Submission in response to the Essential Services Commission's
A BLUEPRINT FOR CHANGE
Local Government Rates Capping & Variation Framework Review
Draft Report

28 August 2015

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Essential Services Commission
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Dear Dr Ben-David

Local Government Rates Capping and Variation Framework Review – Draft Report

Introduction

The Eastern Regional Mayors and CEOs Group (ERG) welcomes the opportunity to respond to the Draft report of the Essential Service Commission's (ESC) draft report *A Blueprint for Change Local government Rates Capping and Variation Framework Review.*

The ERG acknowledges the extensive consultation process the ESC has engaged in with the local government sector in Victoria, and we recognise the sector's concerns and inputs are reflected in many of the recommendations the ESC has put forward for comment.

The ERG incorporates the Boroondara, Knox, Manningham, Maroondah, Monash, Whitehorse and Yarra Ranges municipalities.

Our member councils will prepare their own submissions in response to the ESC's report, covering a breadth of areas. It is the agreed intent of the ERG to focus this submission on the most critical of issues – the form and composition of the rates cap model the ESC has put forward.

Annual rate Cap calculation

The ESC proposes an annual rate cap to be calculated as follows:

Annual rate cap = (0.6 x increase in CPI)

+ (0.4 x increase in WPI)

- (efficiency factor)

The ERG will focus on two areas of concern with this proposed formula – the imposition of an efficiency factor, and the lack of allowance for infrastructure spending.

Efficiency factor

The ERG regards the rate cap set on a combined CPI/WPI basis as being not reflective of the real-world cost imposts the local government sector faces.

It will impose considerable financial hardship on councils required to balance increasing community demands for more and better services, and the need to invest in and maintain council assets and infrastructure, all within a prudent budgetary and financial management framework.

This is a risk the ESC itself has recognised in its report, noting that a potential unintended consequence of the proposed rate capping and variation framework is that:

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

On a CPI/WPI methodology alone, this is a risk highly likely to be realised. Further exacerbating this risk is the proposed imposition of an efficiency factor that will further reduce council revenues.

The ERG opposes the imposition of an efficiency factor in principle and practice.

The ESC suggest that:

> *"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."*[1]

The adherence to a CPI/WPI annual rates cap will in itself, impose considerable constraint on council spending, driving both the finding of efficiencies and reviews of spending priorities and outlays. Many councils will find this a difficult and complex exercise, though as the new rates cap will be mandated, councils will comply meaning the Government will have gained the 'efficiencies' it wants from the local government sector, with the 'benefits' reflected in council rates.

Having achieved Government's objective of driving delivery of a level of genuine efficiency through this mechanism, the further imposition of an arbitrary efficiency factor is superfluous for purposes of fostering productivity and savings in local government, and will prove damaging to the long-term financial viability of local government and the services and infrastructure it is expected to provide to its communities.

In the event that some councils were able to make savings beyond those imposed on them by the CPI/WPI rates cap, councils ought to have the flexibility of choosing how they apply those savings, whether through investment in innovation in practice and programs that will drive further efficiency,

[1] A BLUEPRINT FOR CHANGE Local Government Rates Capping & Variation Framework Review, Draft Report – Volume 1, Pg 14

returned to the community through improved service delivery, meeting new areas of identified need, or through investment in asset maintenance and replacement.

We also note that although the efficiency factor is to be set at 0.05 percentage points each year, the cumulative, open-ended nature of the efficiency factor will have a material impact on council revenues within the near-term, going well beyond the limitations required of the CPI/WPI cap.

In summary, the ERG argues the efficiency factor should be discarded, as:

- the proposed rate cap will, in itself, require councils to find significant expenditure savings year on year.
- the cumulative, open-ended nature of the efficiency factor will have a material impact on council revenues and therefore Councils' financial sustainability.
- councils that are able to achieve savings beyond the requirements of the CPI/WPI rate cap, should have the ability to reinvest surplus savings in innovation, asset replacement or targeted service areas.

Infrastructure funding

In limiting its proposed rate cap formula to only recognising consumer price index and wage price index components, the ESC notes:

"*…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*."[2]

Whilst the ERG understands the ESC's desire for a simplified rate cap model, matters such as addressing infrastructure spending would therefore need to be addressed through the variation process. We propose that there is a clear and evidenced need to incorporate a mechanism to address the infrastructure spending backlog currently identified in Victorian local government through a transparent and accountable mechanism.

CPI/WPI indexes do not adequately address the significant asset renewal backlog that has been identified across the local government sector in Victoria. This backlog can be defined as the difference between the funding councils need to adequately renew existing assets and the funding levels that councils have been able to allow for asset maintenance and replacement.

The need to have this backlog addressed, and ensure suitable levels of asset funding are maintained going forward, has been recognised by Government. The Victorian Auditor-General's Office (VAGO), in its 2014 report Asset Management and Maintenance by Councils, states: "The continuing growth in councils' asset renewal gaps remains of considerable concern." VAGO identifies the asset renewal

[2] A BLUEPRINT FOR CHANGE Local Government Rates Capping & Variation Framework Review, Draft Report – Volume 1, Pg 15

gap across the local government sector as $225 million in 2012, double the renewal gap that existed in 1998.

Whilst improved asset management practices by the local government sector will continue to assist councils in meeting their requirements, a rate cap that serves to do no more than restrict current levels of expenditure in line with inflationary pressures does nothing to provide councils with genuine scope to address the backlog of asset renewal.

To allow for an adequate program of required asset renewal across the sector, the ERG proposes that an allowance of 0.5% be added to the annual rate cap as a ‘renewal gap factor’.

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

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

In proposing such an allowance to address the local government infrastructure backlog, the ERG is mindful of the Government’s objectives to have a rate cap methodology that imposes restraint on recurrent spending. This is why – beyond the imposition of the proposed CPI/WPI formula - having a fixed allowance, for a given period of time, for the stated intent of ensuring infrastructure spending is brought up to appropriate levels enables both the perceived and actual achievement of the Government’s rate capping objectives, as well as making provision for local government to meet recognised infrastructure benchmarks in a reasonable period.

Allocation of the revenues raised through a renewal gap factor to infrastructure spending can be monitored and verified by the ESC and Government through councils’ financial reporting and performance requirements.

Conclusion

The changes put forward by the ERG in this submission will balance the need for the local government sector to control costs and expenditures, whilst still ensuring that fundamental responsibilities for maintaining and renewing community assets can be met.

A rate cap based on CPI/WPI alone will provide more than enough challenge for local government to drive efficiencies, restrict spending and keep rate increases to a minimum. An efficiency factor imposed on top of that is unnecessary and onerous, and will ultimately act against the community’s interest.

The formulation of a rate cap methodology can provide a valuable platform for rectifying the identified backlog in infrastructure spending that local government is struggling to meet, through the design of a measured, transparent and accountable funding mechanism such as that proposed in this submission.

The ERG appreciates your consideration of our submission. We would be pleased to discuss our suggestions or provide any further information the ESC or the Government may require in its deliberations.

Yours sincerely

Cr Maria McCarthy

Mayor Yarra Ranges Shire Council for and on behalf of the
Eastern Region Mayors and Chief Executive Officers Group