ESSENTIAL SERVICES COMMISSION

A BLUEPRINT FOR CHANGE

Local Government Rates Capping & Variation Framework Review

Draft Report — Volume I

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MESSAGE FROM THE CHAIRPERSON

Over the last few months, the local government team and I have met with hundreds of people with an interest in local government. Our discussions have involved ratepayers, council staff, councillors, their representative bodies and other peak organisations. Without fail, our discussions have been informative and positive. We are very grateful that so many people were willing to spend so much time with us. Thank you.

During those discussions, I repeatedly committed that the local government rates capping and variation framework would not be an edifice to bureaucratic elegance. I also emphasised that we had no interest in injecting ourselves into those matters best decided by councils and their communities. The framework we are proposing in this draft report remains true to those commitments.

In many ways, the proposed framework largely relies on the transparent, deliberative and consultative processes that councils advised us they already adopt when setting their budgets and their rates. In this sense, the framework can be viewed as a quality assurance mechanism seeking to give ratepayers confidence that disciplined decision-making is being exercised by their councils, and by the sector as a whole.

This is not to say that the proposed framework does not impose any obligations on local government. Of course it does. The rate cap will limit future rate increases and councils will have some reporting obligations. However, we are very mindful to design a framework that, to the extent possible, uses information that is already collected by councils and relies on councils' own planning processes and consultation practices. Throughout our review, we have attempted to remain focussed on the needs of councils and their communities.

Have we succeeded in our ambitions? Well, that will become clearer as we embark on another round of discussions around the state. We are also inviting anyone with an interest in local government to provide us with a written submission outlining their observations and suggestions. Submissions are due by 28 August.

In order to facilitate the framework's implementation in time for the 2016-17 rating year, we have brought forward the completion date for this review by one month. Our final report will now be submitted to the Ministers for Local Government and Finance by the end of September. It will be made publicly available shortly afterwards.

Dr Ron Ben-David
Chairperson

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1 INTRODUCTION

In January 2015, the Essential Services Commission (the Commission) received terms of reference (see Appendix A) from the Minister for Finance (in consultation with the Minister for Local Government) to conduct a review and report on a local government rates capping and variation framework. In conducting the review we have had regard to the matters set out in the terms of reference.

We have been asked to design a framework that meets the Government's commitment to cap annual council rate increases as well as to develop a workable process to assess any proposals by councils for above cap increases ('variation process').

This draft report outlines the details of the framework that we are proposing and on which we now will consult with interested parties. It is presented in two volumes. This first volume sets out the key design features of the framework. Volume II (*Supporting Material and Analysis*) outlines the analysis we have undertaken to develop our proposed framework and includes draft guidance material. Both volumes can be found on our website.

1.1 WHAT IS A RATES CAPPING AND VARIATION FRAMEWORK?

A rates capping and variation framework should promote a transparent and independently verifiable decision-making process with regards to the trade-offs involved in determining council rates. Independent verification requires that the framework is overseen by an independent authority for the benefit of the community and ratepayers who, individually, have limited capacity to engage with these decision-making processes.

In many ways, the rates capping and variation framework largely relies on the transparent, deliberative and consultative processes that councils advised us they already adopt when setting their budgets and their rates. In this sense, the framework can be viewed as simply seeking to give ratepayers and the broader community confidence that disciplined decision-making is being exercised by their individual councils, and by the sector as a whole.

The three elements of the proposed framework are:

Rate cap — the maximum annual rate of increase that councils can apply to their rate revenue.

Variation process — a mechanism for councils to seek (and have considered) increases in rate revenue that are above the rate cap.

Monitoring and reporting — a means for verifying and reporting on compliance with the cap or variation conditions and providing accurate and reliable information about overall outcomes for ratepayers and communities under the framework. Monitoring and reporting also facilitates a process for identifying and addressing unusual or unexplained outcomes.

Chapters 2 to 4 outline our proposed approach for implementing each of these elements.

1.2 WHAT CONSULTATION HAVE WE UNDERTAKEN SO FAR?

In April 2015, we released a consultation paper which identified some key challenges in designing a rates capping and variation framework. That document outlined the eight principles that would guide us in developing the framework (box 1.1). Our subsequent consultations indicated widespread support for these principles. We are confident that the framework proposed in this draft report is consistent with them.

BOX 1.1 PRINCIPLES GUIDING THE FRAMEWORK'S DESIGN

Principle 1 — Local communities differ in their needs, priorities and resources.

Principle 2 — Local communities and ratepayers are entitled to hold their councils to the highest standards of accountability and transparency when setting rates.

Principle 3 — The framework should support the autonomy of councils to make decisions in the long-term interests of their community and ratepayers.

Principle 4 — Councils will need to satisfy the burden of proof outlined in the framework when seeking a variation above the cap.

Principle 5 — Rate increases should be considered only after all other viable options have been explored.

Principle 6 — The framework should support best practice planning, management systems and information sharing to uphold council decision-making.

Principle 7 — The framework should be flexible and adaptable.

Principle 8 — There should be few surprises for ratepayers and councils in the implementation of the framework.

Since releasing the consultation paper, we have consulted widely, including with:

- councils through one-on-one meetings and various broader sector forums
- ratepayer associations and individual ratepayers, including a forum with ratepayer associations
- peak bodies in the local government sector such as MAV, VLGA, LGPro and FinPro
- unions, private sector representatives and other peak bodies with an interest in local government, and
- with our colleagues in New South Wales at the Office of Local Government, the Independent Pricing and Regulatory Tribunal; and a few NSW councils.

We have also presented to the Fair Go Rates Reference Group established by the Minister for Local Government, as well as the Minister's Local Government Mayoral Advisory Panel.

We received 287 submissions from ratepayers, ratepayer associations, councils, council service providers, sector peak bodies, unions and community organisations in response to our consultation paper. Volume II provides a detailed analysis of the matters raised in submissions.

1.3 WHAT IS THE STRUCTURE OF THIS REPORT?

As noted above, chapters 2 to 4 outline our proposed approach for implementing each of the elements of the framework — namely, the design of the rate cap; the variation process if councils wish to raise rates above the cap; and the monitoring and public reporting to be undertaken by the Commission.

Chapter 5 considers other implementation details not covered in the earlier chapters and chapter 6 discusses some longer term opportunities afforded by the framework.

Our draft recommendations appear in chapter 7. The next steps in our consultation process are outlined in chapter 8, which also invites interested parties to make their views known about the draft framework.

2 THE RATE CAP

The terms of reference ask us to provide advice on how to implement the Government's commitment to cap annual council rate increases. This includes advice on such matters as: whether any refinements are warranted to a cap based solely on the Consumer Price Index (CPI); as well as the base to which the cap should apply.

This chapter outlines the key elements of the proposed approach to setting the cap.

Chapter 2 of Volume II provides more detailed discussion of how we arrived at our approach to setting the cap.

2.1 ONE CAP OR MANY?

There can be no doubt that there is very significant diversity of circumstances across the 79 councils operating in Victoria. Among other things, councils differ with regard to the services required by their communities, the state of the infrastructure under their management, the cost of delivering services, their reliance on different sources of revenue, their demographics and the economic circumstances of their communities, and the natural environment in which they operate.

Councils, peak bodies and other council groups have identified a number of factors which they suggest should be considered when setting the cap. Conversely, ratepayers and other organisations suggested that applying multiple rate caps across Victoria would lead to ratepayers being treated inequitably depending on the council area in which they live.

We have considered whether and how such matters might be taken into account when setting the rate cap. One option we considered was whether separate groupings of councils could be subject to different caps. We also examined the merits of an even more tailored approach whereby each council's rate cap would include adjustments accounting for that council's resource capacity, its rating history and the extent to which it controlled its costs and revenues.

On balance, we have decided against these approaches for a number of reasons. Our primary concern was the arbitrariness of such arrangements. The adjustments that might be made under either of these approaches are not self-evident and would involve a large degree of judgement. We expect neither the community nor councils would be well served with a capping regime that relied extensively on such subjective assessments. We were also concerned that any effort to tailor the rate cap would suggest a false degree of precision in setting the cap and may lead to confusion in the community.

For these reasons, we are recommending that there should be only one rate cap that applies equally to all councils in Victoria. We have concluded that the variation process described in chapter 3 provides a more efficient, transparent and participative mechanism to deal with individual council's circumstances when the capped increase in rate revenue is considered to be insufficient.

2.2 WHICH REVENUES COME UNDER THE RATE CAP?

The terms of reference require us to provide advice on what would be the composition of the revenue base to be capped. Currently, councils are allowed under the legislation to levy general rates, municipal charges, service rates and charges (also referred to as garbage rates and charges), special rates and charges, and 'revenue in lieu of rates'. These are defined in box 2.1.[1]

[1] More detailed information can be found in Volume II of this draft report.

