IPART Independent Pricing and Regulatory Tribunal | NSW

Review of the rate peg methodology

Draft Report

June 2023

Local Government

Acknowledgment of Country

IPART acknowledges the Traditional Custodians of the lands where we work and live. We pay respect to Elders both past and present.

We recognise the unique cultural and spiritual relationship and celebrate the contributions of First Nations peoples.

Tribunal Members

The Tribunal members for this review are:

Carmel Donnelly PSM, Chair
Deborah Cope
Sandra Gamble

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Invitation for submissions

IPART invites comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

Submissions are due by Tuesday, 4 July 2023

We prefer to receive them electronically via our online submission form.

You can also send comments by mail to:

Review of the rate peg methodology
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop, Sydney NSW 1240

If you require assistance to make a submission (for example, if you would like to make a verbal submission) please contact one of the staff members listed above.

Late submissions may not be accepted at the discretion of the Tribunal. Our normal practice is to make submissions publicly available on our website as soon as possible after the closing date for submissions. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed above.

We may decide not to publish a submission, for example, if we consider it contains offensive or potentially defamatory information. We generally do not publish sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please let us know when you make the submission. However, it could be disclosed under the *Government Information (Public Access) Act 2009* (NSW) or the *Independent Pricing and Regulatory Tribunal Act 1992* (NSW), or where otherwise required by law.

If you would like further information on making a submission, IPART's submission policy is available on our website.

The Independent Pricing and Regulatory Tribunal

IPART's independence is underpinned by an Act of Parliament. Further information on IPART can be obtained from IPART's website.

Contents

Foreword from the Chair

The 128 councils in NSW are an important part of our democracy and significant providers of essential services. On average they raise about a third of their revenue through rates and the Independent Pricing and Regulatory Tribunal of NSW (IPART) determines how much each council's total rates revenue can increase each year through the rate peg.

IPART has recently consulted widely with ratepayers, councillors, council staff and other stakeholders across NSW about council rates. Our consultation has been an important part of IPART's current review of the rate peg methodology which is how we calculate the rate peg for each council each year.

When councillors decide they need total rates revenue to increase above the rate peg, they can apply to IPART for a special variation. We have also consulted about 17 council special variation applications, received in February and March 2023, seeking rates increases above the rate peg, including some very large proposed increases.

We want to thank every single person who has come forward and provided feedback. We have considered every issue raised in that consultation.

We have heard that some councils are experiencing financial sustainability problems, which they suggest are related to the current financial model for councils. This is requiring strong financial management and council action to either increase rates or cut services, at a time when many people are less able to afford higher rates or to do without essential council services.

We heard that ratepayers are indeed concerned about cost of living pressures and affordability of rates while they also depend on and value council services.

This has raised the question of whether the funding and financial model for councils is as good as it needs to be, at a time when NSW has faced drought, bushfires, floods, COVID, supply chain disruption, labour shortages, higher inflation and rising interest rates.

Feedback to IPART indicates communities want councils to demonstrate good financial management and provide services that are efficient and value for money, so they can be confident the rates they pay are well used. Councillors, as the representatives of the community, play a key role in holding council management to account, and need the tools and information to do so.

Ratepayers have told us they want to be better consulted about council priorities, so councils deliver good quality services that are needed by their local community. We also heard ratepayers would like more consultation about the way rates are set - so rates are fair, reasonable and affordable.

Some councils have stronger financial sustainability than others. A range of reasons have been suggested for why this is the case. We have heard that the capability, workforce shortages, resources and alternative sources of revenue available to councils are not the same across NSW. Populations, economies, distances and geography are quite varied. Councils are very diverse and we have heard that a 'one size fits all' financial model does not make sense.

Our proposed new rate peg methodology is designed to respond to many of the issues raised in the review so far, including being more forward looking and agile, while recognising the diversity of councils. But it cannot address all the issues people have identified.

The rate peg sets the appropriate movement in a council's existing cost base but does not address the cost base itself. Trying to fix the cost base through the rate peg could potentially lead to unwarranted increases for some councils that could do more to control costs, and insufficient increases for councils with genuine financial need.

In assessing special variation applications, in line with current laws and guidelines, the Tribunal has carefully considered the impact of any increases in rates on individual ratepayers and whether increases in total rates revenue are needed so council services can continue to be provided. We note that, within the total rates revenue approved by IPART, it remains the responsibility of councillors to set rates in a way that takes into account the circumstances of their constituents. Councillors also have the authority to provide hardship programs that lessen the impact on people who cannot afford increased rates.

The Tribunal also questions whether the large special variation applications lodged in February and March indicate the financial model needs closer investigation, if the only way a council is able to address financial sustainability is through seeking substantial rates revenue increases.

The Tribunal believes it would be timely for NSW Government to initiate an independent investigation into the financial model for councils in NSW, including the broader issues highlighted in our draft report on the rate peg methodology.

IPART stands ready to work with the NSW Government, councillors, ratepayers and communities to address the issues we have heard through our consultation over recent months.

Carmel Donnelly PSM
IPART Chairperson

Chapter 1

Executive Summary

01

Across NSW, 128 councils provide important goods, services, and facilities to their local communities. For example, they provide local roads, bridges and footpaths; libraries, parks and playgrounds; sporting fields and swimming pools; and public health, childcare, aged care and emergency management services.

Councils fund their operations from a mix of revenue sources. The rates they levy on property owners typically raise around a third of their total income. The rest comes from government grants, development contributions, and user fees and charges.

Councils' main sources of operating income

Rates and annual charges
This includes residential, business, farming, and mining rates, plus any special rates charged by councils, as well as annual charges such as domestic waste management charges.

Grants and development contributions
Councils may receive or apply for state and federal government grants.
Councils may also charge developers development contributions to fund local infrastructure necessary to serve the needs of the development.

User fees and charges
Councils can charge for the sale of goods and services, such as parking, child and aged care services, building and regulatory services and private works.

However, local councils and their communities vary widely across the state. For example, councils differ in the size of their Local Government Area (LGA), and the level of the development and local infrastructure in this area. Local communities differ in the size of their population, and their demographic and socio-economic characteristics, needs and preferences for local government services.

This diversity means councils can face significant and often different challenges in managing their revenues and costs to meet their community's needs and ensure their financial sustainability. The recent COVID pandemic, recent economic volatility, bushfires, droughts and floods, and growing climate change and cyber security threats, have increased these challenges. They have also reinforced how important it is for councils to be financially sustainable so they can deliver reliable, safe services that their communities can afford.

1.1 The local government rate peg

Councils have the power to levy rates (and other charges) within the constraints of the *Local Government Act 1993*, and the rating system it establishes. Within this system, councils set the rating structure and calculate the rate levels for each rating category. But the total income they can raise through these rates is regulated in several ways – one of which is the local government rate peg.

The rate peg is the maximum amount in percentage terms by which a council may increase its rates income[a] in a year. IPART sets this percentage every year, on behalf of the Minister for Local Government, and has done so since first delegated by the then Minister in 2010.

The purpose of the rate peg is twofold:

1. It allows all councils to automatically increase their rates each year to keep pace with the estimated change in the costs of providing their current services and service levels to households, businesses, and the broader community - that is, their base costs. This helps ensure that they can maintain the scope, quantity and quality of these services over time without undermining their financial sustainability.
2. It also limits the impact of these automatic increases on ratepayers, by ensuring that councils cannot increase their rates by more than the estimated change in their base costs, and that they engage with their communities if they propose a step change in their rates revenue to fund improvements in the scope, quantity or quality of their services.[b]

In recent years, concerns about our methodology for setting the rate peg have emerged. These concerns primarily relate to how we measure the annual change in councils' base costs, including our Local Government Cost Index (LGCI). The previous Premier and the then Minister for Local Government asked IPART to review the rate peg methodology, and recommend a methodology that:

- allows councils to vary their general income annually to reflect (as far as possible) changes in the costs of providing local government goods and services due to inflation and other external factors
- continues to include a population factor.[c]

[a] For almost all councils, general income consists entirely of rates income. For a small number of councils, general income also includes some annual charges such as drainage levies. In our Draft Report and accompanying Information Papers, we use "rates income" to describe general income.

[b] This consultation is one of the requirements councils must demonstrate they have met if they apply to IPART for a special variation to the rate peg. They must be granted a special variation to increase their rates income by more than the rate peg.

[c] See Appendix F: Terms of Reference which is also available here.

1.2 How we approached this review

We have undertaken extensive consultation for this review and have sought to hear the views of both ratepayers and councils across NSW.

We published an Issues Paper in September 2022 and invited submissions from all interested parties. We received 96 submissions, most of which were from councils and council organisations. We also held 7 public workshops – 3 in-person workshops in Wagga Wagga, Sydney, and Tamworth, and 4 online workshops – in late November and early December 2022.

We undertook our own analysis, sought expert advice, and considered the stakeholder views we heard through our consultation. Given the diversity of these views, we decided to develop a range of options for improving the rate peg methodology and undertake further consultation to test and refine these options before making our draft decisions. The Office of Local Government granted an extension to the review to allow for this further work.

In March and April 2023, we held 4 technical workshops (1 with ratepayers and 3 with representatives from local government including councils and academics). We limited the number of stakeholders we invited to participate in these workshops to allow for a more targeted and technical discussion of the options for each element of the rate peg methodology.

In addition, we engaged ORIMA, a specialist market and social research company, to undertake 2 NSW-wide surveys to better understand the views of residential and business ratepayers. ORIMA carried out these surveys in November 2022 and March-April 2023 respectively. ORIMA also held 5 focus groups – 3 with residential ratepayers and 2 with business ratepayers – to further explore the survey results.

We considered all the feedback we received through this second round of consultation, and made the draft decisions, recommendations and findings set out in this Draft Report.

96

Submissions to our Issues Paper

11

Workshops

- 7 public workshops
- 4 technical workshops
- 346 attendees

3,396

Ratepayers surveyed

- 2,881 residential ratepayers
- 515 business ratepayers

44

Ratepayers in focus groups

- 3 residential focus groups
- 2 business focus groups

1.3 What we heard through our consultation

Our consultations highlight that it is in the long-term interests of ratepayers for councils to be financial sustainable and deliver affordable services that their communities want and need.

Councils told us that their primary concern is to achieve and maintain financial sustainability, to use their rates income effectively and efficiently, and to maximise what can be achieved.

Figure 1.1 shows that the interests and objectives of councils and ratepayers are interrelated, and an appropriate rate peg methodology should support the delivery of better outcomes for all stakeholders.

Figure 1.1 Stakeholder interests and objectives for the rate peg

Source: ORIMA, Rate Peg Focus Groups Research Report, May 2023, p 2 and IPART.

1.3.1 What we heard from councils

Councils raised a range of specific concerns about the rate peg methodology, which mostly relate to how accurately the methodology measures the change in their base costs. For example, they said to improve the methodology we should:

- improve the LGCI so that it better reflects their actual costs
- address volatility in the rate peg associated with the lag between when the change in the LGCI is measured and when councils apply the resulting rate peg to their rates income
- better account for differences between individual councils and/or council types
- better reflect councils' actual labour costs, including by recognising their need to compete with private and public sector employers to attract and retain staff
- improve the population factor to better reflect changes in councils' base costs associated with population growth

- capture the change in costs due to external factors outside of councils' control – such as the Emergency Services Levy (ESL), climate change and natural disasters, and cyber security.

Councils also raised concerns about the broader regulatory framework, and its impact on their financial sustainability. They identified a range of issues they consider undermine their financial position and limit the effectiveness of the rate peg in maintaining their financial sustainability. For example, they told us that:

- Some councils have been historically underfunded and increasing their rates income by the rate peg each year is not enough to close the gap between their current income and the true cost of delivering their current services.
- Although councils in this position could apply for a special variation to close this gap, some are reluctant to do so as they think the process is resource-intensive and can become a contentious issue.
- Some of the user fees and charges that councils levy but the NSW Government sets (known as statutory charges) have not been adequately indexed over time. As a result, councils have not been able to increase these fees and charges in line with the costs of providing the services, and so ratepayers are effectively subsidising these costs.
- The proportion of land that is exempt from rates within some LGAs is significant. In these areas, the council's rate base may be too narrow to raise enough income to cover the costs of its services, undermining its financial sustainability. In addition, existing ratepayers are effectively subsidising the cost of providing services to exempt properties.
- Some councils would prefer to set rates based on the capital improved value of a property, rather than the unimproved value as currently required. This would more accurately capture the impact of growth within a council's area. It would also share the costs of local government services more equitably across ratepayers.
- In LGAs with high rates of development and population growth, councils must provide additional community facilities that are not being provided by developers or funded through development contributions.
- The rates concession of up to $250 councils provide pensioners is not indexed, reducing its impact on the affordability of rates for these vulnerable customers. In addition, the NSW Government's requirement that councils fund around half the concession amount increases their costs, particularly in LGAs with a high proportion of pensioners.

1.3.2 What we heard from ratepayers

Ratepayers told us their prime concern was the affordability of their rates, and the impact a new rate peg methodology would have on their cost of living. They also questioned:

- How the rate peg compares to the change in the Consumer Price Index (CPI). Some put the view that council incomes have grown by much greater than the CPI.
- The timing of changes to the methodology. They said changes may not be appropriate in the current economic climate.

- Whether there is an effective measurement of councils' productivity. Many indicated they are not confident councils use the money they collect through rates efficiently.
- Why our review is focusing on the lag in the LGCI. They noted that this lag cuts both ways and councils do not seem to have an issue when inflation is lower than the rate peg.

In the survey, most ratepayers were generally satisfied with the quality and level of services that their council provides. However, they raised some broad concerns about the performance and regulation of councils. For example:

- more than half of all residential and business ratepayers surveyed were concerned about how fairly rates are split across types of ratepayers
- more than 60% of business ratepayers said they were not comfortable trusting their council to keep rates reasonable
- around a third of residential ratepayers said councils' communication about how rates income is used was not good enough.

In the focus groups to further investigate the survey findings it emerged that overall, ratepayers wanted the regulated rate setting framework to reflect the principles of transparency, accountability, efficiency, and fairness. Business ratepayers also wanted more business-like expectations of accountability and performance to be applied to councils.

In addition, the focus groups revealed that:

- there is a widely held view that councils don't use rates income effectively, and therefore ratepayers generally pay more than they need to
- ratepayers have only a general sense of what councils use rates income for, and this is strongly influenced by the services and facilities they can see and personally use
- the opportunity to discuss issues and hear other opinions in an open forum enabled residential ratepayers to better consider the value of paying rates to support council services.

1.4 Our proposed improvements to the rate peg methodology

Based on our analysis and consideration of stakeholder views, we have made draft decision on changes to the rate peg methodology. Our proposed method is simpler than the current method and would result in rate pegs that more accurately reflect changes in the costs NSW councils incur in providing their current services. Under this method, we would:

- Measure the annual change in councils' base costs for 3 groups of councils instead of 1 that includes all NSW councils, to better account for the diversity of councils' base cost patterns. These groups are metropolitan, regional, and rural councils.
- Use a new, simpler model to measure this change instead of the LGCI. This measure, the Base Cost Change (BCC), comprises 3 components that we consider better capture councils' costs:
  - employee costs (primarily wages, including superannuation guarantee)
  - asset costs
  - all other operating costs (including administration, utility costs, insurance).

- Use forward-looking indicators to estimate the change in each BCC component.
- Make an explicit, council-specific adjustment for changes in councils' Emergency Services Levy (ESL) contributions so councils can fund their required contributions to support NSW Fire and Rescue, NSW State Emergency Service, and Rural Fire Service without needing to reduce other council services. Using this method, when changes in the costs of the ESL impact the rate peg, it will be visible to councils, ratepayers, and all stakeholders.
- Make additional adjustments to capture costs driven by external factors that affect councils, where councils have engaged with their community. The costs include managing the impacts of climate change, and cyber security, for example. We are also considering implementing a process through which adjustments for specific external costs could be made for groups of councils that meet certain criteria.
- Continue to add a population factor but use a refined approach to more accurately measure the change in councils' residential populations.
- Continue to consider subtracting a productivity factor if there is evidence of productivity improvements in the local government sector that have not been fully incorporated in the Base Cost Change, noting that the productivity factor has been set to zero in recent years.

We propose to implement the improved methodology in a staged process, with some changes taking place for our decision on the 2024-25 rate peg and the rest for the 2025-26 rate peg. We are interested in stakeholder views on the best and fairest way to implement these changes.

We also propose to review our rate peg methodology every 5 years with a transparent and consultative review process. The review would ensure that our methodology is up to date and fit for purpose.

1.5 Draft recommendation on investigation of financial model for councils

As section 1.3 discussed, throughout our consultations for this review stakeholders have made it clear they have serious concerns about council financial sustainability and affordability of rates in the current cost of living climate.

Our draft decisions on the rate peg methodology may reduce some of these concerns. But many of the issues raised won't be fixed by the rate peg or the special variation process. We consider the financial model for councils needs to be investigated to identify improvements.

IPART is making a draft recommendation that the NSW Government consider commissioning an independent investigation into the financial model for councils in NSW. The investigation could examine the broader issues highlighted by IPART's recent consultation, including financial sustainability, funding, costs and expenditure, financial management and the impact on rates and ratepayers.

Section 9.1 presents some of our draft findings on the current financial model for local government which could be considered as part of the recommended investigation.

1.6 We want to hear from you

We are keen to hear what you think about our draft decisions, recommendations and findings on the rate peg methodology and the broader regulatory framework. These are listed in section 1.7. The questions we particularly seek comment on are also listed in section 1.7.

We will continue to engage with councils, ratepayers, and other stakeholders throughout our review. To have your say, you can:

- provide a submission or feedback to this Draft Report by 4 July 2023
- participate in our public hearing on 18 July 2023.

We will consider all the feedback we receive as well as the results of our analysis, in forming our final recommendations. We will provide our Final Report and recommendations to the Minister for Local Government in August 2023.

Have your say

Your input is critical to our review process.

You can get involved by making a submission, submitting feedback, or attending our public hearing.

We are seeking feedback by **4 July 2023** on our draft decisions, recommendations and findings.

Submit feedback »

Register for the public hearing »

1.7 Our draft decisions, recommendations, and findings

Our draft decisions are:

1.	To replace the LGCI with a Base Cost Change model with 3 components:	24
	a. employee costs	24
	b. asset costs	24
	c. other operating costs.	24
2.	To develop separate Base Cost Change models for 3 council groups:	24
	a. metropolitan councils (Office of Local Government groups 1,2,3, 6 and 7)	24
	b. regional councils (Office of Local Government groups 4 and 5)	24
	c. rural councils (Office of Local Government groups 8 to 11).	24
3.	For each council group, calculate the Base Cost Change as follows:	24
	a. For employee costs, we would use the annual wage increases prescribed by the Local Government (State) Award for the year the rate peg applies, or the Reserve Bank of Australia's forecast change in the Wage Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies). We would adjust for changes in the superannuation guarantee in both cases. We are currently consulting on the best approach to measure changes in employee costs (see Seek Comment 1).	24
	b. For asset costs, we would use the Reserve Bank of Australia's forecast change in the Consumer Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies), adjusted to reflect the average difference between changes in the Producer Price Index (Road and bridge construction, NSW) and changes in the Consumer Price Index (All groups, Sydney) over the most recent 5-year period for which data is available.	24
	c. For other operating costs, we would use the Reserve Bank of Australia's forecast change in the Consumer Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies).	25
	d. Weight the 3 components using the latest 3 years of data obtained from the Financial Data Returns of councils in that group, and update the weights annually.	25
4.	To publish indicative rate pegs for councils around September each year (unless input data is not available) and final rate pegs around May each year.	25
5.	To include a separate adjustment factor in our rate peg methodology that reflects the annual change in each council's Emergency Services Levy (ESL) contribution. This factor will reflect:	53
	a. an individual council's contribution, for councils:	53
	– that are not part of a rural fire district, or	53
	– that are part of a rural fire district but do not engage in ESL contribution cost sharing arrangements, or	53
	– are the only council in their rural fire district, or	53
	– that are part of a rural fire district and engage in ESL contribution cost sharing where we have accurate information about what the council pays.	53
	b. the weighted average change for each rural fire district, for councils that are part of a rural fire district and engage in ESL contribution cost sharing arrangements where we do not have accurate information about what they pay.	53

6.	To set Emergency Services Levy (ESL) factors and a final rate peg for each council in May after ESL contributions for the year the rate peg is to apply are known, so that councils can recover changes in ESL contributions in the year contributions are to be paid.	53
7.	To maintain our current approach and make additional adjustments to the rate peg on an as needs basis for external costs (For the Emergency Services Levy, we have made a separate decision - see *Draft Decision 5)*.	69
8.	To change the 'change in population' component of the population factor to deduct prison populations from the residential population in a council area and then calculate the growth in the non-prisoner residential population of a council area for the relevant year. We would not make retrospective adjustments for previous population factors.	77
9.	To retain the productivity factor in the rate peg methodology and for it to remain as zero by default unless there is evidence to depart from that approach.	99
10.	To review our rate peg methodology every five years, unless there is a material change to the sector or the economy, to ensure its stays fit for purpose.	104

Our draft recommendations are:

1.	That a local government reference group is established to advise on the implementation of our new rate peg methodology.	25
2.	That the NSW Government consider commissioning an independent review of the financial model for councils in NSW including the broader issues raised in this report.	110

We are seeking comment on:

1.	What are your views on using one of the following options to measure changes in employee costs in our Base Cost Change model? How can we manage the risks associated with each option when setting the rate peg?	25
	a. Use annual wage increases prescribed by the Local Government (State) Award for the year the rate peg applies, adjusted to reflect any change in the superannuation guarantee rate.	25
	b. Use the Reserve Bank of Australia's forecast change in the Wage Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies), adjusted to reflect any change in the superannuation guarantee rate.	25
2.	Are there any alternative sources of data on employee costs we should further explore?	25
3.	Do you support releasing indicative rate pegs for councils in September, and final rate pegs that are updated for councils' Emergency Services Levy contributions in May?	25
4.	Do you have further information on arrangements between councils to share Emergency Services Levy (ESL) contribution bills including:	54

a. what these arrangements cover (including whether they cover matters other than ESL contributions), and 54
b. whether they apply to Rural Fire Service, Fire and Rescue NSW and NSW State Emergency Service ESL contributions, or contributions for only some of those services? 54

5. Would councils be able to provide us with timely information on the actual ESL contribution amounts they pay including contribution amounts paid to the: 54
   a. Rural Fire Service 54
   b. Fire and Rescue NSW 54
   c. NSW State Emergency Service? 54

   For example, by providing us with a copy of any cost sharing agreement that sets out the proportion that each council pays. 54

6. Would you support IPART establishing a process to develop adjustment factors for groups of councils to increase the rate peg to cover specific external costs? 69

7. Would you support measuring only residential supplementary valuations for the population factor? 78

8. If you supported using residential supplementary valuations, what data sources would you suggest using? 78

9. What implementation option would you prefer for the changes to the rate peg methodology? 104

Our draft finding is:

1. Some councils that are part of rural fire districts have entered arrangements with other councils to share the costs of the Rural Fire Service component of the Emergency Services Levy (ESL). They may therefore pay an amount that is different to the ESL contribution set out in their assessment notice. 53

Matters for further consideration:

1. The eligibility of current rate exemptions could be better targeted to improve outcomes for ratepayers and councils. 111

2. The use of the Capital Improved Valuation method to levy local council rates could improve the efficiency and equity of rates. 111

3. There could be merit in considering whether to introduce an additional constraint (i.e. conditions) on the rate peg to provide confidence to ratepayers that increases are reasonable. 111

4. Some councils may not have an adequate rates base and a mechanism should be developed to enable councils found to have insufficient base rates income to achieve financial sustainability. 111

5. Statutory charges for services provided by councils may not be recovering the full cost of service provision, such as for development approval fees and stormwater management service charges. 111

6.	Councils could be better supported to serve their communities more effectively to build community trust in councils. This could include improvements in how councils undertake and implement their integrated planning and reporting.	111
7.	There are opportunities to strengthen council incentives to improve their performance, including considering whether there is merit in a model that would exempt councils that demonstrate an agreed level of performance and consultation with ratepayers from the rate peg.	111

1.8 Structure of this report

This Draft Report explains our consideration of the key issues for this review and our draft decisions and draft recommendations in more detail, including stakeholder views and the other options we considered to address these issues:

- Chapter 2 discusses the role of the rate peg within the broader regulatory framework, and how we have considered this role in developing our draft methodology.
- Chapter 3 focuses on how we measure the change in councils' base costs and how we can improve this approach.
- Chapter 4 discusses our proposed changes to councils funding the Emergency Services Levy.
- Chapter 5 discusses options for capturing changes in councils' base costs due to other external factors, including climate change
- Chapter 6 discusses the population factor, and how we can refine how we account for changes in councils' residential population.
- Chapter 7 outlines our proposed approach for the productivity factor.
- Chapter 8 discusses options for how we might transition from the existing rate peg methodology to our proposed methodology.
- Chapter 9 discusses a range of issues that stakeholders raised about the broader regulatory framework for local government.

This Draft Report also includes 6 appendices:

- Appendix A: Recommended rate peg methodology formula
- Appendix B: Alternative options considered
- Appendix C: Ratepayer survey and focus groups
- Appendix D: Council financial sustainability
- Appendix E: Climate change cost considerations
- Appendix F: Terms of Reference.

Chapter 2

The role of the rate peg

02

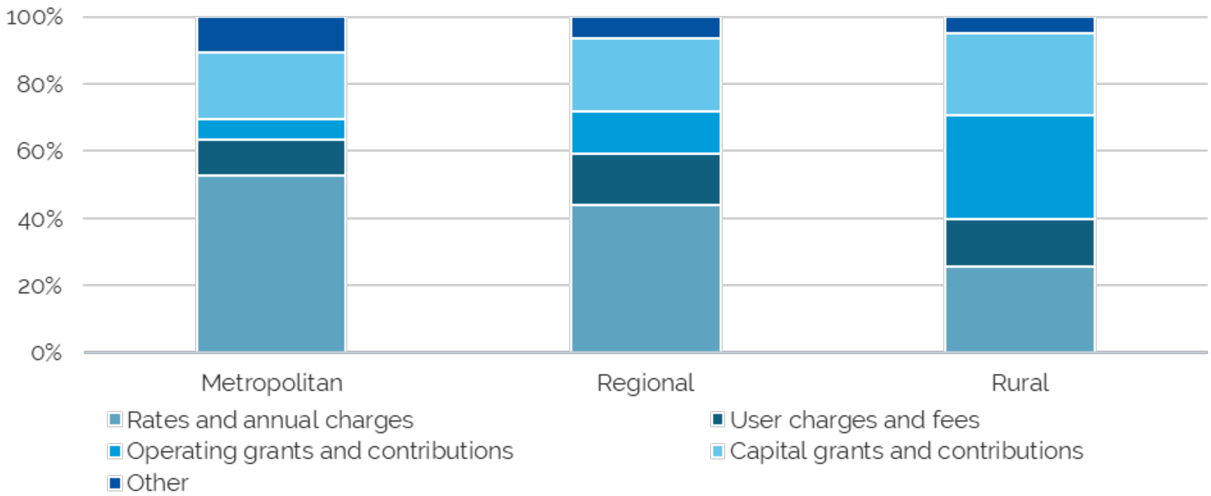
This review focuses on the methodology we use to set the rate peg. The rate peg plays an important role in regulating councils' rates income, which they use to fund the important goods and services they provide to local communities – for example, local roads, bridges and footpaths, and facilities such as parks, libraries, and swimming pools.

However, rates income is just one source of funding for these services. And the rate peg is just one part of the broader governance framework of councils to deliver outcomes for ratepayers. In reaching our draft decisions and recommended changes to the methodology we have considered the needs of ratepayers and councils.

2.1 Rates income as a source of funding for council services

Income from rates represents one of the main sources of funding for the provision of ongoing council services. The importance of this funding source varies across councils (see **Figure 2.1**) but, on average, rates income represents around one third of NSW councils' combined total income. The other major sources of income include grants from state and federal governments, infrastructure contributions and user fees and charges for goods and services councils deliver.

Figure 2.1 Councils' sources of income by council type (2020-21)



Source: Email to IPART, Office of Local Government, 26 April 2023 and IPART analysis.

2.2 The rate peg constrains annual increases in rates income

The rate peg regulates the extent to which councils can increase their rates income in a given year.

It is the maximum percentage increase permitted, and applies to a council's total rates income, not individual rates. Councils can choose to increase their rates income by this percentage, by a lower percentage, or not at all. They can also choose to increase rates for some rating categories by more than the rate peg, and others by less than the rate peg, as long as the overall increase in their total rates income does not exceed the rate peg percentage.

In certain years, councils may need to raise their rates income by more than the rate peg. One example could be so that they could introduce new services or improve service quality. If councils want to increase their rates income by more than the rate peg, they can apply to IPART for a 'special variation' (SV). This requires councils to consult with their communities and demonstrate a case for the SV. If approved, the SV allows the council to increase its rates income by a specified percentage higher than the rate peg in one or more years (up to a maximum of 7 years). This increase may be temporary – that is, the council's rates income must be reduced to what it was prior to applying for the SV, after a specified timeframe. The increase may also be permanent. The rate peg does not prevent councils from seeking to increase their rates income by more than this amount.

Councils' rates income may also increase as a result of supplementary valuations when land may be rezoned or sub-divided to accommodate a growing population.[a] Supplementary valuations can result in land values increasing or decreasing, which impacts the rates income received from the affected properties, leading to a change in a council's rates income.

In addition, the rate peg does not affect councils' ability to increase their income from sources other than rates. For example, councils may raise income to fund the services their communities need or want by seeking government grants. They may also increase income from user fees and charges (with the exception of some fixed statutory charges).

Increasing income through SVs, supplementary valuations and applying for government funding are separate processes that we cannot influence directly as part of this review. However, we recognise these processes are other important means, in addition to the rate peg, through which councils may increase their income to fund the provision of local government services and achieve financial sustainability.

2.3 The rate peg is just one part of a broader regulatory framework

The rate peg forms part of a broader legislative and policy framework under which councils operate. This framework is set out in the *Local Government Act 1993* (LG Act) and other associated regulations, guidelines and policies that aim to support councils to make good decisions that will create positive outcomes for local communities.

Within this complex framework, IPART's role is to set the rate peg, determine applications to increase minimum rates and Crown Land adjustments, and administer the SV process. IPART undertakes these functions under delegation from the Minister for Local Government. IPART also reviews contributions plans above a certain threshold and reports to the Minister for Planning and Public Spaces on those reviews.[b,1]

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a Supplementary valuations are issued outside the usual 3-to-4-year general valuation cycle when changes to property are recorded on the Register of Land Values. Individual ratepayers' rates are impacted by land values set by the Valuer General NSW.

b Contributions plans are prepared by councils and set out the new infrastructure that is needed for a new development and the cost to council of delivering that infrastructure. Developers undertaking the development will pay the costs set out in the contribution plan. Councils need to submit their contributions plans to IPART for review if they propose contributions above $30,000 per residential lot or dwelling in identified greenfield areas and $20,000 per residential lot or dwelling in other areas. For more information see our website.

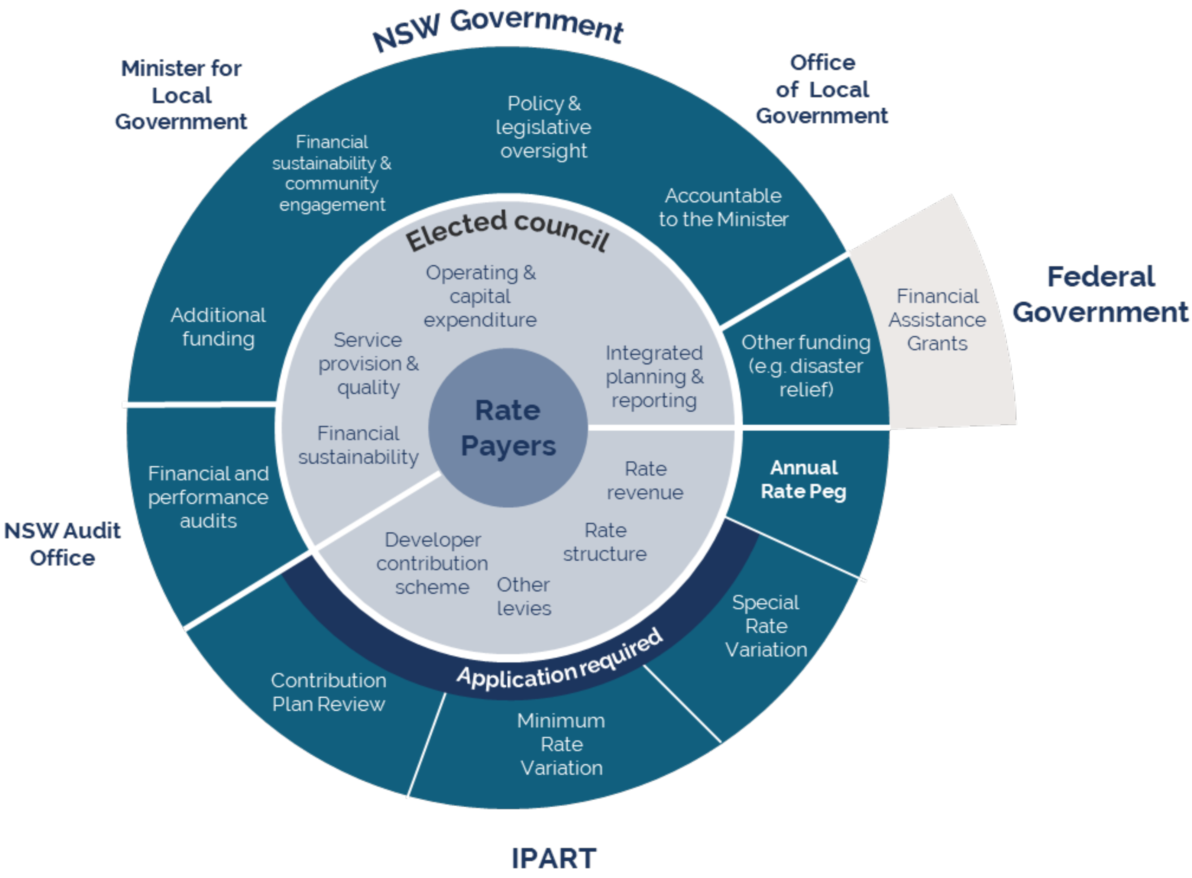
Since 1977, the rate peg has been used to cap increases to council income from rates. IPART sets this percentage every year, on behalf of the Minister for Local Government, and has done so since first delegated by the then Minister in 2010. Previously, the rate peg was set by the Minister for Local Government.

