2024 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 2025–26 are observed in DTF's May 2024 Update. Forecasts for 2026–27 are also from DTF's May 2024 Update.

In 2023–24, however, actual inflation was closely aligned with the rate cap. This trend appears to be continuing into 2024–25, based on the latest available data as of September 2024. Our calculation of local government cost indices for 2024–25 also indicated that Victorian council costs rose by around 2.6 to 2.9 per cent from September 2023 to September 2024.[5] We note that the

[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.

numbers in the MAV's council cost index are generally positioned between the figures in the cost indices we constructed for all years considered. Over the same period, Melbourne headline inflation was 2.95 per cent.[6] We also note that the rate cap for 2023–24 was in line with council cost increases.

Increases in construction costs slowed down, while challenges in capital work delivery persist

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 2023 to September 2024, the road and bridge construction component of the PPI increased by 2.3 per cent, down from 3.8 per cent over the same period last year – both rising at a slower pace than inflation over these periods.

Based on data from 2017–18 to 2022–23, the VAGO's report highlights a significant underspend by councils on capital work programs, relative to their budgeted amounts.[7] This trend existed pre-pandemic and 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.

What we heard from stakeholders

Through our engagement with council peak bodies, some council stakeholders acknowledged these challenges persist, citing limited access to construction resources due to competitive state projects, natural disaster recovery, existing backlogs, and pressures from cumulative gap between the CPI and the rate cap. Rising service and material costs may also prevent some projects from proceeding as planned.

Wage increases are expected in the future

The inclusion of the WPI accounts for changes in employee costs, which represented around 40 per cent of total council expense. From September 2023 to September 2024, the public sector component of the WPI in Victoria rose by 2.4 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 slightly lagged behind inflation, current forecasts show they are

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[6] Actual inflation for Melbourne is sourced from Australian Bureau of Statistics (ABS)'s data as of September 2024 (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] VAGO (2024), Results of 2022–23 Audits: Local Government.

expected to rise. The Victorian May Budget Update forecasts a WPI increase of 3.25 per cent for 2025–26, 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 2024–25. Based on the Fair Work Ombudsman website, 47 councils will have expired enterprise agreements (EA) by the end of 2024–25. More broadly, the Fair Work Commission's minimum wage decision, which applies to contractors performing work for councils, increased the minimum wage by 3.75 per cent in 2024.[8]

What we heard from stakeholders

Some council stakeholders have noted that a number of councils, are finding it difficult to link wage increases to the rate cap as has been the case in the past because of cost of living pressures and the expectations of their workforce. Our data indicates that the average council EA rate increase for 2024–25 was around 2.75 per cent, ranging from 1.5 to 3.84 per cent. Last year's average increase was 3.5 per cent.

Meanwhile, some of them are struggling to attract labor resources. Factors beyond councils' control, such as increases in the superannuation guarantee and worker compensation insurance premium rate, are expected to drive up future council costs.

Cash reserves are declining for some councils, but the sector maintains low levels of debt and 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 224 per cent. While this remains within in a high range overall, 4 councils are budgeting for a working capital ratio below 100 per cent and 20 councils are budgeting for ratios between 100 and 150 per cent in 2024–25. 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 42 councils budgeting to maintain a working capital ratio above 200 per cent in 2024–25.

Though some councils' cash reserves are budgeted to decline, 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 LGV's 2023–24 analysis of council budgets, the sector's borrowing levels remained stable. Our analysis of council

[8] Fair Work Ombudsman (2024) Minimum wages increase from 1 July 2024.

financial data shows that from 2018–19 to 2023–24, the proportion of council loans and borrowing relative to rates revenue decreased from 16.4 per cent to 15.3 per cent. Over the next four years, councils are projecting a slight increase in borrowing, with an average projected rate of 17 per cent. The sector's levels of indebtedness are also expected to remain stable, compared to the past six years.

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. Councils with concerns about their financial sustainability or their capacity to continue delivering essential services and critical infrastructure should be engaging with their communities on the need for a higher cap. We note that in 2024–25, no councils applied for a higher cap. This marks the fifth consecutive year that no councils have applied for a higher cap since 2019–20.

The Reserve Bank of Australia (RBA) forecasts inflation to return to target range in 2025–26

In November 2024, the RBA released the CPI forecast for 2025–26, indicating a projection of 3.4 per cent, an average of December 2025 and June 2026 forecasts. According to the RBA, headline inflation in Australia has declined significantly and is expected to fall within the target range of 2–3 per cent over the coming year due to reduced fuel and electricity prices in the September quarter, alongside temporary cost-of-living support measures provided to households. However, underlying inflation, which is more indicative of inflation momentum, remains high because aggregate demand is still above the economy's supply capacity. This measure is expected to return to the target range by mid-to-late 2025 and to reach the midpoint of the target range by late 2026.[9,10]

In our view, while the expectation of future increases in labour costs and factors beyond councils' control have the potential to present some cost pressures on councils going forward, the sector's financial position remains sound, with low levels of debt and borrowing. In addition, we expect continued alignment between council cost increases and actual inflation into 2024–25. According to the DTF and RBA, inflation has eased and is projected to return to the target range.[11] As a result, we consider that the rate cap should align with the 2024–25 December Budget Update forecast of the CPI for 2025–26 from the DTF.

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[9] Reserve Bank of Australia (2024) Statement by the Reserve Bank Board: Monetary Policy Decision.

[10] Reserve Bank of Australia (2024) Statement on Monetary Policy – November 2024.

[11] We also note that the bond-linked CPI forecasts within our relevant sectors, like water and energy, anticipate an inflation estimate of 2.9 per cent for the year 2025–26.

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.