BOX 2.1 THE DIFFERENT TYPES OF RATES LEVIED BY COUNCILS

General rates — These are applied as a percentage of each property's valuation; can be a uniform rate or a number of different rates for different classes of ratepayers.

Municipal charges — These are to cover some of the administrative costs of the council and are required by the *Local Government Act 1989* to be no more than 20 per cent of the total revenue raised from the combination of municipal charges and general rates.[a]

Service rates and charges — These are to cover services to properties such as waste management and water provision. The only service rates and charges currently in practice are those collected for the collection and disposal of refuse.

Special rates and charges — These are paid by a particular group of property owners for any council service or activity that will be of special benefit to them, such as footpaths, kerbs and channels.

Revenue in lieu of rates — These are payments received on unrateable lands such as railway land, State and Federal Government buildings, mining lands, power stations, airports and wind farms.

[a] Administrative costs are not defined in the *Local Government Act 1989.*

We are recommending that the rate cap should apply to **general rates and municipal charges** only — noting that these two rate bases account for about 88 per cent of the total rate revenue raised by councils.[2] The cap need not apply to **special rates and charges** and **revenue in lieu of rates** because there are adequate checks and balances already in place in the current legislation for these rates and charges. For example, the legislation specifies that special rates and charges should only be used for the purposes of defraying any expenses in relation to the performance of a function which will be of special benefit to the persons required to pay the special rate or special charge.

[2] Based on 2013-14 rates and charges data collected by the VGC from councils.

For now, we are recommending that **service rates and charges** (garbage rates and charges) be excluded from the rate cap.[3] In our survey of council rates and charges, councils reported that their garbage rates and charges are cost reflective and market tested.[4] Therefore, for now, we are not suggesting that these charges be made subject to the rate cap. Nonetheless, we will monitor and benchmark garbage rates and charges.[5] If we find unexplained differences across councils, or if we find that councils are disproportionately allocating their overhead costs to their service rates and charges, then we will make appropriate recommendations to the Government at that time.

The **fire service levy** should be excluded from the cap on the grounds that it is not within the control of the councils, who are acting only as collection agencies for this state levy. In contrast, the **landfill levy** is a levy imposed directly on councils. For now, we are proposing to exclude the landfill levy from the cap as many councils include it in their garbage rates and charges (which we are excluding from the cap).

Supplementary rates are additional rates collected during the course of the year if the value of a property is altered after rate notices have been issued. Supplementary valuations may be a result of either changes in valuation of existing properties or entry of new properties — for example, due to renovations or subdivisions, respectively.[6]

At the end of each financial year, a council will adjust its valuation base and the base for its general rate revenue to include the actual supplementary valuation and supplementary rate revenue received. The adjusted amounts become the basis for determining the next year's rate base. That is, valuations are only treated as 'supplementary' in the year they occur. Thereafter, they are included in the valuation and rates of the properties in question. We are proposing that supplementary rates be excluded from the rate cap in the year they occur.

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[3] There are different practices among councils in covering the cost of garbage services with 72 councils levying a specific garbage charge, while seven councils cover these costs through their general rate revenue.

[4] 38 out of 62 councils reported that they fully outsource their garbage services through competitive bidding, 19 councils partly outsource this service and 4 councils provide the services in-house (one council did not respond to the question).

[5] Councils' garbage related costs will be monitored separately from landfill levy related costs.

[6] Some of the examples cited by councils on their websites for undertaking supplementary valuations are when properties are physically changed (e.g. when buildings are altered, erected or demolished), amalgamated, subdivided, portions sold off, rezoned or are affected by road construction. Supplementary valuations bring the value of the affected property into line with the general valuation of other properties within the municipality. Values are assessed at the same date of the general valuation currently in use.

2.3 SHOULD THE CAP BE APPLIED TO TOTAL RATE REVENUE OR RATE REVENUE PER ASSESSMENT?

In our consultation paper, we asked stakeholders whether the cap should apply to each council's total rate revenue or to average rate revenue per assessment. We raised the same question during many of our meetings with interested parties. Not surprisingly, views were mixed.

Many councils preferred a revenue cap for its simplicity. Other councils opposed the revenue cap on the assumption that supplementary rates would not be added into the base. Some councils and peak organisations clearly preferred capping average rate revenue per assessment. Interestingly, we encountered differing views on why one option might be preferred over another. For example, we encountered quite opposite views about which form of capping was preferable for growth councils.

From a technical perspective, both options are viable and relatively straightforward to administer (particularly with the exclusion of supplementary rates). Both options maintain councils' flexibility to adopt or change their rating policies — that is, both options allow councils to rebalance their revenue raising efforts between general rates and municipal charges and between different types of ratepayers (differential rating).[7]

We consider that the Government's objective in establishing a rate cap is to give ratepayers confidence in councils' rate setting process. We believe it is reasonable to assume that most ratepayers will not be directly involved in the councils' budget and rate setting processes. The only observation on which these ratepayers can rely will be the observed change in the 'amount owing' on their rate notice each year. As such, we are proposing that the framework cap rate revenue per assessment rather than total rate revenue as this most closely reflects most ratepayers' experience with the council rating.

[7] Differential rates are where councils set different rates in the dollar for different categories of rateable land. The council may for example, have differential rates for farm land, various categories of residential property or commercial/industrial properties – each paying a higher or lower rate in the dollar.

However, even under a binding rate cap, individual ratepayers will experience rate changes that differ from the capped rate of increase. There are numerous reasons for these differences that are beyond the control of a rates capping and variation framework, including:

- market forces altering the relative value of properties within an individual municipality
- owner actions altering the value of properties, for example, through renovation or subdivision or
- council policies such as altering the differential rates at which different classes of properties are rated.

In light of these uncontrollable factors, we consider that the best option for the rate cap involves applying the rate cap to a 'typical' or 'average' ratepayer — although we recognise that there will be some or many ratepayers who experience higher and lower rate changes than this notional ratepayer.

In other words, we are recommending that that cap should be applied to the rates and charges paid by the average ratepayer and that this is calculated by dividing a council's total required rate revenue in a given year by the number of rateable properties in that council area. The relationship between these variables is shown in box 2.2. We expect that both these quantities should be readily available to councils and should be readily verifiable.

BOX 2.2 RELATIONSHIP BETWEEN THE RATES BY THE AVERAGE RATEPAYER AND A COUNCIL'S RATE IN THE DOLLAR

The notional 'average ratepayer' is most simply defined as the ratepayer who owns an average valued property in each local government area. The total rates paid by this ratepayer will be the, so called, 'rate in the dollar' applied by the local council multiplied by value of the average ratepayer's property. The simplest possible approach to calculating the value of this average ratepayer's property is to divide the total value of rateable properties by the total number of rateable properties in each council area.

$$Average\ property\ value\ = \frac{Total\ Value\ of\ rateable\ properties}{Number\ of\ rateable\ properties}$$

When determining the 'rate in the dollar' to apply in a particular year, a council will divide the total revenue it requires from rates by the total value of rateable properties in its municipality.[8]

$$Rate\ in\ the\ dollar = \frac{Total\ revenue\ required\ from\ rates}{Total\ value\ of\ rateable\ properties}$$

The rates paid by the average ratepayer will be the product of these two factors.

$$Rates\ paid\ by\ average\ ratepayer = (Rate\ in\ the\ dollar) * (Average\ property\ value)$$

Substituting the two earlier equations into this relationship and simplifying gives:

$$\boldsymbol{Rates\ paid\ by\ average\ ratepayer\ = \frac{Total\ revenue\ required\ from\ rates}{Number\ of\ rateable\ properties}}$$

which is the measure to which the rate cap will be applied each year.

[8] For the purpose of simplifying this discussion, 'rates' refers to general and municipal rates. But in practice, some councils levy municipal charges on a property basis.

The rate cap would apply to the year-by-year increase in the rates paid by this average rate payer. Even so, it will be important for councils (and the Commission) to communicate that this is an 'average' outcome and some ratepayers can expect higher increases, while others will experience lower increases for the reasons stated above.

We have also considered whether 'rebalancing constraints' should be applied. These constraints would limit how far above (or below) the cap an individual ratepayer's rates could be increased (or decreased) in a particular year. For now, we are not proceeding with this idea on the basis that we expect the cost of implementing the required changes to councils' billing systems would outweigh any benefits produced by doing so.

We will create a working group composed of council representatives to develop the specific information we will collect from councils annually to support the proposed rates capping framework.

2.4 HOW SHOULD THE RATE CAP BE CALCULATED?

The terms of reference for this review indicate that the annual rate of change in the CPI should be the Commission's starting point when considering the allowable increase in council rates. We are also required to provide advice on 'any refinements to the nature and application of the cap that could better meet the Government's objectives.' Importantly, the terms of reference require us to have regard to the pressures applying on ratepayers and on councils — for example, through references such as: 'contain[ing] the cost of living' and 'sustainability of councils' financial capacity', respectively.