Figure 2.2 shows the regulatory functions that play a role in supporting councils and their communities. It shows that:

- Ratepayers are at the centre, being the focus for decision making.
- The next layer, the elected council, is the primary decision maker and is accountable to ratepayers through the councils' performance. It makes decisions on council services, expenditure, and funding (including rates in consultation with the community). In making decisions, a council considers the needs of their community, principles under the LG Act and the operating environment established by the NSW Government.
- The outer ring, the NSW Government, are the regulatory bodies and the Minister that make the elected council accountable. Regulatory bodies include: the Office of Local Government, the Audit Office and IPART.[c] The Federal Government also provides funding to councils through financial assistance and other grants.
- The annual rate peg (shown in the outer layer) is the maximum amount in percentage terms by which a council may increase its rates income in a year and is the mechanism that determines the total level of rate income for a given council. It is one element, but an important one, in this framework.

[c] There are also other regulatory bodies that work closely with local government, including the NSW Environmental Protection Authority and the NSW Department of Planning and Environment.

Figure 2.2 Key financial and governance framework for local government



Source: IPART

Councils in NSW are democratically elected (shown in the **Figure 2.2**) and form a separate level of government that is local government. Local government elections in NSW are held every 4 years. Councillors are elected for a 4-year term while mayors can be elected to serve a 2-year or 4 -year term. The number of councillors elected vary across councils.[2]

Local government in NSW is established by state legislation, which sets the framework under which councils operate. There are a range of important roles in administering this framework and monitoring councils' performance. These include:

- The Minister for Local Government
  - develops and implements budgets, policy and new legislation relating to local government, with the support of the Office of Local Government.
  - has a range of oversight and enforcement powers to regulate councils.
- The NSW Auditor-General
  - auditor for councils
  - conducts financial and performance audits[3]
  - reports to Parliament and supports reforms aimed at strengthening governance, improves financial management and public accountability.
- The Office of Local Government

- accountable to the Minister for Local Government and is responsible for strengthening the financial sustainability, performance, integrity, transparency and accountability of the local government sector
- has a policy, legislative, investigative and program focus in regulating local councils, county councils and joint organisations
- supports councils to implement Integrated Planning and Reporting (IP&R) processes (discussed below) with and for their communities.[4]

Recently the NSW Auditor-General reported to Parliament on a performance audit on the regulation and monitoring of local government.[5]

The Integrated Planning and Reporting (IP&R) framework was introduced in 2009. This framework has helped councils develop, document and report on plans for their communities. It sets out guidelines for councils in planning and reporting activities and consulting with their communities. The IP&R framework requires councils to develop and publish 5 key documents:

- Community Strategic Plan
- Resources Strategy
- Delivery Program
- Operational Plan
- Annual Report.

These documents provide useful information to the community about their council and strengthen councils' accountability. We have found throughout this review that there is scope for improvements in how council undertake and implement their integrated planning and reporting. Despite councils raising that the framework satisfies a high level of community engagement, we found through our ratepayer consultation that councils could improve their communication and trust with their communities.[6]

We consider that the rate peg, the focus of this review, can help to drive improvements in councils' performance by creating incentives for them to improve efficiency and productivity by constraining increases in councils' rates income to a measure of cost changes estimated using relevant macroeconomic indicators.

However, as the information above indicates, the degree to which a council meets the needs of its community, and its obligations are driven by a wide range of regulatory mechanisms and various factors. Some of these other mechanisms may be more effective in achieving improvements in councils' financial sustainability and providing better outcomes for ratepayers than changes in the rate peg methodology. We discuss these mechanisms in Chapter 9 as part of our discussion on improvements to the broader regulatory framework.

2.4 Councils have told us they are concerned about the impact of the rate peg on their financial sustainability

We have heard from councils that they are concerned about their ability to remain financially sustainable and simultaneously meet the growing demand for new and improved services from their communities. They consider that the rate peg has constrained their ability to fully recover the costs of providing their current services, and this has negatively impacted their financial sustainability. This is discussed in further detail in Appendix D – Council financial sustainability.

It is in the community's interest that councils maintain their financial sustainability to provide ongoing goods, services, and facilities that their communities can afford. We found that the number of councils reporting operating deficits increased from 2016-17 to 2020-21, and more than half of all councils do not meet the infrastructure backlog ratio benchmark (see Appendix D – Council financial sustainability).

We are aware of significant variation in the average residential rates for different types of councils across the State. This suggests that some councils may be struggling to fund the costs of ongoing activities as a result of an insufficient base level of rates income. This cannot be addressed through the rate peg.

While councils can apply for an SV to improve their financial sustainability and/or meet their communities' service expectations, they argued the existing SV process is resource-intensive and can become a contentious issue.[7] As a result, we consider that councils with longstanding financial sustainability issues driven by an insufficient base level of rates income could benefit from a mechanism to reset their base. Councils also need to work with their communities to build trust and show that rates income is being used in a way that provides good value for money for their communities.

Appendix D sets out our analysis in response to issues raised by stakeholders on council financial sustainability.

2.5 Ratepayers expressed concerns about affordability and considered that councils could improve how they communicate with their communities

We found that ratepayers were principally concerned with affordability of their rates, and the impact a new rate peg methodology would have on their cost of living.[8]

In submissions, ratepayers generally considered that councils' financial sustainability problems reflect unnecessary spending and potential mismanagement.[9] For example, results from our ratepayer survey showed that 34% of respondents thought that councils do not use rates income well enough.[10] Ratepayers generally supported having a rate peg in place.[11]

Ratepayers and local communities expect councils to engage and consult with them directly, and listen and respond to their views. Ratepayers also expect councils to improve their productivity and efficiency to deliver services that their communities value.[12] This is particularly important in the current economic conditions when communities are facing cost of living pressures. It is also important that each council actively involves and engages with its community when planning and developing their short and long-term service delivery plans. This is to ensure councils deliver services that meet their communities' preferences and willingness to pay.

Councils also need to respond to changes in population and evolving ratepayer and community expectations on protecting the environment, reducing greenhouse emissions and improving liveability. Sustained delivery of services that meet their communities' needs requires good long-term planning and prudent financial management. Ratepayers need to be provided with information so they can hold their councils accountable.

More detailed findings from our surveys and focus groups conducted with ratepayers can be found in Appendix C.

2.6 The rate peg should ensure ratepayers pay no more than necessary while enabling councils' rates income to keep pace with changes in their costs

According to our Terms of Reference for this review the "primary purpose of the rate peg is to protect ratepayers from excessive increases in their rate bills".[d] However, some stakeholders disagree with this view. Councils challenged the idea that they impose excessive increases onto their communities, while ratepayers argued that they can still face high rates increases despite the rate peg.[13]

As Chapter 1 discussed, we consider the rate peg to have dual purposes. It allows councils to automatically increase their rates income each year to keep pace with the estimated change in the costs of providing their current services and service levels to households, businesses, and the broader community. At the same time, it limits the impact of these automatic increases on ratepayers, by ensuring that councils cannot increase their total rates income by more than the estimated change in these costs,

If the rate peg is effective in fulfilling these purposes, a council that starts with a sufficient base level of rates income and a reasonable level of efficiency should be able to continue providing its existing services over time, without undermining its financial sustainability. And its ratepayers should not be required to pay more than they need to for those services.

But fulfilling both purposes is not easy. To do so, the methodology for setting the rate peg needs to balance a range of sometimes conflicting factors.

To meet the first purpose, the methodology needs to take into account the difference in individual councils across NSW and enable councils to receive sufficient rates income to support the delivery of services to meet ratepayer needs.

[d] See Appendix F: Terms of Reference which is also available here.

However, to meet the second purpose, the methodology should set the rate peg at a level whereby ratepayers do not pay more than what is needed for the delivery of services. This is important to protect ratepayers and provide a financial incentive for councils to maintain or improve their efficiency and productivity.

At the same time, in line with the principles of good regulation, the methodology needs to be simple and easy to administer. This is important to manage the burden the regulation imposes on councils, ratepayers and taxpayers, and ensure its benefits outweigh its costs.

In reviewing the methodology, we are mindful of the dual purpose of the rate peg as well as the need for simplicity. We have considered the views of both councils and ratepayers who are impacted by the rate peg.

Our draft decisions on the rate peg methodology aim to improve the accuracy and simplicity of the methodology, protect ratepayers and support councils' financial sustainability. However, we note that it will be difficult to achieve a rate peg methodology that is capable of addressing the concerns of all parties involved. This is both due to the diverse nature of councils across the State which increases the complexity of calculating an accurate level of council cost changes, as well as the diverging perspectives and preferences of stakeholders on issues such as cost-reflectivity, timeliness, stability and predictability, and which of these should be prioritised.

Through consultation we also heard from stakeholders on issues that could be better dealt with through mechanisms other than the rate peg. This includes changes to how rates are shared between ratepayers, how councils communicate with their communities, and other funding mechanisms available to councils. As a result, we have also taken the opportunity through this review to report on areas we have identified that have the potential for improvement.

Our draft decisions, findings and recommendations on the rate peg methodology, along with commentary on other issues, are set out in the following chapters.

Chapter 3

Improving how we measure changes in councils' base costs

03

Under our current methodology, we measure the change in councils' base costs using the Local Government Cost Index (LGCI) (see Box 3.1 for more information). This provides an average annual cost change for all councils across NSW, which we include in the rate peg.

In reviewing this step of the methodology, we considered the comments we received from stakeholders on the LGCI and explored a range of alternative options for measuring changes in councils' base costs. We also considered when we should measure the change in base costs and publish the rate peg for the coming year.

In the following sections we outline and explain our draft decisions, including how we have addressed stakeholders' concerns, and discuss the other options we considered.

3.1 Our draft decisions on measuring changes in councils' base costs

Our draft decisions are:

1. To replace the LGCI with a Base Cost Change model with 3 components:
   a. employee costs
   b. asset costs
   c. other operating costs.

2. To develop separate Base Cost Change models for 3 council groups:
   a. metropolitan councils (Office of Local Government groups 1,2,3, 6 and 7)
   b. regional councils (Office of Local Government groups 4 and 5)
   c. rural councils (Office of Local Government groups 8 to 11).

3. For each council group, calculate the Base Cost Change as follows:
   a. For employee costs, we would use the annual wage increases prescribed by the Local Government (State) Award for the year the rate peg applies, or the Reserve Bank of Australia's forecast change in the Wage Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies). We would adjust for changes in the superannuation guarantee in both cases. We are currently consulting on the best approach to measure changes in employee costs (see Seek Comment 1).
   b. For asset costs, we would use the Reserve Bank of Australia's forecast change in the Consumer Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies), adjusted to reflect the average difference between changes in the Producer Price Index (Road and bridge construction, NSW) and changes in the Consumer Price Index (All groups, Sydney) over the most recent 5-year period for which data is available.

c. For other operating costs, we would use the Reserve Bank of Australia's forecast change in the Consumer Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies).
d. Weight the 3 components using the latest 3 years of data obtained from the Financial Data Returns of councils in that group, and update the weights annually.

4. To publish indicative rate pegs for councils around September each year (unless input data is not available) and final rate pegs around May each year.

Our draft recommendation is:

1. That a local government reference group is established to advise on the implementation of our new rate peg methodology.

We are seeking comment on:

1. What are your views on using one of the following options to measure changes in employee costs in our Base Cost Change model? How can we manage the risks associated with each option when setting the rate peg?
   a. Use annual wage increases prescribed by the Local Government (State) Award for the year the rate peg applies, adjusted to reflect any change in the superannuation guarantee rate.
   b. Use the Reserve Bank of Australia's forecast change in the Wage Price Index from the most recent Statement on Monetary Policy (averaging the changes over the year to June and December for the year the rate peg applies), adjusted to reflect any change in the superannuation guarantee rate.

2. Are there any alternative sources of data on employee costs we should further explore?

3. Do you support releasing indicative rate pegs for councils in September, and final rate pegs that are updated for councils' Emergency Services Levy contributions in May?

3.2 We propose to replace the Local Government Cost Index with a new Base Cost Change model

We propose to replace the LGCI with a new Base Cost Change (BCC) model. We propose to apply the BCC to measure the base cost change for 3 groupings of councils– metropolitan, regional and rural – each year.

We propose that the BCC includes only 3 components – employee costs, asset costs and all other operating costs (excluding the Emergency Services Levy (ESL)). We would measure changes in councils' ESL contributions separately through an ESL factor (see Chapter 4).

- To measure the change in employee costs, our preferred option is to use annual wage increases prescribed by the Local Government (State) Award (the Award) for the year the rate peg applies, adjusted to reflect changes in the superannuation guarantee rate. When the Award increase is not available, we would use the Reserve Bank of Australia's (RBA's) forecast change in the Wage Price Index (WPI) from the most recent Statement on Monetary Policy (Statement) (averaging the changes over the year to June and December for the year the rate peg applies), adjusted to reflect changes in the superannuation guarantee rate.[a] We are consulting on whether this is the best approach and how the potential risks might be managed (see section 3.4.1).
- To measure the change in asset costs, we would use the average difference between the year-on-year change in the Producer Price Index (PPI) for Road and bridge construction and the year-on-year change in the Consumer Price Index (CPI) for All groups, Sydney over the most recent 5-year period for which data is available to adjust the RBA's forecast change in the CPI from the most recent Statement (averaging the changes over the year to June and December for the year the rate peg applies). This enables us to derive a forecast change in the PPI (Road and bridge construction).[b]
- To measure the change in all other operating costs (excluding the ESL), we would use the RBA's forecast change in the CPI from the most recent Statement (averaging the changes over the year to June and December for the year the rate peg applies).

Appendix A sets out this calculation and our draft methodology in detail.

We have modelled how the BCC for each council group would have performed over the period from 2016-17 to 2023-24 compared to the percentage change in the LGCI included in the rate peg.

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a As the Award is renegotiated every 3 years, we would not be able to reflect the increase in the first year of each Award in the year it occurs due to the timing of the rate peg decision.
The Local Government (State) Award 2023 covers wage increases for the 2023-24, 2024-25 and 2025-26 financial years. This is still being negotiated as of May 2023, however, IPART released the rate peg for 2023-24 in September 2022.

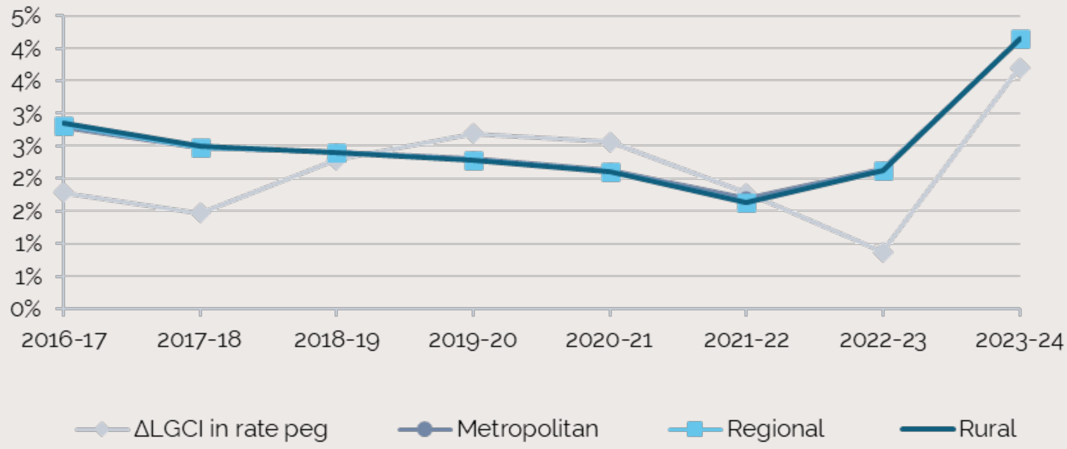
b The RBA's forecasts are published in November, August, February and May each financial year. We would use the forecasts to June of the year for which we set the rate peg. For example, for the 2024-25 rate peg we would use the average of the forecast to December 2024 and the forecast to June 2025. We propose to use the average of the forecasts to December and June (rather than simply the forecast to June) to better capture price movements throughout the year. This approach is more consistent with the way we currently measure inflation for the LGCI. For the LGCI, we measure inflation throughout the year (i.e. the average of 4 quarters divided by the average of the 4 preceding quarters). This method better captures inflation throughout the year and tends to be less volatile than quarter-on-quarter measures (e.g. June on June).

Our analysis suggests that the BCC model should produce a more timely measure of changes in councils' base costs, by referring to forward-looking measures of changes in councils' costs (see Box 3.1). However, like the LGCI, our draft BCC measures only changes in unit costs and does not measure changes in the amounts, quality or types of services provided. The population factor in the rate peg ensures per capita income can be maintained as population grows and our proposed 'other adjustments' could be used to account for some changes outside of councils' control (Chapters 5 and 6). We propose to include a separate factor in the rate peg to account for changes in the ESL (Chapter 4).

Box 3.1 Our new BCC model

The following graph compares our preferred BCC for each council group and the change in the LGCI included in the rate peg over the period from 2016-17 to 2023-24.

Based on the approach set out above, the BCCs would have been very similar for all 3 council groups over this period.



Compared to the change in the LGCI, the BCCs would have been:

- less volatile and a more timely reflection of changes in councils' costs, most noticeably in 2022-23
- lower for all councils in 2020-21, when CPI inflation was around 1.5%[a]
- higher for all councils in 2022-23 and 2023-24, reflecting higher expected inflation.

a. The average inflation rate for the year, measured as the average of four quarters divided by the average of four quarters in the previous year.

3.2.1 We made a draft decision to change to a 3-component model

In this review we have considered opportunities to simplify our methodology and improve the predictability of the rate peg.

Our LGCI includes 26 cost components to capture the range of goods and services used by the average council in NSW. However, the materiality of many of the components is negligible and it might be preferable to reduce some of the complexity of our measure of councils' base costs for a simpler method, without diminishing accuracy.

Box 3.2 Our current LGCI methodology

Under our current methodology, we measure the average annual change in councils' base costs using the LGCI. This index measures the change in prices of a fixed 'basket' of goods and services purchased by the average council relative to the prices of the same basket in a base period. It is similar in principle to the CPI used to measure changes in prices for a typical household.

We developed the LGCI for use in setting the rate peg in 2010, following a review of the revenue framework for the local government sector. We made the decision to set the rate peg with reference to a local government-specific cost index rather than a broad economic index (such as CPI or the WPI) to better reflect the composition of councils' costs and the relative importance of individual costs. We considered that this would produce more cost-reflective estimates.

The LGCI was designed to reflect the changes in unit costs that councils face when providing goods and services to their communities, including labour, construction, and administration costs. It currently includes 26 cost components, each of which is weighted to reflect its relative contribution to councils' total costs. Two of the components account for around 60% of total costs (labour and roads and bridges construction). We maintain the accuracy of the index by collecting data on councils' cost every 4 to 5 years and using this data to update the weights of the cost components.

To measure the annual change in each cost component, we use an appropriate inflator. In most cases, this is a price index published by the ABS. This is intended to provide transparency and independence in estimating cost changes. However, as we rely on historical data to set the rate peg, there is a 2-year lag associated with this method.

Source: IPART, Local Government Cost Index – Information Paper, December 2010, p 1; IPART, Revenue Framework for Local Government - Final Report, December 2009, pp 135-136; and IPART, Rate peg for NSW councils for 2023-24, September 2022, p 9.

In our Issues Paper we sought feedback on how we can simplify the rate peg calculation without diminishing accuracy and received differing views on this from stakeholder submissions.

Some councils indicated a preference for reducing the complexity of our measure of councils' base costs. This is exemplified by the submission from Mid-Western Regional Council which noted that 14 of the 26 components of the LGCI have a weighting of less than 1%. The council added that it is likely there would be no material impact and would likely improve understanding of the calculation by removing these items or combining into other costs and using an All-Groups CPI.[14] Albury City Council and North Sydney Council also expressed support for reducing the number of cost components in the LGCI and simplifying the rate peg methodology.[15]

We also received a number of submissions, mainly from councils and council organisations, expressing the view that cost-reflectivity is the key priority, and simplicity should not be at the expense of accuracy.[16] The United Services Union submission said that simplicity should not be the primary purpose of the rate peg, and cautioned the multiplier effect on the costs of inaccurate rate caps.[17]

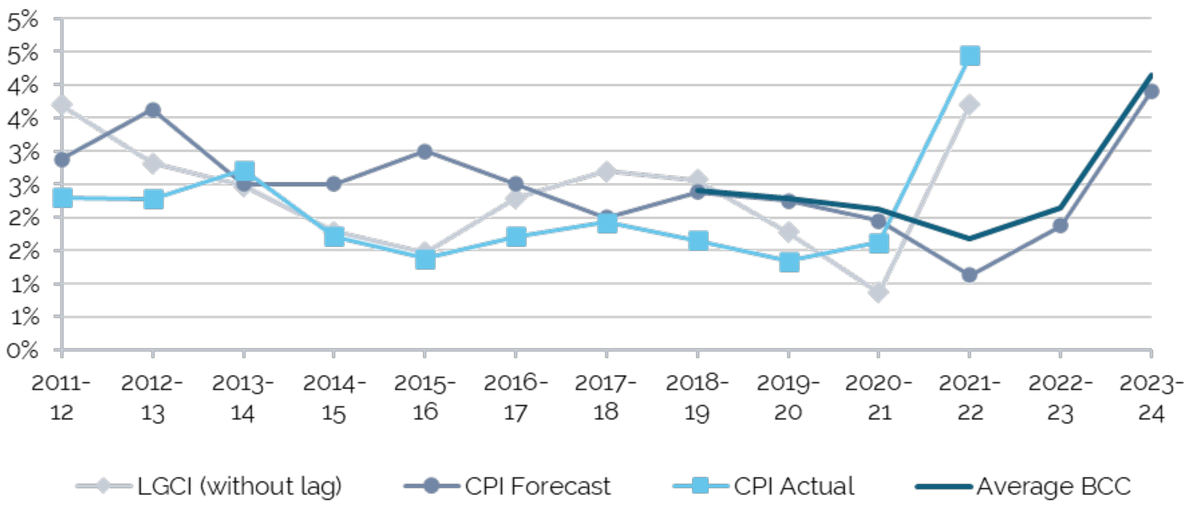
We did not receive many comments from ratepayers on whether it would be preferable to simplify the LGCI, though one ratepayer submission questioned why the LGCI is considered to be a better measure of changes in councils' costs than the CPI, and proposed that the rate peg be based on the CPI.[18]

The CPI published by the Australian Bureau of Statistics (ABS) measures price changes in a 'basket' of goods and services consumed by the typical metropolitan household. This includes goods and services that may not reflect council purchases (e.g. purchases of new dwellings, household items and groceries).

We consider that our measure of councils' cost changes should reflect what councils are known to spend on. This includes employee costs (such as salaries and wages, leave entitlements and superannuation) and asset costs (such as expenditure on roads, parks, and other community facilities). A measure that captures changes in these cost categories is likely to be more cost-reflective for councils than the CPI, which measures changes in costs for metropolitan households.[19]

Figure 3.1 shows the variations between the annual percentage changes in the LGCI, our draft BCC, the RBA's CPI forecast, and the historical All groups CPI (Australia) published by the ABS. We note that our draft BCC is higher than the CPI in some years, and lower in other years, due to including measures of changes in employee and asset costs.

Figure 3.1 Comparison of changes in the LGCI, draft BCC and measures of CPI



Note: the average BCC is the BCC for all councils combined.

Source: IPART analysis

We referred to costs reported in councils' Financial Data Returns to set the cost components in our BCC model

We have reviewed data on councils' operating costs recorded in their Financial Data Returns (FDRs) and considered the feedback received through consultation. We have made a draft decision to move from the current 26-component LGCI to a 3-component measure of councils' base cost changes (i.e. the BCC model).

Our review has shown that different councils across the State have different priorities and services they provide to their communities, and incur different costs in doing so. Our new BCC model is designed to capture 2 key costs that all councils incur in providing services to their communities – employee costs and asset costs. Our analysis shows that these 2 cost components account for around 60% of councils' costs (see **Table 3.2**).

We have combined all other council costs into an 'other operating costs' component because there is a range of different costs incurred by councils across the State, each of which represent a small share of council costs. We consider that including any additional specific cost components in our BCC model would not lead to any substantial improvement in cost-reflectivity, and there is also limited value in including components with minor weightings as they are unlikely to have a material impact on the rate peg outcome.

We also note that the Essential Services Commission (ESC), which provides advice to the Minister for Local Government in Victoria on setting the rate cap for council rates, also uses a simple model to measure changes in council costs. The ESC's recommended council rate cap is typically set with reference to 2 indicators – the CPI and WPI. More recently, the ESC has set its average rate cap with reference to just the CPI.[20]

While our proposed BCC model only includes 3 components and measures only the change in costs (not amounts, quality or types of services), we are aware that each council incurs a range of costs, influenced by its needs and circumstances. Chapter 4 discusses how we might be able to account for additional costs impacting all councils, or subsets of councils, through the rate peg methodology.

3.2.2 We are seeking feedback on how we measure changes in each of the components in the BCC

At our workshops held in March and April 2023 we also presented alternative options for how we measure changes in the BCC cost components, including:

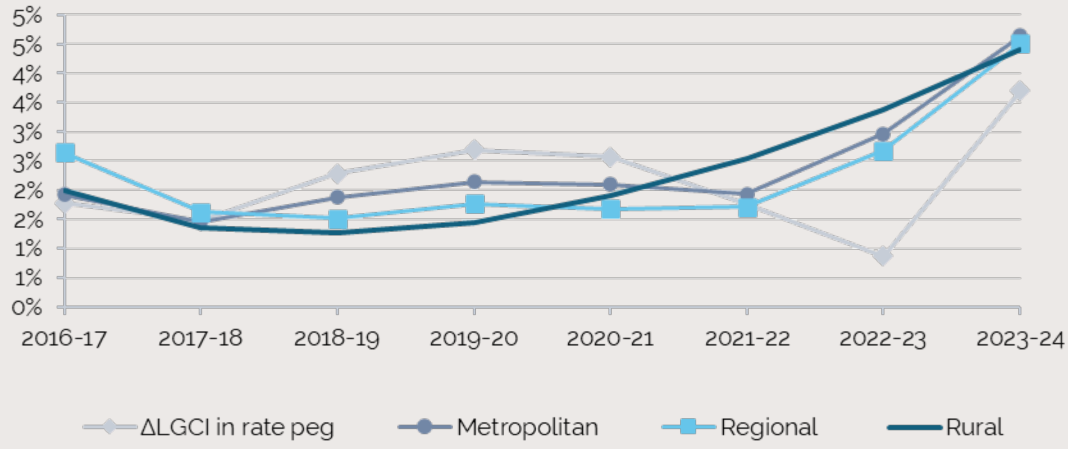
- for employee costs, using the RBA's forecast WPI each year or the Fair Work Commission's minimum wage decisions
- for asset costs, using a lagged measure of changes in depreciation (adjusted for population growth).

Box 3.3 presents an alternative BCC based on RBA's forecast WPI each year to measure changes in employee costs, a lagged, 3-year rolling average of changes in depreciation per capita to measure changes in asset costs and RBA's forecast CPI to measure changes in other operating costs.

Section 3.4 discusses the different options we considered for how we measure changes in costs and the stakeholder feedback we received in detail.

Box 3.3 An alternative BCC

We modelled how an alternative BCC for each council group would have performed over the period from 2016-17 to 2023-24 compared to the change in the LGCI included in the rate peg.



Box 3.3 An alternative BCC

Our analysis shows that this alternative BCC would have been:

- different for metropolitan, regional, and rural councils, reflecting the differences in their depreciation profiles
- less volatile and a more timely reflection of changes in councils' costs compared to the change in the LGCI, most noticeably in 2022-23
- lower than the change in the LGCI (and our preferred BCC model shown in Box 3.1) between 2017-18 and 2021-22, largely reflecting the impact of stagnant depreciation prior to 2018-19.

However, we are unsure to what extent the differences in depreciation are due to differences in councils' asset management, accounting, and reporting practices.

3.3 Developing measures by council group to account for diversity

Many councils expressed concern about using the LGCI to measure the average change in base costs for all NSW councils. They told us that this approach does not accurately reflect how their costs are changing, as different councils across the State have different priorities and services they provide to their communities, and incur different costs in doing so.[21] Findings from our residential and business ratepayer surveys suggest that around two-thirds of respondents would also support a rate peg methodology that is better tailored to the needs and circumstances of each individual council.[22]

Our analysis shows that councils do spend their money differently. As an example, we observed that asset costs generally represent a larger proportion of total costs for regional and rural councils than metropolitan councils (see **Table 3.2**).

Some councils argued for the rate peg methodology to include a measure of base cost change that is unique to each council, based on their reported costs.[23] We have also heard from councils through our consultation processes on how their circumstances impact the services they must provide and the costs they incur.[24]

While we recognise that each council's circumstances may be unique, we also need to consider whether a methodology that allows for the pass through of councils' actual costs would remove incentives for productivity and efficiency. Results from our ratepayer survey showed that 'money from rates is being used effectively by the council' was the second most important consideration for respondents, following 'rates are affordable'.[25] Attendees at our ratepayer focus groups also identified 'effective use' as an important consideration, because it is the key to maximising the value achieved from rates.[26] We also received one ratepayer submission to our Issues Paper that stressed the importance of incentivising productivity.[27]

We would like to better reflect the diversity of councils across the State through the rate peg methodology. We consider this could be supported by developing separate measures of base cost change for groups of 'similar' councils. Any additional differences between councils would need to be captured through other elements of the rate peg (see Chapters 4, 5 and 6).

To establish groups of councils with similar characteristics we have decided to refer to the council types used by the Office of Local Government (OLG). Under this classification, councils are categorised in 5 council types – metropolitan, metropolitan fringe, regional, rural, and large rural – based on broad demographic variables.[28] These 5 council types could be combined into 3 broader groups – metropolitan, regional and rural.

We also considered separating councils into 4 or 5 groups, as some stakeholders suggested, by splitting the metropolitan group and/or rural group into subgroups.[29] However, we consider that 3 groups could be the best option. This is based on our analysis, which shows:

- There is very little difference in the share of expenditure on the 3 cost components captured by the BCC model between metropolitan and outer-metropolitan councils, and between rural and large rural councils. Consequently, there would be very little, if any, difference in the base cost change under our proposed methodology.
- The number of councils in the metropolitan fringe and rural subgroups is relatively small (9 and 15, respectively). This would be problematic if, in the future, we were to use depreciation to measure the change in the asset cost component of the base cost change. This is because a large change in the depreciation cost of a single council could have a substantial impact on the base cost change for all councils in that subgroup. This could make the base cost change for councils in the subgroup more volatile and cumulatively less reflective of changes in their actual costs over time. Similarly, data inaccuracies would be amplified. For example, had we used this methodology over the period 2016-17 to 2023-24, the BBC for the (15) rural councils would on average have been lowest of the 5 council groups – but we cannot be sure to what extent this is a true reflection of actual costs rather than data issues (See Appendix B for more information).

We agree with stakeholders that the rate peg methodology should take better account of the diversity of councils. We are open to exploring alternative groupings based on other characteristics and are currently investigating the issue of council groupings using statistical techniques.

We recommend establishing a local government reference group

We consider that it would be beneficial to establish a reference group of local government representatives, OLG and Local Government NSW to advise us on the implementation of our new rate peg methodology.

We would develop a Terms of Reference for the reference group and consult publicly on this. We would also make the minutes of meetings with the reference group publicly available to support transparency.

3.4 Changing how we measure costs to improve cost-reflectivity and timeliness

Currently we mainly use independent measures of price changes published by the ABS to produce an objective measure of changes in inflation and costs incurred by councils. Although we use the most up-to-date ABS data available, there is a 2-year lag between the time period that price changes are observed over and when councils can recover these price changes by applying the rate peg to their rates income.

Most councils and their representative bodies submitted that the 2-year lag is a problem.[30] This is because, when inflation is volatile, as it has been in recent years, the lag means the rate peg can be substantially above or below actual increases in costs due to inflation. For example, in the 2022-23 rate peg the change in the LGCI was 0.9%[c], while the change in the All groups CPI (Australia) over the 12 months to the June quarter 2022 was 6.1%.[d] Councils' preferred solution to address the lag was to use forward-looking indicators, such as forecasts.

We also considered the option of using rolling averages, which would assist with stabilising volatility. However, this would also lead to a less forward-looking and less cost-reflective measure. This was not a preferred option for attendees at our technical workshops held in March and April 2023.

3.4.1 We propose to use a measure of changes in employee costs that is more timely, and better reflects the costs incurred by councils

Employee costs are the largest single component of council costs, representing around 39% of councils' total costs on average (see **Table 3.2**). Currently we use the ABS WPI for the NSW public sector to measure how councils' employee costs are changing.[31]

A key issue for councils is that the NSW public sector WPI mainly captures changes in wages for State Government employees and does not always reflect the increases councils are required to pay under the Award, which sets out the pay and conditions of employment for most councils in NSW.[32] Councils also noted that the NSW public sector WPI does not account for the premiums that councils have to pay to attract and retain staff, particularly for specialised roles, and in regional and remote areas of the State.[33]

Award increases would improve cost reflectivity and reduce the lag

Many councils supported using the wage increases prescribed by the Award to measure changes in employee costs as it would improve the cost-reflectivity of the rate peg.[34] Additionally, we have heard from councils that the current 2-year lag in the rate peg is problematic in periods of economic volatility. Moving to the wage increases prescribed in the Award would address the lag, to an extent, as the changes are generally known in advance.

