

OVERVIEW

Decisions on higher cap applications for 2016-17

May 2016



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1 CONTEXT

The Fair Go Rates System (FGRS), established in the *Local Government Act 1989* (the Act), requires local councils to limit their average annual rate increases to a rate cap, determined annually by the Minister for Local Government (the Minister).¹ For the 2016-17 rating year, the cap has been set at 2.5 per cent.

This overview paper outlines the Essential Services Commission's decision for the nine Councils that have applied for a higher cap in 2016-17. The individual decision for each of the nine councils is published separately.

In arriving at our decisions, we had regard to the six legislative matters² and the statutory objectives³ of the FGRS (box 1).

The six legislative matters are:

- the proposed higher cap for each specified financial year
- the reason for which the council seeks the higher cap
- how the views of ratepayers and the community have been taken into account in proposing the higher cap
- how the higher cap is an efficient use of council resources and represents value for money
- whether consideration has been given to reprioritising proposed expenditures and alternative funding options and why those options are not adequate and
- that the assumptions and proposals in the application are consistent with the council's long-term strategy and financial management policies set out in the council's planning documents and annual budget.

¹ Sections 185B and 185C of the *Local Government Act* define rates for the purposes of the cap.

² Section 185E of the *Local Government Act*.

³ Section 10E(7) of the *Essential Services Commission Act 2001* and section 185A of the *Local Government Act*.

BOX 1 OBJECTIVES OF THE FAIR GO RATES SYSTEM

- to promote the long-term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure and
- to ensure that a Council has the financial capacity to perform its duties and functions and exercise its powers.

2 OUR APPROACH

In assessing the applications, we examined each of the six legislative matters and considered how each council addressed them. In line with legislation, we were careful to ensure that our decisions would not compromise councils' financial capacity to perform their duties in a manner consistent with the long-term interests of ratepayers and the community. We can either approve or reject an application in whole, or in part, from a council seeking a higher cap that is above the cap set by the Minister for Local Government. We made our decisions this year drawing on information provided by the relevant councils, our analysis and expert advice.

The legislation envisages that councils seeking a rate increase above the cap must demonstrate a long-term funding need that justifies a permanent rate increase in their rate base that is higher than the statewide cap set by the Minister for Local Government.⁴ We define a long-term funding need as a situation in which a council's projected long-term operating revenue is less than the projected long-term operating expenditure that it will need to perform its duties and functions, including some capacity to accommodate unforeseen future events.

A council that is projecting a positive underlying operating result (that is, its operating revenue is projected to exceed its operating expenses including depreciation) would be generating sufficient revenue to offset the cost of its current service provision. In this situation, ratepayers and fee-for-service recipients in any year are collectively 'paying their way'. Revenue attributed to depreciation should help ensure that, on average and over time, the council generates about sufficient net cash flow to accommodate its asset renewal needs.

⁴ A higher cap has a long-term impact on ratepayers. It establishes a higher rate base that then compounds year on year, at least by as much as the annual rate cap.

The manner and rigour in which a council establishes its long-term funding need is equally important. Consistent with legislation, in establishing a long-term funding need, councils need to demonstrate that they:

- engaged effectively with their ratepayers and communities about their services, infrastructure needs and financial outcomes
- considered other options to reduce or re-prioritise expenditure, or explored alternative funding and revenue sources. If they reject any options, council must be able to demonstrate why those options were not adequate or appropriate and
- developed and applied rigorous and consistent internal policies, plans and processes.

To do so, councils need a rigorous approach to long-term financial planning, encompassing:

- service reviews (service planning and service prioritisation) leading to affordable services (and service levels), informed by community engagement
- asset management planning that identifies cost-effective outlays and is based on properly considered and documented risk management practices and
- rigorous and well documented financial strategies and practices.

Councils with well-developed Long-term Financial Plans (LTFP) should not need to resort to a higher cap as a simple and convenient way to balance any net cash needs in their budget from year-to-year. Any short-term cash needs would be managed by a council within its existing budgetary measures, including the use of existing cash holdings. It would not be consistent with ratepayers' and communities' long-term interests to have councils seeking ongoing higher rates in order to fund year-to-year fluctuations in their cash needs.