In considering how best to balance these requirements, we have considered which measure of CPI to adopt and which refinements are best placed to address the pressures faced by ratepayers and councils.

There are numerous available measures of CPI and these can be backward looking (that is, telling us what inflation was in a past period) or forward looking (that is, based on a forecast of what inflation will be in a future period). Each option has its merits and each has its flaws.

Based on our consultations to date, we are recommending that the framework should adopt a cap based on the forecast rate of increase in the CPI for the year in question. This approach appears to align with councils' current practices of estimating their annual budget using their forward assumptions of CPI or some other relevant indices.

The CPI forecast we are proposing to adopt is produced by the Victorian Department of Treasury and Finance (DTF), which is published in May as part of the State Budget and is updated in December. On each occasion, DTF releases its four year forecast of inflation. Importantly, the CPI forecasts released by DTF are adjusted for volatile items, making them more stable than the 'headline' rate of inflation typically reported in the media.

Table 2.1 shows the indicative increases in CPI based on DTF's forecasts in May 2015.

TABLE 2.1 DTF'S FORECASTS OF RATE OF INCREASE IN CPI (UNDERLYING)
Per cent

	2015-16	2016-17	2017-18	2018-19
Underlying CPI forecast	2.75	2.75	2.50	2.50

Councils and their representative bodies have made repeated representation to the Commission that a cap based solely on changes in the CPI may unduly constrain their operations. The relatively high proportion of employee costs,[9] and the relatively high rate of increase in those costs in recent years across the local government sector, appears to be the primary cause for this concern.

Elsewhere in the economy, where prices are regulated, the price regulator will generally not concern itself with an individual service provider's costs of procuring services. Rather, benchmarks for the cost of acquiring those services will be used to inform price decisions. We accept that there are merits for adopting a similar approach within the rates capping and variation framework. On the basis of the evidence before us, we consider that any such refinements to the rate cap should be limited to councils' main source of concern, namely, labour costs.

[9] These claims are supported by the Victorian Grants Commission's data.

Councils vary considerably in terms of the composition of their costs and the proportion comprising labour costs. The average proportion that labour costs represent across the Victorian local government sector is around 40 per cent. We therefore propose that this proportion be assigned to labour costs when constructing each year's rate cap. In other words, a 60 per cent (i.e. 100 - 40 per cent) weighting would be applied to the rate of increase in the CPI and a weighting of 40 per cent would be applied to the benchmark rate of increase in labour costs.

As with CPI, we propose adopting the Wage Price Index (WPI) increases reported by DTF as the benchmark rate of increase for labour costs in the rates capping framework.

Table 2.2 shows the indicative increases in the WPI based on DTF's forecasts in May 2015.

TABLE 2.2 DTF'S FORECASTS OF RATE OF INCREASE IN WPI
Per cent

	2015-16	2016-17	2017-18	2018-19
WPI forecast	3.25	3.5	3.5	3.5

While this proposed adjustment for labour accounts for the cost pressures facing local government, it does not address the 'cost of living' pressures faced by ratepayers. The standard approach to creating incentives for service providers to pursue efficiencies in their operations, and then share the benefits of those efficiencies with 'customers', is to impose an efficiency factor on those service providers. Known as the 'efficiency factor', this imposed efficiency requirement can vary significantly from sector to sector. For example, in our water pricing function we impose an efficiency factor of between 1-2 per cent and for tow trucks the efficiency factor has been as low as 0.5 per cent. The NSW rates capping regime adopts an efficiency factor of 0.04 per cent.

We believe there is merit in adopting an efficiency factor in the proposed rates capping and variation framework. However, given that at the outset of the new framework councils will have locked in costs under contracts, we propose that the efficiency factor initially be set at zero, increasing by 0.05 percentage points each year. We propose to undertake a detailed productivity analysis of the sector to assess the appropriate long-term rate for the efficiency factor.

On the basis of these refinements, the annual rate cap would be given by:

Annual Rate Cap = (0.6 x increase in CPI)
+ (0.4 x increase in WPI)
- (efficiency factor)

Table 2.3 shows some indicative forecasts for the annual rate cap (as at July 2015)

TABLE 2.3 INDICATIVE FORECASTS FOR THE ANNUAL RATE CAP (AS AT JULY 2015)

Per cent

	2016-17	2017-18	2018-19
Underlying CPI forecast (60 per cent weighting)	2.75	2.5	2.5
Plus WPI forecast (40 per cent weighting)	3.5	3.5	3.5
Less Efficiency factor	0	0.05	0.10
FORECAST ANNUAL RATE CAP	**3.05**	**2.85**	**2.80**

As already noted, we are not proposing to adjust the cap to reflect other cost pressures faced by local councils, such as the costs of materials of construction. Similarly, in order to keep the cap as simple as possible, we have not attempted to adjust the cap to account for structural differences between councils, for cost pressures beyond councils control and infrastructure renewal. We consider these matters will be more appropriately dealt with through the variation process described in chapter 6.

2.5 WHAT IS THE BASE YEAR FOR SETTING THE CAP?

Our preliminary view is that we will adopt the 2015-16 revenue from general rates and municipal charges as the starting base for 2016-17. Similarly, we will require councils to advise us of the number of rateable properties as at 1 July 2016.

2.6 WHAT INFORMATION WILL BE REQUIRED EACH YEAR?

As noted in the section 2.4 above, in May and December each year the Commission will publish updated forecasts for the annual rate cap as shown in table 2.3. The December forecast, would be the binding cap for the following financial year, irrespective of any updated figures published by DTF the following May.

In order to support the rates capping framework, the Commission will collect information from councils each year. We will create a working group composed of council representatives to develop the specific information we will collect from councils annually to support the proposed rates capping framework. Our initial considerations of this information are set out in table 2.4.

TABLE 2.4 INDICATIVE INFORMATION TO BE MONITORED FOR COMPLIANCE WITH THE CAP AND APPROVED VARIATIONS ($ million)

	Actual (2015-16)	Forecast (2016-17)	Forecast (2017-18)
Total council revenue requirement (all sources)			
General rates			
Municipal charges			
Service rates & charges			
Special rates & charges			
Supplementary rates			
Statutory fees & fines			
User fees & charges			
Net gain(loss) on disposal of property, infrastructure, plant and property			
Other income			
Grants (all sources)			
Contributions – monetary			
Contributions – non monetary			
Miscellaneous			
Total value of rateable properties[a]			
Total number of rateable properties as at 1 July[a] (no.)			
Breakdown of garbage related costs:			
Council cost			
Landfill levy			

[a] At the commencement of the financial year.

3 THE VARIATION PROCESS

The terms of reference ask the Commission to ensure that the variation framework:

- provides a mechanism through which councils can justify any proposed increase above the cap
- takes into account factors that impact on local governments' short and long-term financial outlooks
- specifies any technical requirements (including information requirements) on councils that request exemptions from the cap.

This chapter outlines the variation process by which we propose councils will be able to seek an increase in their rates above the rate cap.

3.1 WHY IS A VARIATION PROCESS NEEDED?

In chapter 2 we describe how it is not practical to design a rate cap that takes into account the diversity, different needs and different legacies faced by individual councils. Nevertheless, the increase permitted by the rate cap represents the annual additional revenue requirement typically expected for councils on a state-wide basis. Some councils may consider this additional revenue insufficient in light of their particular circumstances. A variation process provides a mechanism for individual councils to seek a rates increase in excess of the cap.

The budget pressures facing councils are many. Priorities change over time. New services are introduced, while other services are expanded or discontinued. New infrastructure is built and existing infrastructure needs to be maintained. Revenues fluctuate either because of economic circumstances or following policy decisions by other levels of government. And, on occasion, natural disasters happen.

Sometimes budget pressures will arise due to a specific or one-off expenditure requirement. At other times, budgets will struggle with more generalised cost pressures.

The variation process needs to accommodate different sources of cost pressures and it should be able to respond flexibly in different situations. Likewise, councils should be expected to assess all their options before seeking a rate variation. If this were not the case, the rate cap and variation process would be of little benefit.

When faced with budget pressures, councils can pursue one or more of the following strategies; and the preferred response is likely to depend on the source of the budget pressure and whether it is momentary or structural. The four broad options facing councils include:

- scrutinising the full suite of their operations and planned investments for opportunities to deliver outcomes more efficiently
- ensuring the range of services they are delivering align with their community's highest priorities
- assessing the possibility and merits of alternative funding or financing options for different activities and investments and
- increasing their revenues through higher rates and charges.

The role of representative councils with delegated responsibilities from and accountable to their communities, is to assess how best to manage the trade-offs between these four options. This responsibility rests inherently with local government. A well-designed variation process will not shift this responsibility away from councils — rather, by promoting transparency and engagement, a variation framework ensures all options are canvassed before rate increases (above the cap) are pursued.