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c The 2022-23 rate peg included the change in the LGCI over the year to June 2021. The rate peg was 0.7%, because 0.2% was deducted from the change in the LGCI to remove the 2021-22 election cost allowance.

d Percentage change from the corresponding quarter of the previous year for Australia (i.e. all capital cities). The average inflation rate in 2021-22 (measured as the average of four quarters divided by the average of four quarters) was 4.4%

We need to consider if a methodology that is based on annual wage increases set by the Award is an appropriate measure of efficient employee costs, and whether it would reduce councils' incentive and ability to negotiate effectively and advocate for optimal wages, productivity gains and conditions when participating in award negotiations. While most councils in submissions and at the technical workshops supported the use of the Award, one participant noted that it might cause difficulties for negotiations with unions.[35] Additionally, the Award increases would not account for any attraction or retention premiums that councils may have to pay, nor changes in conditions, resulting from increased competition in the labour market. We are considering how the risks associated with using the Award might be mitigated.

Most ratepayers that attended our technical workshops did not support the idea of using the Award to measure changes in employee costs.[36] One ratepayer submission to our Issues Paper also noted that as councils collectively negotiate the Award, there would no incentive to negotiate lower wage increases if these could be recouped through a higher rate peg.[37]

Using an all sectors WPI forecast would also address the lag

As part of our technical workshops held in March and April 2023, we explored alternative measures of efficient employee costs that would reflect the increases necessary to enable councils to compete with other employers in the market to attract appropriately skilled and qualified staff (see IPART's website). Potentially, this could be achieved by referring to a measure of employee costs that is representative of both public and private sector wage increases, as we have heard from councils that they struggle to compete with both the private sector, and the State Government, to attract and retain staff.[38]

We found that the RBA's forecast WPI could be an appropriate measure of changes in councils' employee costs as it covers both public and private sector wage increases. It addresses the lag under the current approach, and is updated every 3 months to reflect changing economic conditions. We consider the RBA's forecasts are the best independent, publicly available forecasts.

Using a forecast would address the lag in the rate peg methodology. However, forecasts are prone to error and may lead to a divergence between rate peg and actual employees cost changes, in the absence of any true-ups.

We also considered alternative measures of employee costs

Another measure of employee cost increases we considered is the Fair Work Commission's minimum wage decision. This is an independent data source that is determined by an Expert Panel of the Commission through an annual review process. One potential issue with using this data is that changes in the national minimum wage may not reflect changes in councils' efficient labour costs. Additionally, using the Fair Work Commission's minimum wage decision would reduce the lag in the rate peg methodology, but not eliminate it.[e] We consulted on this option as part of our technical workshops, but did not receive much feedback on or support for it.

[e] There would still be a 1-year lag.

We also considered broader ABS WPI options such as the NSW WPI for all sectors. This is an independent measure of employee costs that would reflect the competition councils face in the labour market from both the public and private sectors. However, the main disadvantage of using this measure for our BCC is that it does not address the lag, and therefore is inconsistent with stakeholder preferences for a forward-looking measure of cost changes.

We engaged the CIE to provide advice on options for labour cost indexation

We engaged an independent economic consultant – the Centre for International Economics (The CIE) to provide advice on options for the labour cost indexation in the rate peg.

Table 3.1 compares select alternative options to the current approach, and the indexation outcomes that would have occurred using each option historically.

Table 3.1 Indexation options and historical outcomes

Indexation option	Cumulative 5-year increase (%)	Cumulative 10-year increase (%)
ABS NSW WPI public sector **(Current approach)**	11.4%	27.1%
ABS NSW WPI all sectors	10.5%	26.3%
ABS NSW WPI private sector	10.3%	26.1%
Award increases	12.2%	29.3%
Fair Work Commission minimum wage increase	12.2%	29.9%
Forecast WPI for Australia from RBA[a]	na	na

Note: 5-year and 10-year increases are unavailable for the RBA's forecast WPI because the RBA only started forecasting WPI in November 2018.

Source: The CIE, Local government labour cost indexation, May 2023, pp 1-2.

The CIE found that:

- The Award performed well against other indexation options based on The CIE's assessment, however its main weakness is how it interacts with the wage negotiation process, which could lead to very significant unintended consequences. The CIE considered that if the rate peg is directly linked to the Award increases, then negotiations for award increases could alter significantly — councils would have much less incentive to keep wage increases constrained and would also much prefer wage increases to changes in conditions. The CIE also noted that this measure would be aligned to when councils will face cost increases with the exception of when negotiations are occurring, where this may not necessarily be the case and there may be a gap in timing.[39]
- Forecasts perform best on timeliness. However, these indicators are more likely to have persistent bias relative to actual wage pressures and a lower level of accuracy.[40]
- The Fair Work Commission's minimum wage decisions do not have to relate to the actual labour market pressures faced by councils. Additionally, the National Minimum Wage award is typically made in mid-June to start 1 July that year. This suggests that there would likely be a one-year lag if this measure is used to set the rate peg.[41]

- Broader ABS WPI options (i.e. NSW WPI all sectors and NSW WPI private sector) perform better than the existing WPI public sector option. The CIE identified similarities between the local government and the broader private sector, in terms of workforce compositions and education levels. The main drawback of using these ABS indexes is that they do not address the issue of timeliness.[42]

Further information is available in The CIE's report on local government labour cost indexation, which can be found on IPART's website.

We are seeking stakeholder feedback on our preferred approach to use Award increases to measure changes in employee costs

We are considering and consulting on options for how we measure changes in employee costs incurred by councils. Our preferred approach is to use the annual wage increases prescribed by the Award for our BCC, as it would improve the cost-reflectivity and timeliness of the rate peg. When the Award increase is not available, we would use the RBA's forecast WPI from the most recent Statement (averaging the changes over the year to June and December for the year the rate peg applies).

Some stakeholders have raised concerns about using the Award increases in the rate peg. We acknowledge that there is a risk, and we are considering whether current mitigating factors are sufficient. These include:

- Councils are required, as part of the IP&R process, to consult with their communities on their long-term financial plans and expected cost increases (including increases in employee costs).
- Ratepayers have the ability to oppose their council's decisions by voting the elected council out of power at the next election.
- Once council representatives and unions come to an agreement on the Award (including the wage increases), this needs to be approved by NSW Industrial Relations Commission, which is bound by its wage fixing principles. This could reduce the risk of councils seeking to pass through unreasonable wage increases through the rate peg.

We are interested in stakeholder feedback on whether it is appropriate to use the Award increases to measure changes in employee costs for our BCC model, and whether the risks we have identified, including the risk of potential impacts on the negotiation process, can be adequately managed through the mitigating factors discussed above. We would also like feedback on whether there are other ways we could mitigate these risks when measuring employee costs in the rate peg. We note that if we decide to use the Award increases to measure changes in employee costs, we would re-examine this in our next review of the rate peg methodology to determine whether there are any unintended consequences resulting from this approach.

If stakeholders do not support using the Award increases, we consider that the next best option would be to use the RBA's forecast change in the WPI (averaging the changes over the year to June and December for the year the rate peg applies). This would also improve the timeliness of the rate peg and could better account for changes in labour market conditions that affect attraction and retention premiums, or changes in conditions not measured by the Award increases. However, the main risk associated with this option is accuracy. This could be addressed through a true-up, however, this would offset the benefits of moving to a forward-looking measure of cost changes.

We recognise that the (employer funded) superannuation guarantee is expected to increase from 10.5% in 2022-23 to 12% in 2025-26, at a rate of 0.5% per year, which will not be captured by the Award increases, nor the RBA's forecast WPI.[43] We will adjust for superannuation guarantee increases if we decide to use either of these measures. In addition, for the 2024-25 rate peg we will include the full catch-up to (the expected) 11.5% from the 10% included in the 2023-24 rate peg.[f]

3.4.2 We propose to use the RBA's forecast CPI with a PPI adjustment to measure changes in asset costs

Asset costs, measured using depreciation, represent around 21% of councils' total costs on average (see **Table 3.2**). Currently we use PPIs, published by the ABS to measure how councils' asset costs are changing (mainly the PPI for Road and bridge construction).

We would use an adjusted CPI forecast to address the lag

As previously discussed, a key problem with our current measure is that it is lagged by 2 years. The only way to address the lag is to use a forecast, but PPI forecasts are not available. Instead, to address the lag we would use the RBA's CPI forecast adjusted for the difference between the year-on-year change in the CPI and the year-on-year change in the PPI (Road and bridge construction) over the most recent 5 years for which data are available. For example, over the 5 years to 30 June 2022 the NSW PPI (Road and bridge construction) was on average 0.6% higher than the CPI (All groups, Sydney). The asset cost component of the BCC for 2023-24 would therefore have been 0.6% higher than the RBA's CPI forecast:

$$BCC\ asset\ cost\ = 3.9\% + 0.6\% = 4.5\%$$

We would not include a true-up for actual inflation, because doing so would offset the benefits of moving to a forward looking measure of cost changes. When inflation is volatile, true-ups can be quite large and could overwhelm the forecast. For example, the true-up for the 2021-22 rate peg would have been -1.2%, reflecting unexpectedly low inflation in 2019-20. The asset cost component of the BCC would have been -0.1% instead of 1.2%. Similarly, the true-up for the 2023-24 rate peg would have been 4.5%, reflecting unexpectedly high inflation in 2021-22. The asset cost component of the BCC would have been 8.6% instead of 4.5%.

[f] The 2023-24 rate peg includes the increase from 9.5% in 2020-21 to 10% in 2021-22, which is the increase for the same year as the change in the (lagged actual) WPI.

We considered using changes in depreciation costs to measure asset costs

The LGCI measures the change in the prices councils face for given' basket' of good and services and does not factor in changes in volumes. Hence a number of councils pointed out that the LGCI does not adequately account for the ongoing maintenance, renewal, and replacement of capital assets. They identified 2 issues:

- Many councils receive capital grants to construct assets. However, they are required to fund the maintenance, renewal, and replacement of these assets themselves.44
- Natural disasters and severe weather events are expected to increase in frequency and intensity due to climate change. These events accelerate wear-and-tear and lead to increasing asset renewal and replacement costs.[45]

Councils depreciate assets over their expected lives which in effect allows them to make provision for future capital expenditure to renew and replace the assets. We acknowledge that the LGCI does not account for higher rates of depreciation and asset maintenance costs due to grant-funded assets, accelerated depreciation or indeed any additional or improved assets not associated with population growth. Instead, it accounts for capital costs by assuming stable amounts of capital expenditure each year that increases in line with the relevant PPI.

After considering councils' concerns, we explored the option of using depreciation costs in the BCC as a proxy of changes in asset costs. The purpose of this component would be to capture increases in costs caused by both inflation and the higher volumes that result from the grant-funded assets, accelerated depreciation, and additional or improved assets not associated with population growth. Unlike our proposed adjusted CPI forecast, using deprecation to measure changes in asset costs would increase the volume of services that are included in the base costs.

There are no independent, reliable forecasts of efficient council deprecation costs. Therefore, for this component of the BCC we considered the use of lagged actual depreciation. We consider the best available objective measure is the depreciation reported in councils' financial statements, which are signed off by the Audit Office, then provided to OLG in October each year in their FDRs.[g]

Changes in depreciation can be volatile from year to year. For example, the average annual rate of change over the period 2016-17 to 2021-22 ranged from 1.4% to 8.5% for metropolitan councils and 4.0% to 8.0% for rural councils. To reduce volatility in the rate peg, we would use a 3-year rolling average of the annual change in depreciation.

We would also adjust depreciation costs for population growth by measuring the change in depreciation on a per capita basis. The reason we would adjust for population growth is because the population factor in the rate peg and supplementary valuations already provide income for additional infrastructure due to population growth. Further, for consistency with the population factor (which is limited to minimum of 0%), we would impose a floor of 0% on population growth to avoid increases in depreciation per capita due to a declining population.

For each council grouping we would use the unweighted average change in depreciation, to avoid individual large councils dominating the measure.

g We would use only the depreciation expense and exclude asset impairment costs, which are currently captured in the Depreciation & Amortisation cost item reported to OLG.

In summary, if we use changes in depreciation costs to measure asset costs, we would calculate this by:

- Obtaining depreciation data from the councils' financial data returns submitted to OLG.
- Obtaining population data from the ABS's Population estimates[46] then adjusting the data for councils with declining populations by keeping populations constant.
- Calculating the change in per capita depreciation for each council.
- Calculating the (unweighted) average per capita depreciation rate for metropolitan, regional, and rural councils respectively.

Stakeholders raised concerns about using depreciation to measure asset costs

During our recent round of consultation, some industry stakeholders expressed support for using depreciation to measure asset costs.[47] However, a number of other stakeholders raised concerns about this approach.[48] Some of the main concerns raised by industry stakeholders included:

- Depreciation is a "backward looking" measure.
- The quality of councils' asset management processes and documentation varies across the State.
- Depreciation is an accounting measure and the method for measuring depreciation could change over time (hence reflecting accounting practice rather than changes in costs).
- Some councils were concerned that a grouping for depreciation might not accurately reflect the differences between the councils within the group, in particular for councils with growing populations.
- Rural Fire Service and State Emergency Services assets are included in council's depreciation as assets, but councils are unable to conduct full audits of the equipment. Further, we understand they have limited control over the purchase, maintenance, or use of the assets. The 'Red Fleet' issues is discussed in Box 3.4.

Box 3.4 The Red Fleet

The NSW Rural Fire Service's (RFS) bushfire fleet (Red Fleet) includes the 6,345 firefighting fleet assets[a] used to carry out the RFS' legislated firefighting functions and respond to other emergencies such as floods, storms, motor vehicle accidents and structural fires. Most of the land-based appliances commonly associated with firefighting, such as water pumpers and water tankers, are purchased by the RFS and vested with local councils under the *Rural Fires Act 1997*.[b] The vesting of firefighting assets with local councils means that the assets are legally owned by the council for which the asset has been purchased. The RFS is able to use the firefighting assets through District Service Agreements with local councils or groups of councils. Councils are also responsible for undertaking fleet maintenance and repairs.[c]

Box 3.4 The Red Fleet

We heard through our consultation processes that while councils are required by the NSW Government to account for the depreciation of Red Fleet assets, in reality they do not incur any costs on these assets. Rather NSW Government continues to fund the maintenance and renewal of Red Fleet assets.

This means that if we use councils' depreciation costs to measure changes in asset costs within our BCC model, changes related to the Red Fleet assets would feed into the rate peg, and be passed through to ratepayers despite costs being funded by the NSW Government.

At this stage, we do not have sufficient information to determine the value of Red Fleet assets in councils' financial statements and understand the magnitude of any potential impacts on the BCC model, and the rate peg.

a. As of 2021.
b. Section 119(2).
c. Rural Fires Act 1997, s 119(5).

Source: The Audit Office of NSW, Planning and managing bushfire equipment, February 2023, p 3; Department of Planning and Environment, Guidance on accounting treatment of NSW Rural Fire Service (RFS) assets, February 2023, p 5 and IPART, Summary of discussion at rate peg methodology workshops for the local government sector, June 2023, p 2.

Ratepayers also raised a number of concerns, including the possibility that using depreciation would create an incentive for councils to make capital expenditure decisions that are not the best value for money.[49] They were also concerned that councils may artificially change their depreciation rates.[50]

We carefully considered stakeholders' concerns and agree that measured changes in depreciation may reflect changes in asset management, accounting and reporting practices in addition to changes in actual costs. For example, we found that around 46% of councils reported reductions in total depreciation in 2014-15 compared to 13% in 2019-20 and 24% in 2021-22. We also found bigger increase in depreciation, on average, over the period 2017-18 to 2021-22 compared to the period between 2010-11 and 2017-18. We consider it unlikely that these changes capture only actual changes in asset costs. We believe they also reflect changes in asset management and accounting practices, following the Auditor General's 2017 and 2018 reports on local government, which raised a number of concerns and made recommendations around asset management and accounting practices.[51, 52]

We do not agree with the concern expressed by some ratepayers that using depreciation would create an incentive for councils to make poor capital expenditure decisions. We consider that using a 3-year rolling average for all councils in a regional group, combined with a 2-year or 3-year lag, would reduce the incentive for individual councils to make poor capital expenditure decisions or manipulate depreciation rates beyond efficient levels. In addition, depreciation and asset lives are to an extent governed by accounting principles and codes of practice which reduce the ability of councils to artificially increase depreciation costs.

On balance, we decided to not use depreciation to measure asset costs at this time. We may revisit our decision in the future if we are confident that changes in depreciation reflect changes in actual costs.

3.4.3 We propose to use the RBA's CPI forecast to measure changes in other operating costs

To measure changes in all other operating costs (such as materials and services costs and borrowing costs), we propose to use the CPI forecast from the RBA's most recent Statement (averaging the changes over the year to June and December for the year the rate peg applies). We would not include a true-up for observed inflation, because doing so would offset the benefits of moving to a forward-looking measure of cost changes.

Some councils also suggested that the rate at which costs are changing can also vary across the State.[53] One attendee at our technical workshops proposed using different CPI measures for different councils across the State – for example, cost changes experienced by councils located close to the Queensland border could be more consistent with the CPI for Brisbane, and councils located around Canberra could refer to the CPI for Canberra.[54]

We consider that changes in the CPI for different capital cities are predominately driven by factors specific to these capital cities, such as the performance of the housing market, and are unlikely to reflect changes in costs incurred by councils in NSW. While we do not support directly using the CPI for other capital cities, we note that the RBA's CPI forecast includes all capital cities, which we consider could be a better measure of the expected cost changes for councils across the State.

We also considered CPI and WPI forecasts from alternative sources

We could obtain forecasts from the following sources instead of using RBA forecasts:

- NSW Treasury, which provides CPI and WPI forecast in its Budget Statement (published in June) and half-yearly budget reviews (published in December or February).
- Commonwealth Treasury, which provides CPI and WPI forecasts in its budget documents,[h] which it publishes at various times of the year.

Like the RBA's forecasts, these are highly reputable and publicly available. However, we consider the RBA's forecasts are the best available for our purposes, as they updated more frequently than either NSW Treasury of Commonwealth Treasury forecasts.

A number of private financial institutions also provide CPI and WPI forecasts, but we consider these are not appropriate for our purposes. They are not easily available from public sources and can vary fairly widely. Consolidated forecasts are available from private companies such as Bloomberg Professional Services and Refintiv Financial Solutions, but for a fee. In addition, private institutions tend to focus on short-term forecasts, and many do not provide them for 2 years ahead.

[h] Budget Paper No;1: Budget Strategy and Outlook

We consider that PPI could be a better measure, but forecasts are not available

One attendee at our technical workshops expressed the view that the CPI is only relevant to capacity to pay arguments for households, and that the PPI is the relevant index for the cost of providing services for local government.[55]

We recognise that the PPI could be a better measure of general costs incurred by councils. However, the only way to address the lag in the rate peg is to use forward-looking indicators and we are not aware of any available PPI forecasts.

In section 3.4.2 we outline our approach to adjusting the RBA's forecast CPI using the difference between CPI and PPI – Road and bridge construction over the most recent 5-year period to produce a 'forecast' for PPI – Road and bridge construction. This is also an option we can explore further in the next stage of our review if we receive stakeholder interest and feedback.

3.4.4 We propose to use councils' Financial Data Returns to weight the BCC's components

We have made a draft decision to use councils' FDRs to weight the 3 components of the BCC and update these weights each year. To avoid volatility and for consistency we will use data from the most recently reported 3-year period.

Table 3.2 shows the weights for each council group, using data for the 3 years to 2021-22. It shows that asset costs constitute a larger proportion of costs for regional and rural councils than metropolitan councils. Employee costs and other operating costs each account for between 36% and 41% of the total costs, depending on the council type. Consistent with financial reporting practice, we propose to use depreciation to weight the asset cost component of the BCC. We consider using deprecation as a weight is less problematic than using annual changes in depreciation to measure the asset component of the BCC, as discussed in section 3.4.2. We consider that, for each group, a 3-year rolling average of depreciation is the best available proxy for the share of asset costs in total costs.

Table 3.2 Indicative weights using data for 2019-20 to 2021-22

Council type	Employee costs	Asset costs	Other operating costs (incl. materials and contracts)
Metropolitan	41%	18%	41%
Regional	37%	23%	40%
Rural	36%	26%	38%
All councils	**39%**	**21%**	**40%**

Source: Financial data return information from OLG, IPART analysis

Some stakeholders suggested we use councils' Financial Data Returns to measure changes in costs

Several stakeholders suggested we use data from the FDRs councils submit to OLG each year to measure the BCC. Our major concern with this approach is that it would allow councils to pass their actual cost changes through to ratepayers, albeit with a lag. This would reduce their incentive to improve their efficiency and keep their costs under control.

This would be the case particularly if we set a BCC for each council based on its FDR. If we used the average change in costs for all councils in a group, it would reduce the incentive for an individual council to relax cost control. However, in principle, it could provide an incentive for councils as a group to relax these controls.

Our other concerns with this approach are:

- Using FDR data could have unintended consequences, for example if some councils in a regional group received special variations (SVs), the (measured) increase in expenditure for all councils in that group would exceed increases in expenditure due to inflation.
- FDR data would be lagged by 2 to 3 years, depending on when we publish the final rate peg. A September publication would mean 3-year lag, which is even greater than the 2-year lag under our current methodology. As noted above, most councils and their representative bodies submitted that the 2-year lag in our current methodology is problematic.

3.5 We propose to release an indicative rate peg around September each year

We currently set and publish the rate peg to apply from 1 July to 30 June in September of the previous year. This timing is intended to allow councils to start their IP&R process for the coming financial year in October.

However, publishing the rate peg 9 months in advance may affect how accurately the BCC reflects councils' base cost changes. The main reason for this is the RBA's CPI forecasts can change from one quarterly Statement to the next, especially when economic conditions are volatile. For example:

- The CPI forecast to June 2023 increased from 2.0% in the August 2021 Statement to 2.75% in the February 2022 Statement and again to 4.3% in the May 2022 Statement.[56]
- The CPI forecast to June 2024 increased from 3.5% in the August 2022 Statement to 4.2% in the November 2022 Statement.[57]

Some stakeholders suggested we publish an indicative rate peg around September and a final one closer to the implementation date.[58] Other stakeholders expressed a preference to maintain the current release date due to budgeting and IP&R requirements, and to allow them time to make decisions on SV applications.[59]

On balance, we have made a draft decision to release an indicative rate peg around September, and the final rate peg around May each year. We would calculate all of the components of the rate peg around September, with the exception of the ESL factor for each individual council, and release this as the indicative rate peg. The only change between the indicative rate peg and the final rate peg would be the inclusion of councils' ESL factors once this data becomes available.

We consider that this approach balances the need to provide councils with certainty, while ensuring that councils are appropriately funded for the contributions set out on their ESL assessment notices, which are issued by Revenue NSW in late April for the upcoming financial year. The issues around the timing of the councils' ESL assessment notices are discussed in further detail in section 5.3.

We would like to hear stakeholders' views on this timing, in light of our other draft decisions in relation to the rate peg methodology.

3.6 We modelled options for measuring the components of the BCC

As previously discussed, we considered alternative ways to measure the employee and asset cost components of our 3-component BCC for the 3 council groups. This section shows what the BCCs would have been under each of these options for the period 2016-17 to 2023-24 (see **Table 3.3**). For comparison, the table also shows the change in the LGCI and the change in the CPI over the period.

For employee costs, we modelled a BCC using:

- the Award increases for the year the rate peg applies, and the RBA's WPI forecasts for the other years (**Table 3.3**, Preferred BCC)[i]
- the RBA's forecast WPI for the year the rate peg appliesj (**Table 3.3**, Option 1)
- the Fair Work Commission's minimum wage increases (**Table 3.3**, Option 2).

We adjusted all 3 measures to include the expected increase in the superannuation guarantee. We found that the BCC using the RBA's forecast WPI instead of the Award increases would be very similar to our preferred BCC. The BCC using the Fair Work Commission's minimum wage increases would have been slightly higher, on average, than our preferred BCC.

For asset costs, in addition to our draft decision we considered using:

- Changes in depreciation per capita as a proxy for changes in asset costs (lagged rolling average). This measure would reflect regional differences to a far greater extent than our draft BCC, but as previously indicated we are unsure to what extent this reflects data problems rather than real changes in asset costs (**Table 3.3**, Option 3).
- A lagged PPI (Road and bridge construction), but we note that this would introduce a considerable price lag in the BCC (**Table 3.3**, Option 4).

[i] The preferred BCC is based on annual wage increases prescribed by the Award for the year the rate peg applies for employee costs; the RBA's forecast change in the CPI, adjusted to reflect the average difference between changes in the PPI (Road and bridge construction, NSW) and changes in CPI (All groups, Sydney) over the most recent 5-year period for which data is available, for asset costs; and the RBA's forecast change in the CPI for other operating costs.

[j] The RBA has provided WPI forecasts since its 2019 Statement on Monetary policy, which provided the forecast for 2020-21. For the earlier years we used forecasts from NSW Treasury's Budget Statements.

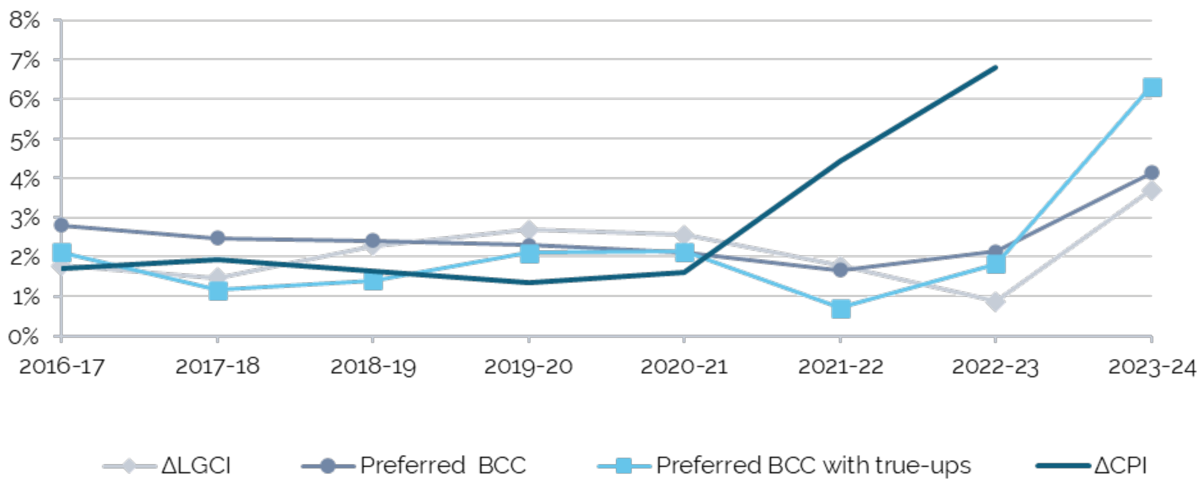
We also modelled an option (Option 5) with a true-up for each of our draft BCC components:

- for employee costs, in the 2nd year of each Award period we applied a true-up from the RBA WPI forecast to the Award rate that applied in the 1st year
- for asset costs, we applied a true-up to actual PPI (Road and bridge construction)
- for other costs, we applied a true-up to actual CPI (Australia).

As shown in **Table 3.3**, and **Figure 3.2**, true-ups could introduce considerable volatility into the BCC. For example, in 2021-22 the BCC would have been 0.7% compared to a change in the LGCI of 1.8% and a preferred BCC of 1.7%. Over the period, the BCC for rural councils would have ranged between 0.7% and 6.5% (compared to 0.9% to 3.7% for the change in the LGCI and 1.6% to 4.2% for our preferred BCC).

For reference, the table also shows the change in CPI. However as discussed in section 3.2, we consider our proposed BCC is more reflective of changes in councils' costs than the change in CPI. From March 2022 to March 2023, the groups experiencing the highest inflation were housing, food, and recreation and culture,[60] which are not reflective of councils' cost. In addition, we expect that councils' costs would generally be less volatile than changes in CPI because employee costs, which account for around 40% of councils' total costs, tend to be less volatile than CPI. For example, between 2016-17 and 2021-22, the change in the NSW WPI (Private and Public, all industries) varied between 1.5% and 2.4% compared to changes in NSW CPI over the same period of between 1.0% to 3.9%.[k]

Figure 3.2 Preferred BBC with true-ups compared to preferred BCC, change in the LGCI and change in the CPI



Source: IPART analysis.

[k] Both measured as the average change over the year (i.e., average of four quarters divided by the average of four quarters in the previous year).

Table 3.3 The BCC using alternative measures compared to our preferred BCC

	ΔLGCI	ΔCPI[a]	Preferred BCC Award PPI CPI	Option 1 RBA WPI PPI CPI	Option 2 FWC[b] PPI CPI	Option 3 RBA WPI Depreciation CPI	Option 4 Award Lagged PPI CPI	Option 5 Preferred BCC with true up[c]
Metropolitan								
2016-17	1.8%	1.7%	2.8%	2.8%	2.7%	1.9%	2.5%	2.1%
2017-18	1.5%	1.9%	2.5%	2.5%	2.3%	1.5%	2.1%	1.2%
2018-19	2.3%	1.6%	2.4%	2.4%	2.7%	1.9%	2.2%	1.5%
2019-20	2.7%	1.3%	2.3%	2.4%	2.7%	2.1%	2.3%	2.1%
2020-21	2.6%	1.6%	2.1%	2.1%	2.4%	2.1%	2.4%	2.1%
2021-22	1.8%	4.4%	1.7%	1.4%	1.6%	1.9%	1.6%	0.7%
2022-23	0.9%	6.8%[d]	2.1%	2.4%	2.4%	3.0%	2.0%	1.9%
2023-24	3.7%	na	4.1%	4.1%	4.5%	4.6%	4.3%	6.2%
Regional								
2016-17	1.8%	1.7%	2.8%	2.8%	2.7%	2.6%	2.5%	2.1%
2017-18	1.5%	1.9%	2.5%	2.5%	2.3%	1.6%	2.0%	1.1%
2018-19	2.3%	1.6%	2.4%	2.4%	2.7%	1.5%	2.1%	1.4%
2019-20	2.7%	1.3%	2.3%	2.4%	2.7%	1.8%	2.3%	2.1%
2020-21	2.6%	1.6%	2.1%	2.1%	2.4%	1.7%	2.5%	2.2%
2021-22	1.8%	4.4%	1.6%	1.4%	1.5%	1.7%	1.5%	0.7%
2022-23	0.9%	6.8%[d]	2.1%	2.3%	2.3%	2.7%	1.9%	1.8%
2023-24	3.7%	na	4.1%	4.1%	4.5%	4.5%	4.3%	6.4%
Rural								
2016-17	1.8%	1.7%	2.8%	2.8%	2.7%	2.0%	2.4%	2.1%
2017-18	1.5%	1.9%	2.5%	2.5%	2.4%	1.4%	2.0%	1.1%
2018-19	2.3%	1.6%	2.4%	2.4%	2.7%	1.3%	2.0%	1.3%
2019-20	2.7%	1.3%	2.3%	2.4%	2.6%	1.4%	2.3%	2.1%
2020-21	2.6%	1.6%	2.1%	2.1%	2.3%	1.9%	2.6%	2.2%
2021-22	1.8%	4.4%	1.6%	1.4%	1.5%	2.5%	1.5%	0.7%
2022-23	0.9%	6.8%[d]	2.1%	2.3%	2.3%	3.4%	1.9%	1.8%
2023-24	3.7%	na	4.2%	4.2%	4.5%	4.4%	4.4%	6.5%

a. Australian CPI, average of four quarters to June each year.
b. Fair Work Commission minimum wage increases
c. Draft BCC with true-ups: for employee costs, true-up to the Award in the 2nd year of each Award period. For asset costs, true-up to actual PPI (Road and bridge construction). For other costs, true-up to actual CPI (Australia).
d. Estimate.

3.7 We considered alternatives to a 3-factor BCC for the 3 regional groups

We also considered a number of alternative options to a BCC model. The alternative options are identified below and discussed in further detail in Appendix B.

Rolling average using both historical and forecast data (Option A)

A commonly suggested mechanism to reduce volatility is to use a rolling average. However, a rolling average based on actual historical data would increase the lag. A compromise solution suggested by some stakeholders would be to use a 3-year rolling average of a measure of changes in costs using historical data combined with a measure of changes in costs using forecast data, each with a 50% weighting. This approach would reduce both volatility and the forecast risk.

Under this option, for each regional group we would calculate:

- the 3-year rolling average of a 3-factor BCC using lagged actual NSW All industries WPI (Private and public), NSW PPI (Road and bridge construction) and CPI data.
- a 3-factor forecast BCC using our proposed methodology.

The BCC included in the rate peg would be the average of these 2 measures. We did not support this option because it would only partially address the lag,

Single year historical and forecast data combination (Option B)

Another option we considered would be a variation of option A. To reduce the lag compared to that under Option A while still addressing the forecast risk, for each regional group we would use:

- a 3-factor BCC using lagged actual WPI, PPI and CPI data for the most recently available year
- a 3-factor forecast BCC using our proposed methodology.

The BCC included in the rate peg would be the average of these 2 measures. Similar to the previous option, we did not support this option because it would only partially address the lag.

A 2-factor BCC using forecast CPI for asset and other costs (Option C)

The third option we considered would be a 2-factor BCC that uses forecast CPI for both asset and other costs. The benefit of this approach compared with our draft BCC is that it is simpler. The disadvantage compared to our draft approach is that it is even less able to reflect regional differences.

BCCs for 5 regional groups (Option D)

A further option we considered would be a separate 3-factor BCC for each of the 5 regional groups, namely metropolitan, outer metropolitan, regional, large rural and rural. We rejected this option for the reason outlined in section 3.3.

We did not pursue the option of a longer-term rate peg at this stage

In our Issues Paper, we raised the option of setting a longer-term rate peg, and sought feedback from stakeholders. The feedback we received was mixed. On one hand, councils said a long-term rate peg would provide certainty in planning and reduce volatility. However, they also indicated they were more concerned about lag and cost reflectivity than volatility. For this reason, we did not pursue this option at this stage.