Of the nine applications for a higher cap we received this year, 4 highlighted short-term budget pressures as the reason for their applications. Our response to these applications depended on other factors — most prominently, our assessment of the long-term financial sustainability of each council.

We note that a number of the councils that applied for a higher cap this year are reporting: deficits in their operations, have large infrastructure renewal needs, have limited alternative sources of income and a small rate base. Other councils that applied are in financial positions that appear to have sufficient financial flexibility to manage short-term funding needs, without needing higher rates in 2016-17 and without compromising their capacity to deliver sustainable services and infrastructure outcomes.

A council's underlying financial circumstances are an important consideration, particularly in the first year of implementation. In certain circumstances, we felt that, on balance, it was prudent to approve an application for a higher cap even though the council is yet to demonstrate fully the extent of its long-term funding need. This being the first year of the new framework, we extended the benefit of the doubt to these councils in light of their underlying deficits (typically related to their renewals programs). Nevertheless, we qualified our support for these applications by highlighting the steps these councils still need to take to better establish their long-term funding needs.

We expect future applications made under the Fair Go Rates System will demonstrate clearly the extent of the long-term funding need. To do so, applications will need to have regard to the matters discussed above. Applications will also need to give consideration to how any proposed rate increases will allow councils to manage their year-on-year fluctuations in cash requirements in a way that does not simply pass on all risk to ratepayers.

In summary, our decision about whether to approve a higher cap rests on how confident we are (at this point in time and based on information from the council) in the council's long-term financial planning and their financial capacity to deliver sustainable outcomes for services and infrastructure.

Generally, we consider that a higher cap is not appropriate where an application:

- does not demonstrate a long-term funding need
- proposes to apply the higher cap to fund short-term needs
- is not supported by adequate long-term financial planning
- is not supported by our analysis of the council's financial capacity and overall flexibility to manage its short-term needs.

In not approving a higher cap in three cases this year (and one in part), we drew on expert financial advice that these councils have adequate overall financial flexibility to manage their identified short-term needs.

Our role in approving or rejecting a rate increase above the cap is limited to a determination regarding rate revenue. Whether specific expenditures identified in an application proceed or not, is a matter that always remains within the full discretion of the council. We approve rates, not expenditures. Similarly, our decisions do not impose on councils a greater or lesser reliance on debt. Councils continue to determine matters of financial management.

We would expect, however, that where councils elect to deviate from the expenditures (and debt outcomes) outlined in their applications, they would do so transparently and with the knowledge of their communities.⁵

Under the FGRS framework, we are required to report annually on each council's compliance with its rate cap and every two years on outcomes from the FGRS. When doing so, we will monitor and report on whether councils operating under a higher cap have spent those funds in accordance with the expenditure needs cited in their applications. While we approve rates and not individual expenditures, it will be important that communities and ratepayers receive confirmation that their council has fulfilled its expenditure commitments. In the event that those additional funds have been redirected to other areas of expenditure, we will seek and publish council's explanation for the reallocation of those funds.

The following chapter summarises our decisions for each of the nine applications we received. Chapter 4 summarises our reasons for each decision. The full decision for each application can be found on our website (www.esc.vic.gov.au).

⁵ Likewise, we would expect these deviations, and the reasons for them, to be documented fully in any future applications for higher rates.

3 THIS YEAR'S OUTCOMES

A total of ten Councils applied for a higher cap in January 2016. The City of Geelong later withdrew its application. Table 1 summarises our decisions on the remaining nine applications.

TABLE 1 SUMMARY OF COMMISSION DECISIONS

Council	Decision	Commentary
City of Ballarat	Not approved	Average rate can increase by the 2.5 per cent Minister's rate cap for 2016-17
City of Casey	Not approved	Average rate can increase by the 2.5 per cent Minister's rate cap for 2016-17
Wyndham City Council	Not approved	Average rate can increase by the 2.5 per cent Minister's rate cap for 2016-17
Murrindindi Shire Council	Approved in part	Average rate can increase up to 4.3 per cent for 2016-17
Buloke Shire Council	Approved (qualified)	Average rate can increase up to 3.05 per cent for 2016-17
Horsham Rural City Council	Approved (qualified)	Average rate can increase up to 3.5 per cent for 2016-17
Pyrenees Shire Council	Approved (qualified)	Average rate can increase up to 3.83 per cent for 2016-17
Moorabool Shire Council	Approved	Average rate can increase up to 3.5 per cent for 2016-17
Towong Shire Council	Approved	Average rate can increase up to 6.34 per cent for 2016-17

Note: Under the Local Government Act 1989, a council's capped average rate in 2016-17 cannot exceed its base average rate (calculated as at 30 June 2015-16) by more than the specified cap. For example, Casey's capped average rate in 2016-17 cannot exceed its base average rate (calculated as at 30 June) by more than 2.5 per cent.