3.2 WHEN CAN COUNCILS SEEK A VARIATION?

Councils have generally argued that the variation process should include a broad list of events after which a variation should be permitted (subject to community consultation). The submissions that listed specific reasons for possible variations focused on factors outside of councils' control such as the loss of a revenue source, natural disasters, demographic changes, and superannuation requirements. Conversely, ratepayer groups emphasised that councils should be required to justify fully any variation and they should not be permitted to circumvent the rate cap by unnecessarily increasing their borrowings. Submissions from a variety of parties were concerned that the variation process should not be so onerous as to prevent otherwise justifiable rate increases above the cap.

We consider that embedding a list of predetermined triggers (including events) in the rates capping and variation framework would be counterproductive. We propose not to define triggers that would qualify for a variation because:

- in general terms, we consider councils and ratepayers are best placed to decide whether circumstances warrant applying for a variation
- there is no self-evident list of triggers, so any attempt to produce such a list is likely to be a distraction
- disputes are likely to arise about whether particular circumstances conform with the wording of the triggers
- we expect that very few situations will involve single and easily identifiable events that displace all other options before councils
- we believe that situations involving sudden and genuine budget emergencies will be self-evident and that all relevant parties will have a strong incentive to cooperate on quickly identifying a solution
- we prefer to keep the rules of the framework as simple as possible to make it easy to understand and to avoid a legalistic process.

We also consider that there are no circumstances under which councils should be prohibited from seeking a rate variation above the cap. In other words, we do not propose to define situations where a council's application for a variation would be automatically accepted or automatically rejected. We consider that councils should always have the opportunity to apply for a variation and that each application should be assessed on its merits.

That said, we are likely to have an unfavourable disposition towards applications for higher rates due to unbudgeted increases in controllable costs in the past year (more commonly known as 'cost blow outs').

How we would propose to assess applications is discussed in the following section.

3.3 HOW WOULD A COUNCIL DEMONSTRATE THE NEED FOR A VARIATION ABOVE THE RATE CAP?

There are many reasons a council might consider applying for a variation. Even when we face two applications for seemingly similar reasons, we expect they will differ on the facts when scrutinised more closely. This suggests that different information will probably be required for the purposes of assessing each application. This makes it impossible to establish a single set of information requirements that would be required to accompany each application for a variation. This also suggests that if we attempted to establish a single list of requirements it would probably impose irrelevant (and costly) obligations on most councils seeking a variation.

A more accommodating and flexible approach involves providing guidance to councils on the subject matter areas that will need to be considered when an application for a variation above the cap is being assessed. We propose the following five matters would need to be addressed in each application.

- **The reason for a rate increase greater than the cap.** The reason for the variation will need to be articulated clearly and the amounts involved will need to be quantified. Reasons could include: change in costs, a change in asset management, or a change in the services that councils are required to provide. These claims would need to be substantiated.
- **The application takes account of ratepayers' and communities' views.** The application would need to demonstrate that the views of ratepayers and communities have been identified and describe how their concerns have been addressed. This consultation will need to include the presentation of other realistic options for meeting the funding need, and the trade-offs those options would entail. Importantly, applications will need to account for ratepayers' views on specific expenditure items or cost pressures (where relevant) as well as their impact on the council's overall budget position.

  The Commission will not prescribe how councils ought to engage with their communities. Such decisions naturally sit with councils rather than the Commission. Nevertheless, we have developed a set of four key engagement principles which we expect to be reflected in the engagement undertaken in support of an application for variation (see table 3.1).

- **The variation represents good value-for-money and is an efficient response to the need.** This means that, where additional expenditure is involved, any amount proposed to be recovered through higher rates should represent a good value option for achieving the desired outcome. It would be helpful to submit business cases or cost-benefit analyses where higher rates are being proposed in order to fund the delivery of new or expanded services, or new infrastructure.
- **Service priorities and funding options have been considered**. The application will need to demonstrate that councils have considered reprioritising funding from other areas of expenditure; and the reasons for not proceeding with that reprioritisation (in part or in whole). The application will need to demonstrate that councils have whether other suitable funding or financing options have been considered and the decision (and reasoning) reached in relation to those options.
- **The proposal is integrated into the council's long-term strategy**. The matters giving rise to the variation application should be consistently represented and addressed in all of the council's relevant planning instruments — for example: its Council Plan and Asset Management Plan.

TABLE 3.1 RATEPAYER AND COMMUNITY ENGAGEMENT PRINCIPLES

Principles	
Principle 1	The engagement program must contain clear, accessible and comprehensive information and follow a timely process to engender feedback from the community
Principle 2	The engagement program should be ongoing and tailored to community needs
Principle 3	The engagement program should prioritise matters of significance and impact
Principle 4	The engagement program should lead to communities becoming more informed about council decision-making

In table 3.2 (at the end of this chapter), we provide guidance on how we would expect councils to address these five subject matter areas in their applications for a variation. Under each heading, the table sets out:

- questions that councils should ask about whether they require a variation, and if so, what form the proposed variation might take
- actions councils should take when they develop a variation application and
- evidence that councils should provide in their variation applications.

This table is for guidance only and the ultimate information requirements will depend on the type of variation sought by councils. Councils will be responsible for providing sufficient information to justify a variation application.

3.4 WHO DECIDES WHETHER A VARIATION IS APPROVED?

Some submitters suggested the Commission should only have a role in advising councils on whether their proposed variation is appropriate (leaving councils to decide whether to proceed with the increase). Such a light-handed approach does not appear to be consistent with the regime envisaged in the terms of reference or in public statements made by the Government.

We consider there are three viable options for who administers the rate variation process. Of course, there are variations on each option.

The first option would involve the Minister for Local Government being responsible for considering each application and deciding whether to approve the application. Under this option, the Minister could seek the advice of her department in relation to each application. The second option is similar to the first but the Commission would be responsible for independently advising the Minister on the appropriate response to each application. Under the third option, the Commission, as an independent and standalone authority, would be responsible for assessing and determining the response to all applications. The Commission could be given this authority directly or under delegation from the Minister.

Public statements from the Government suggest that the third option is preferred.

3.5 WHAT DECISIONS SHOULD BE MADE IN RESPONSE TO AN APPLICATION FOR A VARIATION?

Councils will need to be very precise about the rate outcome they are seeking through the variation process. It cannot be left to the Commission to second-guess a council's true intentions in making an application.

Where the Commission determines that an application satisfactorily justifies the need for the proposed rate variation, it would simply approve the proposal. However, we expect that some applications will not justify adequately the rate increase they seek. In such situations, we recommend that the Commission only be given the power to reject the application (in which case, the council would be bound by the rate cap).

We do not recommend the Commission be given the power to substitute an alternative rate increase to the one proposed. Nor do we suggest the Commission be given the power to negotiate with the council on an alternative rate increase. Such powers are occasionally given to bodies such as the Commission. In those instances, the regulator collects detailed information about the costs and revenues of the businesses being regulated (and develops detailed financial models of those businesses). We have not considered such an intrusive and resource intensive approach when designing the rates capping and variation framework outlined in this draft report. These more intrusive options could be considered at a later date if required.

3.6 HOW DIFFICULT WILL IT BE TO HAVE A VARIATION APPROVED?

As already noted, we consider each application should be assessed on its merits. In conducting that assessment, it is incumbent upon the Commission to outline its expectations in advance (table 3.2 begins this process). Nonetheless, some degree of judgement will unavoidably need to be exercised by the Commission when assessing how well an application meets those expectations.

In exercising that judgement, we must strike a balance between being too lenient and being too restrictive. Ratepayers would soon lose confidence in the framework's capacity to promote discipline and transparency in the rate setting process if the Commission systematically erred in favour of councils. Conversely, an approach that consistently erred against councils could lead to perverse outcomes and communities could become disillusioned if their councils were prevented from providing sought after services.

All things being equal, we do not expect a large number of applications each year. We will expect however, that when we receive an application, it will reflect a situation of genuine need and it will demonstrate that need rigorously. If these expectations are not met, and if through the variation processes the Commission finds itself routinely becoming involved in councils' rating decisions, we risk becoming a de facto regulator of the local government sector. Such an outcome would be contrary to the autonomy of councils — which is something we have endeavoured to preserve in designing the proposed framework.