Some stakeholders requested that we consider setting a 'range' for the rate peg

Some stakeholders raised the idea of IPART providing a rate peg range to recognise the diverse circumstances of local communities across the State and the uncertainty in both future predictions and past data.[61]

We have not pursued this option, as IPART's rate peg represents the maximum percentage amount by which councils can increase their rates income, and councils already have discretion to choose within a range between zero and this maximum. Additionally, councils that do not apply the full rate peg increase have the ability to catch up on the shortfall in rates income over any one or more of the next 10 years. We consider that this provision gives councils flexibility to make decisions on rate increases that are in the interests of their local communities.

Chapter 4

Adjusting for the Emergency Services Levy

04

The NSW Government requires councils to make an annual contribution to the cost of providing emergency services to their communities – which contributes to funding the NSW State Emergency Service (SES), Fire and Rescue NSW (FRNSW), and the NSW Rural Fire Service (RFS). This is known as the Emergency Service Levy Council Contribution (ESL contribution).

Councils generally fund their ESL contribution from their general income and recover this cost through rates. However, the extent to which they are able to do this is an important and long-standing issue for councils.

Our current rate peg methodology captures the average annual change in councils' ESL contribution across NSW. This means it does not accurately reflect the change in individual councils' contributions. Therefore, the rate peg allows some councils to over-recover the change in their ESL contribution, while other councils under-recover this change. When a council faces a much larger than average increase in their ESL contributions, this under-recovery may mean they must reduce services or impact their financial sustainability to fund the increase.

We consider that the rate peg methodology needs to capture individual councils' change in the ESL contribution so that councils can fully recover the changes in this cost. This will help councils meet their ESL obligations without diverting funds needed to maintain service levels and infrastructure for their communities.

Given this, our draft decision is to include a separate, council-specific adjustment factor for the ESL in the rate peg methodology to reflect the change in councils' ESL contributions. However, this is not straightforward because we do not have access to accurate and timely information on each council's annual contribution.

The NSW Government issues each council with an ESL contribution assessment notice, which sets out its total contribution, as well as the contribution to each service. While it would be preferable to capture what each council is invoiced, we understand that the assessment notices do not always reflect what a council pays. This is because in rural fire districts, some councils' assessment notices include their whole district's contribution to the RFS, while other councils' assessment notices include no contribution to the RFS. Where this is the case, some councils have entered arrangements to share these costs. We do not have access to information on these councils' true ESL contributions, or the annual changes in these contributions. Furthermore, we currently only have access to the total invoiced amounts.

Where we can identify that the council is either not part of a rural fire district or does not engage in ESL contribution cost sharing arrangements, we propose to set its ESL factor based on its total annual ESL contribution assessment notice. Where we can identify that the council is part of a rural fire service district and may engage in ESL contribution cost sharing arrangements, and if we are unable to obtain information about what councils actually pay, we propose to set its ESL factor to reflect the weighted average change in its rural fire district's ESL contribution.

We consider there is a need for a more detailed approach to capturing the ESL in the rate peg methodology. Finding what councils' actual ESL contributions are and accurately reflecting this would ensure ratepayers do not pay more than or less than what is appropriate.

We are seeking views on how to best capture what councils' actual ESL contributions are. To reflect changes in each council's individual ESL contribution, we require further information on what councils pay including the details of any ESL contribution cost sharing arrangements in rural fire districts and if other cost sharing arrangements exist that apply to the FRNSW and SES components of councils' ESL contributions.

Our current methodology also uses data that is lagged by one year. This is because assessment notices for the coming year are not issued until April after we set the rate peg. This means we use the amounts from the year before the rate peg is to apply, so that councils recover changes in their ESL contributions in the year after they are paid.

We have also made a draft decision to set the council-specific ESL factors in May of each year, after councils' ESL contribution assessments for the year the rate peg is to apply are known. We propose to publish an indicative rate peg in September, and a final rate peg the following May. The indicative rate peg would show the rate peg percentage for each council, excluding the ESL adjustment. Once the ESL adjustment is known in May, the final rate peg for each council would be published.

The proposed approach means the rate peg would more accurately reflect the actual change in each council's ESL contribution payments, and would allow councils to recover this change in the year contributions are to be paid. Using our proposed method, when changes in the costs of the ESL impact the rate peg, it will be visible to councils, ratepayers and all stakeholders.

We consider that the ESL contribution is a specific external cost that affects all councils, and an obligation all councils must meet, and we have sufficient information about what the cost is to calculate an adjustment to the rate peg. We are treating the ESL in a way that reflects our approach for treating other external costs in the rate peg methodology, that is, to make explicit adjustments to reflect the change in the external cost where we have information to do so (see Chapter 5 for more information).

4.1 Our draft decisions and findings on capturing the costs of the ESL

We are seeking feedback on our draft decisions on our treatment of the ESL for setting the rate peg.

Our draft decisions are:

5. To include a separate adjustment factor in our rate peg methodology that reflects the annual change in each council's Emergency Services Levy (ESL) contribution. This factor will reflect:
   a. an individual council's contribution, for councils:
      - that are not part of a rural fire district, or
      - that are part of a rural fire district but do not engage in ESL contribution cost sharing arrangements, or
      - are the only council in their rural fire district, or
      - that are part of a rural fire district and engage in ESL contribution cost sharing where we have accurate information about what the council pays.
   b. the weighted average change for each rural fire district, for councils that are part of a rural fire district and engage in ESL contribution cost sharing arrangements where we do not have accurate information about what they pay.

6. To set Emergency Services Levy (ESL) factors and a final rate peg for each council in May after ESL contributions for the year the rate peg is to apply are known, so that councils can recover changes in ESL contributions in the year contributions are to be paid.

Our draft finding is:

1. Some councils that are part of rural fire districts have entered arrangements with other councils to share the costs of the Rural Fire Service component of the Emergency Services Levy (ESL). They may therefore pay an amount that is different to the ESL contribution set out in their assessment notice.

We are seeking comment on:

4. Do you have further information on arrangements between councils to share Emergency Services Levy (ESL) contribution bills including:
   a. what these arrangements cover (including whether they cover matters other than ESL contributions), and
   b. whether they apply to Rural Fire Service, Fire and Rescue NSW and NSW State Emergency Service ESL contributions, or contributions for only some of those services?

5. Would councils be able to provide us with timely information on the actual ESL contribution amounts they pay including contribution amounts paid to the:
   a. Rural Fire Service
   b. Fire and Rescue NSW
   c. NSW State Emergency Service?

   For example, by providing us with a copy of any cost sharing agreement that sets out the proportion that each council pays.

4.2 ESL is an important issue for councils

Councils pay contributions to the NSW Government through the Emergency Services Levy (ESL) to support emergency services in NSW. These contributions contribute to the funding of the NSW State Emergency Service (SES), Fire and Rescue NSW (FRNSW), and the NSW Rural Fire Service (RFS). These payments cover 11.7% of the costs of the 3 services. 73.7% is funded through insurance companies through insurance premiums and foreign insured policy holders and the balance is met by the NSW Government (14.6%).[62] Ratepayers may be contributing towards the ESL through both their rates and through insurance premiums in NSW. Within the ESL funding system, it has long been the case that those with home and vehicle insurance contribute to the ESL through their insurance.

Different methodologies are used to determine the contribution by individual councils for each emergency service under the relevant emergency services legislation. The Minister for Emergency Services determines each councils' FRNSW contribution[63], the SES contribution[64] and RFS contribution.[65] Councils receive an annual notice of assessment at the end of April each year detailing the amounts they must contribute.

We recognise that the ESL is an important and long-standing issue for councils and for this review. Local Government NSW (LGNSW) identified the ESL as one of the largest areas of cost changes for councils and an example of higher levels of government increasing obligations on councils.[66] Several submissions from councils to the Issues Paper supported consideration of ESL, including raising concerns about the impacts on different councils particularly on rural councils.

Several councils noted that there was a need to account for the varying impacts of external costs such as the ESL.[67] A few submissions supported measuring the ESL by council groupings.[68] One council organisation argued that the rural fire service contributions should be separated and only applied to the calculation of the local government cost index for councils that pay for it.[69]

LGNSW submitted that under the current methodology the cost of the ESL is averaged and diluted and therefore it does not adequately compensate those most affected. It argued that individual councils should be allowed to adjust rates to recover the full cost of the ESL and has supported decoupling of the ESL from the rate peg.[70] North Sydney Council and Kyogle Council, supported the removal of the ESL from general income.[71] Canberra Region Joint Organisation and one individual supported a separate charge for the ESL.[72] These concerns were also expressed at our technical workshops.[73]

Table 4.1 summarises issues concerning the ESL for this review. We discuss these issues throughout this chapter.

Table 4.1 Summary of issues

Issue	Proposed solution	Limitations
1. The current methodology captures an average increase in ESL contributions across all councils and not councils' individual ESL contributions. Therefore, some councils under-recover and some over-recover.	Setting a separate adjustment for the ESL that allows councils to collect an amount that reflects what their ESL contributions are and how they change.	We need data on the amounts councils actually pay. We would prefer to use information set out in council ESL contribution assessment notices. However, we have found that what councils pay can be different to the amounts set out in councils' assessment notices. We found this applies to councils in rural fire districts.
2. Councils that have historically under-recovered.	Councils can apply for an SV to address any under-recovery on their ESL contributions due to the current methodology, if this under-recovery has had a material impact on financial viability.	No limitations
3. The current methodology uses data lagged by one year, so councils do not recover the ESL contribution amount they need to pay in the year it is payable. This is because ESL contributions for the year the rate peg is set are not known until after we set the rate peg. We set the rate peg based on ESL contributions for the previous year the rate peg is to apply.	We propose removing the lag and setting ESL factors once ESL contributions for the year the rate peg is set are known. i.e. we would set ESL factors and a final rate peg in May.	Our final rate peg would be released much later than we have previously released (September) which may impact timeframes for council budgeting and consulting with the community.
4. The 2023-24 rate peg did not capture increases in the 2023-24 ESL contributions. These ESL contributions were unknown when IPART set the rate peg.	We propose removing the lag to prevent this in the future.	We need to understand the implications for ratepayers and councils.
5. We understand that the NSW Government has discontinued subsidising the increases in ESL contributions for 2023-24. The rate peg has not captured increases in the ESL contributions since the NSW Government started subsidising these increases in 2019-20.	We will consider how to capture the additional costs to councils due to the discontinuation of the subsidy.	We need to understand the implications for ratepayers and councils.

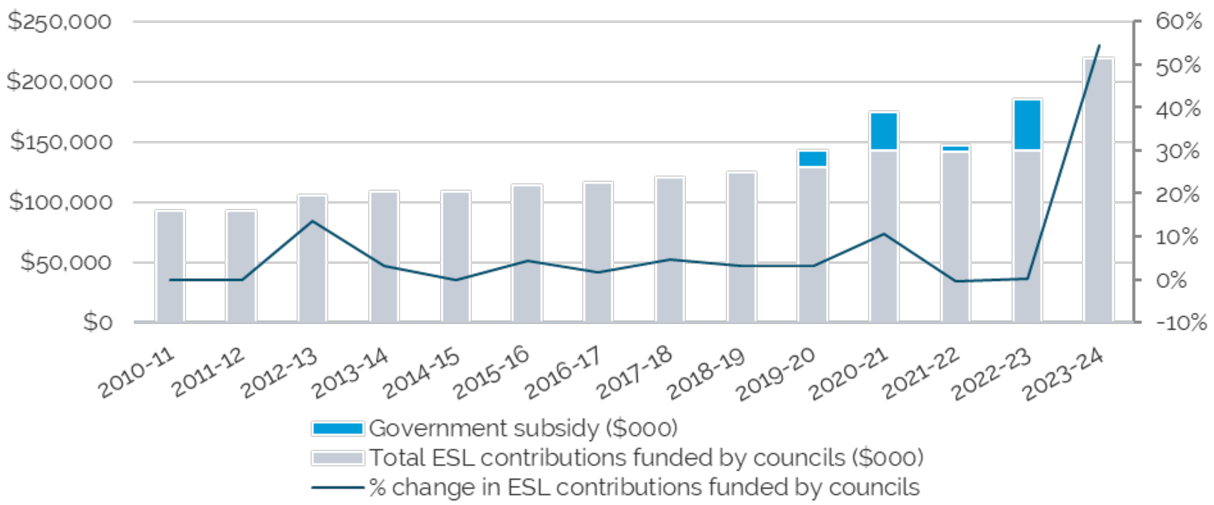
4.2.1 Councils are concerned about ESL increases for 2023-24

There have been some substantial increases in the ESL contributions invoiced to councils over the years. However, over the last 4 years, the NSW Government has subsidised these increases in council's ESL contributions to mitigate the impacts:

- In 2019-20, the NSW Government fully subsidised the increase in council ESL contributions to fund increases in the cost of providing emergency services due to changes made to workers' compensation for volunteer and career firefighters.[74]
- In 2020-21, the NSW Government fully subsidised the increase in council ESL contributions as part of its COVID-19 Local Government Economic Stimulus Package. The NSW Government continued to subsidise increases in 2021-22. [75]
- In 2022-23, NSW Government subsidised the increase in council ESL contributions due to recent natural disasters at the time that led to an increase in the levy rate.[76]

Figure 4.1 shows that since 2010, ESL contributions funded by councils have risen.

Figure 4.1 Council ESL contributions have increased since 2010



Source: Data provided by OLG and Secretariat analysis

We understand that the NSW Government has not continued to subsidise the 2023-24 ESL contributions. This has led to an increase of 54% on average from the level of contributions funded by councils in 2022-23. Councils have raised concerns about this decision and the implications of this on council budgets and service provision.

We understand that this places pressure on councils' budgets for the upcoming financial year, especially as increases in ESL contributions have not been factored into the rate peg since the NSW Government began subsidising the increases. At the time of setting the rate peg, this meant ratepayers did not have to pay for increases in ESL through their rates. However, with the discontinuation of the subsidy there is now an increase in ESL costs that was not included in the calculation of the rate peg.

We recognise that this means that councils will experience substantial cost increases in 2023-24 that they will not be able to recover from rates and this will impact council budgets and services. This could lead to cash flow problems for some councils.

Under our current methodology, councils would only recover these increases in the following year.

When setting the rate peg, we only captured the ESL contributions councils were expected to fund, that is, ESL contributions less the government subsidy. This is shown in **Figure 4.1** above by the light grey columns. This is so that ratepayers did not have to pay for increases in the ESL contributions that councils did not have to fund.[a] Since the NSW Government began subsidising increases in 2019-20, increases in ESL contributions (shown as the top of the columns between 2019 and 2022 in **Figure 4.1**) have not been factored into the rate peg.

As a result, the total increase in the 2023-24 ESL contributions that councils are expected to fund is substantial (54%). However, the increase in the amounts set out in councils' assessment notices between 2022-23 and 2023-24 before government subsidies, is 19%.

4.3 Our proposed methodology aims to better reflect increases faced by individual councils

To improve councils' ability to fund the costs of the ESL contributions, we recognise that there are a number of potential options. For example, stakeholders mentioned establishing a separate ESL charge, such as a property tax, that could be levied on ratepayers and so that it does not form part of general income. However, we note that this would require legislative change.

For this review, we have focussed on how we could improve the rate peg methodology to better reflect the change in costs associated with emergency services under the current legislative framework.

4.3.1 Our existing methodology captures average changes to ESL with a lag

Our current rate peg methodology captures average changes in ESL contributions funded by councils through a component in the Local Government Cost Index (LGCI). When we first developed the LGCI in 2010, we included an ESL component in the cost index.[b] We calculate changes in ESL contribution amounts (across all FRNSW, SES and RFS services) expected to be funded by councils (i.e. excluding government subsidies). This is based on information provided to us by the NSW Government on each council's ESL contribution.

We apply a single percentage change based on the weighted average increase in ESL contributions for all councils.[c] We use the average weight of the ESL as a share of total costs, based on information collected in our last local government cost survey.

[a] For the 2023-24 rate peg, there was no increase to the ESL adjustment as we noted that the NSW Government had undertaken to fully fund the increase in ESL contributions in 2021-22 and 2022-23. Councils would pay the same ESL contribution amount they paid in the previous year.

[b] We found that growth for budget allocations for emergency services had exceeded CPI and expected further growth.

[c] The weighting for the ESL was 1.5% as at June 2021.

As described above, while we currently use the most up to date ESL information available when setting the rate peg, it is lagged by one year. ESL contribution amounts are not known until after 30 April of each year, which is months after we set the rate peg in September.

Our current approach does not capture changes in individual council's ESL contributions. We recognise that changes in ESL contributions vary for different councils and represent varying shares of their rates income. This means that some councils would over-recover, and others under-recover, under our current approach.

Having regard to stakeholder feedback, we considered there was a need to include a separate adjustment for the ESL. We explored options for an adjustment to the rate peg methodology which included:

- rolling over the single factor ESL cost component from the current LGCI as a stand-alone adjustment factor in the rate peg methodology
- setting an adjustment factor based on a weighted average change in ESL contribution for each of the council groups in line with our proposed Base Cost Change (BCC) model
- setting an adjustment specific to each council that reflects each council's change in ESL contribution.

At our technical workshops, we consulted on whether there should be a separate ESL factor to more accurately capture changes in ESL costs in the rate peg methodology, including whether there should be an individual factor for each council. Feedback at these workshops emphasised the need to reflect how these costs vary greatly amongst councils.[77]

We do not consider it appropriate to continue applying a single factor to all councils, as in the current methodology. This is because averaging councils' ESL costs across all councils or groups of councils would result in some councils over-recovering and some councils under-recovering costs that are not in their control. For example, ratepayers would pay more than they need where their councils' contributions have risen less than the average. Councils whose contributions have risen by more than the average would need to make savings or trade-offs with other services to fund their ESL, resulting in negative impacts on ratepayers. We recognise that the current average approach means that some councils have historically under-recovered, and others over-recovered.

4.3.2 Our proposed methodology would capture changes in individual council ESL contributions in a more timely manner

Our draft decision is to make an explicit adjustment for the ESL in the rate peg methodology:

- Using a separate stand-alone adjustment factor for the ESL.
- Set ESL factors that allow councils to collect an amount that reflects what their individual ESL contributions are and how they change, so that the rate peg is more cost reflective. However, we recognise there are challenges with this approach which we discuss below.
- Setting ESL factors and a final rate peg in May of each year after ESL contributions for the year the rate peg is to apply are known.

Setting a cost pass-through in percentage terms would reflect actual ESL contributions

Introducing a separate ESL factor into our rate peg methodology to allow councils to collect an amount that reflects what their individual ESL contributions are and how they change, would improve councils' ability to fund their contributions. It would also ensure Our proposed approach reflects a cost pass-through expressed in percentage terms. We consider that allowing a cost-pass through is justified because councils do not have control to change these costs and they are required to fund these contributions through their general income.

This approach would be more reflective of each council's actual ESL costs. It would mean that councils would not have to use funds needed to cover labour, asset, and other operating costs to meet ESL obligations.

A separate stand-alone adjustment factor for the ESL would also allow us to respond to any changes in mechanisms or policy on funding the ESL, for example, as a result of government reform.

Moving away from an averaged approach would better reflect costs

An adjustment that more accurately reflects individual ESL contributions for each council would provide greater transparency of these costs and the variability of the impact of these costs on councils. It would address council concerns about the disadvantages to the councils with higher ESL contributions associated with using an average across all councils or council groups (such as metropolitan, regional, and rural groupings). Going forward, it would address the issue of under-recovery while also preventing over-recovery by councils that experience smaller than average increases.

Allowing councils to better recover what is needed to meet the ESL contributions will have impacts on ratepayers through higher rates increases for councils that have under-recovered under the local government cost index. However, for councils that have over-recovered, this would mean lower rates increases.

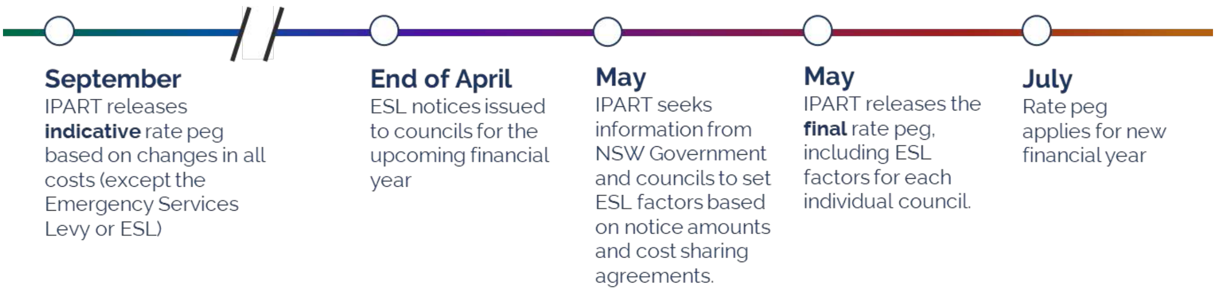
Our proposed approach, however, would not address historical over- or under-recovery that some councils experience under our averaged approach. We do not propose adjusting ESL factors to allow councils that have previously under-recovered due to our methodology to 'catch up' on that under-recovery. Instead, councils that have under-recovered could apply for a special variation (SV) to catch up on years of under-recovery on their ESL contributions, where it has had a material impact on their financial viability.

By removing the lag councils can recover income to fund ESL contributions in the same year

Councils have raised concerns regarding the one-year lag between when councils need to pay their ESL contributions and when they can recover income from rates, and the resulting impacts on cash flow. To address this, we propose setting ESL factors and a final rate peg once ESL contributions for the year the rate peg is to apply, are known.

We propose setting an indicative rate peg in September to apply to all other factors in the methodology aside from council's ESL contributions (See Section 3.5). The ESL factors and a final rate peg would be set in May. This means, for example, we would set an indicative rate peg for 2024-25 in September 2023 and once ESL contributions amounts are known in late April 2024, we would set ESL factors for councils based on the 2024-25 ESL contributions for the final rate peg for 2024-25 in May 2024.

Figure 4.2 Proposed timeline for the setting the rate peg and ESL factors



We would like to hear from stakeholders on their views about our proposed timing for setting an indicative and final rate peg when we are able to set ESL factors, and whether this timing will have any adverse implications for councils when preparing their budgets and operational plans.

4.4 Our ESL factor calculation accounts for councils' full ESL contribution for the year they pay for it

Our proposed rate peg methodology includes an ESL adjustment factor that allows councils to collect an amount that reflects what their individual ESL contributions are and how they change. We propose setting ESL factors for each council. The ESL factor would be calculated in such a way as to ensure that the council's Notional General Income (NGI) includes the full ESL amount councils are expected to pay. This would capture the increase in a council's ESL contributions each year to meet their ESL obligations.

The method to determine ESL factors requires us to calculate the impact of the change in ESL contributions on a council's income, expressed in percentage terms. ESL factors are not the simple increase in a council's ESL contribution.[d] Instead they reflect the additional change to NGI after the impact of the rate peg's BCC, population factor plus any other adjustments, that is needed for a council to meet its ESL obligations.

We would calculate the ESL factor by isolating the impact of the change in ESL contributions on the notional general income in a given year. Our steps for setting ESL factors for the 2024-25 rate peg would be as follows:

1. Calculate the rate peg before ESL factor (i.e. BCC plus population factor plus other adjustments).

[d] This approach would double count the allowed increase as it would allow total NGI including the portion of ESL contribution, to be raised by the BCC or LGCI and then again by the increase in ESL contributions. Our calculation prevents this over-recovery.

2. Apply this rate peg before ESL factor to council's NGI at 2023-24 minus the ESL contribution from 2023-24. We do this to calculate the effect of the rate peg before ESL factor on the non-ESL portion of NGI (in dollar terms).
3. Add the ESL contribution for 2024-25 to the NGI calculated in step 2 (in dollar terms).
4. Calculate the change in the NGIs, comparing NGI for 2023-24 (including the ESL) to the NGI calculated in step 3 (including the ESL). This NGI in step 3 is the non-ESL portion of NGI that is increased by the rate peg before ESL factor, and plus the new ESL contribution. The percentage change is the final rate peg (including the ESL factor).
5. Calculate the ESL factor by subtracting the rate peg before ESL factor calculated in step 1 from the final rate peg (including the ESL factor) calculated in step 4. The ESL factor shows by how much more (or less) the rate peg needs to increase over and above the increase in the rate peg *before ESL factor*.

The general formula is:

$$ESL\ factor = \frac{\left[\left(NGI_{(t-1)} - ESL_{(t-1)}\right) \times (1 + Rx_t)\right] + ESL_{(t)}}{NGI_{(t-1)}} - (1 + Rx_t)$$

Where:
NGI = Notional General income
ESL = ESL Levy Contribution
Rx = Rate peg excluding the ESL factor
t = The current year

For the full formula please see Appendix A - Draft rate peg methodology formula.

The ESL factor captures the change in NGI caused by the change in ESL contributions. The ESL factor is calculated such that it is positive when the change in ESL contributions is greater than the change in the BCC and population factor, and negative when the change in ESL contributions is less. An ESL factor is 0 when the change in ESL contributions is equal to the change in the BCC and population factor. **Box 4.1** provides 2 simplified working examples using the new methodology that shows how an ESL factor can be positive or negative.

Box 4.1 Simplified working example using the new methodology

IPART is setting the rate peg for 2024-25 using a new methodology and needs to determine an ESL factor for Council A and Council B.

- Council A and Council B both have an NGI at 2023-24 of $10 million.
- Council A's 2023-24 ESL contribution was $1 million. Council B 's 2023-24 ESL contribution was $50,000.
- The rate peg before the ESL factor based on the BCC, population factor and other adjustments is 3%.

Box 4.1 Simplified working example using the new methodology

- Council A's 2024-25 contribution is $1.1 million. Council B's 2024-25 contribution is $50,500.

Table 4.2 Worked example data for Council A

Council A	2023-24	2024-25
Rate peg before ESL factor (i.e. BCC, population factor and other adjustments)		3.0%
Notional general income	$10 million	
ESL contributions	$1 million	$1.1 million

Steps to calculate the ESL factor for Council A:

1. Subtract the council's 2023-24 ESL contribution from its NGI at 2023-24. Increase this amount by the rate peg before the ESL factor (defined as X).

$$X = (\$10.0m - \$1.0m) \times (1 + 3.0\%) = \$9.27m$$

2. Add the council's 2024-25 ESL contribution to be recovered by the 2024-25 rate peg (defined as Y).

$$Y = X + \$1.1m$$

$$Y = \$9.27m + \$1.1m = \$10.37m$$

3. Find the percentage change between the initial NGI ($10 million) and new NGI ($10.37m, from step 2). This is the final rate peg.

$$R_{24-25} = \frac{Y}{\$10.0m} - 1$$

$$R_{24-25} = \frac{\$10.37m}{\$10.0m} - 1 = 3.7\%$$

4. Subtract from the final rate peg the rate peg before the ESL factor to find the ESL factor.

$$ESL\ factor = R_{24-25} - 3.0\%$$

$$ESL\ factor = 3.7\% - 3.0\% = 0.7\%$$

1. Applying the full formula.

$$ESL\ factor = \frac{[(\$10.0m - \$1.0m) \times (1 + 3\%)] + \$1.1m}{\$10.0m} - (1 + 3\%)$$

$$ESL\ factor = 0.7\%$$

$$Rate\ peg\ for\ Council\ A = 3.7\%$$

Box 4.1 Simplified working example using the new methodology

Table 4.3 Worked example data for Council B

Council B	2023-24	2024-25
Rate peg before ESL factor (i.e. BCC, population factor and other adjustments)		3.0%
Notional general income	$10 million	
ESL contributions	$50,000	$50,500

Steps to calculate the ESL factor for Council B:

1. Subtract the council's 2023-24 ESL contribution from its NGI at 2023-24. Increase this amount by the rate peg before the ESL factor (defined as X).

$$X = (\$10.0m - \$50{,}000) \times (1 + 3.0\%) = \$10.249m$$

2. Add the council's 2024-25 ESL contribution to be recovered by the 2024-25 rate peg (defined as Y).

$$Y = X + \$50{,}500$$

$$Y = \$10.249m + \$50{,}500 = \$10.299m$$

3. Find the percentage change between the initial NGI ($10 million) and new NGI ($10.299m, from step 2). This is the final rate peg.

$$R_{24-25} = \frac{Y}{\$10.0m} - 1$$

$$R_{24-25} = \frac{\$10.299m}{\$10.0m} - 1 = 2.99\%$$

4. Subtract from the final rate peg the rate peg before the ESL factor to find the ESL factor.

$$ESL\ factor = \ R_{24-25} - 3.0\%$$

$$ESL\ factor = 2.99\% - 3.0\% = -0.01\%$$

5. Applying the full formula,

$$ESL\ factor = \frac{[(\$10.0m - \$50{,}000) \times (1 + 3\%)] + \$51{,}000}{\$10.0m} - (1 + 3\%)$$

$$ESL\ factor = -0.01\%$$

$$Rate\ peg\ for\ Council\ B = 2.99\%$$

In 2022-23, because increases in ESL contributions were subsidised, councils did not need to recover an increase on this amount. Therefore, the increase captured was zero. Under our proposed approach, an ESL factor for 2022-23 would be negative as it was lower than the change in the LGCI (as shown in the working example for Council B above). The ESL factor would therefore negatively adjust the rate peg so the ESL portion of NGI would not increase by the rate peg. Therefore, total NGI would need to be increased by a smaller percentage so ESL factors would be negative in this case.

As calculated above in the working example for Council B, it is possible for ESL factors to be negative if the change in ESL contributions is less than the changes in the other costs measured through the BCC. This is to ensure that increases to the ESL are not applied twice to income so that ratepayers do not pay more than they should.

We note that due to the discontinuation of the NSW Government subsidy for the 2023-24 ESL contributions and the subsequent increase in ESL contributions, future ESL factors could likely be positive factors (as shown in the working example for Council A). This is because ESL factors would capture large increases on average. However, it is also possible in the future that ESL factors could be negative for some councils that experience smaller increases in ESL contributions on average.

4.5 We could set individual ESL factors for some councils but not all

We propose to set ESL factors that reflect the increase in each council's individual ESL contribution. While it would be preferable to capture each council's individual ESL contribution as set out in their assessment notices, we recognise that there are challenges with this approach. We have found that these amounts do not reflect the amounts that some councils actually pay.

We understand that some councils in rural fire districts are billed the total Rural Fire Service (RFS) component of the ESL contribution for the rural fire districts they belong to (which often includes more than one council). We understand that these councils are 'lead councils' and that their assessment notices would include large RFS contribution amounts. As a result, councils within a rural fire district have entered arrangements which we understand to be 'zone agreements', with other councils to share these costs, to collectively meet the rural fire district's total ESL contribution.

Therefore, we understand that these councils and their ratepayers pay an amount to contribute to the ESL that is different to the contribution set out in their assessment notice. We do not have information on these amounts, and this is a challenge in setting ESL factors that better reflect what councils are expected to pay.

We are seeking further information on these arrangements including what these arrangements cover (i.e. whether they cover matters other than ESL contributions) and whether similar cost sharing arrangements exist in respect of NSW State Emergency Services (SES) and Fire and Rescue NSW (FRNSW) and components of the ESL contribution.

We do not propose setting an ESL factor based on the individual ESL invoice amounts for councils in rural fire districts. Doing so, would mean that the ratepayers of a lead council would be expected to fund the entire rural fire district's contribution, and that councils that are not lead councils would not be able to recover from their ratepayers what they need to meet their rural fire district's obligation, as set out by zone agreements.

While it would be preferrable to set an ESL factor that reflects each council's actual ESL contribution, we would need information on how much each council actually pays, particularly in rural fire districts. This would include:

- each council's assessment notice from Revenue NSW
- the amount of a 'lead council's' bill that is recovered from other councils and the amount each council pays to the lead council.

In the absence of this information, we instead propose setting an ESL factor for councils that share paying for the costs of the RFS component of the ESL contribution, that reflects the weighted average increase in total ESL contributions for the councils in the rural fire district. We would treat each rural fire district similar to one council when setting an ESL factor and each council would receive the same ESL factor as those councils in its rural fire district. It would allow councils to recover what they need to meet the ESL contributions for the entire rural fire district on average.

For councils that do not engage in ESL contribution cost sharing arrangements or for which we have information about what they actually pay, we can set an ESL factor that reflects their individual ESL contribution as per their assessment notices.

We note that the information we currently receive on ESL contributions captures the total ESL contributions and not the separate amounts per emergency service contribution.

In order to set an adjustment that captures each council's actual individual ESL contributions, we would need information on the details of any ESL contribution cost sharing arrangements and separate contribution amounts to SES, FRNSW and RFS. We would also need this information in a timely manner to consider this when setting ESL factors in May for the final rate peg. We would like to work with stakeholders to find a way to better reflect what each council pays.

Of the 128 councils, we found that there are 111 councils that are part of one of the 45 rural fire districts. 33 councils could receive an ESL factor that is specific to their council. Some of these councils are part of rural fire districts but are the only council in the district. 95 councils would receive an ESL factor that would reflect the weighted average increase in ESL contributions for the rural fire district they belong to, unless we have information about what these councils actually pay.

4.6 Transitioning to a new ESL methodology would impact ratepayers

We propose changing how we capture the ESL as one of the first steps in transitioning to the new methodology. This would mean transitioning away from our averaged increase in ESL contributions approach for all councils, to a tailored approach that captures as accurately as possible what councils actually pay. We consider that a separate adjustment factor that reflects the actual ESL costs to councils would improve cost-reflectivity and the transparency of these costs for ratepayers which could better inform them of the trade-offs their councils face in funding services and meeting obligations.

Using our proposed methodology, when changes in the costs of the ESL impact the rate peg, it will be visible to councils, ratepayers, and all stakeholders. This would enable better scrutiny over the costs of the ESL and levels of emergency services resourcing, and whether the charges represent good value for money.