Our decisions apply to the increase in the average level of rates for each council. Individual ratepayers may experience higher or lower rate changes than those shown in table 1. There are numerous reasons for these individual variations that are beyond the control of the FGRS, 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.

Our decision relates to only the general rates and municipal charges components on a rates notice. The FGRS does not cap other fees, charges and fines.

Local Government Victoria has issued *Local Government (General) Amendment Regulation 2016* (the amending Regulations) which came into operation on 8 April 2016. The amending Regulations give effect to the Government's commitment to expand the information contained in the notice of rates and charges to include the following information:

- The rate cap for the relevant financial year that applies to the Council.
- Whether Council has complied with the rate cap.
- The reasons why an individual ratepayer's rates and charges for that financial year may have increased or decreased by an amount different from that council's rate cap.

The amending Regulations, and the updated Principal Regulations containing the new amendments can be found at www.legislation.vic.gov.au.

4 SUMMARY OF OUR DECISIONS

This section sets out our decision for each council. The detailed assessment for each Council is published separately.

COMMISSION'S DECISION ON BALLARAT CITY COUNCIL

Ballarat has applied for a higher cap of 3.7 per cent that is, 1.2 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Ballarat's application, and decided not to approve its proposed higher cap of 3.7 per cent for 2016-17. Ballarat will be required to keep its average rate increase for 2016-17 within the 2.5 per cent cap set by the Minister.

The Commission is not satisfied that Ballarat's application supports a higher cap for 2016-17. The Commission reached this decision for the following reasons:

- The Commission found Ballarat's capital planning and processes do not adequately support its application for a higher cap.
- The Commission does not consider that it is in the long-term interests of ratepayers to fund the one-off cost or funding shortfall identified by Ballarat with a permanent increase to the rate base as this would result in ratepayers continuing to pay higher rates after the short-term need had been addressed.
- The Commission was not satisfied that Ballarat has demonstrated how it had taken into account the views of its ratepayers and the community in forming its application for a higher cap.

COMMISSION'S DECISION ON CITY OF CASEY

Casey has applied for a higher cap of 3.47 per cent, that is, 0.97 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Casey's application, and decided not to approve its proposed higher cap of 3.47 per cent for 2016-17. Casey will be required to keep its average rate increase for 2016-17 within the 2.5 per cent cap set by the Minister.

Casey's application has not demonstrated the need for an ongoing rate increase above the cap in 2016-17. Casey's overall financial position is strong with a forecast adjusted underlying surplus in the order of \$33.9 million (without the proposed higher cap). Casey has also been granted additional funding of \$2.5 million as part of the Interface Growth Fund. This frees up funds equivalent to \$2.5 million which could be used to fund other capital projects, possibly including those made the subject of the higher cap application. Casey will have the financial capacity to meet its duties and functions without the proposed higher cap, including its planned capital works program in 2016-17.

COMMISSION'S DECISION ON WYNDHAM CITY COUNCIL

Wyndham has applied for a higher cap of 4.5 per cent, that is, 2 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Wyndham's application and decided not to approve its proposed higher cap of 4.5 per cent for 2016-17. Wyndham will be required to keep its average rate increase for 2016-17 within the 2.5 per cent cap set by the Minister.

Wyndham's application has not demonstrated the need for a higher cap in 2016-17. Wyndham's analysis shows it to be in a strong financial position in 2016-17 with the financial capacity to consider funding alternatives and expenditure offsets, without increasing rate revenue above the rate cap. Wyndham acknowledged that it had not yet pursued some of the options and alternatives available because it wishes to consult further with the community about the potential impacts of those options. As such, Wyndham's application is yet to confirm the long-term revenue needs that would justify a permanent increase in the rate base.