TABLE 3.2 QUESTIONS, ACTIONS AND EVIDENCE FOR A VARIATION APPLICATION

Why the Commission needs this information	Questions	Actions	Evidence
The reason a variation from the cap is required			
We need to establish whether there is a need for a rate increase greater than the cap.	• What is the underlying driver of the need for an increase in rates above the prescribed cap?	• Identify the need for additional revenue. (Is it necessary to meet short-run cash flow needs and/or long-run operating capability?) • Estimate the additional revenue that is required, above the rate cap. • Determine whether the additional revenue requirements are ongoing or temporary.	• Documents identifying the cause of the variation. • Documents justifying the costs associated with the cause of the variation. • Financial statements showing the council's financial performance and position for previous period.[a] • Budgeted financial statements for current period.[a] • A strategic resource plan and asset management and long-term financial plans.
	• Is the proposed rate increase consistent with the council's revenue strategy and policy on funding and financing? • Has the council taken into account the effects of price shock, and whether a staggered increase in rates would be more appropriate? • Has the council considered spreading the funding needs over time by raising the additional expenditure through borrowings and/or by using existing financial assets; or through user charges, rather than general rates?	Review the council's policies and practices: • revenue raising mix (e.g. taxes and user charges); • revenue target; and • role and use of debt.	Documented policies and strategies regarding: • mix of own-source revenue-raising; and • funding and financing (role of debt).

[a] This may be demonstrated through the baseline information (see Appendix D in Volume II).

Continued next page

TABLE 3.2 (CONTINUED)

Why the Commission needs this information	Questions	Actions	Evidence
The application takes account of ratepayers' and communities' views			
We want to be sure that ratepayers and communities are aware of the variation and that their views have been considered. The Commission provides detailed guidance on community engagement in Volume 3.	**All variation applications:** • How has the council engaged with its ratepayers and communities on the requested rate increase? • What information was provided to ratepayers and community members during the engagement? • How has the engagement impacted the council's decision to seek a rate increase? • Is a rate increase the preferred option of the community? • Have the Commission's four key engagement principles been incorporated into the engagement? **Major new projects / material increases in service levels:** • Has the community been consulted on the proposal including the implications for the council's overall costs and revenue needs? **Asset management:** • Are asset management activities within community expectations and willingness/capacity to pay? • Are asset management expenditure projections based on reasonable and affordable service levels?	• Assess extent of engagement with ratepayers and the community on the options available and justification for the council's proposed option. • Review modelling of financial impacts on asset management need projections with various options in service level specifications from assets.	• A document setting out the council's consultation/engagement processes with ratepayers and communities including how the council gathers, records and incorporates the views gathered. This should include the council's rating strategy. • Information on results of past consultation/engagement relevant to the variation application. • Information on the engagement consultation on the current variation application. • Documented evidence of engagement/ consultation with the community and community satisfaction with the proposed variation. • Evidence of modelling of the financial impacts of asset management needs, including options for varying service level specifications.

Continued next page

TABLE 3.2 (CONTINUED)

Why the Commission needs this information	Questions	Actions	Evidence
The variation represents good value-for-money and is an efficient response to the need			
We want to ensure that the change in costs or services proposed by a council represents good value for ratepayers.	• Have sound processes to cost the expenditure been undertaken? • Are there benchmarks from the past or outside the council that demonstrate that costs are appropriate?	• Examine processes to ensure optimal cost/service outcomes when costing capital and operational work. • Gather material that can demonstrate that the variation application is funding items that are fit for purpose and the lowest cost for the selected level of service.	• Information on how the costs that led to the variation were incurred including tender documents if relevant.
Service priorities and funding options have been considered			
We want to know that councils have considered the prioritisation of services and different funding options before seeking a variation.[a]	• Why are the existing cost bases increasing? • What other funding options have been considered in addition to a rates increase? • What steps have been pursued to meet preferred expenditure through productivity and efficiency improvements? • Is it appropriate to raise rate revenue rather than reduce other service levels to meet priority needs? • Is the council satisfied the asset management expenditure projections are based on soundly based (cost-effective and timely) treatments for specified service levels?	• Identify drivers of the need for additional revenue. Are they controllable or non-controllable? • Identify all funding options to deal with the new spending priority. • Identify results from productivity and efficiency improvement programs.	• Information showing how the council has considered the possible reprioritisation of services. • Information showing consideration of differing funding options. • Information on councils' processes for seeking efficiencies and information on efficiencies used to offset increases in costs that have led to the variation. • Information showing drivers of cost increases and the extent to which they are non-controllable. • Community survey results showing preference for rate increases relative to service level reductions. • Evidence in asset management plan of rationale for timing and extent of projected asset management outlays (e.g. to minimise whole of lifecycle costs).
The proposal is integrated in the council's long-term strategy.			
We want to ensure a proposed variation has been incorporated into a council's plans.	• Does the council have an up-to-date Strategic Resource Plan, Asset Management Plan and financial plan? • Is the proposed rate increase consistent with those documents?	• Review the council's Strategic Resource Plan. • Confirm whether the need for additional revenue is identified in the Strategic Resource Plan.	• Demonstrate the variation application is consistent with the council's Strategic Resource Plan and long-term asset management and financial plans.

4 MONITORING AND REPORTING

Monitoring outcomes is the necessary third element (in addition to the rate cap and variation process) of the framework the Commission has been asked to develop. The terms of reference ask the Commission to consider the monitoring of council performance so that deteriorations in service delivery, infrastructure or financial position can be identified and addressed promptly. The Commission is also requested to consider any benchmarking or assessment of the effectiveness of the regime.

This chapter outlines the monitoring and reporting element of the proposed rates capping and variation framework.

4.1 WHY IS A MONITORING REGIME SO IMPORTANT?

Without a monitoring regime the procedural arrangements of the rates capping and variation processes can remain disconnected from the 'real world' outcomes experienced by ratepayers and communities in their daily lives. Public reporting of these outcomes allows ratepayers to verify the linkages between the rates they pay and the outcomes they observe. In other words, a well-designed monitoring and reporting regime can inform ratepayers' assessment of the value-for-money delivered by their councils, as well as how this might change over time. As the framework matures, it should also support comparisons with other councils.

A good monitoring and reporting regime can also assist councils to demonstrate the value-for-money they deliver with the resources they have available. Not only can this support how councils communicate with their communities, but it can also assist them to communicate with other levels of government about the trade-offs faced by local government. The monitoring and reporting regime will also provide opportunities for additional benchmarking of performance, as the data set becomes more consistent and robust over time.

One of the key concerns identified during our recent consultations, particularly by councils and peak bodies, was the risk that in order to avoid the variation process, councils may reduce their expenditures on services and critical infrastructure following the introduction of the framework. Many submissions cited the current financial and infrastructure challenges facing the local government sector in NSW as evidence of the potential impacts and unintended consequences of capping council rate revenue. We have heeded these warnings. We are confident that our proposed monitoring and reporting arrangements will promote transparency of, and accountability for, rate and service outcomes in Victoria by highlighting unexplained reduced performance.

4.2 WHAT MAKES A GOOD MONITORING REGIME?

In order to promote transparency of, and accountability for, outcomes under the rates capping and variation framework, the monitoring and reporting regime should:

- provide accurate and reliable information on outcomes
- make findings known publicly and on a regular basis
- present information in a consistent, clear and meaningful manner
- demonstrate whether councils have adhered to the cap or the conditions of an approved variation above the cap
- describe the relationship between rates and council performance in the areas of service and infrastructure delivery, and financial performance
- provide councils with the opportunity to explain unexpected or unusual outcomes
- facilitate a process for addressing unusual or unexplained outcomes where such responses are warranted.

We are conscious that the requirements of the monitoring regime should not impose an unnecessary reporting burden on councils. We therefore intend to rely as much as possible on the information already reported publicly by councils and other relevant authorities (including the Auditor-General and Local Government Victoria). In the months ahead, we will continue to work with councils on these information requirements.

Importantly, the monitoring regime should also allow the Commission (and anyone else with an interest) to assess whether the design and implementation of the framework might be responsible for any unintended outcomes following its introduction. Were such shortcomings identified, we would review and consult on options for how the framework could be improved. These reviews could be part of, or in addition to, the regular framework reviews discussed in chapter 6.

4.3 HOW WILL WE MONITOR ADHERENCE WITH THE CAP OR VARIATION CONDITIONS?

To maintain the integrity of the framework, we consider it necessary to establish a mechanism to oversee and verify that, in setting rates and charges, councils adhere to the rate cap or any approved variation above the rate cap.

Accordingly, the Commission is proposing to monitor that:

- the relevant council rates and charges are set in accordance with the rate cap for the corresponding financial year
- councils with an approval to vary rates above the cap, have set their rates and charges in accordance with the conditions of the approval.

We would report our findings publicly and on an annual basis. Amongst other things, these reports would address: year-on-year changes in rates, discrepancies between forecast and actual outcomes, and broader trends within and across the local government sector. Councils would be invited to provide comments explaining any unexpected or unusual findings.

While we consider that the indicative information requirements listed in table 2.4 will be largely sufficient for the purpose of this report, we will continue to consult with councils before finalising our information requirements. Most of this information should already be available to councils as part of their budgetary and planning processes so we do not consider completion of this table to be a significant reporting burden.

We have also considered how we should respond to situations where we identify significant or sustained instances of non-compliance with the rate cap or an approved variation. We have considered three options including: (i) developing a mechanism where excess funds are returned to ratepayers, (ii) making downward adjustments to allowable revenues in the following year, and (iii) further investigation and referral.