Given the variability in ESL contributions across councils, changing the way we account for the ESL by removing the averaging approach, would be beneficial to those ratepayers that have been paying more than what was needed for their council to pay for the ESL. We also recognise that other ratepayers may now need to pay more for the ESL. While the averaging approach to the ESL may have reduced what these ratepayers may have had to pay in the past, it may have meant their councils had reduced their services in order to fund ESL contributions. We consider that it is not in the interests of ratepayers for councils to have to potentially need to trade-off other council services in order to fund ESL contributions, as under our current methodology. We consider that councils are not able to reduce these contributions. We considered that improving the cost reflectivity of how we capture ESL contributions would reduce these negative outcomes.

We recognise that setting a specific adjustment for each council could mean substantial impacts on ratepayers, such as larger increases in rates, for councils with significant changes in the ESL and where changes to the ESL fluctuate greatly. There are especially large impacts in capturing the increases in the 2023-24 ESL contributions because of the discontinuation of the NSW Government subsidy.

However, councils ultimately have discretion when setting rates as to how the impact of rate changes are distributed among ratepayers. Councils may decide to increase rates by less than the rate peg and consult with their communities on rates and service level trade-offs that would be needed to fund the council's ESL contributions.

Chapter 5

Capturing external changes outside councils' control

05

Our Terms of Reference requires us to investigate and make recommendations on "options for capturing external changes, outside council's control, which are reflected in council's costs".[a] In this Draft Report, we refer to costs as a result of external changes that are outside councils' control as 'external costs'. External costs could include those driven by weather or natural disaster, NSW Government actions, such as regulatory changes, or changes to required services or service standards and/or legislative changes.[78] External costs could also arise from legislated restrictions on funding options. External costs can vary widely across councils.

We considered making adjustments to the rate peg to capture costs from external changes and consulted with stakeholders on what these external changes could be, what types of costs are outside of councils' control and whether such costs should be reflected in the methodology. We asked ratepayers about their preferences for funding these costs through rates in our survey and sought advice from our consultant, The Centre for International Economics (The CIE), on how we could potentially account for these costs in the rate peg methodology. As part of this investigation, we also looked specifically at how climate change may be impacting council costs.

Climate change is one of the most significant issues that will impact the lives of people in NSW now and into the future. Councils play a vital role in responding and adapting to climate change including natural disasters with the costs of mitigating and adapting likely to be substantial and with a high degree of variation. Government grants to councils meet some of these climate change costs such as emissions reduction projects, and natural disaster recovery. As ratepayers and the community benefit from councils being able to provide resilient and safe services, it is reasonable for rates to also meet some of these costs.

Our draft decision is to maintain our current approach and make additional adjustments to the rate peg on an as needs basis for external costs (our approach to the Emergency Services Levy is discussed in Chapter 5). Under the approach, we would be able to make additional adjustments to the rate peg for external costs (such as costs associated with climate change or with new statutory functions, or costs where restrictions in funding pose challenges to cost recovery) where ratepayers benefit from these activities and when we have the necessary information to accurately ascertain the quantum of those costs.

We are seeking feedback on a process to strengthen our approach for making adjustments to the rate peg to capture external costs. One option could be a separate process for developing adjustment factors for groups of councils to increase the rate peg to cover specific external costs (e.g. cyber security costs, or climate change costs). We would work with stakeholders to understand what this process should include, for example, requiring that councils demonstrate they meet specific criteria to be eligible for an adjustment to their rate peg.

We are currently considering potential processes and how to establish them. We discuss this further in Section 5.4. In the meantime, we recommend that councils utilise the special variation (SV) process for external costs that have not been included in the rate peg. This process already requires consultation with communities to ensure community awareness of these additional costs.

[a] See Appendix F: Terms of Reference which is also available here.

5.1 Our draft decision on treating external costs

We are seeking feedback on our draft decision and comment on a process to incorporate external costs into the rate peg.

Our draft decision is:

7. To maintain our current approach and make additional adjustments to the rate peg on an as needs basis for external costs (For the Emergency Services Levy, we have made a separate decision - see *Draft Decision 5)*.

We are seeking comment on:

6. Would you support IPART establishing a process to develop adjustment factors for groups of councils to increase the rate peg to cover specific external costs?

5.2 Stakeholders had differing views on funding external costs

Throughout our consultation, councils raised concerns about funding additional requirements and responsibilities outside the control of councils. Submissions to our Issues Paper identified a range of costs that are not reflected in the current rate peg. Many councils supported adjustments to the rate peg methodology to reflect these costs.

Some commonly cited costs included:

- operational costs and depreciation[b] that emerge from infrastructure that may be gifted or transferred to councils
- audit, and audit risk and improvement committee costs[c,79]
- costs driven by climate change, natural disaster emergencies and response (see Section 5.5 below)
- providing community facilities as these are not funded by developer contributions
- cyber security
- costs associated with new functions that councils take responsibility for due to legislative change.

[b] Many councils mentioned the costs of rural fire service assets. In its 2021 report on local government, the NSW Audit Office found that 68 councils had not recorded rural firefighting equipment in their financial statements worth $145 million, and made clear the view that these assets are the responsibility of councils under the section 119(2) of the *Rural Fires Act 1997*. It made a similar finding in the previous report. The NSW Government has confirmed these assets are not controlled by the NSW Rural Fire Service and are not recognised in the financial records of the NSW Government.

[c] Submissions to our Issues Paper suggested these costs could range from $50,000 as estimated by Riverina Joint Organisation to $150,000 estimated by Kyogle Council.

Many submissions from councils requested that rates revenue cover in full councils' contributions to the Emergency Services Levy (ESL). We have made a draft decision to enable councils to recover these costs – see Chapter 4.

In submissions and feedback at both public and technical stakeholder workshops, some councils wanted increases in their rates revenue for the range of services councils provide including health, welfare, and housing services. Councils, particularly in regional and rural areas, told us that they are having to step in to provide services as a last resort because they were previously provided by other levels of government or due to a lack of private providers.[80]

Councils at our public workshops suggested that state or federal government decisions that increase the cost base for councils should be included within the rate peg methodology.[81] One council considered that council specific adjustments would be too difficult to achieve, may become subjective, can be difficult to get agreement and support, can be inequitable and may not be easily understood by ratepayers. It also submitted that one-off external costs for specific councils should be addressed through funding from other levels of government (such as grants and disaster relief funding), or through a more simplified special variation process.[82]

Some ratepayer submissions opposed capturing external costs in the rate peg proposing that councils should manage these costs.[83] An individual submission to our Issues Paper and feedback at our technical workshop for ratepayers considered that external costs should be funded through improvements in efficiency and regular prioritisation of all services to ensure resources are matched with strategic priorities and community expectations.[84] At our technical workshop for ratepayers, some ratepayers said that if costs are directly transferred to councils from the NSW Government, that government funding should be provided rather than ratepayers funding these costs.[85]

Results from our survey of ratepayers showed limited support for rates being used to fund climate change measures. At most, 34% of community ratepayer respondents and 34% of business ratepayer respondents to our survey indicated that rates should fund climate change costs.[86]

5.3 We considered several options for funding external costs

We considered several options for how and if external costs should be included in the rate peg, including proposals from stakeholders and expert advice. For example, Campbelltown City Council and others considered that if there were costs that IPART and the Office of Local Government could identify that would affect councils uniformly, these costs should be added to the rate peg. Such costs could then be removed through a negative adjustment if needed.[87,d]

[d] This has been done for local election costs. See IPART, Rate peg for NSW councils for 2022-23 – Information Paper, December 2021, p 2

Feedback at our technical workshops indicated interest in an alternative process that would be similar to an SV process for external costs. Feedback suggested that although external costs would be incorporated in the Integrated Planning and Reporting (IP&R) process an alternative process for external costs would require councils to increase transparency of these costs. Another stakeholder at our workshops suggested that there was a need to consider a regional view of external costs, including a regional view of cost where councils are taking responsibility for additional services due to legislative change.[88]

Bathurst Regional Council also suggested a council submissions process to enable IPART visibility and approval.[89] Canberra Region Joint Organisation and Snowy Valleys Council suggested councils provide the net costs as a result of underfunding costs of programs devolved by government and incorporating the changes of these net costs in the methodology.[90]

We sought advice from a consultant, The CIE, on options for considering external costs in the rate peg methodology.[e] The CIE provided and analysed 4 options based on a criterion of feasibility; unbiasedness; accuracy and timeliness; simplicity and cost; methodology stability; and potential for unintended consequences or perverse incentives. The options include:

- Option 1: Do not factor in external costs.
- Option 2: Develop a process whereby councils submit external cost claims.
- Option 3: Examine actual cost data.
- Option 4: Request that NSW Government provide estimates of costs for councils related to regulatory changes.

The CIE's analysis found that Option 2 and, to some degree, Option 4 are feasible. However, The CIE identified that there is little evidence about the overall cumulative materiality of positive and negative changes on councils' costs and how much are already included in the Local Government Cost Index (LGCI). Its assessment on historical cost data showed that cost data is too variable, and it is not possible to separate out costs from external factors.[91]

5.4 We can improve how we capture external costs

Our draft decision is to maintain our current approach of making additional adjustments for external costs that affect all councils or a group of councils and where it is appropriate that ratepayers fund these costs. For example, we have made adjustments to account for changes in the superannuation guarantee in 2021-22, which we included in the 2023-24 rate peg and for local government election costs. The adjustment for local government election costs was followed by a negative adjustment the following year so that ratepayers do not pay for costs councils do not incur.[92] This approach was supported by some stakeholders.[93]

We have also proposed to include a separate adjustment to capture contributions councils make to the Emergency Services Levy (ESL). We currently adjust for the ESL in the Local Government Cost Index. We discuss this in Chapter 4.

[e] The CIE's report on treating external costs can be found here.

We also are seeking feedback on a process that could support and strengthen this approach for making adjustments so that we can more proactively capture external costs where necessary. Our findings suggest that external costs can be variable and that although there may be similar types of costs, councils can be impacted differently. Given the variability in external costs, the difficulty identifying these costs and the external factors driving costs, we consider that additional processes are needed to better identify these costs and their impacts on councils and ratepayers. This approach is also consistent with findings from The CIE.[94]

5.4.1 We could develop adjustment factors to capture specific external costs

We are exploring options for a separate process that could strengthen our approach for applying adjustments to the rate peg depending on information and evidence of specific external costs that affect all councils or groups of councils and where an increase to general income is needed to fund these costs.

We have considered developing adjustment factors that could cover specific external costs such as cyber security costs, or climate change costs. We also considered developing adjustment factors for specific groups of councils whose similar circumstances drive similar cost increases, for example, councils that experience drought.

We consider that for some adjustments, a process could require councils to meet certain criteria to be eligible for an adjustment to apply to their rate peg. We consider that such criteria could also be tailored to the particular adjustment.

A separate process for capturing external costs could also encourage councils, as suggested by stakeholders, to better identify external costs which could lead to new council processes for recording and reporting these costs and improving the transparency of these costs.

We propose to work with stakeholders to discuss how the process could be developed including how it could fit into the annual rate peg determination. We consider that this process would require us to collect additional data and further investigate differences between councils.

We consider that a review of the special variations process could support better capturing external costs in the rate peg. A review of the special variation process could consider options, for example, for streamlining the process, reducing administrative burden on councils and enabling councils to make joint applications.

A new process would require time to develop

We recognise that implementing a separate process for capturing external costs could take time and we would want to consult with stakeholders on that process. When we identify a relevant external cost that affects all councils similarly, we will consider an adjustment. In the meantime, councils can continue to use the special variation process where they consider an increase to general income is needed to fund other external costs. We consider that the special variation process is still an appropriate channel for councils to seek to recover these costs, after consulting with their communities.

5.5 Climate change, cyber security and providing community facilities are all examples of external costs

We consider that the "impactor, beneficiary, or taxpayer-pays hierarchy" is appropriate to use to determine whether ratepayers should pay for certain external costs. Box 5.1 below provides more detail on who should pay.

Box 5.1 Impactor-pays, beneficiary-pays and taxpayer-pays funding hierarchy

Across a range of industries, we typically apply the following funding hierarchy when allocating costs between different entities.

1. Preferably, the **impactor** should pay – the entity that creates the costs, or the need to incur the costs, should pay the costs.
2. If that is not possible, the **beneficiary** should pay – the entity that benefits from the service should pay the costs of the service. In some cases, the impactor and the beneficiary are the same entity.
3. As a last resort, **taxpayers** should pay – taxpayers may be considered as a funder of last resort where impactors or beneficiaries have not been clearly identified, or where it is not administratively efficient or practical to charge them (ie, it is too difficult or costly).

We used this framework to understand who should pay for climate change costs.

Source: IPART analysis and IPART, Review of local government election costs – Final Report, August 2019, p 64. See also IPART, Review of funding framework for Local Land Services NSW – Draft Report, September 2013.

Climate change

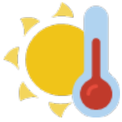
Ratepayers and the community benefit from councils being able to provide resilience and safe services and councils play an important role in addressing climate change. When making decisions, councils should consider the long term and cumulative effects of actions on future generations and principles of ecologically sustainable development.[95]

We identified 3 types of climate change related costs: mitigation, adaptation and natural disaster-related costs.[f]

[f] These costs are consistent with those identified by the Queensland Competition Authority's current Climate change expenditure review 2022–23.

Mitigation costs

- Direct mitigation e.g. reducing emissions projects.
- Indirect mitigation such as purchasing offsets.



Adaptation costs

- Increased costs to existing services e.g. increased maintenance due to increased frequency and severity of storms.
- New/additional costs e.g. need to build new infrastructure to adapt to climate change.

Natural disaster-related costs

- Planning, recovery and response costs including clean-up, repair and replacement of assets and community support programs.

We also considered who should fund these costs. For example, we considered whether those that cause climate change should pay for mitigating and adapting services. We also considered whether those that benefit from receiving more resilient services should pay.

Climate change is one of the most significant issues that will impact the lives of people in NSW now and into the future. We all play a role in addressing climate change and contributing towards the costs of mitigating and adapting.

Communities that may face higher costs and climate risks, such as those affected by recent disasters, are likely to be increasingly vulnerable with a diminishing capacity to pay. Federal, State and Local Governments all play a role in addressing climate change and sharing the costs with the community and ratepayers.

There are a wide range of views on the extent to which climate change should be reflected in rates. Some stakeholders consider that councils' costs associated with climate change should be reflected in the rate peg methodology. Other stakeholders were less supportive of councils funding climate change costs through rates. One stakeholder suggested that councils be required to demonstrate progress on reducing climate impacts to qualify for the rate peg.[96]

Further detail on our climate change considerations for the rate peg methodology and stakeholder views are set out in Appendix E.

Cyber security

The growing importance of cyber security is an issue that affects all councils. In its submission to our Issues Paper, The Hills Shire Council identified cyber security as an external cost that could be included in the rate peg because it has an industry wide impact.[97] Councils at our technical workshops raised concerns about the additional costs of cyber security.[98] The Office of Local Government released new Cyber Security Guidelines for NSW Local Government in December 2022.[99] Councils can adopt these guidelines or use them to form their own cyber security policy.

We consider that it is appropriate for ratepayers to fund some of the costs of enhancing cyber security. The increase in cyber security spending is necessary to protect the personal information of ratepayers and ensure councils are mitigating the operational risk of cyber-attacks.

Community facilities

Councils have also told us that there is increasing demand to provide community facilities for new developments that in the past were provided by the property developers. In its submission to our Issues Paper, Blacktown City Council told us that in its North West Growth Area there is "$525 million [of] unfunded capital costs for community facilities." The council further stated that the "State government policy decision to exclude community facility buildings from funding by developers has meant councils now need to fund these capital expenses from rates revenue."[100]

Concern around the increasing costs of community facilities such as libraries, halls and recreational spaces was also raised by councils in inner-metropolitan areas. North Sydney Council told us in its submission to our Issues Paper that "increasing urban density puts increasing reliance on community facilities while concomitantly increasing land prices. The result is councils having to expend significant sums in providing multi-level and multi-purpose community/recreational facilities and maximising usage of existing spaces such as using artificial surfaces (with their higher capital and maintenance cost) rather than grass. In essence, increasing population in dense urban areas has an exponential impact on the cost of provision of community facilities and their ongoing maintenance."[101]

As a result, councils, like Blacktown and North Sydney, face increased costs to provide community facilities, above the costs already captured in the rate peg and population factor. We consider that in the absence of developer funding for this infrastructure, it would be reasonable for ratepayers to fund some of these costs. Spending on community facilities contributes to providing essential infrastructure and services to new communities in high growth councils. Ratepayers in these new areas directly benefit from access to these services. Ratepayers in existing areas may indirectly benefit through greater provision of community facilities which can lessen the demand on existing community facility assets and delay the need for maintenance and renewal costs.

Chapter 6

Refining the population factor

06

Our current rate peg methodology includes a population factor. The intended purpose of the population factor is to give councils the additional revenue required to keep revenue per capita before inflation consistent, as populations grow. This is designed to allow councils to continue delivering services as their communities grow.

Our Terms of Reference ask us to investigate and make recommendations on, 'whether the population factor is achieving its intended purpose.' The Terms of Reference also ask us to make recommendations on alternate data sources to measure changes in councils' costs. We have also considered alternative data sources to measure changes in population (see Section 6.4.)

6.1 Our draft decisions on the population factor

We have carefully considered the issues raised by stakeholders about the calculation of the population factor. This includes issues with how supplementary valuations are treated in our methodology and the treatment of prison populations. We have investigated these issues to determine if the changes suggested by stakeholders would support the purpose of the population factor. We have also considered how changes to the population factor interact with the other matters we have been asked to investigate and consider under our Terms of Reference.

Our draft decisions is:

8. To change the 'change in population' component of the population factor to deduct prison populations from the residential population in a council area and then calculate the growth in the non-prisoner residential population of a council area for the relevant year. We would not make retrospective adjustments for previous population factors.

Box 6.1 outlines the change we propose making to the population factor. We propose to exclude the number of prisoners from the overall residential population for a council area to calculate the 'change in population' component. We consider this decision will improve the accuracy of the population factor in calculating the residential population of a local government area, we discuss this issue further in Section 6.3.1

Box 6.1 Our draft changes to the population factor

We propose to change how the 'change in population' component of the population factor formula is calculated. The change would be to calculate the 'change in population' by deducting the prison population from the residential population of a council area and then calculating the change in the non-prisoner residential population of a council area for the relevant year.

Proposed 'change in population' formula for 2024-25 rate peg:

$$Change\ in\ population = max\left(0, \frac{(ERP\ 2022\ -\ PP\ 2022)}{(ERP\ 2021\ -\ PP\ 2021)} - 1\right)$$

where

ERP = estimated residential population published by the Australian Bureau of Statistics

PP = prison population published by the Australian Bureau of Statistics

We are seeking comment on:

7. Would you support measuring only residential supplementary valuations for the population factor?

8. If you supported using residential supplementary valuations, what data sources would you suggest using?

6.2 We will maintain the population factor but make a minor adjustment to improve accuracy

While the population factor has not been in place long, our analysis of its operation so far suggests that our overall approach to the population factor is still appropriate. We consider that the current formulation of the population factor and its objective of maintaining per capita revenue as populations grow is still the best way to account for the additional costs of population growth.

Where we have received feedback from stakeholders on potential improvements to the factor, we have listened to these views and considered the suggestions. One suggestion proposed by ratepayers was to remove the impact of new prisons and population growth in prison populations from our methodology. The ratepayers submitted that the population factor was providing the council with additional revenue that it did not require, as the prison should not affect council costs.[102] We agree with this suggestion and we are proposing to make a minor adjustment to our methodology to exclude any change in prison population from our calculation of the change in population in a council area.

We received feedback on several other issues that concerned stakeholders. Stakeholders asked us to consider:

- Removing the adjustment for supplementary valuations from our calculation of the population factor.[103]
- Calculating a catch-up adjustment for historical changes in population growth.[104]
- Adjusting the rate peg to give councils additional revenue for decreases in population.[105]
- Measuring the service population of councils as well as residential population.[106]
- Adjusting the population factor to account for economies of scale.[107]
- Using rateable properties as a measurement of population instead of total population.[108]
- Basing our measurement of population changes on forecasts instead of lagged historical figures.[109]

We do not propose to make changes to the population factor to reflect these suggestions. Our analysis of these issues is in Section 6.3 and Section 6.4.

Box 6.2 The current population factor

The population factor enables councils to maintain per capita general income over time as their populations grow. Maintaining per capita income will help councils maintain existing service levels and provide the services their growing communities expect.

We currently calculate the population factor as follows:

$$Population\ factor = \\ max\ (0,\ change\ in\ population - supplementary\ valuations\ percentage)$$

The population factor has a minimum value of 0%, i.e. it cannot be negative. This means that a council's rate peg will not be reduced due to a declining population. We recognise that when a council's population declines there are still significant maintenance and operating costs required to continue providing services.

The current population factor accounts for changes in supplementary valuations. Supplementary valuations are revaluations of property when there are changes in land value outside the usual 3 to 4-year general valuation cycle. They can occur for a number of reasons such as subdivisions or changes in zoning as communities develop and grow. To calculate the population factor we deduct any increase in general revenue from supplementary valuations from the change in population.

Box 6.2 The current population factor

When councils' supplementary valuations increase the value of land, there is an increase in council rates revenue (which is based on the value of the land owned by the ratepayer). This increase already partly compensates councils for the cost of servicing a growing population. As such, we deduct it from the population factor, to recognise that some of the costs of growing populations are already being recovered elsewhere. Without the deduction of supplementary valuations, some councils would be overcompensated for population growth at the expense of ratepayers.

Source: IPART, Review of the rate peg to include population growth – Final Report, September 2021, pp 2, 3, 8, 11.

6.3 Stakeholders raised a range of concerns with the current population factor

We have analysed the impact of the changes suggested by stakeholders while considering the purpose of the population factor which is to maintain per capita general income as populations grow. Our analysis suggests that it is appropriate to adjust the population factor to exclude prison populations. There are a number of other issues raised by stakeholders that we do not consider appropriate to address by changing the population factor. The issues we considered and our analysis is outlined below.

6.3.1 The population factor should be adjusted to exclude prison populations

In submissions to our Issues Paper and at our public workshops, ratepayers raised concerns that the population of a new prison was being included in their council's population factor.[110] One submission stated "All extra monies paid in FY 2023/24 because of the SERCO[a] prison numbers should be deducted from the rate peg set for 2024/25."[111] The ratepayers submitted that the population factor was providing the council with additional revenue that it did not require, as the prison should not affect council costs.[112]

In our second round of workshops, some stakeholders raised concerns that prisons may increase the cost of road maintenance within local government areas, but most stakeholders did not consider that prisons were a significant cost to councils.[113] Some ratepayers commented that they would like to see more information about the impact of prisons on council expenditure.[114]

[a] SERCO is a private correctional services operator.

The population factor uses estimated residential population (ERP) data from the Australian Bureau of Statistics (ABS) to track the population growth in local government areas. The ABS confirmed this data includes prison populations. The ABS also releases an annual Prisoners in Australia publication that measures the change in the number of prisoners at each prison, gaol, or other type of facility.[b][115] This prisoner data for each prison or other facility in a council area could be deducted from the council's estimated residential population figures to obtain a non-prisoner population figure. If this approach is adopted, IPART would need to monitor the Prisoners in Australia publication to ensure we have up to date data about the opening and closing of prisons and other facilities across each council area in the state.

We found the inclusion of prison populations could have a significant impact on the population factor of a council. We investigated the opening of 3 new prisons in different council areas and estimated the impact these had on the change in population for the council. The three councils we examined were Cessnock Council, Dubbo Regional Council and Clarence Valley Council. Cessnock Council and Dubbo Regional Council both had prisons open in 2018.[116] We estimated that the impact on the population factor would have been about 0.67% and 0.71%, respectively.[c] Clarence Valley Council had a prison open in 2020-2021[117] and we estimated the impact to be about 1.85%. These calculations do not include an adjustment for the impact of any supplementary valuations.

We then examined whether a council incurs measurable costs due to the opening of a prison within their area. We were unable to determine what significant costs councils would consistently face due to the opening of a prison, except for potentially the impact on road maintenance which was raised during our workshops.[118] We consider that any costs incurred would be difficult to quantify and be individualised to a council. If there are any associated costs that a council is not able to fund through the rate peg or other means, the council could apply for a special variation to recover those costs.

We propose that this adjustment should be forward looking. We do not propose to make adjustments for previous population factors.

6.3.2 The population factor should continue to adjust for supplementary valuations

Adjusting for supplementary valuations

The current formula for calculating the population factor deducts growth in general income from supplementary valuations from the population growth experienced by a council. We adopted this approach because the increase in council general income from supplementary valuations accounts for approximately 60% of the cost of population growth.[119] Without the adjustment, some councils would be overcompensated for population growth.

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b Other facilities include, among others, cells in court complexes, transitional centres and mental health facilities administered under Corrective Services departments. A full list of the types of facilities is available at Prisoners in Australia methodology.

c This is the population change for the 2017-18 financial year, which was prior to the introduction of the population factor in the rate peg and therefore did not impact Cessnock Council's or Dubbo Regional Council's rate pegs. Instead, this highlights the impact that would have occurred if the population factor was used at the time.

Stakeholders made submissions to our Issues Paper which called for the removal of the adjustment for supplementary valuations from the population factor. Northern Beaches Council stated, "It is councils view that the growth in rates from supplementary valuations should not be used to reduce the population factor in the current rate peg methodology."[120] This was echoed by a number of councils.[121]

We considered the feedback from councils that the adjustment for supplementary valuations should be removed entirely from the population factor. In its submission to the Issues Paper Blacktown City Council stated "The population factor has not provided any additional revenue for Blacktown City and will not avoid a continued decrease in our general income on a per capita basis. It is also erroneous to assume that current income per capita for established areas of a LGA are sufficient for newly developed areas of a LGA in which services and required infrastructure still need to be provided".[122]

Stakeholders at our second round of workshops also discussed the issue of adjusting for supplementary valuations. Most councils were in favour of removing the adjustment for supplementary valuations from the population factor.[123] Alternatively, some ratepayers expressed their support for maintaining the adjustment for supplementary valuations in the population factor.[124]

Box 6.3 Deducting supplementary valuations does not reduce the rating base

We heard concerns from some stakeholders that deducting the percentage increase in supplementary valuations as part of our population factor formula meant that the rate base would be permanently lower.

This is not the case, as increases in revenue from supplementary valuations are added to the notional general income that is indexed each year by the rate peg. This means that the income from supplementary valuations is added to the rate base and compounded over time like increases in revenue from the rate peg.

Source: IPART, Summary of discussion at rate peg methodology workshops for ratepayers, June 2023, p 3.

We considered the impact of completely removing supplementary valuations from our formula. This would have the effect of increasing revenue per capita of many councils, rather than just maintaining it. It would also mean that some councils could be overcompensated for population growth. The purpose of the population factor is to maintain per capita income (before inflation) as populations grow, not to increase income per capita (before inflation). Any overcompensation for population growth would be compounded over time by further increases in the rate peg. Some councils, including Blacktown, have suggested there are additional costs of servicing new populations for example community infrastructure such as swimming pools that are not funded through developer contributions.[125] When additional revenue is needed, for example, to provide infrastructure for new communities, this could form the basis of a special variation application. If a council's expenses per capita before inflation are increasing, for example due to rising community expectations for service levels, this can be discussed with communities through the IP&R process as part of the development of funding options such as special variations.

We consider it appropriate that the population factor methodology continue to deduct increases in general revenue from supplementary valuations from changes in population growth. This is a necessary component to achieve our aim of maintaining per capita revenue as populations grow, while making sure ratepayers pay no more than is necessary for the services they need.

Adjusting for negative supplementary valuations

Some councils that made submissions suggested that the population factor should be adjusted to account for negative supplementary valuations.[126]

The current supplementary valuation formula has a minimum of 0%, meaning that a council would not be compensated for negative changes in supplementary valuations. A negative supplementary valuation decreases the general income of a council. This is set out in the *Local Government Act 1993* (LG Act).[d] This is a concern for councils because a decline in property value doesn't necessarily equate to a decline in the cost of services that need to be provided to the property, particularly fixed costs. This means that councils must absorb any decrease in their notional general income caused by a reduction in the rateable value of land but any increases in rateable value are used to offset their increases in income from the population factor.

We investigated the impact that negative supplementary valuations have on council income. We found that:

- In 2019-20 and 2020-21 there were 14 and 15 councils respectively that experienced a net negative supplementary valuation.
- The average impact on income was -0.29% and -0.20% respectively.

On balance we consider that the population factor should not be adjusted for net negative supplementary valuations. We acknowledge the impact that negative supplementary valuations have in depressing the notional general income of councils. However, it is unclear if negative supplementary valuations are caused by population change. Because of this we do not think it is appropriate to include them in our population factor. The purpose of the population factor is to maintain per capita revenue as populations grow, not in all circumstances.

Additionally, the LG Act provides a framework under which councils' total permissible general income fluctuates from year to year where land values change due to supplementary valuations. Adjusting for negative supplementary valuations in the rate peg methodology would be inconsistent with this framework as it would operate to add back into general income the reduction in income required under the LG Act. It would also result in councils with declining or stable populations receiving a positive population factor in years where they experience negative net supplementary valuations.

[d] Section 509.

Measuring supplementary valuations using residential land

In our investigation of issues raised by stakeholders, we also proactively investigated improvements to the methodology that were not suggested by stakeholders. As part of this we considered whether there is a more appropriate way to adjust for supplementary valuations in our population factor. In the current formula, supplementary valuations are based on total rateable property within the council area. We are considering whether it is appropriate to include an adjustment for supplementary valuations of all rateable property or only residential rateable property.

The population factor is designed to maintain per capita general income as populations grow. As the formula deducts the increase in general income from supplementary valuations, it implicitly assumes that all supplementary valuations are caused by population growth. We consider that this assumption may not be entirely accurate as supplementary valuations can occur absent of population growth. We are seeking feedback from stakeholders about whether it would be more appropriate to assume that residential supplementary valuations are driven by population growth. We believe this may be a better method of calculating the revenue required to fund the cost of growth.

We are considering options to obtain data on the number of residential supplementary valuations that occur within each council area each year. Currently the information on total supplementary valuations is publicly available in councils' Annual Financial Statements. However, these statements do not break down supplementary valuations by rating category.

We consider that using residential supplementary valuations may be an appropriate change to the methodology, but it is important that we can secure accurate and reliable data to measure these changes. If we are unable to obtain the data for all councils each year, we may be unable to accurately calculate the rate peg for affected councils that year.

We are seeking feedback from stakeholders on sources for this data. Currently we have examined data from the Office of Local Government (OLG) and the Valuer General. Their publicly available data does not appear to be suitable for calculating the number of residential supplementary valuations.

We have considered whether sourcing the information directly from councils is a feasible alternative. This would increase the administrative burden, as we would need to source the data from 128 councils instead of only a single source such as OLG or the Valuer General. There is also the issue of transparency as the data being sourced from councils is not currently available to the public. We would need to take measures to ensure that stakeholders have access to this data. If stakeholders are in favour of using residential supplementary valuations, we could discuss with the Office of Local Government about amending Annual Financial Statements to include residential supplementary valuations.

6.3.3 The population factor should not include historical population growth

In our 2021 review of the rate peg to include population growth, we recommended that the population factor be a forward–looking adjustment and there would be no 'catch–up' for historical population growth.[127] In submissions to our Issues Paper stakeholders asked us to revisit this issue and requested a historical catch up for population growth they experienced prior to the introduction of the population factor.[128] The City of Newcastle stated that "it is disappointing that there has been no retrospective adjustment to reimburse Council for past growth."[129] Bayside Council stated "there is already an existing gap between per capita rate and per capita costs as a result of the historical rate peg regime… A one-off catch-up adjustment should be considered through this review to address this historical restriction to Council's general revenue."[130]

To investigate this issue, we examined the historical population growth experienced by councils from 2002-2019[e] and how this could have increased rates revenue. This analysis differed to the application of our actual population factor in two ways; for simplicity we have not deducted supplementary valuations, and we have included population change as it occurred, i.e. without a lag. We have also not included changes in the rate peg over the period. The below findings are based on increases in population to illustrate the impacts of population increases on councils. Our findings were:

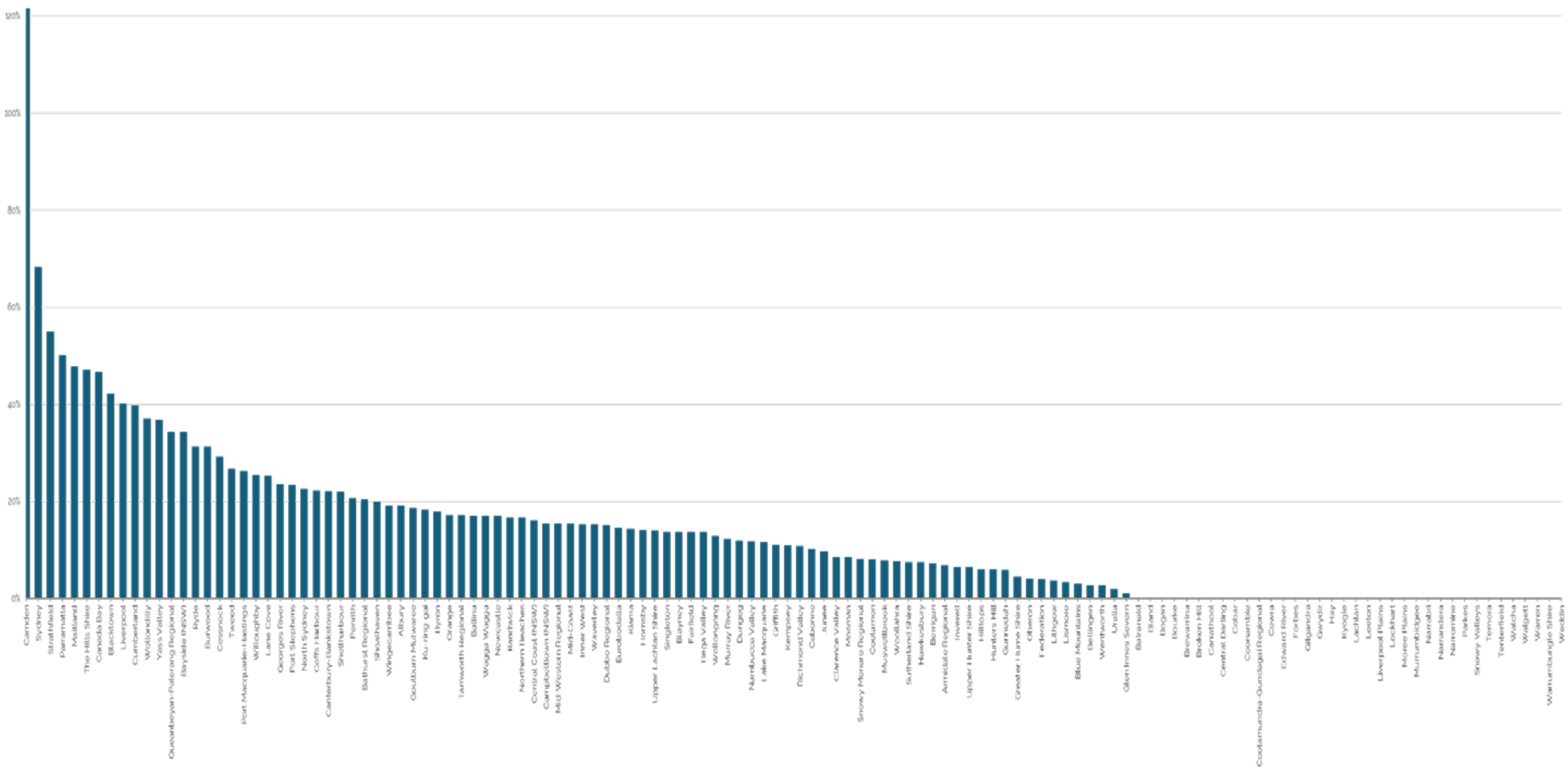
- From 2002-2019, the average population growth across councils was 13.9%. The population increased in 92 councils, and the average growth of these councils was 19.3%.
- **Figure 6.1** shows the historical population growth of NSW councils, those with population decline are marked as 0% as our population factor does not reduce income for decreases in population.
- For example, Albury Council's population increased by 19.1%. If this growth was the only increase in rates they received (i.e. zero rate peg and zero supplementary valuations), general income in 2019 would have been 20.6% higher than in 2002 solely due to population growth.
- The increased rates revenue for Albury Council over the period due to this growth would have had a net present value (NPV) equivalent to a one off 148.1% increase in general income.[f]
- If we sought to compensate councils for historical population growth since 2002 by starting each council at the same level of income and increasing their income by only changes in population and calculating the NPV of these increases, the average council would receive a one–off catch–up of 112.3%. 54 councils would receive a catch–up over 100%. The highest one–off catch–ups would be received by the City of Sydney and Camden council which would receive catch–ups of 687.6% and 641.7% respectively.