COMMISSION'S DECISION ON MURRINDINDI SHIRE COUNCIL

Murrindindi has applied for a higher cap of 5.4 per cent in 2016-17, that is, 2.9 per cent above the Minister's rate cap for 2016-17.

The Commission has assessed Murrindindi's application, and decided to approve the higher cap for infrastructure renewal (1.8 per cent) and not to approve the higher cap related to services (1.1 per cent). Murrindindi will be required to keep its average rate increase within a higher cap of 4.3 per cent.

The Commission is satisfied that the infrastructure renewal component relates to a long-term need that is consistent with Council's Long-term Financial Plan (LTFP). The Commission is not satisfied that the increase sought for the provision of services is a need that warrants a permanent increase to the rate base.

COMMISSION'S DECISION ON BULOKE SHIRE COUNCIL

Buloke has applied for a higher cap of 3.05 per cent, that is, 0.55 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Buloke's application and decided to approve its proposed higher cap of 3.05 per cent for 2016-17.

On balance, the Commission is satisfied that a higher cap is appropriate because Council has clearly identified in its current 4 year Strategic Resource Plan a strategy to repay a \$7 million loan in 2019. The application is consistent with that strategy.

However, the Commission considers Buloke should prioritise the development of a comprehensive long-term financial plan that extends beyond the repayment of the loan and reflects community preferences and affordability, including setting clear targets for key financial indicators to achieve ongoing financial sustainability.

COMMISSION'S DECISION ON HORSHAM RURAL CITY COUNCIL

Horsham has applied for a higher cap of 3.5 per cent, that is, 1 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Horsham's application and decided to approve its higher cap of 3.5 per cent for 2016-17.

On balance, the Commission is satisfied, that based on current and forecast road asset service levels, a higher cap is appropriate for 2016-17 because Horsham does not otherwise have sufficient options to increase its road renewal expenditure for 2016-17.

However, the Commission considers Horsham should undertake a more strategic infrastructure need assessment, including seeking views from the community and ratepayers on infrastructure need and affordability as part of its long-term financial planning as a matter of high priority.

COMMISSION'S DECISION ON PYRENEES SHIRE COUNCIL

Pyrenees has applied for a higher cap of 3.83 per cent, that is, 1.33 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Pyrenees' application, and decided to approve its higher cap of 3.83 per cent for 2016-17.

On balance, the Commission is satisfied that a higher cap is appropriate for 2016-17 because Pyrenees does not otherwise have sufficient options to increase its road renewal expenditure for 2016-17.

However, the Commission considers Pyrenees should undertake a more strategic infrastructure need assessment, including seeking views from the community and ratepayers on infrastructure need and affordability as part of its long-term financial planning as a matter of urgency.

COMMISSION'S DECISION ON MOORABOOL SHIRE COUNCIL

Moorabool has applied for a higher cap of 3.5 per cent, that is, 1 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Moorabool's application and approves its proposed higher cap of 3.5 per cent for 2016-17.

The Commission is satisfied that the higher cap is consistent with Moorabool's well-developed long-term financial plan to deliver sustainable outcomes in services and critical infrastructure in the long-term interests of its community. We find Moorabool's application and long-term financial plan to be consistent with the requirements of the Fair Go Rates System.

COMMISSION'S DECISION ON TOWONG SHIRE COUNCIL

Towong has applied for a higher cap of 6.34 per cent, that is, 3.84 per cent higher than the Minister's rate cap for 2016-17.

The Commission has assessed Towong's application and approves its proposed higher cap of 6.34 per cent for 2016-17.

The Commission is satisfied that the higher cap is consistent with Towong's well developed long-term financial plan to deliver sustainable outcomes in services and critical infrastructure in the long-term interests of its community. We find Towong's application and long-term financial plan to be consistent with the requirements of the Fair Go Rates System.

5 SOME OBSERVATIONS ON IMPROVING APPLICATIONS

The nine decisions released with this overview paper are the first to be made under the FGRS. Under the legislation, Councils were limited to applying for a higher cap for one year only. From next year, councils will have the option of applying for up to four years of higher caps. As multi-year rate caps will compound over the period covered by the application, it will be even more important that such applications demonstrate the long-term planning discussed in chapter 2.

