

7 December 2016  
**Our ref:** C/16/23068

The Hon Natalie Hutchins MP  
Minister for Local Government  
Level 27, 1 Spring Street  
Melbourne VIC 3000

Dear Minister

**ESSENTIAL SERVICES COMMISSION'S ADVICE ON THE  
AVERAGE RATE CAP FOR 2017-18**

On 15 November 2016, you requested the Commission's advice on the following matters in setting the average rate cap for 2017-18, pursuant to section 185D(3)(a) of the *Local Government Act 1989* (the Act):

- a recommendation for any adjustment(s) to be applied to Consumer Price Index (CPI) 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 and pursuant to section 185D(4) of the Act, we provide the following advice.

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

$$\text{ARC} = (0.6 \times \text{CPI}) + (0.4 \times \text{WPI}) - 0.05 \text{ efficiency factor}$$

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 (WPI), less an efficiency factor. The allowance made for labour costs in the rate cap formula serves only as a generalised acknowledgement that some costs, particularly direct and indirect labour costs, are inflexible in the short to medium term.

In the absence of further analysis, we have applied an efficiency factor of 0.05 percentage points for 2017-18 as recommended in our 2015 final report.

The Department of Treasury and Finance (DTF) will release the budget update on 15 December 2016. We expect that the CPI and WPI forecasts will differ from those in the May 2016 budget. We show in table 1 the possible ARCs for 2017-18 based on different CPI and WPI forecasts, where 2.65 per cent represents the ARC based on the forecasts from DTF in May 2016.

**Table 1: ARC based on different assumptions of CPI and WPI (per cent)**

	WPI = 2.25	WPI = 2.50	WPI = 2.75	WPI = 3.00 <sup>a</sup>	WPI = 3.25
CPI = 1.75	1.9	2.00	2.10	2.20	2.30
CPI = 2.00	2.05	2.15	2.25	2.35	2.45
CPI = 2.25	2.2	2.30	2.40	2.50	2.60
CPI = 2.50 <sup>a</sup>	2.35	2.45	2.55	2.65 <sup>a</sup>	2.75
CPI = 2.75	2.5	2.60	2.70	2.80	2.90

Note: Estimates includes an efficiency factor adjustment of 0.05 percentage points. <sup>a</sup> Based on DTF forecast from May 2016 Budget Papers.

We recommend that a uniform cap should apply for all councils in 2017-18. 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 council(s) 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.

Using DTF's forecasts for future years (as at May 2016) suggests the following estimates for the average rate cap.

**Table 2: Estimates for the average rate cap (per cent)**

Year	2018-19	2019-20
<b>CPI forecast (DTF)</b>	2.50	2.50
<b>WPI forecast (DTF)</b>	3.25	3.50
<b>Efficiency factor<sup>a</sup></b>	0.10	0.10
<b>Average rate cap</b>	2.70	2.80

<sup>a</sup> In our 2015 report, we recommended that an efficiency factor should initially be set at zero in 2016-17 and increase 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 by mid-2017, in order that the outcomes can be applied from 2018-19 and beyond).

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