[e] 2018-19 being the last financial year not counted in the population factor.
[f] Based on a 1.3% real discount rate which was IPART's local government discount rate in July 2019, available here.

This does not represent how much councils have 'missed out on' because councils have applied for special variations, applied for grants, and had supplementary valuations in this time. All of these sources of income could have compensated councils for some of the costs of a growing population. We consider that adjusting the population factor to include historical growth would likely overcompensate councils for that past growth. We also consider that calculating an accurate historical catch-up would be a difficult and complex calculation that is unlikely to be precise. It would need to be conducted on a council-by-council basis and involve consideration of several factors such as special variations, grants, and supplementary valuations. A historical catch up would also significantly impact ratepayer affordability.

A catch-up for historical population growth would be difficult to calculate. There is a high risk that it could over compensate councils for the costs of historical population growth. It would also have significant impacts on ratepayer affordability.

Figure 6.1 Historical population growth of NSW councils (2002-2019)



Source: ABS Estimated Residential population. IPART analysis.

6.3.4 The population factor should not give councils more revenue for declining populations

In its submission to our Issues Paper, Lachlan Shire Council submitted that the population factor methodology "is not structured to support Councils' who are experiencing stable or declining populations."[131] Stakeholders echoed this theme and suggested that the population factor could offer support for councils to recover the costs of declining populations.[132]

We also heard from councils and other local government sector stakeholders at our second round of workshops about the difficulties of servicing a declining population. Some stakeholders said that the population factor was widening the gap between councils with greater financial sustainability and those with less.[133] We have also heard alternative views from councils with large population growth, who argued that they do not receive the necessary developer contributions to pay for the infrastructure to support growth.[134] Some stakeholders told us that as populations decline council expenditure can increase and that the population factor should help councils recover these costs.[135]

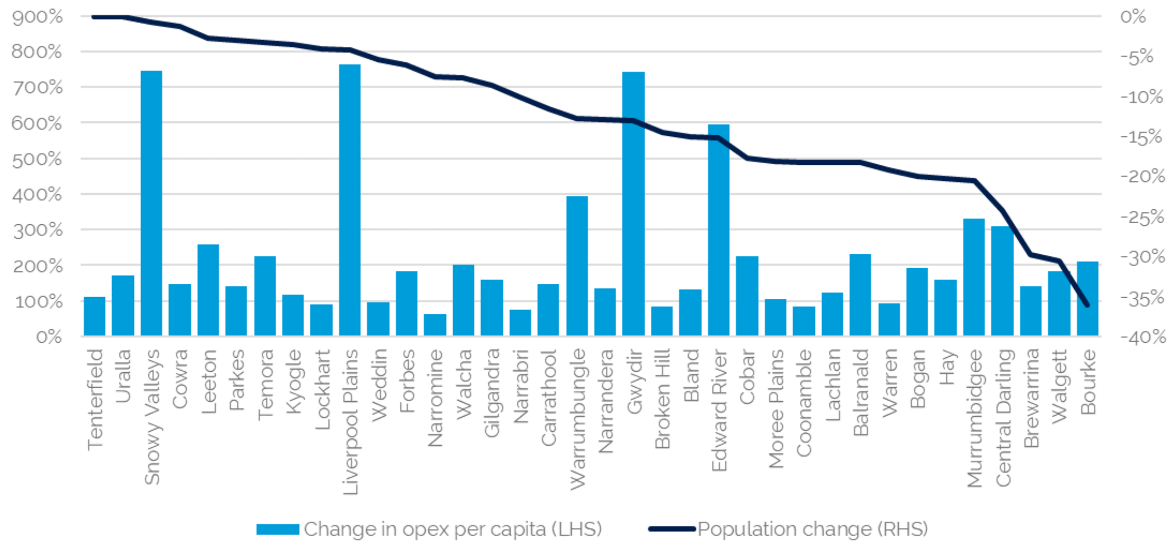
Using data from the Office of Local Government on council operating costs, we investigated the changes in operating costs that have occurred for NSW councils and compared this to changes in population. By tracking changes in operating costs per capita we can compare it to changes in population. The information given below is in nominal values.

Measuring operating costs captures the cost pressures of a declining population as it includes the costs of continuing to provide services and maintain assets over time. It also indicates the labour costs over time required to attract and retain staff in areas of declining population. Capital costs were not included because a lot of capital costs for smaller councils are funded through grants. Analysing capital costs could have skewed results because there may be less constraints on capital spending.

Figure 6.2 and **Figure 6.3** show the change in nominal operating costs per capita along with population change for councils between 2002-2021. **Figure 6.2** shows those councils which had population decline, **Figure 6.3** shows all councils. Both figures show that operating cost per capita is increasing for almost all councils, regardless of population growth.

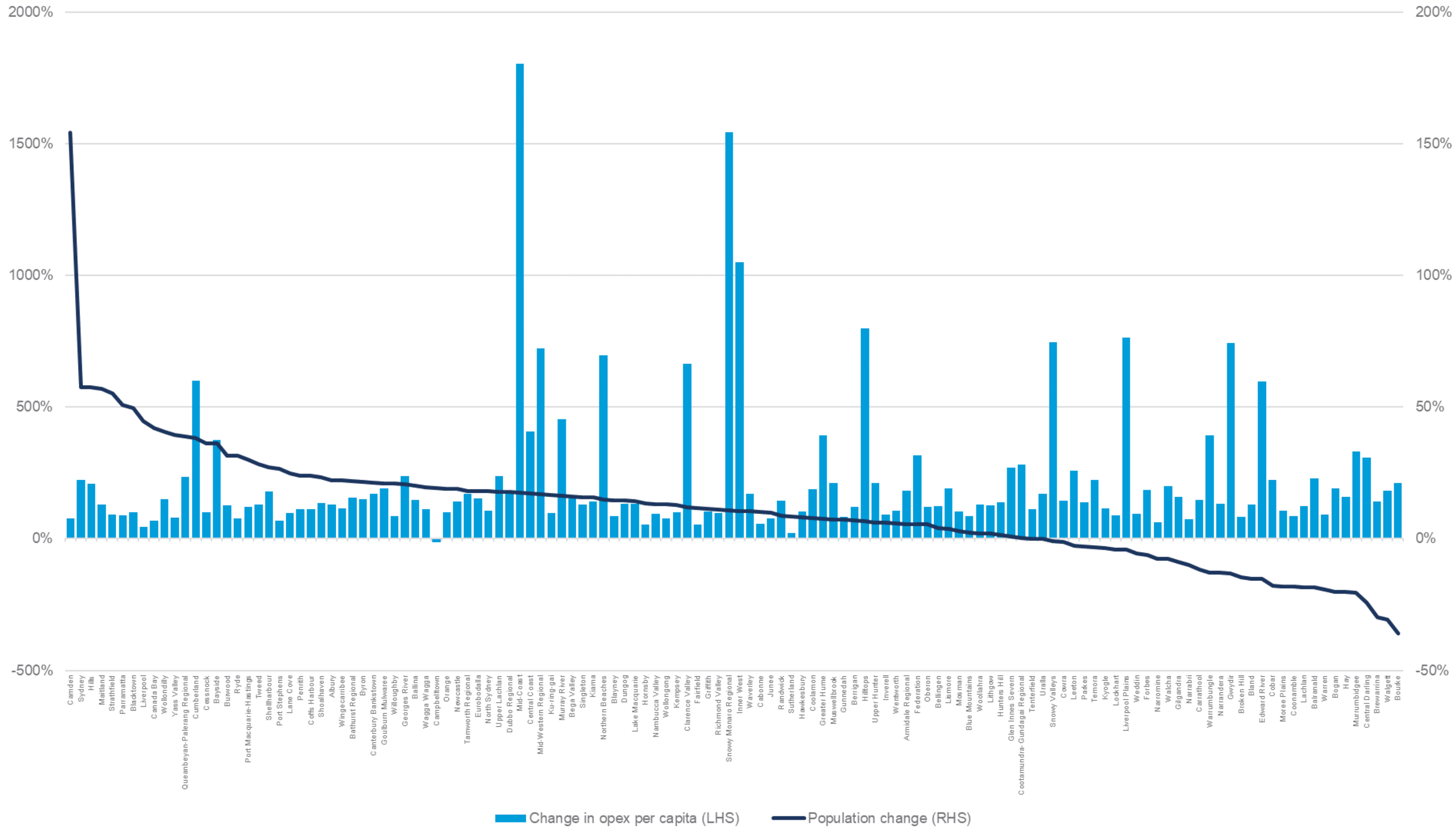
Of the 36 councils with population decline, the average increase in operating cost per capita was 226.3%. The median was 159%. The 92 councils with positive population growth had an average 217% increase in operating cost per capita, and a median of 130.5%. Based on this analysis, population decline does appear to put a small upward pressure on operating cost per capita. Although there may be other factors that have created the difference in changes in operating cost per capita, such as changing demand and community preferences for services. Further investigation would be required to be definitive about a relationship between population decline and increases in operating cost per capita.

Figure 6.2 Change in operating costs per capita with population change – Councils with population decline (2002-2021)



Source: OLG time series data. ABS Estimated Residential population. IPART analysis.

Figure 6.3 Change in operating costs per capita with population change – All councils (2002-2021)



Source: OLG time series data. ABS Estimated Residential population. IPART analysis.

There appears to be an additional cost that is associated with population decline. However, we do not consider it appropriate for this to be recovered through a population factor. The population factor does not reduce the amount of rates revenue a council receives if their population declines. As a council's population declines, its operating cost per capita (before inflation) would increase. An increasing real operating expenditure per capita over time helps councils maintain service levels. The costs of population decline are already recovered because a council's rates revenue is not reduced when its population declines. This occurs because the population factor cannot be negative. If councils were to receive additional revenue through a population factor that compensated councils for population decreases, this would increase the burden on ratepayers that already exists. As populations decline the council's total rates revenue would be concentrated over a decreasing number of ratepayers.

While we do not consider it appropriate for the population factor to compensate councils for the costs associated with population decline, it may be appropriate for this issue to be considered in a future review into the financial model for councils. That would present an opportunity to investigate whether some councils would require greater support over time to continue providing the same quality and quantity of services expected by their communities.

6.3.5 The population factor should not measure service populations

Stakeholders submitted that councils should be compensated for the costs of providing services to non-residents, i.e. that their population should be based on their service population as well as their residential population.[136] Some examples of service populations for councils include:

- Tourist populations, including day visitors and short-term holiday makers.
- Regional business or cultural hubs. Some areas of NSW, such as Paramatta CBD and Sydney CBD see large increases during parts of the day.
- Councils providing services to workers who work in one council area, but live and pay rates in different council areas.

In its submission to our Issues Paper Hawkesbury Council stated that the population factor "does not capture the increased cost of demand for commercial, employment and tourism sectors."[137] Stakeholders argued that the cost of service populations should be recovered through rates.[138]

This issue was considered in our 2021 Review of the rate peg to include population growth. Submissions to the Issues Paper and Draft Report of that review highlighted the costs incurred by councils where their serviceable population is higher than their residential population. Councils may have larger service populations due to tourism or because they are employment, business, or cultural hubs.[139]

At the time we considered whether we should include service populations within a population factor, and concluded that:

- It is challenging to accurately measure service populations.
- There is some benefit to business ratepayers from a larger serviceable population. However, ultimately ratepayers across all rating categories, including residential ratepayers, could pay higher rates if our methodology accounted for changes in service populations.

- Collecting revenue from service populations is better achieved through user pays approaches, although councils can only use user charge approaches for some services such as car parking.
- Councils can apply to IPART for a special variation if they require additional revenue to accommodate their service populations.[140]

We consider the findings of our 2021 Review of the rate peg to include population growth to still be appropriate and are not proposing to change the population factor to measure service populations.

6.3.6 The population factor should not be adjusted to include economies of scale

We received submissions to our Issues Paper and feedback in our workshops that the population factor should be adjusted to take into account economies of scale. A submission from a ratepayer stated "More customers should mean economies of scale in service delivery. Fixed costs are spread over a larger number of customers meaning unit costs of service provision (cost per capita) should fall. Managed well, population growth should provide opportunities for Councils to reduce the per capita costs of their services and improve efficiency."[141]

> Economies of scale occur where the average cost per output (goods or services) decreases as the total number of outputs increases.

Economies of scale is an important concept that explains how firms can utilise their capital (e.g. equipment, buildings, etc.) and their labour to decrease the average cost of producing their goods or services. However, economies of scale are finite; eventually if another unit of output is produced the average cost will no longer decrease. If a firm continues to produce more outputs, beyond this level, the average cost of the outputs will begin to increase. This is called diseconomies of scale.

In our 2021 Review of the rate peg to include population growth we considered whether economies of scale existed in the local government sector. We found that some services and functions of councils have economies of scale, but not all. Our findings showed that a doubling of a council's population implies a "range of cost increasing by 72% to 95%."[142]

There does not appear to be universal economies of scale in the local government sector. At this time, we consider that introducing an economies of scale adjustment to the population factor would not accurately capture the varying economies of scale experienced by individual councils. Such an adjustment could favour councils that are well positioned to achieve economies of scale either due to their demographics, socio–economic factors or mix of services provided. It could also disincentivise councils to provide services if they do not scale well, despite community preferences. This may disincentivise councils to be the provider of last resort for important community services in areas such as health and aged care. At this time there does not appear to be sufficient evidence to introduce an adjustment for economies of scale, however this may change in the future.

6.4 We considered alternative sources of data

The current population factor methodology measures historical changes in the total population of council areas. This is calculated using the estimated residential population data published by the ABS. We received submissions to our Issues Paper that asked us to consider alternative methods for measuring changes in population. Stakeholders submitted that changes in the number of rateable properties is a better indicator of councils' costs compared to changes in the total population, because the majority of council services are property based. [143] Stakeholders also submitted that using rateable properties or population forecasting would be more timely than historical data.[144] These issues and our analysis are discussed below.

6.4.1 Using rateable properties would reflect costs but may not be independent

In our 2021 review of the rate peg to include population growth we considered two different methods to measure how councils' costs increase as populations grow: changes in total population and changes in rateable properties.[145] This issue was considered because councils provide services to both property and to people and it is important to capture whether properties or people are more responsible for increasing councils' costs. Our decision for that review was to use total residential population instead of rateable properties.[146]

In the submissions we received to the Issues Paper of our current review, stakeholders asked us to revisit the issue of using rateable properties as a measure of population change.[147] Stakeholders submitted that we should revisit this issue because of the importance of council services to property. The submission of the United Services Union, which included a commissioned research paper, stated "the number of rateable assessments in a given local government area is a much more accurate proxy variable for municipal size than absolute population size."[148] We also heard from stakeholders in our second round of workshops that rateable properties could be a more accurate measurement of population growth.[149]

This concern was raised in the 2021 Review of the rate peg to include population growth. At the time, we engaged the Centre for International Economics (CIE) to consider the impacts of using rateable properties or total population to measure the costs of population growth.

The CIE indicated a slight preference for using total population over rateable properties. This was because total population figures are derived independently via the ABS and are used by the NSW Grants Commission.[150]

Some of the differences between using rateable properties or population growth were highlighted by The CIE:

- Rateable properties include non-residential activity — councils with a large business focus, such as the Sydney CBD, are outliers in the cost per capita chart because they service non–residential activity.
- Considering only residential activity, properties and population will not necessarily move together, and they may be more or less directly related to costs. For example:
  - Occupancy rates of property could change, meaning a larger population, but no change in rateable properties.
  - Rateable properties could change as development occurs but prior to the dwellings being occupied — i.e. a difference in timing.
  - Rateable properties may be a driver of costs related to infrastructure such as roads and stormwater.
  - Population may be a better driver for costs related to services such as health, education, community services.[151]

The CIE found that a 1% increase in the base of rateable properties leads to a 1.02% increase in council expenditure. While a 1% growth in population caused a 0.85% increase in council expenditure.[152] Both of these measurements have a close relationship with changes in council expenditure. On balance, we consider that it is still appropriate to measure councils' total residential population as an indicator for increasing council costs.

Using rateable properties as a measure of population growth is problematic because councils are directly involved in the decisions that increase the number of rateable properties. This is a measurement that councils have much greater direct influence over than their total population.

In submissions to our Issues Paper some stakeholders were also concerned about the presence of intercensal data errors when using changes in total population.[153] This was reiterated in our public workshops[154] and our second round of workshops, where stakeholders also discussed intercensal data errors.[155]

This issue was considered in our 2021 Review of the rate peg to include population growth. IPART proposed to include a true–up for all councils when the next census data is released. This will impact the rate peg in 2024-25. This true–up would be for all councils, but not adjust the population factor below zero.[156]

For subsequent censuses, the recommendations of the report were to include a true–up where councils had a difference in estimated residential population and actual census data greater than 5%. This approach will maintain certainty and not disadvantage councils with small populations that are likely to experience large deviations between estimated and actual population data.[157]

The concerns of stakeholders are prudent and have been considered in depth. We also received a proposal for a new formula from Lane Cove Council.[158] Its proposed formula would still use residents as a measure of population, but it would calculate the change in residents as the number of new assessments multiplied by the average persons per dwelling. We have outlined the proposed formula below:

$$Population\ factor = \frac{Average\ residential\ rate\ per\ capita\ x\ Total\ new\ residents}{Total\ rates\ yield}$$

Where the total new residents is calculated by multiplying the increase in residential rating assessments by the average number of persons per dwelling.

We considered this proposed formula when investigating the effectiveness of our population factor. We consider that this proposed formula does not address the issue of supplementary valuations already providing revenue to councils to recover the cost of population growth. Further, using averages in terms of the residential rate per capita and the average persons per dwelling may be less accurate than using absolute population figures.

Overall, we still consider the findings from The CIE to be appropriate. We also consider that the concerns raised about intercensal errors will be appropriately addressed through the 5-year true–up in the methodology. We do not propose to adjust the population factor to measure rateable properties instead of total population.

6.4.2 Using population forecasts would be less accurate than historical population data

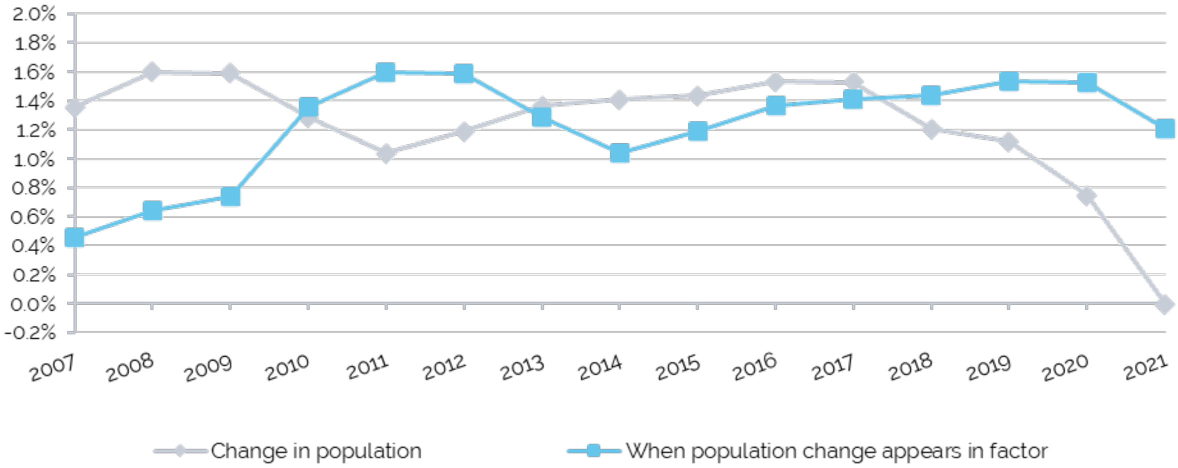
In the submissions we received to our Issues Paper, stakeholders were concerned about the lag in the current population factor. [159] Gunnedah Shire Council stated that "it is vital that the difference in timing should be reduced to enable a closer alignment of the population growth to the associated increase in demand for council services."[160]

The population factor in the 2023-24 rate peg was calculated using population changes from 2019-20 to 2020-21.[161] Some stakeholders argued that this lag was too long and that it was not responsive enough to changes in council population growth.[162]

It was suggested by some stakeholders that using rateable properties instead of ABS population figures would resolve the lag issue.[163] Several submissions that were concerned with this lag also suggested using population forecasts.[164]

Figure 6.4 shows the lag in the population factor; it shows the year in which the population change occurs and the year it is captured in the factor. During the lagged period the council would have to fund the cost of services provided to additional residents without receiving compensation. This is similar to the issue that has been raised with the LGCI. It should be noted that changes in population were atypical during 2020 and 2021 due to the COVID-19 pandemic, these were some of the first years captured by the population factor. The reduction in immigration over that period appears to have contributed to the lack of population growth on a state–wide basis. This may not have been consistent across the state and certain areas could have seen population growth caused by intrastate migration.

Figure 6.4 When population change occurs versus when it applies to the population factor



Note: This is yearly population change across all of NSW and therefore includes population decline for individual councils.
Source: ABS estimated residential population.

The options of using rateable properties or population forecasting were considered in our 2021 Review of the rate peg to include population growth. Neither of these options were considered optimal. There are limited data sources for alternative measures of population growth.

The concerns with using rateable properties were discussed above. In our 2021 Review of the rate peg to include population growth we outlined some of the issues with using population forecasts. The key findings on that issue are outlined below:

- We found that Department of Planning and Environment population projections were a good estimate of future population growth. Over the past 5 years, at the state level, the projections have been a good predictor of actual population growth. Our analysis also found that the projections were relatively accurate for most councils in NSW. However, most submissions to our 2021 Draft Report supported the use of ABS data.[165]
- We found that using both historical estimates and forward-looking projections maintain the relationship between council revenue and the costs of population growth over time.[166]
- We tested our methodology using both ABS and Department of Planning and Environment data over 5 years and found that using ABS data produced better results and reduced the need to use a 'true-up' in the methodology to maintain accuracy over time.[167]
- We also considered using third party population projections, particularly those used by councils. Individual councils' forecast series are based on assumptions agreed by each individual council and the third-party provider. The relationship is not independent, and we prefer an estimate that is derived at 'arm's length' from councils' processes.[168]

While the lag in the population factor is an issue, it is not concerning to the same degree as the lag present within the LGCI because councils already recover about 60% of the costs of population growth through supplementary valuations.[169] Because of this councils are not as impacted by the long lag in the population factor as they are by the lag in the LGCI.

We consider that our conclusions in the 2021 review of the rate peg to include population growth regarding the suitability of forecasting compared to historical ABS data are still valid. We have not received compelling evidence from stakeholders that these conclusions were incorrect. We propose to maintain our approach for the population factor of using historical population data rather population forecasts.

Chapter 7

Retaining the productivity factor

07

Our current methodology includes an explicit factor to account for productivity gains in the local government sector. The productivity factor was incorporated to reflect the year-on-year productivity gains that could be expected of councils as service delivery becomes more efficient over time.

From 2011-12 to 2017-18, we calculated the productivity factor using information published by the ABS on market sector value-added multifactor productivity.[170] The productivity factors we applied ranged from 0.0% to 0.2%.[171]

Since 2018-19, the productivity factor has been set at zero as a default to recognise that improvements in productivity are already reflected, to an extent, in the ABS price indexes we use to measure price changes in LGCI cost categories.[a,172] However, we retain discretion to deduct a productivity factor if there is evidence of productivity improvements in the local government sector that have not been fully incorporated in the LGCI.

We have received considerable feedback from stakeholders about the productivity factor and whether it should remain in the rate peg methodology. On balance, our draft decision is to retain the productivity factor within our methodology and that it should remain as zero by default unless we have evidence to depart from that approach. The views that we heard from stakeholders and the reasoning for our draft decisions are outlined below.

7.1 Our draft decisions on the productivity factor

Our draft decision is:

9. To retain the productivity factor in the rate peg methodology and for it to remain as zero by default unless there is evidence to depart from that approach.

7.2 Stakeholders had mixed views about the productivity factor

Over 60% of submissions commented on the productivity factor. Some stakeholders, particularly councils, advocated for the productivity factor to be removed or remain at zero.[173] Some councils considered that a productivity factor would penalise councils or could create unintended consequences and disincentivise pursuing efficiencies if it would reduce income.[174] Other councils said that they already actively pursue efficiency in order to remain financially sustainable, and that productivity improvements are encouraged by the IP&R process.[175]

Another key issue raised in submissions was how to measure productivity, the use of appropriate indicators and evidence for productivity improvements. Several stakeholders considered that productivity cannot be accurately measured across councils.[176] Some stakeholders instead suggested the use of customer satisfaction surveys as evidence for productivity improvements for individual councils and monitoring performance indicators rather than reducing income.[177]

a Under our current methodology, we use price indexes published by the ABS to measure price changes for 25 of the 26 LGCI cost items. The ABS price indexes we use are pure price indexes – i.e., the ABS makes quality adjustments to ensure the inflationary movement is unaffected by any change(s) in quantity and/or quality.

Submissions from ratepayers tended to support the idea of improving council efficiency and driving productivity gains.[178] One submission from a ratepayer considered that IPART should have a better method for measuring productivity (output per employee). They suggested IPART could incentivise efficiency gains through developing a credible way to measure councils' productivity and publishing results, or releasing a rate peg lower than the LGCI.[179]

Ratepayers and councils in our second round of workshops both expressed concerns that there is not a robust measurement for productivity in the local government sector.[180,181] Some industry stakeholders argued that councils should not be compared to the private sector for productivity as they are not operated for profit. They stated that productivity improvements in local government often lead to improved quality of services and longer–term value for money rather than cost savings.[182] We consider there is merit in further investigating how we might better measure and incentivise productivity gains in the local government sector, including more broadly than through the rate peg.

7.3 Efficiency and productivity in the local government sector

The productivity factor is not the only method of encouraging efficiency in the local government sector. We acknowledge the feedback we have received from stakeholders about the importance of the IP&R process and other council initiatives in promoting efficiency and productivity.

In submissions to our Issues Paper and at our workshops, councils told us that they create efficiencies through a range of plans and programs. Blacktown City Council told us in its submission that the council has a "comprehensive business improvement program".[183] Blacktown City Council also mentioned that the "…program is progressively reviewing each of our core service areas to identify whether the service is meeting current (and projected future) expectations and requirements, how the service can be improved and at what cost, and what opportunities exist to improve the efficiency of service delivery and thereby lower its net cost."[184]

Councils also told us that it is difficult for efficiency and productivity gains to be transformed into financial savings, as the improvements are instead generally used to increase the quality and quantity of service delivery. Hawkesbury Council told us in its submission that "productivity enhancements are generally linked to being able to achieve more, using the same resources and very rarely results in financial savings. For example, reducing the time to produce planning certificates will result in staff being able to reduce backlogs and respond more quickly to customer requests."[185]

We also heard from Wollongong City Council in its submission to our Issues Paper that organisational wide efficiency gains can be difficult to achieve because of the different industries and sectors that the council operates in and the shortfall in service delivery compared to demand.[186] The council's submission stated "With most councils having asset management shortfalls, service gaps and increases in natural environmental issues, any improvements in individual process are immediately redirected to improving these shortfalls. This does not then reflect in the consolidated annual accounts or through reductions in average rates."[187]

The productivity factor is not the only method for encouraging efficiency improvements. We have heard from councils that they independently undertake a wide range of programs to improve efficiency. We have also heard from councils that it is difficult for these gains to decrease average rates bills.

However, the productivity factor is a part of encouraging efficiency in the local government sector. In the future if there are factors in the rate peg methodology index that are not adjusted for productivity gains, council productivity will improve but this would not be reflected in increases in rates income from the rate peg. Councils may receive an increase in rates income that is higher than what is necessary to efficiently produce the same number of outputs. Providing councils more income than is required is a concern because the rate peg is designed to provide additional income for councils to compensate councils for increases in their costs to continue providing the same level of outputs. If this were to be the case in the future, there may be scope to review the current approach of setting the productivity factor to zero. A productivity factor would then ensure that councils continue to have enough income to produce the same amount of outputs (i.e. goods and services) as they currently do when factoring in productivity improvements.

7.4 We will retain the option of including a productivity factor

We have considered the feedback from stakeholders. We acknowledge that, as we have set the productivity factor to zero as a default since 2018-19, we could remove the explicit productivity factor from the rate peg methodology. We note that this would:

- Simplify the methodology.
- Still leave us the option to make specific productivity adjustments in the future if needed through the "Other adjustments" factor.

However, on balance we have made a draft decision to retain the productivity factor in our methodology. We consider that it is appropriate to retain the productivity factor because we are proposing to change the index we use to measure changes in councils' costs (from the LGCI to the BCC). We are considering a new approach to the rate peg and the change in our methodology may give rise to a case to revisit our decision to set the productivity factor to zero.

Stakeholders have rightly commented that if in the future the productivity factor were to be greater than zero there would need to be a methodology to calculate productivity in the local government sector. The rate peg for 2017-18 was the last to include a productivity factor greater than zero.[b,188] In our fact sheet for that year we explained that we "calculated the productivity factor using the ABS market sector value-added multifactor productivity (MFP) based on quality adjusted hours worked."[189] If in the future we were to investigate whether the productivity factor should be greater than zero we would take an evidence-based approach to evaluate what an appropriate methodology could be.

b The average productivity increased by only 0.001% so while the factor was greater than zero it had no material impact on the LGCI that year.

Productivity improvements are something we consider when councils apply for a special variation. In addition to other requirements established by the OLG's SV guidelines, such as community consultation, councils are required to demonstrate cost savings and productivity improvements.

7.5 We think there are opportunities to improve productivity across the local government sector

During our public workshops and our second round of workshops with councils, council organisations, ratepayers and other organisations, there was discussion about opportunities to improve productivity in the local government sector.

Some stakeholders questioned whether there are opportunities for councils to use common services to reduce costs, such as using a common cyber security provider.[190] It was suggested that efforts can be duplicated across councils when they are each developing an individual solution to an issue that affects them all.[191] There may be opportunities for the costs and risk management challenges to be spread across councils.

Some councils acknowledged the apparent benefits to this approach and stated that they had approached the NSW Government to discuss programs to facilitate such an approach. They stated that if the NSW Government took a lead in negotiating with key service providers, there could be opportunities to increase efficiency and productivity across the sector.[192]

We also heard from some councils that overhauling core systems such as financial software or cyber security to meet a common standard would require significant investment that may not be available in existing budgets.[193] Councils have told us throughout this review that they struggle to afford investments in systems for efficiency gains.[194] Some councils noted that significant special variations would be required for some councils to move to a common system.[195]

Some councils noted that an opt-in would be the most balanced approach to provide the councils the opportunity to bargain together for services, without mandating changes on councils that cannot afford it.[196] An opt-in approach would also best support the democratic accountability of councils compared to enforced adoptions of common service providers and systems.

We consider that such efforts would be in the best interests of the local government sector and ratepayers. Increasing productivity and efficiency provides councils with more funds within their existing budgets to improve service quality and increase service provision. Ratepayers will benefit through improved and/or new services. We recommend that the NSW Government explores opportunities across the sector to improve productivity, particularly through service provision of solutions to address key issues facing the local government sector.

Chapter 8

Transition arrangements

08

We are considering implementation and transition options for the changes to the rate peg methodology.