This chapter seeks to highlight some observations drawn from this year's assessment process that may assist councils prepare submissions in future years.

The rejection of a higher cap in 2016-17 does not prevent a council from applying for a higher cap in the future. Similarly, the approval of a 2016-17 higher cap does not necessarily mean a council's application for a higher cap will be approved automatically if submitted in the future. Each application will be considered on its merits at the time the application is made.

In light of the insights gained from the 2016-17 application and assessment process, it has become very clear that the intention of the legislation is best achieved by councils directing their efforts to developing robust and well-informed long-term financial plans. The assessment process just completed highlights that for councils to establish a funding need requiring higher rates, their applications must focus on demonstrating they have modelled and responded to long-term trends in revenues and costs. Without an integrated long-term financial planning framework neither councils nor their communities can be confident in the merits of a rate increase above the cap set by the Minister. Development of a long-term plan (and subsequently an application for a higher cap) should involve the following processes:

1. Community and ratepayers' views on services and infrastructure needs and affordability are identified, understood and taken into account in informing council plans (and applications for a higher cap). Where councils seek to proceed in directions that differ from those preferred by their communities, the reasons for doing so should be made clear and actions to address community concerns should be highlighted.
 - a. Insights from 2016-17: The applications from councils demonstrated that a variety of engagement techniques had been used and that in most cases council had received a spectrum of views from their communities and ratepayers. However, council applications did not clearly explain how they had taken into account those views in making the decision to seek a higher cap. This shortcoming was most obvious where councils had received mixed views from their community and ratepayers. In these cases it was not clear to the Commission how the council had weighed up these differing views nor what additional information they may have relied upon in deciding to make and application
2. During community engagements about services and infrastructure, councils must make clear to their community the major financial trade-offs and service impacts of the different choice available. Councils will be expected to identify community responses to the different trade-offs presented and articulate clearly how those responses have informed their applications for a higher cap.
 - a. Insights from 2016-17: Most councils appear to have provided their communities and ratepayers with information about the proposed higher cap. However, it was not clear to the Commission that councils had presented appropriate information on financial trade-offs and the potential impacts on services and service levels.
3. Council has continued to seek ongoing operational improvements and revenue opportunities to minimize the need to apply for a higher cap. Where efficiencies have been made, or are being planned, applications should identify appropriate measures that can be used to confirm that Council is delivering the efficiencies to which it has committed. Such measures will provide communities with confidence that a proposed higher cap is being pursued in line with the FGRS.
 - a. Insights from 2016-17: Applications from a few councils contained details of comprehensive actions that they had implemented in pursuit of savings in their

or capital expenditure. Other councils indicated that service reviews had been undertaken but did not clarify how they would ensure any efficiencies or savings would be realised.

4. Council has a comprehensive, balanced and demonstrable approach to financial management addressing one-off funding needs. Responsible long-term financial planning will ensure council has sufficient funds to deliver services that are in accordance with its commitments to its community and ratepayers. When one-off funding needs can be anticipated, councils should be accounting for these funding needs within their overall program of service and infrastructure delivery. Unless completely unforeseeable, it is our expectation that one-off funding needs are unlikely to warrant cause for a higher cap.
 - a. Insights from 2016-17: A few applications identified short-term needs as the basis for seeking a permanent increase to the rate base. When questioned about the need for ongoing higher rates (that is, beyond the short term needs identified in their applications), these Councils typically sought to assure the Commission that the additional funds would be required to deal with other budget pressures. The Commission was not in a position to accept these assurances at face value. These applications were not approved for 2016-17.
5. Council has developed and applied rigorous and consistent internal policies, plans and processes, including asset management plans. Inconsistencies between councils' various planning instruments undermine our confidence in an application for a higher cap.
 - a. Insights from 2016-17: Some councils have well developed long-term financial plans that greatly assisted us in understanding the different service and infrastructure impacts on their financial position, including demonstrating their long-term funding needs. In other instances, we identified discrepancies between a council's various planning instruments. There is limited time and opportunity for such discrepancies to be resolved in the short time available to the Commission to assess an application. We urge councils to ensure the use of consistent forecasts, timelines and definitions across all their planning instruments.