For now, we consider the first two options too interventionist (particularly while the framework is still in its infancy). We therefore propose that the third option be adopted. We will engage with relevant councils to better understand the reasons for any apparent non-compliance identified in their setting of rates and we will prepare a report to the Minister for Local Government on our findings.

4.4 HOW WILL WE MONITOR OVERALL OUTCOMES FOR RATEPAYERS AND COMMUNITIES?

Perhaps the single most important benefit of an effective rates capping and variation framework is the quality assurance mechanism it provides ratepayers and communities by informing their assessment of the value-for-money delivered by their councils. We have found in other sectors that independent scrutiny, analysis and reporting of these outcomes is essential for providing users and providers of services with confidence in the integrity of the overall framework.

Importantly, we consider that this scrutiny over outcomes should be applied to all councils — not just those seeking a variation above the rate cap. Indeed, the problematic consequences attributed to the NSW rate pegging arrangements arose in those councils which did not seek approval for higher rates.

To minimise the reporting burden on councils and to ensure the regime complements the existing accountability and oversight provisions, the Commission proposes to use and consolidate the existing performance data. To the greatest extent possible, we intend to draw data from:

- councils' existing reporting instruments — including: annual reports, budgets, council plans and strategic resource plans
- the annual Local Government Performance Reporting Framework (LGPRF) to be compiled by Local Government Victoria and the Community Satisfaction Survey
- data collected by the Victorian Grants Commission and financial sustainability indicators compiled by the Auditor-General
- and possibly the asset management data reported by the Municipal Association of Victoria through its STEP program.[10]

And, of course, we will use:

- the information that we collect through the rates capping and variation processes described in earlier chapters.

Only if we find gaps or weaknesses in these existing data sets will we seek to develop additional measures of performance with respect to services, infrastructure or financial performance. Before doing so, we would work with councils to determine the best approach for defining and collecting the required information.

As a first step, we are developing a 'baseline information' data template that all councils would complete and submit each year that provides additional asset and financial information in relation to councils' services, in consultation with a small number of councils and will soon commence broader consultation.[11] This information will be used to assist councils and the Commission during the variation process and to monitor changes in services, asset and financial outcomes.

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[10] The package of asset management tools developed by the MAV known as the STEP program was created to assist councils to improve their planning and asset management. The STEP program utilises a renewal gap calculation based on an assessment of the condition of the asset, in contrast to the accounting approach based on straight-line asset depreciation. The usefulness of the MAV STEP data as a consistent measure of asset management performance will need to be further evaluated.

[11] For more specific detail about the design and content of the 'baseline information' datasheet, see Appendix D of Volume II.

In analysing this information, we will examine: year-on-year changes in the services and service levels delivered by councils, discrepancies between expected and actual outcomes, and the emergence of trends within or across the local government sector. We would publicly report our findings each year. As with our reports on adherence with the rate cap, councils would be invited to provide comments explaining significant unexpected or unusual findings.

We propose to undertake more detailed analysis where we identify a trend or possible trend indicating a significant deterioration in services, infrastructure management or financial sustainability. This further analysis could address findings about an individual council, a group of councils or across the sector. In these instances, our intention would be to develop a better understanding of the reasons for these anomalous findings, how affected councils consulted with their communities about these outcomes and how they are reflected in councils' strategic planning instruments. We would report our findings to the Minister for Local Government as needed.

To assist directing this more detailed analysis to where it is most appropriate, we are considering adopting a risk-based approach that utilises the risk thresholds applied by the Auditor-General and target bands in the LGPRF. If we consider other triggers for more detailed analysis are warranted, we will consult with councils and other government agencies on their design and application.

The terms of reference also request that the rates capping and variation framework include measures that assess and promote councils' efficiency in delivering services and infrastructure. We consider such measures to be particularly important in assisting councils to deliver the best possible value-for-money to their communities; and conversely, allowing communities to hold their councils to account for the outcomes they deliver. We expect that as the data set becomes more robust and consistent, increasingly sophisticated measures of efficiency will become possible. This includes benchmarking opportunities.

4.5 WHAT PUBLIC REPORTS WILL WE RELEASE EACH YEAR?

Regular public reporting is crucial to maintaining transparency and accountability around the impact of the framework, the role of the Commission as the administrator and councils' performance under the framework. Table 4.1 outlines the key reports that the Commission will produce with regard to the rates capping and variation framework. The publication date for most of these reports will depend on the final timelines adopted for the framework (see section 5.1).

TABLE 4.1 FRAMEWORK REPORTING
Key Reports

Report	Description
Setting the rate cap (chapter 2)	In May, following the state budget, the Commission will issue a statement with its forecast for the rate cap for the next financial year and the following two years. In December, following release of the state budget update, the next year's rate cap will be finalised and published along with the forecast for the two following years.
Variation Applications (chapter 3)	At the conclusion of the application period for rate cap variations, the Commission will issue a statement summarising details of each application received for a rate variation above the cap.
Variation Decision(s) (chapter 3)	The Commission will publish reports detailing the outcome of each application for a variation above the rate cap (approval or refusal). Each report will detail the basis for the Commission's decision.
Annual Rates Report (chapter 4)	Each year the Commission will publish a report into councils' adherence with the rate cap or relevant variation conditions in the financial year just completed.
Annual Monitoring Report (chapter 4)	The Commission will release a report on the performance of the framework. The report will bring together information about the cap and variations, with key findings from the monitoring regime. We initially expect this report will be available in February each year but will endeavour to bring forward its publication as the framework matures.
One-off reports	From time to time, the Commission may issue one-off reports into matters pertaining to the operation of the framework.

5 IMPLEMENTING THE FRAMEWORK

Previous chapters have described the structural design features of the three elements of the rates capping and variation framework — namely: the rate setting arrangements, the variation process, and the monitoring and reporting of outcomes. This chapter addresses the framework's implementation requirements.

5.1 WHAT WILL BE THE TIMELINES FOR THE CAPPING AND VARIATION PROCESS?

In developing a timetable for the framework we have sought to:

- provide sufficient time for councils to prepare for a variation following the announcement of the cap
- provide time for the Commission to properly consider the applications from councils for variations
- fit into the existing timelines for councils' budgetary and planning processes.

Table 5.1 sets out a proposed timeline for next year's capping and variation process.

TABLE 5.1 PROPOSED TIMELINES FOR 2016-17 RATING YEAR

	2015-16
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

Another option could involve shifting the beginning and end of the variation process two months later to provide councils with more time for their planning and consultation. This would, however, require a later adoption of budgets (say, in August).

5.2 ARE SPECIAL TRANSITIONAL ARRANGEMENTS REQUIRED?

The terms of reference for this review indicate the rates capping and variation framework is to be implemented from the 2016-17 financial year — that is, within 18 months from the time the review was commissioned. Some submissions to our consultation paper urged transitional arrangements in the implementation of the framework. Councils, in particular, were concerned that implementation in 2016-17 would not provide councils with sufficient time to prepare a variation application and to consult with their communities.

A number of councils argued for the full introduction of the framework in 2017-18 to align with new Council Plans and Strategic Resource Plans following council elections (in October 2016). Many council submissions expressed concern that the property revaluation scheduled for 2016 would mean that ratepayers' rates notices were unlikely to increase in line with the rate cap and that this would cause widespread confusion. Ratepayers generally rejected the idea of a phased or transitional introduction of the framework.

We recognise that there is only a short time between completion of our report and commencement of the framework (and submission of applications for variations). In response, we are proposing to submit our final report to Ministers one month earlier than requested; that is, we will submit by the end of September (rather than the end of October). We also note the following:

- The rate cap we are proposing (chapter 2) provides councils leeway by: (i) including a provision for councils' labour costs; and (ii) setting the initial efficiency factor at zero and having it increase only very slowly in subsequent years.
- The requirements we proposed for the variation process (chapter 3) have been informed by our discussions with councils. We are confident that councils with well-established processes for strategic planning and community consultation will not find these requirements unduly onerous.
- The timelines proposed in the previous section have sought to delay lodgement of applications for variations to the latest date possible in order to provide councils with as much time as possible to prepare their submissions. Further delays might be possible if adoption of council budgets was postponed.
- The Government has made its intentions known since late-2014 and our preliminary thoughts about the framework's design were released in April. While the framework's precise details await conclusion of this review, we consider that councils already have enough information to undertake the necessary contingency planning to allow them to respond quickly once arrangements are finalised.

In addition, we are proposing that in the framework's first year of implementation, the Commission should only be authorised to approve variations for one year. Thereafter, councils should be permitted to submit, and the Commission approve variations of the length shown in table 5.2. In other words, the length of permissible variations increases as councils and ratepayers become more familiar with the framework. Councils could still apply for shorter variations than the maximums shown in table 5.2. The Commission could be asked to review this timetable for phasing in the variation process after 2-3 years.