The timing of our changes to the methodology would influence rate peg outcomes and have varying impacts on different stakeholder groups.

We are seeking comment on which implementation option stakeholders would prefer. IPART sets the rate peg under delegation from the Minister for Local Government and, in exercising that function, can implement changes to our rate peg methodology.

In undertaking this review, we have also identified issues outside of our Terms of Reference and delegation, and have made a recommendation to the Minister for Local Government to consider a further review of the financial model for the local government sector (see Chapter 9).

Our Final Report will specify the changes we intend to make to our rate peg methodology. It will also outline measures outside the scope of this review and our delegation. These are measures that we consider could improve the effectiveness of the rate peg within the current local government financial and governance framework.

Our draft decision is:

10. To review our rate peg methodology every five years, unless there is a material change to the sector or the economy, to ensure its stays fit for purpose.

We are seeking comment on:

9. What implementation option would you prefer for the changes to the rate peg methodology?

8.1 Our draft decisions would include changes in timing

Our proposed changes to the rate peg methodology (see Section 1.4) would impact the timing of when changes in the data are reflected in the rate peg. We outline any timing differences for individual components below:

- The backward-looking LGCI (2-year lagged with 26 cost components) would be replaced with a forward-looking BCC model with 3 cost components (i.e. employee, asset and other operating costs).
  - For employee costs, we would use the annual wage increases in the NSW Local Government (State) Award or the forecast change in the Wage Price Index published by the RBA in its most recent Statement on Monetary Policy (Statement).
  - For asset costs, we would use the RBA's forecast change in the CPI in its most recent Statement, adjusted to reflect the average difference between changes in the Producer Price Index (Road and bridge construction, NSW) and changes in CPI (All groups, Sydney) over the most recent 5-year period for which data is available.

  - For other operating costs, we would use the RBA's forecast change in the CPI from its most recent Statement.
- The current methodology captures annual increases in the ESL through a component in the LGCI and provides for an averaged amount to apply uniformly to all councils. We would replace this ESL component in the LGCI with a separate ESL adjustment consisting of ESL factors that allow councils to collect an amount that reflects what the change in their ESL contributions are (See Section 4.5). The 1-year lag would also be addressed by IPART publishing an indicative rate peg in September of each year (excluding the ESL factor) and once data on ESL contributions for the year the rate peg is to apply is available in April, publishing a final rate peg with the ESL factors in May.
- There would be no change in timing for the population factor component.
- We would make additional adjustments to capture costs driven by external factors that affect councils. These adjustments could be forward looking or backward looking, depending on the type of adjustment. In terms of timing, this will be similar to the 'other adjustments' factor in the current rate peg methodology.

We are seeking comment from stakeholders on how they would prefer to implement our proposed changes to the methodology (see Section 8.3 and Section 8.4). It is important that we consider the impact of timing changes and stakeholder preferences for implementing our proposed draft decisions.

8.2 We considered implementation and transition options for our draft decisions

When we implement our draft methodology, the first year under our new methodology would not follow consecutively from the last year under our current methodology. This is because the LGCI is lagged, and the BCC is forward looking. This means that the cost changes in some years would not be captured in the rate peg, and therefore not be reflected in increases in rates income. Because of the significant economic volatility that has occurred over the past 12 months we consider it may be appropriate to allow cost changes over 2022-23 to be reflected in the rate peg for 2024-25, to be released around September 2023. This would mean delaying the implementation of the BCC until the release of the rate peg for 2025-26, likely around September 2024.

We propose to implement our draft methodology in a staged approach, with some changes taking place in the 2024-25 rate peg and the rest taking place in the 2025-26 rate peg. We have considered 4 different implementation options for our draft methodology. Our preferred option and the alternative options are discussed further in Section 8.3 and Section 8.4 respectively. We have also modelled the differences between retaining the LGCI for 2024-25, or switching to the BCC in 2024-25, in Section 8.5.

We recognise that stakeholders will have differing views on the different implementation options. We are seeking feedback on which option would be the most appropriate to transition to the draft methodology.

8.3 Our preference is to implement some changes, but maintain the LGCI for the 2024-25 rate peg

Our preferred option is to implement some of our draft decisions in the 2024-25 rate peg but not all of them. We think that this is a balanced approach that allows some changes to take effect sooner and for the recent economic volatility to be reflected in the cost index.

For the 2024-25 rate peg we would:

- Use the LGCI but remove the ESL cost component from the LGCI (25 components) and develop separate ESL factors that reflect:
  - an individual council's contribution, for councils:
  - that are not part of a rural fire district, or
  - that are part of a rural fire district but do not engage in ESL contribution cost sharing arrangements, or
  - are the only council in their rural fire district, or
  - that are part of a rural fire district and engage in ESL contribution cost sharing where we have accurate information about what the council pays.
  - the weighted average change for each rural fire district, for councils that are part of a rural fire district and engage in ESL contribution cost sharing arrangements where we do not have accurate information about what they pay.
- Amend the population factor to remove prison populations from our calculation.[a]

We note that if economic volatility continues over the next 12 months the same issue could arise when it is time to set the 2025-26 rate peg. We do not think it would be appropriate to delay the implementation of the BCC beyond the 2025-26 rate peg.

8.4 Alternative implementation options

We think that there are alternative implementation options worth considering. We would like your feedback if any of these options are preferable to our preferred option set out in Section 8.2. We have outlined the options below:

- Do not implement changes in the 2024-25 rate peg. We would:
  - delay implementing all the changes to our methodology until the 2025-26 rate peg.
- Implement all changes in the 2024-25 rate peg. We would:
  - replace the LGCI with the 3-component BCC model and use 3 council groups
  - amend the population factor to remove prison populations
  - develop a separate ESL factor.

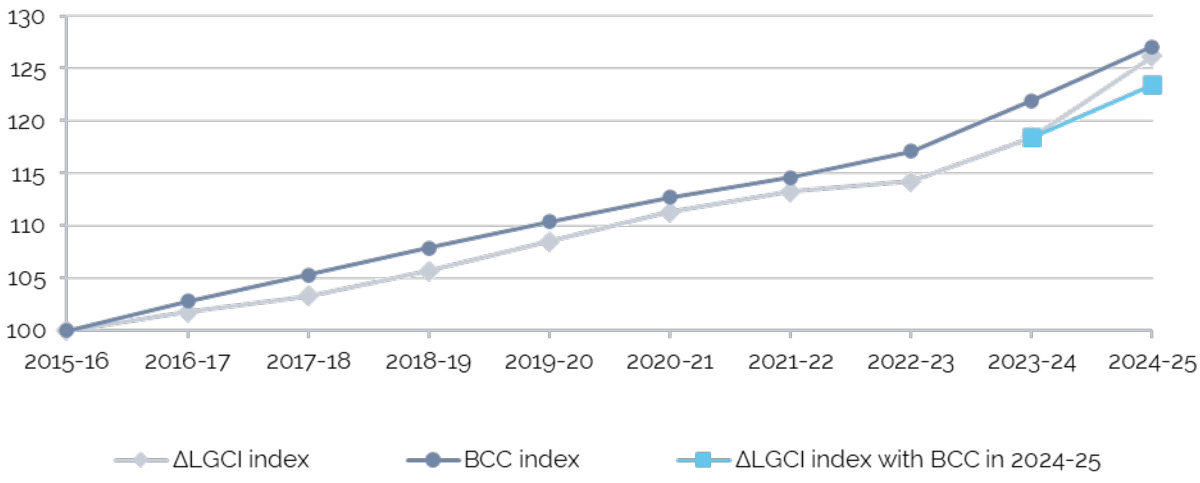
[a] In 2024-25 our rate peg methodology will include a Census true-up for the population factor. This was a decision from our 2021 Review of the rate peg to include population growth. We propose to implement this true-up in 2024-25 regardless of the implementation of the decisions of our current review of the rate peg methodology.

- Implement all changes in the 2024-25 rate peg and include a true-up. We would:
  - replace the LGCI with the 3-component BCC model and use 3 council groups
  - amend the population factor to remove prison populations.
  - develop a separate ESL factor, and
  - include a one-off true-up adjustment for the differences between the LGCI and the BCC (excluding the ESL) so that councils would be no worse off under the new methodology compared to what they would have received under the existing methodology for 2024-25.

8.5 Comparison between options

We have predicted the impact on the rate peg of switching from the LGCI to the BCC in 2024-25. **Figure 8.1** compares the change in the LGCI to the BCC. It shows that if the change in LGCI or the BCC was used from 2015-16 through to 2024-25 the index in 2024-25 would be approximately the same. However, it shows that if the change in LGCI is switched to the BCC in 2024-25 it would produce a lower cost index, which would provide councils with less rates income. This shows that switching to our new methodology in 2024-25 would create a disconnect where councils are not compensated for cost increases in 2022-23.

Figure 8.1 Difference between the change in LGCI and BCC index in 2024-25



Source: IPART analysis

8.6 We propose to undertake regular reviews of our rate peg methodology

We have found through this review that the local government regulatory framework is changing over time.

We propose to review our rate peg methodology at least every 5 years with a transparent and consultative review process. The review would ensure that our methodology remains up to date and fit for purpose. If there are material changes in the sector or the economy this would prompt a review earlier than 5 years.

Chapter 9

Improving the broader regulatory framework

09

Throughout this review, stakeholders have made it clear they have serious concerns about how local government services are funded and rates are regulated in NSW. As section 1.3 discussed, it is in the long-term interests of ratepayers for councils to be financial sustainable and deliver affordable services that their communities want and need.

Councils told us their primary concern is achieving and maintaining financial sustainability[197], so that they consistently have enough income to fund the services and facilities their particular communities want and need – whether they live in dense, highly developed urban areas or remote, sparsely populated rural areas. It is also in the interest of councils to use their rates income effectively and efficiently. Ratepayers also share concerns about the efficient and effective use of rates income. However, ratepayers' prime concern was the affordability of rates and the impact on their cost of living.

Our draft decisions on the rate peg methodology would reduce some of these concerns. But changes to this method alone cannot adequately improve the broader regulatory framework to deliver better outcomes for both councils and ratepayers.

The sections below outline our draft recommendation for a review of the financial model for councils and we have identified some matters that could be considered as part of this review.

9.1 Overview of draft recommendation on financial model for councils

The Terms of Reference for our review requires us to have regard to the differing needs and circumstances of councils across NSW and the Government's commitment to ensure that councils cannot increase their rates by more than the estimated change in their base costs. We consider there would be benefits of reviewing the financial model for councils to ensure improved outcomes for the citizens of NSW and enhance the local government rating system, the local government revenue framework, and the relationships between councils and ratepayers.

We also consider that it is important to strengthen the incentives for councils to improve their performance. The recommended review could also consider incentives for councils that demonstrate good performance to be rewarded with greater autonomy. Autonomy could be providing councils more flexibility to determine appropriate increases in total rates revenue for themselves.

Recently the NSW Auditor-General reported to Parliament on a performance audit for the regulation and monitoring of local government. The report makes findings and recommendations for the government to consider.[198]

Our draft recommendation is:

2. That the NSW Government consider commissioning an independent review of the financial model for councils in NSW including the broader issues raised in this report.

Matters for further consideration are:

1. The eligibility of current rate exemptions could be better targeted to improve outcomes for ratepayers and councils.
2. The use of the Capital Improved Valuation method to levy local council rates could improve the efficiency and equity of rates.
3. There could be merit in considering whether to introduce an additional constraint (i.e. conditions) on the rate peg to provide confidence to ratepayers that increases are reasonable.
4. Some councils may not have an adequate rates base and a mechanism should be developed to enable councils found to have insufficient base rates income to achieve financial sustainability.
5. Statutory charges for services provided by councils may not be recovering the full cost of service provision, such as for development approval fees and stormwater management service charges.
6. Councils could be better supported to serve their communities more effectively to build community trust in councils. This could include improvements in how councils undertake and implement their integrated planning and reporting.
7. There are opportunities to strengthen council incentives to improve their performance, including considering whether there is merit in a model that would exempt councils that demonstrate an agreed level of performance and consultation with ratepayers from the rate peg.

9.2 Measures to improve the equity of the rating system

We identified 3 measures that could be implemented to improve the equity of the rating system and local government revenue framework. By doing so, they would reduce cross-subsidisation between ratepayer groups and between ratepayers and other users of council services. This will generally improve the affordability of rates for ratepayers. These measures would also improve the efficiency of the rating system, and better support councils' financial sustainability in the longer term.

These measures are:

- Better targeting eligibility criteria for rates exemptions to ensure ratepayers do not subsidise the costs of providing council services to properties where this is not justified on efficiency and equity grounds, and properties with comparable uses of land attract the same rating treatment.
- Allowing councils to use the Capital improved value method to set the variable component of rates to ensure they can set equitable and efficient rates for all residential and business ratepayers, regardless of their property type.
- Ensuring that statutory charges reflect the full costs councils incur in providing statutory services, so councils do not need to use rates income to cover the costs of providing the services.

Each of these measures would require legislative change.

9.2.1 Better targeting eligibility criteria for rates exemptions

In the submissions we received to our Issues Paper and the consultation workshops we held, many stakeholders raised concerns about the proportion of land that is exempt from rates within some LGAs.[199, 200] For example, Bellingen Shire Council submitted that more than 50% of land within its area is exempt.[201]

When a significant proportion of land is rating-exempt, the council's rate base may be too narrow to raise enough income to cover the costs of the services its community needs. This undermines their financial sustainability. In addition, existing ratepayers may have to pay higher rates to cover the cost of services to exempt properties, or accept lower service levels. This reduces the affordability of their rates, and may undermine their trust in the council.

Some councils also commented that the inequities associated with rating-exempt land are increased when development of this land causes population growth – for example, it is used to build retirement villages, social and community housing, or aged care facilities. This puts an increased burden on existing ratepayers to bear the cost of providing services to a growing population.[202]

Stakeholders also pointed to examples of inequities in the way rates exemptions are currently applied. For instance, one council cited an aged care facility had been constructed in their LGA. The council indicated that even though a majority of the residents were self-funded, just one resident accommodated through social housing would make the entire facility rating exempt.[203]

Stakeholders raised similar concerns in our 2021 review of whether the rate peg should account for population growth,[204] and our 2016 review of the local government rating system.[205]

Previous reviews found current exemptions result in inefficient and inequitable outcomes

In the 2016 review, we examined the exemptions provided in the *Local Government Act 1993* (LG Act).[206] These exemptions are broad ranging. They include general exemptions based largely on who owns the land – for example, land owned by the Crown, religious bodies, schools, and public benevolent institutions or public charities is exempt.[207]

We consider that the current exemptions result in inefficient and inequitable outcomes, for example, properties with comparable land uses being rated differently – for example, retirement villages owned by Public Benevolent Institutions (PBI) being exempt while privately owned villages pay rates.

Better targeting exemptions would improve outcomes for councils and ratepayers

In light of the above, our 2016 review found rates exemptions should be carefully targeted to ensure ratepayers do not subsidise the costs of providing services to properties where this is not justified on efficiency and equity grounds, and properties with comparable uses of land should attract the same rating treatment.[208] In particular, we found:

- General exemptions should be based on land use not land ownership, and land used for commercial or residential purposes should not be exempt, regardless of who owns it.
- Some explicit exemptions should be retained or amended, as they are consistent with the general exemptions. For example, these include those for land owned by a religious body used for religious purposes, land vested in the NSW Aboriginal Land Council, and land owned by a hospital and used for that purpose.
- Some explicit exemptions should be removed on the basis that the land is used for a commercial or residential purpose. For example, these include those for land owned or vested in a water authority, and land used for commercial logging.
- Exemptions for land used for both exempt and non-exempt purposes should cover the portion used for exempt purposes only.

We consider that the NSW Government should review the recommendations of our 2016 review of the rating system on reforming the provisions for rates exemptions in the LG Act.

9.2.2 Allowing councils to use the Capital Improved Value method

In submissions to our Issues Paper, councils asked us to revisit one of the key issues we examined in our 2016 review of the local government rating system – namely whether councils should continue to be required to use the Unimproved Value (UV) method to set the variable component of rates, or should use the Capital Improved Value (CIV) method.[209] Shellharbour City Council submitted that "rates…should be levied against the CIV of a property, and not the UV. This would provide a more equitable system of spreading Council's rates across a Council's ratepayers."[210]

Stakeholders who attended our consultation workshops expressed similar views. Some industry stakeholders said that CIV would be a more appropriate calculation of property values and would more accurately capture growth within a council's area. [211] Some considered the population factor in the rate peg methodology would be more effective if property values were based on CIV rather than UV. [212] Some ratepayers said that CIV would be a more equitable method of calculating rates. They argued that rates are a regressive form of taxation that can unfairly impact low-income households.[213]

Previous reviews found metropolitan councils should use CIV to set rates

In our 2016 review of the local government rating system, we found that the CIV method is a better basis for setting rates in metropolitan areas because it:

- Performs better against the tax principles of efficiency, equity and simplicity. Rates calculated using CIV better reflect the benefits the ratepayer receives from council services, and the costs of supplying council services, and is more equitable and better understood by ratepayers.
- Addresses limitations of the current system. Mandatory use of the UV method means councils cannot set equitable, efficient rates for those who own apartments and units. This makes it difficult for them to raise an appropriate level of rates income from these residential and business ratepayers. This is an increasing problem as areas become more built up over time.[214]

We also found that CIV is consistent with best practice in other jurisdictions. There is a trend away from UV towards CIV to set rates, both in Australia and internationally.[215]

In non-metropolitan areas, we found that the benefits of CIV are lower, particularly in rural and remote areas with a low level of capital development.[216]

Enabling the use of CIV would improve outcomes for councils and ratepayers

Given these findings, our 2016 review concluded that the CIV method should be mandated as the basis for setting rates in metropolitan local government areas. However, non-metropolitan councils should have a choice between CIV and UV, as this would allow them to choose the valuation method that best suits the needs of their local communities.[217]

We maintain this view and consider that these changes to the rating system would improve the financial sustainability of metropolitan councils' rates bases. They would also help to share the rates burden more equitably across ratepayers, supporting the affordability of rates.

We consider that the NSW Government should review the recommendations from our 2016 review of the local government rating system on the use of the CIV method to levy local council rates.

9.2.3 Ensuring statutory charges reflect the full costs of service provision

The NSW Government regulates charges for certain statutory services provided by councils. During our review, councils told us that some of these charges have not been adequately indexed over time. This means councils are unable to recover the full cost of providing the services.[218] When this occurs, councils may need to use rates income to cover the gap. As a result, ratepayers may be cross-subsidising statutory service users, placing undue upward pressure on rates levels.

For example:

- **Stormwater Management Service Charge.** Councils can levy this charge to cover the costs of providing new/additional stormwater management services.[219] It is currently capped at $25 per rateable property.[220] One stakeholder said that the charge has not been reviewed for over 20 years and does not cover the cost of the services.[221] Tamworth Council also said the charge has not changed over time, and that the resulting unrecovered costs should be included as an adjustment to the rate peg.[222]
- **Development Approval fees**. Councils can levy fees to cover the cost of assessing Development Applications (DAs). Some councils stated that the current level of these fees does not cover their costs of assessment.[223] Tweed Shire Council submitted it is not fair for existing residents to subsidise the costs of Development Application assessments because the charge has not been indexed over time.[224]
- **Development contributions caps**. Councils can levy developers' contributions towards the cost of providing local infrastructure such as new roads, stormwater management and open space. However, councils cannot levy developers for the cost of providing community facilities such as swimming pools. Tweed Shire Council submitted that these caps mean development contributions provide insufficient income and place resourcing constraints and forward strategic planning of asset constraints on councils. It also said it is not equitable for existing ratepayers to fund infrastructure provision (through an increase in their rates) for new developments.[225]

We consider that statutory charges for services provided by councils should be at fully cost reflective and efficient levels to enhance financial sustainability and improve equity and affordability for ratepayers. They should be appropriately indexed and periodically reviewed to ensure they remain at cost reflective levels.

We consider that the NSW Government should review the amounts councils can charge for statutory services to ensure these amounts reflect the full cost of providing these services.

9.3 Measures that require further investigation

We identified a range of measures that the NSW Government, Office of Local Government and councils could consider to better support councils serve their communities more effectively and build community trust in councils. These include measures to:

- address significant financial sustainability issues
- improve how councils communicate with ratepayers about rates
- enable councils to provide better services to disadvantaged or vulnerable groups in their communities, particularly in regional and remote areas where these services are not provided by the private sector. For example, medical and aged care services.
- provide better assistance to vulnerable ratepayers and ensure they are aware of the assistance they are eligible for
- provide individual ratepayers confidence in the rating system
- provide councils that demonstrate good performance with greater autonomy.

9.3.1 Enable councils to address significant financial sustainability issues

Some councils told us they are struggling to maintain their current level of service while remaining financially sustainable.[226] They mainly attributed this to:

- the rate peg not fully reflecting the changes in inflation and costs of providing council services
- changes in the amount of income they receive through other funding sources such as grants, and user fees and charges
- historically unsustainable levels of rates income that they feel unable to address through the current special variation (SV) process.

Our analysis for this review confirms that some councils are facing financial sustainability challenges. Appendix D shows that the number of councils reporting operating deficits increased from 2016-17 to 2020-21 and more than half of all councils have infrastructure backlog ratios that do not meet the OLG's benchmark of less than 2%. Councils also need to consult with their communities and demonstrate that they have implemented productivity improvements.

In addition, the per capita value of Financial Assistance Grants to NSW councils has declined in real terms (although the experience of individual councils is likely to be more varied) (see Appendix D). This may mean that councils historically reliant on grant funding to cover their day-to-day expenses face increased financial sustainability issues.

Currently no appropriate means to address financial sustainability issues

It is in the interest of ratepayers for councils to be financially sustainable. This ensures councils can continue to provide the service levels their communities need and want. However, we consider there is currently no effective/appropriate means for councils to resolve significant or longstanding financial sustainability issues.

As Chapter 2 discussed, the rate peg is designed to allow councils to increase their rates income annually to keep pace with estimated changes in the costs of providing their current services and service levels. If their rates income is already below the level required to provide these services and service levels, or their income from other sources substantially declines, the rate peg will not help them to achieve financial sustainability.

The SV process allows councils to apply to IPART for a step change in their rates revenue – that is, an increase higher than the rate peg – to improve their financial sustainability. Some councils have used this process for this reason. However, we heard through our consultations for this review that other councils can be reluctant to apply for an SV, even when it is necessary. Councils said the existing SV process is resource-intensive, can be contentious, and perceived by ratepayers as a sign of financial mismanagement and inefficiency.[227] We acknowledge that these are concerns faced by some councils.

We consider that there is scope for improvements in how councils undertake and implement their Integrated Planning and Reporting (IP&R). While councils raised that the framework satisfies a high level of community engagement, we found through our ratepayer consultation that councils could improve their communication and trust with their communities.[228]

We also consider that capacity building programs such as leadership training that are available for senior government employees may also assist local government professionals.

We propose that IPART in consultation with OLG and stakeholders develop an effective mechanism to address these issues

We consider that an effective mechanism for addressing significant or longstanding financial sustainability issues needs to be developed. During our consultations, several potential approaches were raised. For example:

- Some councils suggested that financial sustainability could be directly accounted for in the rate peg methodology. An adjustment factor could be calculated based on each council's financial need and included in the rate peg as a one-off. This would enable all councils across the state to reset their rates income at a sustainable level.[229] However, some financial sustainability issues might be best addressed through other revenue sources, rather than rates.
- IPART establish a process to enable councils to reset their rates base through a one-off increase in rates income, to support councils' financial sustainability and enable delivery of ongoing services. This could be a simplified version of the existing SV process, or separate, tailored process.

Whatever approach is used, councils would need to be able to demonstrate they are currently collecting insufficient rates per capita to fund services and service levels their communities need and find acceptable. This would not be straightforward, as these services and services levels are likely to vary between types of councils. For example, regional and rural councils are generally responsible for managing greater kilometres of roads, and need to spend more on the maintenance of this asset category compared to metropolitan councils. Some councils are required to provide specific services, such as aged care facilities, in the absence of alternative providers in their LGAs.[230]

We consider that a mechanism needs to be developed to enable councils found to have insufficient base rates income to achieve financial sustainability.

9.3.2 Improve how councils communicate with ratepayers about rates

As part of the IP&R framework, introduced in 2009, councils are required to develop a series of plans for the future, centred around the aspirations of their community. The plans should set out the goals and strategic actions required to fulfill them. It involves a reporting structure to communicate progress to council and the community.[231] We heard from both councils and ratepayers in relation to council communication and the IP&R process. Councils indicated that:

- The IP&R process facilitates robust conversations with their communities around financial planning and uses for rates revenue.[232]

- Councils were disappointed at our Issues Paper question about whether the rate peg has protected ratepayers from "unnecessary" rate rises.[233] The Central NSW Joint Organisation cited that the question underplays the role of the IP&R process.[234] Councils believe that they are accountable to their communities through the IP&R process which ensures decisions are made with the community in its best interests.[235] These councils suggested that the community holds councils accountable and that aspects of the IP&R framework such as the Community Strategic Plan (CSP), Delivery Program and Financial Data Return's (FDR's) allow community visibility.[236] Therefore, such processes were already in place to protect ratepayers.
- The Community Strategic Plan and the IP&R process are major cost items for councils.

Results from the ratepayer survey suggested that councils could potentially improve their engagement with their communities. We asked ratepayers how they rated the communication of their council around both how rates revenue is used, and how rates change. About 36% of community ratepayers in NSW thought that council communication around how rates revenue is used was *not good enough*, as opposed to 27% that said it was *good* or *very good*.[237] The results were marginally better for business ratepayers.[238]

When considering the communication of their respective council around changes in rates, 29% of community ratepayers[239] and 26% of business ratepayers said that communication was *not good enough.*[240] 31% of community respondents[241] and 35% of business respondents said that it was *good* or *very good.*[242]

The survey results suggested that some ratepayers lacked trust in their council to keep rate increases reasonable. 61% of community ratepayers[243] and 63% of business ratepayers[244] indicated that they were *not very comfortable* or *not at all comfortable* with trusting councils to keep rate increases reasonable. Ratepayers in large rural and metropolitan fringe council areas showed the least trust in their councils.

The ratepayer survey results suggested that there is an insufficient level of communication from councils and that trust from ratepayers is lacking, particularly in large rural councils. We consider that improving communication around rates is integral to understanding ratepayers' affordability and what kinds of services they are willing to pay for. We propose:

- That councils consider ways to improve how they communicate with their ratepayers about rates.
- That the Office of Local Government continues to work with councils to utilise the IP&R framework in council's communication with ratepayers on rates.

9.3.3 Enable councils to provide better services to disadvantaged or vulnerable groups in their community

We heard from some councils, particularly in rural and regional areas about the need for providing a range of services beyond base level services, for example, medical services, youth services and other services essential to social outcomes in their area. It was acknowledged that in other communities, typically more populated communities, these services could also be provided by the private sector but in their communities, councils were often providers of last resort.[245]

Some of these councils argued that the rate peg should consider the unique challenges to help fund these services. While the rate peg hasn't been designed to cover these specifically, it is important that councils are supported to provide services that the community needs.

For councils with limited rate bases, capturing these additional services through the rate peg may not be appropriate if it adds greater burden to ratepayers particularly where there are disadvantaged or vulnerable communities that have limited capacity to pay.

We consider that there may be other ways these community services could be funded sustainably through the overall revenue framework. For example, if the government can better support councils to provide social services they are required to provide through targeted grants, if the community expresses a willingness to support these services through their rates than an SV may be an appropriate mechanism, or adjustments to the rate peg (discussed above in external costs).

9.3.4 Provide better assistance to vulnerable ratepayers

We recognise the importance of affordable rates, especially in the current high inflation environment and as the cost-of-living increases and consider the role that other mechanisms can play to alleviate cost pressures for ratepayers.

One such example includes pensioner concessions. Under the *Local Government Act 1993*, eligible pensioners can be provided with concessions on their rates. The entitlement is up to $250 on ordinary rates and charges for domestic waste management services.[246] however this amount has not been indexed. Councils made the following comments on pensioner rebates:

- Nambucca Valley Council considered that the rate peg should take into account the proportion of pensioner concessions that are not funded by the government, so councils with older demographics are not being penalised or handicapped financially for having pensioners reside in the area.[247] United Services Union, Dubbo Council, Bellingen, Tamworth, Ryde, Lane Cove, Gunnedah Shire Council, LGNSW and Sydney of City others held similar views regarding the rate peg to capture these costs.[248]
- Campbelltown City Council in its submission stated that councils lost $61 million in 2015-16 through the NSW Government's failure to fully reimburse councils for mandatory pensioner rate rebates, unlike all other state/territory governments in Australia.[249]

Capturing increases in pensioner rebates in the rate peg could lead to further increases for other ratepayers.

We consider that the NSW Government should undertake a state-wide review on the current pensioner concessions and other programs that could be introduced or be better utilised and targeted to assist ratepayers experiencing vulnerability.

Councils may provide other ways to help ratepayers. These should be promoted and clearly communicated to ratepayers. Feedback at our workshop indicated there was confusion from ratepayers about assistance they were eligible for.

9.3.5 Provide individual ratepayers confidence in the rating system

In NSW councils are responsible for setting individual rates for residential, business, farmland and mining rating categories. As the rate peg applies to total rates income rather than to individual rates, individual rates may increase by more or less than the rate peg.

- Ratepayers expressed concerns that while the rate peg could protect ratepayers collectively, it does not protect individual ratepayers from unreasonable increases.[250]
- Some ratepayers raised the issue about the impacts of valuations on their rates and how these could lead to volatile changes. We heard from 3 submissions and in feedback at our technical workshops that IPART should consider the current calculation of property valuations that affect the total rates paid by individuals.[251] Property valuations are undertaken by the Valuer General of New South Wales. We heard that such valuations can be volatile and, in some cases, result in large rate increases (over 20%) for some households and reductions in others.[252] Changes in land valuations (other than supplementary valuations) do not increase income for councils. Rather, they redistribute rates between ratepayers. Box 9.1 provides additional information on the effect of land valuations on rates.

Box 9.1 Effect of land valuation on rates

Routine changes to land valuations will result in some individual ratepayers paying either higher or lower rates. These changes do not increase the total amount of general income the council can recover from ratepayers (also known as the 'permissible general income' or PGI). A council's PGI for each year is limited by the rate peg or a percentage determined by IPART in a special variation.[a]

Individual rates depend on the combination of:

- the council's rating structure
- the relevant rating category
- the property's unimproved land value.

The variable component of rates, ad valorem, is determined by:

$$\textit{ad valorem component} = \textit{amount in the dollar} \times \textit{land value}$$

Generally, the council recalculates the 'amount in the dollar' rate every year to ensure the council does not collect rates above its PGI.

A routine increase in a ratepayer's land value by the Valuer-General does not mean that ratepayer's rates will automatically increase. The impact on rates depends on whether the land value has increased or decreased compared to others in the ratepayer's local government area.

Another issue raised was that different rating category groups may be cross-subsidising other groups. Ratepayer stakeholders raised concerns about the disproportionate sharing of rate peg increases. The Shopping Centre Australia submitted that the rate peg does not prevent discriminatory and disproportionate rate burden being applied to a small number of ratepayers. For example, it showed that for some shopping centre business ratepayers, premiums in rates could be up to 10 times the base business ad valorem rate. It suggested that councils' application of a discriminatory differential rating policy can adversely affect ratepayers individually.[253] Similar issues were raised at our technical workshop for ratepayers.[254]

Currently councils have discretion as to how they apportion the increase across different rating categories. We have considered whether additional constraints (i.e. conditions) on the rate peg would help provide individual ratepayers confidence in the rating system and reduce the likelihood of ratepayers experiencing significant changes in their rates. In the past, IPART has received complaints from a significant number of ratepayers in different LGAs complaining of rate increases that were either because of rebalancing or harmonising of rates.

[a] Councils' PGI may be affected by supplementary valuations of rateable land under the Valuation of Land Act 1916 and estimates provided under section 513 of the Local Government Act 1993. Such supplementary valuations and estimates are made when land with a council area has changed outside the general valuation cycle (such as where land has been subdivided or rezoned). This is distinct from the routine changes in land value by the Valuer-General.

IPART's delegated powers under the LG Act permit IPART to specify the percentage by which councils' general income may be varied each year. IPART can set a different rate peg for each council and may specify a methodology for determining the rate peg. However, the LG Act does not currently permit side-constraints (i.e. conditions) on the application of the rate peg. We consider that there could be merit in considering whether to introduce additional constraints to provide further confidence to ratepayers.

9.3.6 In the future councils that demonstrate good performance could be rewarded with autonomy

We consider that incentives in the regulatory environment for good performing councils could be developed. There may be merit in considering whether to develop a mechanism where councils could be provided with the autonomy to set their own rate increases, subject to certain conditions such as a medium-term plan, a record of strong financial management, a clear plan for ongoing productivity improvements and community support.

Council independence and democratic accountability

In the submissions we received to our Issues Paper and during our public workshops, stakeholders expressed a desire for greater rate setting autonomy to be provided to councils.[255] Berrigan Shire Council stated that the rate peg "creates a beggar mentality where Councils can avoid the difficult discussions with residents about their rates and simply complain that the Federal and State governments need to provide more funding."[256] Some of these stakeholders submitted that councils have a robust framework such as the IP&R Framework that makes them accountable to local communities. [257] Some stakeholders submitted that the democratic process would allow councils to maintain rates in line with community expectations.[258]

Many councils submitted that this autonomy should occur through the abolishment of the rate peg.[259] Some stakeholders who called for the removal of the rate peg, also gave other alternatives such as streamlining the special variation process and lowering the burden on councils or changing IPART's role to monitoring rates rather than setting a rate peg.[260] In submissions, ratepayers were generally supportive of the rate peg. However, some considered that large special variations may be circumventing the role of the rate peg. Some ratepayers were also concerned about the impact of these Special Variations on their own finances.[261]

We consider that the recommendations from the 2009 review of the revenue framework for local government provide a starting point for councils and the State Government to discuss increased autonomy with their local communities and other stakeholders. [262]

Appendices

Appendix A

Rate peg methodology formula

A

Box A.1 Recommended rate peg formula

The **current** rate peg formula is:

$$Rate\ peg = \Delta LGCI - \ productivity\ factor + population\ factor + other\ adjustments$$

Our **proposed** rate peg formula for the Draft Report is:

$$Rate\ peg = Base\ Cost\ Change\ (BCC) - productivity\ factor + population\ factor + Emergency\ Services\ Levy\ (ESL)\ factor + other\ adjustments$$

Calculating the BCC for 2025-26

We propose to publish a BCC for each of the metropolitan, regional and rural council groups.