Importantly, if councils seek longer variations in future years, they would be expected to manage budgetary fluctuations within their approved multi-year variation. That is, once approved a variation would not be revisited (or re-opened) other than in the event of material and extenuating circumstances outside the council's control.

TABLE 5.2 MAXIMUM LENGTHS OF VARIATION

Years

First year of variation	Length of permissible variation
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)

The Commission will exercise its professional judgement when assessing variations in the first year. Its expectations of the rigour of applications for variations in the first year will be different from the expectations it will hold after a few years of experience with the framework. For the avoidance of doubt, this statement should not be interpreted as suggesting a ‘green light’ to poor quality applications.

5.3 WHAT ABOUT THE COSTS OF ADMINISTERING THE FRAMEWORK?

ADMINISTRATION COSTS

The terms of reference request advice on options for funding the Commission’s administration of the rates capping framework, including cost recovery. In broad terms, the Commission’s costs will comprise of: (i) a base level of funding to administer the rates capping arrangements and its monitoring and reporting responsibilities; and (ii) a variable funding requirement dependent on the number of applications for variations received each year.

A majority of submissions that responded to the issue of cost recovery did not support these costs being recovered from local government. In contrast, some submissions suggested that the Commission could either set licence fees to recover costs from councils or could apply an application fee for considering variations above the cap. It was also suggested that fines could be applied to councils that failed to comply with the framework. In NSW, the State Government funds the costs of its scheme.

If some or all of the Commission's costs are to be recovered from local government, some options for cost recovery include:

- A fixed charge — applied to each council regardless of whether they apply for a variation. The same charge could be levied on each council or it could be apportioned depending on a factor that takes into account councils' ability to pay such as relative size of revenue.
- A variable charge — charges could vary depending on whether councils seek a variation to the rate cap. Costs could be structured equally or apportioned depending on a factor that takes into account of councils' ability to pay.
- A combination — charges to councils could include fixed and variable components.

COMPLIANCE COSTS

Although we have been mindful of not imposing unnecessarily burdensome requirements on local government, councils will still incur compliance costs following introduction of the framework. While we consider most of these costs will just become the 'cost of doing business' for a council, we expect that there might be some need for an initial investment in capacity building in the sector. The Government may wish to consider providing or coordinating assistance for councils (particularly in smaller councils) as they transition to working under the framework. Local Government Victoria could partner with peak bodies in delivering this assistance.

5.4 GUIDANCE AND SUPPORT

While this document outlines the structural features of the proposed rates capping and variation framework, we appreciate that 'the devil will be in the detail'. For this reason, the provision of detailed guidance and support, particularly in preparing a variation application, will be a central focus of the Commission over coming months. Guidance material will cover areas such as:

- the questions, actions and evidence required for a variation application
- suggestions on how the proposed community engagement principles can be operationalised
- the baseline information required from councils.

In some cases, the guidance material will be detailed and prescriptive; elsewhere it will be principles-based and provide councils with discretion regarding how they comply. Our ‘baseline information’ requirement is an example of the former, while our guidance on community consultation adopts the latter approach.

Over the coming months we will develop draft guidelines in relation to the areas that will be needed most immediately at the commencement of the framework.[12] We will commence consultation on this guidance and we will establish technical working groups where required. We expect the most immediately required guidance will be finalised before the end of the year.

[12] For further information see Volume II of this draft report tables 3.1 and 3.2, and Appendix D.

6 OVER THE LONGER TERM

Our experience in establishing related frameworks in other sectors suggest that the rates capping and variation framework proposed in this draft report will evolve as experience with the framework matures. As councils, ratepayers and the Commission begin operating under the framework, gaps and ambiguities may become evident. We will work closely with all interested parties to identify and address these concerns.

We also know from experience that with the passage of time, opportunities will emerge to raise the framework's level of ambition. As the parties become more familiar with the framework, they will seek to use it for increasingly sophisticated purposes. Sometimes this will necessitate significant changes to the design of the framework, but often even small minor modifications will enable significant new opportunities.

It will be important for the long-term success of the framework that it is capable of maturing and evolving to meet changing needs and circumstances.

6.1 WHEN SHOULD A COMPREHENSIVE REVIEW OF THE ENTIRE FRAMEWORK BE UNDERTAKEN?

As with any regulatory arrangements, the rates capping and variation framework should be subjected to periodic review. The ongoing monitoring regime detailed in chapter 4 will provide some assurance that the key elements of the framework are being adhered to. It will also help identify whether features of the framework are responsible for any deterioration or unintended consequences in council performance.

However, there is a need to conduct a more comprehensive review of the framework on a periodic basis in order to assess how effectively it is achieving its intended objectives. Such a review should seek to identify any necessary refinements to the legislative or regulatory architecture so that the framework is capable of meeting relevant policy objectives at that time.

Strong and broad support for a review of the framework was evidenced in submissions. Including a formal review mechanism into the design of the framework is consistent with best practice policy and program delivery principles.

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 all relevant information including the data and trends identified through the ongoing monitoring regime. All interested parties should have an opportunity to provide input to that review. Elsewhere, similar reviews are programmed into legislation for periods of varying length ranging from 3 to 10 years. We consider a review period of 4 years to be appropriate in this case.

6.2 WHAT IS STILL REQUIRED TO REALLY DRIVE EFFICIENCY?

The terms of reference emphasise in various places that efficiency is a primary objective of the rates capping and variation framework. Despite some common misconceptions, efficiency is not synonymous with cost cutting. For the purposes of this report, efficiency may be defined as:

> *Delivering the mix, quality and quantity of services wanted by ratepayers, in the way and at the time they want, and at a price they are willing to pay; and doing so at the lowest possible cost. Moreover, it involves adopting new technologies as they become available for producing and delivering these services; and it includes being able to adapt to ratepayers' changing preference in a timely manner.*

Alternatively defined, efficiency is about producing the required mix of outputs using the fewest and best mix of inputs.

Significant sector initiatives (internal and externally driven) have been progressed over the past 5 years to promote better resource management and decision-making. These initiatives include:

- improvements in asset management and its integration within broader council planning
- introduction of the Local Government Performance Reporting Framework as a tool to gather data on a selection of common service areas
- clearer and more expansive guidance from Local Government Victoria on rate setting policies, collaborative procurement and service sharing, budget and financial templates and the LGPRF
- increased used of collaborative tendering and shared services
- more sophisticated approaches to risk management and reporting
- continuous efforts and the use of new media to consult with ratepayers and communities.

These initiatives are welcomed and they should continue, but they are often being pursued on inadequate foundations — meaning that while they may be helpful for management from an administrative perspective, some councils' information management systems remain poorly placed for supporting an assessment of how efficiently they are operating. Increasingly, over time council systems should be able to:

- reflect uniform definitions and standard measures for the inputs used and the outputs produced
- identify or measure the resources utilised to produce different outputs
- generate unit costs for the outputs they produce.

Until this information is available, councils' information management systems will limit the capacity of the rates capping and variation framework, including the monitoring and reporting arrangements, to highlight and drive opportunities for improved efficiency. We consider that a concerted effort is required to standardise the recording of council inputs and outputs across the sector.

We would welcome the opportunity to work with councils and relevant government agencies to develop, and progressively implement, standardised definitions and measures of councils' inputs and outputs. Specific sectoral accounts could be developed that contain financial and resource-use information relevant to assessing how efficiently councils' produce and deliver services to their communities. Sectoral accounts would sit alongside the statutory accounts already produced by local government but they would focus on providing information on costs, revenues, and asset values related to the delivery of relevant services.

6.3 SHOULD COUNCILS BE GIVEN ANY GUIDANCE ON THEIR FINANCING OPTIONS?

Based on publicly available data, we have observed that councils have generally been averse to debt financing and many have established quite substantial capital reserves. While we note that this is purely within councils' prerogative, we question whether there would be a benefit in the State Government providing councils with guidance on the responsible use of debt — particularly with respect to funding long-lived infrastructure, and green field and intergenerational assets. In any event, councils may need to strengthen their policies regarding debt utilisation in light of our proposed approach to the trade-offs councils need to consider before applying for a variation (chapter 3).

6.4 SHOULD THERE BE GREATER COST REFLECTIVITY IN SOME COUNCIL RATES AND CHARGES?

In section 2.2, we propose that service rates and charges be excluded from the rate cap on the basis of councils' claims that these charges are set on a cost reflective basis. We have not tested these claims. However, we note that, whereas the *Local Government Act 1989* (the Act) requires that special rates and charges must be cost reflective, there is no corresponding obligation on service rates and charges. The relevant legislation in NSW requires that waste related charges are not to exceed the reasonable cost of providing the services and that general rates must not be used to fund the cost of providing waste management services.

If service rates and charges are to be excluded from the cap, we believe there is merit in the Government reviewing the Act provisions regarding service rates and charges to require that these charges must reflect the efficient costs of providing the underlying service.

In some cases, fees associated with statutory services provided by councils (for example, planning fees) are regulated by the Government. It is not necessarily clear how these fees are determined and some have remained unchanged for a number of years. These fees would not be covered by the rate cap.

Following introduction of the rates capping framework, we consider that councils should be able to recover the efficient costs of providing these statutory services. There is merit in periodically reviewing fees for statutory services to ensure they reflect the efficient cost of providing those services.

7 DRAFT RECOMMENDATIONS

This chapter outlines our 11 draft recommendations regarding the design and implementation of a local government rates capping and variation framework. Table 7.1 at the end of the chapter guides the reader to the section in each volume relevant to our draft recommendations.

THE CAP

Draft recommendation 1

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

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.

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.

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

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.

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.

VARIATION

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.

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.

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.

First year of variation	Length of permissible variation
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)

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.

MONITORING

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.

Draft recommendation 11

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

MATTERS FOR FURTHER 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.

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.

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.

TABLE 7.1 WHERE IS EACH DRAFT RECOMMENDATION DISCUSSED?

Draft Recommendation No.	Volume I	Volume II
1.	Section 2.1	Section 2.1
2.	Section 2.2	Section 2.2
3.	Section 2.3	Section 2.3
4.	Section 2.4	Section 2.4
5.	Section 2.5	Section 2.5
6.	Section 3.2	Section 3.2
7.	Section 3.3	Section 3.3
8.	Section 5.2	Section 3.5
9.	Section 3.4,3.5	Section 3.6
10.	Section 4.3	Section 4.4
11.	Section 4.4	Section 4.5

8 WHAT COMES NEXT

We will now commence an extensive round of consultation across the state to test the rates capping and variation framework that we have proposed in this draft report. Those consultations will include:

- discussions with councillors, council staff and ratepayers, and their representative bodies (MAV, VLGA, LGPro, FinPro, unions)
- public information sessions in Melbourne and regional Victoria (see table 8.1 for schedule). Further details will also be placed on our website and you can register to attend by emailing localgovernment@esc.vic.gov.au
- convening deliberative discussions with groups of randomly selected ratepayers and community members.

We will also establish a working group drawn from the sector, to refine some of the detailed design and implementation requirements of the framework.

Interested parties are invited to comment on this paper by providing a written submission by 28 August 2015 (see details below).

In the meantime, we will continue to publish a newsletter periodically providing updates on how we are progressing with the review and consultations.

Our final report setting out the recommended rates capping and variation framework will be provided to the Minister for Local Government and the Minister for Finance by the end of September — following which, the final report will be released publicly.

For further updates please go to our website: www.esc.vic.gov.au/Local-government or contact us on 03 9032 1300 or localgovernment@esc.vic.gov.au

TABLE 8.1 PUBLIC INFORMATION SESSIONS

Region	Day	Date	Time	Venue
Traralgon	Monday	10 August 2015	5:00-6:30pm	Premier Function Centre, 29 Grey Street, Traralgon
Melbourne	Monday	17 August 2015	5:00-6:30pm	Telstra Business Centre, 242 Exhibition Street, Melbourne
Wangaratta	Thursday	20 August 2015	5:00-6:30pm	Quality Hotel Wangaratta Gateway, 29-37 Ryley Street, Wangaratta
Bendigo	Wednesday	26 August 2015	12:00-1:30pm	La Trobe University Visual Arts Centre (VAC), 121 View Street, Bendigo
Horsham	Wednesday	26 August 2015	6:00-7:30pm	Horsham Golf Club 304 Golf Course Road Horsham

HOW TO MAKE A SUBMISSION

Submissions are due by 28 August 2015. Where relevant, submissions should contain supporting evidence for any claims made.

To promote an open and transparent review process, our normal practice is to make all submissions publicly available on our website. If there is information that you do not wish to be disclosed publicly on the basis that it is confidential or commercially sensitive, this information should be clearly identified in the submission.

Any questions about this draft report can be directed to Angelina Garces on (03) 9032 1300. Submissions should be emailed to: localgovernment@esc.vic.gov.au

You can also send comments by fax to 03 9032 1303 or by mail marked:

Local Government Rates Capping and Variation Framework Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

APPENDIX A — TERMS OF REFERENCE

Local Government Rates Capping Framework

Terms of Reference

I, Robin Scott MP, Minister for Finance, under section 41 of the *Essential Services Commission Act 2001* (the 'ESC Act'), refer to the Essential Services Commission (ESC) the development of a rates capping framework for local government.

As provided for by section 185b of the *Local Government Act 1989,* the Minister for Local Government can cap council general income. The Government has announced a commitment to cap annual council rate increases[1] and has also provided additional guidance on factors to be considered during the implementation of the cap[2].

The State Government's objective is to contain the cost of living in Victoria while supporting council autonomy and ensuring greater accountability and transparency in local government budgeting and service delivery. The Government intends to promote rates and charges that are efficient, stable and reflective of services that the community needs and demands, and set at a level that ensures the sustainability of the councils' financial capacity and council infrastructure, thereby promoting the best outcomes for all Victorians.

The ESC is asked to inquire into and advise the Ministers for Finance and Local Government on options and a recommended approach for a rates capping framework for implementation from the 2016-17 financial year. Advice should include and/or take into account the following matters:

1) Available evidence on the magnitude and impact of successive above-CPI rate increases by Victorian councils on ratepayers.

2) Implementation of the Government's commitment to cap annual council rate increases at the Consumer Price Index (CPI) with councils to justify any proposed increases beyond the cap, including advice on the base to which the cap should apply (e.g. whether to rates or to general income).

3) Any refinements to the nature and application of the cap that could better meet the Government's objectives.

4) Options for the rate capping framework should be simple to understand and administer, and be tailored to the needs of the highly diverse local government sector. The framework should take into account factors that may impact on local governments' short and longer term financial outlook, such as:

    a) actual and projected population growth and any particular service and infrastructure needs;

    b) any relevant Commonwealth Government cuts to Local Government grants;

    c) any additional taxes, levies or increased statutory responsibilities of local governments as required by the State or Commonwealth Governments;

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[1] Media release by Daniel Andrews, *Andrew Announces Fair Go for Ratepayers*, 5 May 2014.

[2] ALP's response to MAV's *Local Government Call to Political Parties*, p.1, November 2014.

d) any extraordinary circumstances (such as natural disasters); and

e) other sources of income available to councils (for example, ability to raise user fees and charges from non-residents).

5) Consider how local governments should continue to manage their overall finances on a sustainable basis, including any additional ongoing monitoring of council service and financial performance to ensure that any deterioration in the level, quality or sustainability of services and infrastructure and councils' financial position is identified and addressed promptly.

6) The processes and guidance to best give effect to the recommended approach for the rates capping framework and a practical timetable for implementation, including:

a) the role of councils, the ESC and the Victorian Government and the expected time taken by local governments and by the Victorian Government or its agencies, for each step in the rate capping process;

b) any technical requirements including the information requirements on councils that request exemptions from the cap;

c) any guidance required to give effect to the rate capping options (including in relation to consultation with ratepayers) and to improve accountability and transparency; and

d) any benchmarking or assessment of the effectiveness of the regime, including options to continuously refine the regime and improve council incentives for efficiency.

7) Options for ongoing funding to administer the rate capping framework, including the potential for cost recovery.

In conducting the inquiry and providing its advice, the ESC will have regard to:

- the role of local government in the provision of infrastructure and services to the community and the general efficacy with which they currently perform this task;

- the differences between rural, regional and metropolitan local councils in terms of costs, revenue sources and assets maintained;

- the Revenue and Rating Strategy guide and Local Government Performance Reporting Framework to be administered by the Department of Environment, Land, Water and Planning;

- matters regarding rating practices and asset renewal gap raised by the Victorian Auditor-General's Office (VAGO);

- Department of Treasury and Finance's Victorian Guide to Regulation and Victorian Cost Recovery Guidelines; and

- any relevant insights from the experience of rate pegging in New South Wales, including any reviews or evaluations that can suggest ways to minimise any unintended consequences.

In conducting this independent inquiry, the ESC will be informed by wide consultation. This will include, but is not limited to: councillors and officials from local government; representative bodies such as Municipal Association of Victoria, Victorian Local Government Association and LGPro; unions; VAGO; and relevant government agencies and departments. In addition, the ESC will consult regularly throughout the course of the inquiry with a sector consultative panel established by the Minister for Local Government. The ESC's consultation will be guided by its Charter of Consultation and Regulatory Practice.

The ESC will publish a draft report on the rates capping framework no later than six months after receipt of these terms of reference. The draft report must be made publicly available and invite comments from local governments and other interested parties. A final framework report along with draft guidance material will be provided to the Minister for Finance and Minister for Local Government no later than 31 October 2015.

ROBIN SCOTT
Minister for Finance
Dated: 19 January 2015