The calculation is shown in the following formula:

$$BCC = w_E E + \ w_A A + \ w_o O$$

Where:

E represents the change in employee costs

A represents the change in asset costs

O represents the change in other operating costs

w_E represents the weighting of employee costs

w_A represents the weighting of asset costs

w_O represents the weighting of other operating costs

and

$$w_E + w_A + w_O = 1$$

Our preferred approach is to calculate the change in employee costs using wage increases prescribed by the Local Government (State) Award for the year the rate peg applies, adjusted to reflect any change in the superannuation guarantee rate. When the Award increase is not available, we would use the forecast Wage Price Index (WPI) published by the Reserve Bank of Australia (RBA) in its most recent Statement on Monetary Policy (averaging the year–on–year change for the June and December quarters for the year the rate peg applies), adjusted to reflect any change in the superannuation guarantee rate.

Box A.1 Recommended rate peg formula

The calculation for 2025-26 is shown in the following formula:

$$Change\ in\ employee\ costs = Award_{2025-26} + change\ in\ superannuation\ guarantee$$

The change in asset costs for each of the metropolitan, regional and rural council groups would be calculated using the Consumer Price Index (CPI) forecasts from the RBA's most recent Statement on Monetary Policy averaging the year–on–year change for the June and December quarters for the year the rate peg applies), adjusted to reflect the average difference between change in actual PPI (road and bridge construction) and the change in the CPI (Australia) over the most recent 5-year period for which data are available, as published the Australian Bureau of Statistics (ABS).

The calculation for 2025-26 is shown in the following formula:

$$Change\ in\ asset\ costs = \left(\frac{\Delta CPI_{Dec\ 2025} + \Delta CPI_{Jun\ 2026}}{2}\right) + \left(\frac{\sum_{i=0}^{5}(\Delta PPI_{t-i} - \Delta CPI_{t-i})}{5}\right)$$

Where:

Δ = the change in

The change in other operating costs would be calculated using the CPI forecasts from the most recent Statement on Monetary Policy (averaging the year–on–year change for the June and December quarters for the year the rate peg applies) published by the RBA.

The calculation for 2025-26 is shown in the following formula:

$$Change\ in\ other\ operating\ costs = \frac{\Delta CPI_{Dec\ 2025} + \Delta CPI_{Jun\ 2026}}{2}$$

The weightings of employee, asset, and other operating costs for each of the metropolitan, regional, and rural council groups would be calculated using information reported in councils' Financial Data Returns from the most recently reported 3-year period.

As an example, the weighting of employee costs would be calculated using the following formula:

$$w_E = \frac{\sum_{2020-21}^{2022-23}(employee\ costs)}{\sum_{2020-21}^{2022-23}(total\ operating\ costs)}$$

We would use a similar formula to calculate the weightings of asset and other operating costs. For asset costs, we use depreciation to calculate the weights.

Calculating the population factor for 2024-25

We propose to maintain the existing formula for the population factor but change how the change in residential population is calculated in the formula. The population factor is equal to the maximum of the change in residential population less the supplementary valuations percentage or zero.

The calculation is shown in the following formula:

$$Population\ factor = \max\left(0, change\ in\ population - supplementary\ valuations\ percentage\right)$$

The change in population for each council would be calculated using Estimated Residential Population (ERP) data and prison populations (PP) data for 2021 and 2022 published by the Australian Bureau of Statistics (ABS). This is the most up to date ABS population data for the 2024-25 rate peg.

The calculation for 2024-25 is shown in the following formula:

$$Change\ in\ population = max\left(0, \frac{(ERP_{2022} - PP_{2022})}{(ERP_{2021} - PP_{2021})} - 1\right)$$

Where:

ERP represents estimated residential populations published by the ABS

PP represents prison population published by the ABS

Calculating the ESL factor for 2024-25

We propose to remove the ESL component measured in our current LGCI and include a separate ESL factor for each council. This would be calculated using the net ESL contributions (net of any subsidy) paid by each council for 2023-24 and 2024-25, based on data provided by the NSW Government on each council's individual ESL contribution and information provided by councils.

We propose to calculate the ESL factor in 2 ways.

- An ESL factor that reflects an individual council's ESL contribution, for councils:
  - that are not part of a rural fire district, or
  - are the only council in their rural fire district, or
  - that are part of a rural fire district but do not engage in ESL contribution cost sharing arrangements, or
  - that are part of a rural fire district and engage in ESL contribution cost sharing arrangements where we have accurate information about what the council pays.

Box A.1 Recommended rate peg formula

- An ESL factor that reflects the weighted average change in ESL contributions per rural fire district, for councils that are part of a rural fire district and engage in ESL contribution cost sharing arrangements where we do not have accurate information about what they pay.

The ESL adjustment is calculated in such a way as to ensure that the Notional General Income (NGI) includes councils' full ESL contributions.

The ESL factor measures the impact on the rate peg from the change in the ESL contribution. We calculate the ESL factor by isolating the impact of the change in ESL contributions on the NGI in a given year, for example in 2024-25.

We do this by removing the 2023-24 ESL contributions from the NGI for 2023-24. We then increase this amount by the 2024-25 'rate peg' *excluding* the ESL factor. In this step, we have calculated what the NGI would be in 2024-25 without the ESL contribution (X). We then add the 2024-25 ESL contribution for the 2024-25 rate peg to (X) to give the total NGI in 2024-25 ($Y = X + ESL_{2024-25}$).

We determine the final 2024-25 rate peg *including* the ESL factor by dividing the total 2024-25 NGI (Y) by the total 2023-24 NGI (including the ESL contribution). The ESL factor is the difference between the final rate peg for 2024-25 and the rate peg excluding the ESL factor.

Below we set out the steps in the formula to find the ESL factor in 2024-25:

$$Rx_{24-25} = BCC + population\ factor + productivity\ factor + \ other\ adjustments$$

$$X = \ (NGI_{23-24} - ESL_{23-24})\ \times (1 + Rx_{24-25})$$

$$Y = X + \ ESL_{(24-25)}$$

$$R_{24-25} = \frac{Y}{NGI_{(23-24)}} - 1$$

$$ESL\ factor = \ R_{24-25} - Rx_{24-25}$$

The general formula is:

$$ESL\ factor = \frac{\left[\left(NGI_{(t-1)} - ESL_{(t-1)}\right) \times (1 + Rx_t)\right] + ESL_{(t)}}{NGI_{(t-1)}} - (1 + Rx_t)$$

Box A.1 Recommended rate peg formula

Where:

NGI = Notional General income

ESL = ESL Levy Contribution

Rx = Rate peg excluding the ESL factor

t = The current year

If the change in the ESL contributions is the same as the Rate peg (excluding the ESL factor), then the ESL factor would be 0%.

ESL factor for councils in a rural fire district where we do not have accurate cost information about what they actually pay.

For councils that are part of a rural fire district and engage in ESL contribution cost sharing arrangements where we do not have accurate information about what they pay, we calculate an ESL factor that reflects the weighted average change in ESL contributions per rural fire district. This is done by using the same formula as above to determine the ESL factor calculation for each individual council, except instead of using only the individual NGI and ESL contributions for one council, we sum the NGI and ESL contributions for all councils in the rural fire district.

For the purposes of this formula, we would also use a combined rate peg for each of the councils in an RFS district before the ESL factor (RW).

$$ESL\ factor_{RFS} = \frac{\left[\sum_1^n (NGI_{(t-1)} - ESL_{(t-1)}) \times (1 + RW_t)\right] + \sum_1^n ESL_{(t)}]}{\sum_1^n NGI_{(t-1)}} - (1 + RW_t)$$

Where:

$$RW_t = \frac{\sum_1^n [NGI_{(t-1)} \times (1 + R_x)]}{\sum_1^n NGI_{(t-1)}} - 1$$

n= the number of councils

Appendix B

Alternative options considered

B

This appendix presents more information on the alternative options we considered for measuring annual changes in councils' base costs as identified in Chapter 3, namely:

- Rolling average using both historical and forecast data (Option A)
- Single year historical data and forecast data combination (Option B)
- A 2-factor BCC using forecast CPI for both asset and other costs (Option C)
- BCCs for 5 regional groups (Option D).

Rolling average using both historical and forecast data (Option A)

As indicated in Chapter 3, our draft BCC prioritises reducing the lag over volatility – in other words, it prioritises maintaining 'real time' cost reflectivity at the expense of stability and predictability. As an alternative to our draft approach, we considered a compromise option that would reduce volatility and improve predictability – but at the risk of reducing 'real-time' cost reflectivity.

A commonly suggested mechanism for reducing volatility is to use a rolling average. A compromise solution suggested by some stakeholders[263] is to use a 3-year rolling average of a measure of changes in costs using historical data combined with a measure of changes in costs using forecast data, each with a 50% weighting.

The main benefit of using a measure of changes in costs using historical data rather than a measure of changes in costs using forecast data is that, over time, it more accurately captures actual changes in costs due to inflation, albeit with a lag. In comparison, forecasts may not be accurate, especially in volatile economic conditions. The benefit of using a combination of historical and forecast data is that it reduces both the lag and the risks associated with forecasts.

Based on the compromise solution described above, we considered the following approach: for each regional group we would calculate a 3-year rolling average of a BCC using historical data and a BCC using our proposed methodology as described in section 3.2 (that uses forecast data). Under Option A, we would include the average of these 2 measures in the rate peg.

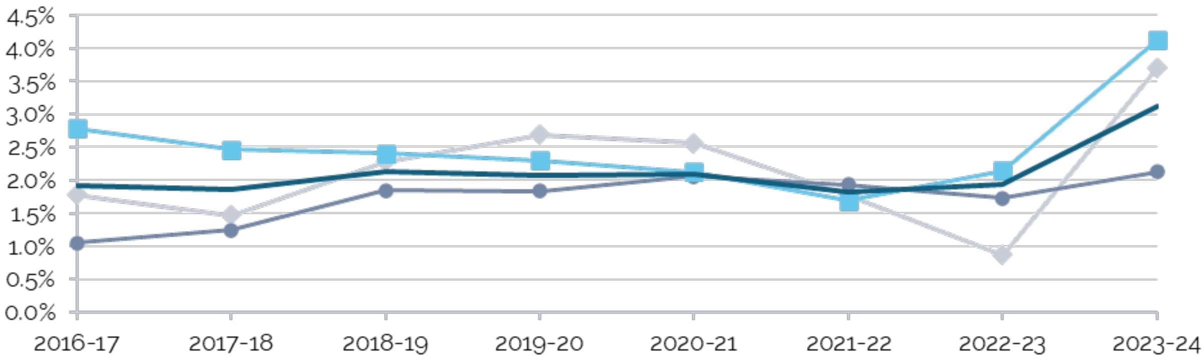
To calculate the BCC using historical data for each group we would:

- For employee costs, use the change in the NSW All industries WPI (Private and Public), obtained from the ABS. Unlike for the LGCI, we would use the NSW Public and Private sector WPI in recognition of the fact the councils compete for labour with all sectors of the economy, as discussed in Chapter 3.
- For asset costs, use the change in the NSW PPI (Road and bridge construction).
- For all other costs, for metropolitan councils use the change in the Sydney CPI (All groups). For regional and rural councils, we would use the change in the Australia CPI (All groups) to recognise that, in some respects, these councils may have more in common with some of the smaller capital cities (such as Darwin, Hobart and Perth) than with Sydney.

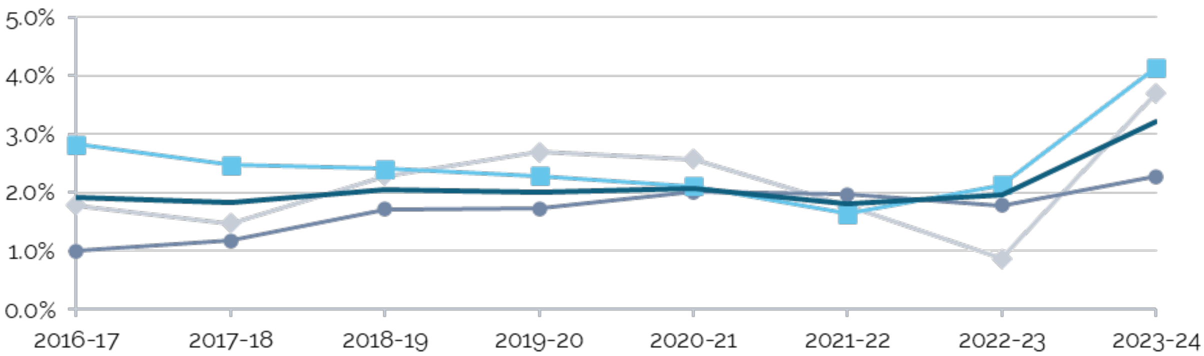
As shown below, over the period 2016-17 to 2023-24 the combined forecast and rolling average BCCs (Option A) would have been more stable than our proposed BCC but less reflective of annual costs (**Figure B.1**).

Figure B.1 Performance of the combined forecast and rolling average BCCs, 2016-17 to 2023-24

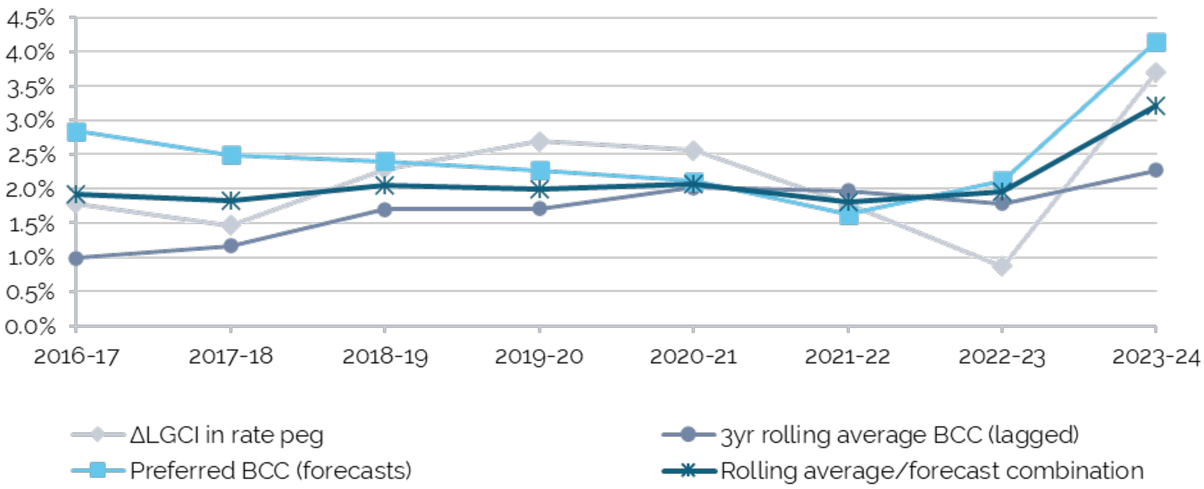
Metropolitan



Regional



Rural



Single year historical and forecast data combination (Option B)

Another option we considered is a variation of Option A. To reduce the lag compared to that under Option A while still addressing the forecast risk, for each regional group we would use a measure of changes in costs using the most recent single year of historical data and our draft BCC. The BCC–Option B included in the rate peg would be the average of these 2 measures.

Using historical data, modelling suggests that BCC–Option B would be more volatile than BCC–Option A, but less volatile than the change in the current LGCI (see **Figure B.2** and **Table B.1**).

A 2-factor BCC using forecast CPI for both asset and other costs (Option C)

The third option we considered would be a 2-factor BCC that uses forecast CPI for both asset and other costs. The benefit of this approach compared to our draft BCC is that it is simpler. The disadvantages compared to our draft BCC are that a 2-factor BCC:

- will not capture any differences between asset costs and all other non-employee costs
- is even less able than our draft BCC to reflect regional differences (see **Table B.1**).

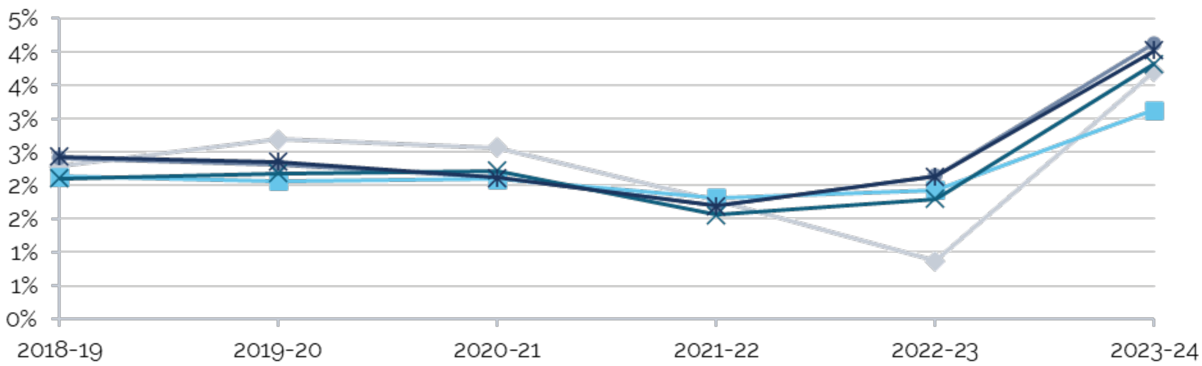
BCC–Option C would be lower than our draft BCC when the PPI adjustment factor is greater than 0%, and *vice versa*, where the PPI adjustment factor is the difference between NSW CPI and NSW PPI (Road and bridge construction) over the most recent 5 years for which data are available. Historical analysis suggests, that over the period 2016-17 to 2023-24, in general a 2-factor BCC would have been the same as, or slightly lower than our preferred BCC[a] (see **Figure B.4** and **Table B.1**). Over the period 2004-05 to 2021-22, the change in the NSW PPI (Road and bridge construction) was higher than the change in the NSW CPI for 13 of the 19 years (68% of the time).

Historical analysis also suggests that a 2-factor BCC would likely be very similar, if not the same across all regional groups in most years (**Table B.1**, last column). This outcome is similar to our preferred 3-factor BCC that measures the change in asset costs as the forecast CPI plus the PPI adjustment factor.

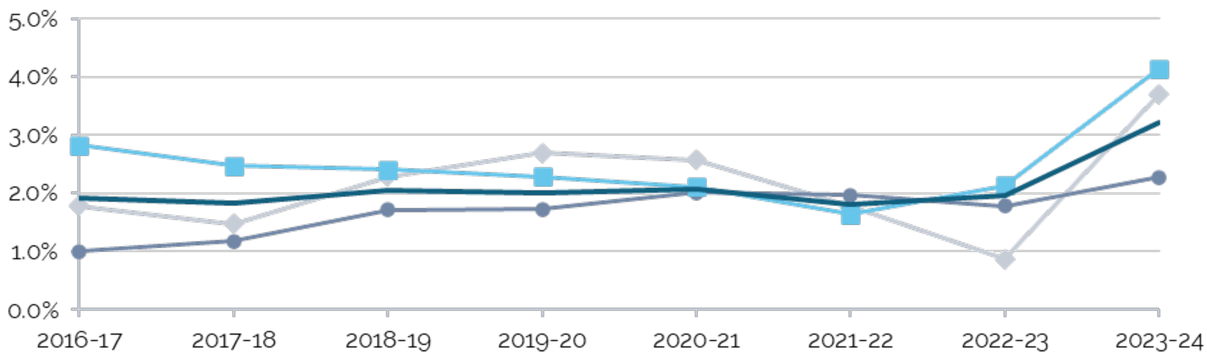
[a] Our preferred BCC refers to our draft BCC model as described in Section 3.2, using the Award to calculate the change in employee costs.

Figure B.1 Indicative historical performance of preferred[a] BCC and Options A to C

Metropolitan



Regional



Rural

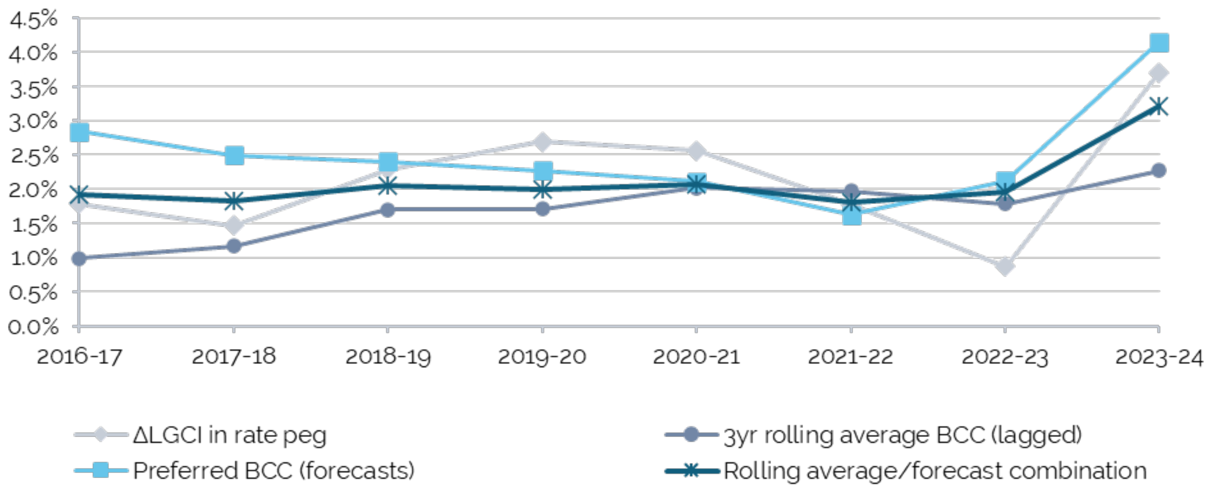


Table B.1 Indicative historical performance of preferred BCC and Options A to C

	ΔLGCI	Preferred 3-factor BCC	Option A Combined forecast and historical rolling average BCC	Option B Combined forecast and single year historical BCC	Option C 2-factor BCC using CPI and WPI forecasts
Metropolitan					
2016-17	1.8%	2.8%	1.9%	2.4%	2.6%
2017-18	1.5%	2.5%	1.9%	2.1%	2.3%
2018-19	2.3%	2.4%	2.1%	2.1%	2.4%
2019-20	2.7%	2.3%	2.1%	2.2%	2.4%
2020-21	2.6%	2.1%	2.1%	2.2%	2.1%
2021-22	1.8%	1.7%	1.8%	1.6%	1.7%
2022-23	0.9%	2.1%	1.9%	1.8%	2.1%
2023-24	3.7%	4.1%	3.1%	3.8%	4.0%
Regional					
2016-17	1.8%	2.8%	1.9%	2.4%	2.6%
2017-18	1.5%	2.5%	1.8%	2.0%	2.3%
2018-19	2.3%	2.4%	2.1%	2.0%	2.4%
2019-20	2.7%	2.3%	2.0%	2.2%	2.3%
2020-21	2.6%	2.1%	2.1%	2.2%	2.1%
2021-22	1.8%	1.6%	1.8%	1.6%	1.6%
2022-23	0.9%	2.1%	2.0%	1.8%	2.1%
2023-24	3.7%	4.1%	3.2%	4.0%	4.0%
Rural					
2016-17	1.8%	2.8%	1.9%	2.4%	2.6%
2017-18	1.5%	2.5%	1.8%	2.0%	2.3%
2018-19	2.3%	2.4%	2.0%	2.0%	2.4%
2019-20	2.7%	2.3%	2.0%	2.1%	2.3%
2020-21	2.6%	2.1%	2.1%	2.3%	2.1%
2021-22	1.8%	1.6%	1.8%	1.5%	1.6%
2022-23	0.9%	2.1%	2.0%	1.8%	2.1%
2023-24	3.7%	4.2%	3.2%	4.0%	4.0%

a. Our preferred BCC means a BBC using the Award to calculate the change in employee costs

BCCs for 5 regional groups (Option D)

A further option we considered was a separate 3-factor BCC for each of the 5 regional groups (see **Table B.2**).

As explained in Chapter 3, our draft decision is to use only 3 groups mainly because there is very little difference in the share of expenditure on the 3 cost components captured by the BCC model between metropolitan and outer-metropolitan councils, and between rural and large rural councils (**Table B.2**). Consequently, there would be very little, if any difference in the base cost change under our proposed methodology. The indicative historical BCCs for the 5 regional groups are show in **Table B.3**.

Table B.2 Example weights for 5 regional groups using data for 2019-20 to 2021-22

Council type	Number of councils	Employee costs	Asset costs	Other operating costs (incl. materials and contracts)
Metropolitan (OLG groups 1 to 3),	25	41%	18%	41%
Outer metropolitan (OLG groups 6 and 7),	9	41%	19%	40%
Regional (OLG groups 4 and 5)	37	37%	23%	40%
Large rural (OLG groups 10 and 11)	42	36%	26%	38%
Rural (OLG groups 8 and 9)	15	38%	25%	37%
All councils	128	39%	21%	40%

Table B.3 Indicative historical 3-factor BCC for 5 regional groups using PPI adjusted CPI forecasts to calculate the change in asset costs

	Metropolitan	Metropolitan fringe	Regional Town/City	Large rural	Rural
2016-17	2.8%	2.8%	2.8%	2.8%	2.8%
2017-18	2.5%	2.5%	2.5%	2.5%	2.5%
2018-19	2.4%	2.4%	2.4%	2.4%	2.4%
2019-20	2.3%	2.3%	2.3%	2.3%	2.3%
2020-21	2.1%	2.1%	2.1%	2.1%	2.1%
2021-22	1.7%	1.7%	1.6%	1.6%	1.7%
2022-23	2.1%	2.1%	2.1%	2.1%	2.1%
2023-24	4.1%	4.1%	4.1%	4.2%	4.2%
Cumulative index (2015-16 = 100)	121.8	121.8	121.7	121.8	121.9

In addition, as discussed in Chapter 3 we considered using changes in per capita depreciation to calculate asset costs. If we were to use this approach, another reason we would calculate a BCC for only 3 regional groups is due to the relatively small numbers of councils in the outer metropolitan (9) and rural (15) subgroups. The small number in each subgroup means a large change in a single council could have substantial impact on the BCC for all councils in that subgroup. This could make the BCC for those subgroups more volatile and cumulatively less reflective of changes in their actual costs over time. The indicative historical BCCs for the 5 regional groups using per capita depreciation to calculate the change in asset costs are show in **Table B.4**.

Table B.4 Indicative historical 3-factor BCC for 5 regional groups using per capita depreciation to calculate the change in asset costs

	Metropolitan	Metropolitan fringe	Regional Town/City	Large rural	Rural
2016-17	2.1%	1.4%	2.7%	2.2%	1.8%
2017-18	1.7%	0.7%	1.6%	1.8%	0.8%
2018-19	1.8%	1.9%	1.5%	1.5%	1.0%
2019-20	2.1%	1.8%	1.7%	1.4%	1.4%
2020-21	2.1%	2.2%	1.7%	2.0%	1.8%
2021-22	2.2%	2.3%	1.9%	2.8%	2.7%
2022-23	2.7%	3.0%	2.5%	3.3%	3.0%
2023-24	4.6%	4.7%	4.5%	4.4%	4.4%
Cumulative index (2015-16 = 100)	121.1	119.5	119.6	121.1	117.9

Appendix C

Ratepayer views from surveys and focus groups

C

C.1 Surveys of community and business ratepayers

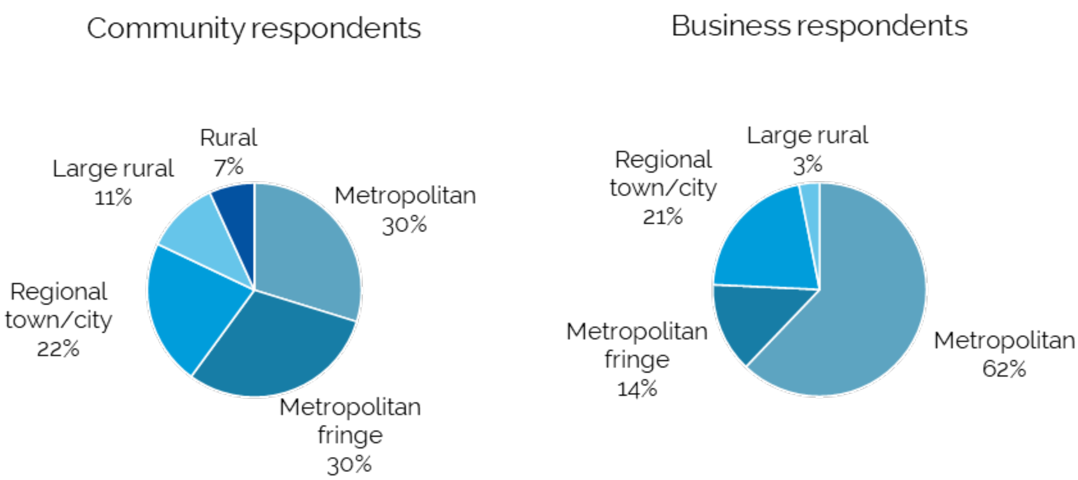
We commissioned ratepayer surveys to gain insights from community (residential) and business ratepayers and to better understand their perspectives on rates-related issues. We engaged independent market research company, ORIMA Research, to run the surveys and worked with them to develop questions that would help us to inform key aspects of the review. While we asked similar questions, surveys were adapted to target the different ratepayer groups. The questionnaires can be found in the appendices of ORIMA's Rate Peg Survey Integrated Report.

The surveys were undertaken to broadly understand the perceptions of a wide range of ratepayers on rate peg issues. The surveys investigated:

- Ratepayers' current experience of council services.
- Ratepayers' current experience of council communication around rates.
- Ratepayer preferences around how rates are set.
- The types of services rates should cover.

The community survey reached both owner-occupiers and renters primarily through an online panel, and then through telephone interviews where required to reach a representative sample.[264] Three demographic variables were used to structure the sample including age, gender and the type of council that they resided in (metropolitan, metropolitan fringe, regional town/city, rural and large rural), in accordance with the Office of Local Government's (OLG's) classification of local governments.[265] **Figure C.1** demonstrates the mix of respondents according to council type.

Figure C.1 Mix of respondents to the ratepayer surveys per council type



Source: ORIMA, Rate Peg Survey Integrated Report, April 2023, pp 1 & 15-16.

The business survey was conducted entirely online by ORIMA using members of a business research panel. ORIMA sought a representative sample of business owners or key decision makers across business size and council type. 28% of respondents were sole traders, 23% had 2-5 employees, while 16% had 6-20 employees, 21-100 employees and 101+ employees respectively.[266]

Further details on the methodology can be found in ORIMA's Rate Peg Survey Integrated Report.

C.1.1 Key findings from the surveys

The survey of community and business ratepayers found that:

- Affordability is very important to ratepayers.
  - Over half of respondents ranked affordability as the first or second most important consideration with respect to rates. Around 1 in 3 community ratepayers and 29% of business ratepayers rated affordability as the most important consideration.[267]
  - The second most important consideration for both types of ratepayer respondents was that councils use money from rates effectively.[268]
  - When asked about how rate changes are reviewed, almost 2 thirds of the community (62%) and business (63%) ratepayer respondents preferred that IPART prioritise protecting ratepayers from unreasonable increases rather than ensuring councils have enough money to continue to deliver services.[269]
- Councils could improve their communication and trust with their ratepayers.
  - A larger proportion of ratepayer respondents indicated that council communication around how rates revenue is used, was not good enough compared to those that said it was good or very good.[270]
  - 61% of community ratepayer respondents and 63% of business ratepayer respondents indicated that they were not very comfortable or not at all comfortable with trusting councils to keep rates reasonable.[271]
  - 4 in 5 ratepayer respondents believe that they should have some or a lot of influence in how rates are decided.[272]
  - Community ratepayers had moderate views about quality and level of services that their council provides.[273]
  - 78% of community ratepayer respondents rated both the quality and level of current services that their respective council provides as at least OK. 76% of business ratepayer respondents rated the quality and level of current services that their respective council provides as at least OK.[274]
  - Around 1 in 5 community and business ratepayer respondents thought that the quality and level of services was not good enough.[275]

- Ratepayers preferred that IPART maintain the status quo of rate setting.
  - More than half of all ratepayer respondents preferred councils to increase rates to maintain their current service levels rather than reduce service levels and minimise rates.[276]
  - Around 80% of all ratepayer respondents preferred that IPART approve a small change in the base rate each year, with councils being required to actively consult about larger changes.[277]
- Ratepayers supported rates accounting for the diversity of councils.
  - Over 2 in 3 ratepayer respondents supported having each council's rate change be a different amount to suit their situation.[278]
- Ratepayers were concerned with the fairness of how rates are split across types of ratepayers.
  - More than half of all ratepayer respondents said that they were not very or not at all comfortable with how fairly rates are split across types of ratepayers.[279]

For more information on the surveys please refer to ORIMA's Rate Peg Survey Integrated Report.

C.2 Focus groups with community and business ratepayers

In April 2023, we engaged ORIMA to conduct a series of 90-minute focus groups to undertake an in-depth investigation of the ratepayer views gathered from the initial surveys. ORIMA recruited participants through specialist qualitative research recruiters using a script to explain the process, obtain informed consent to participate, and identify which group participants best fit into.[280] ORIMA conducted the focus groups online with participants from metropolitan, regional, and rural areas of the state.[281]

- 3 community focus group where ratepayers were grouped with other like-minded community ratepayers, according to their preferences around rates.[282]
- 2 business ratepayer focus groups including one with micro businesses (sole traders up to a maximum of 4 other employees) and one with small and medium businesses with 5-100 employees.[283]

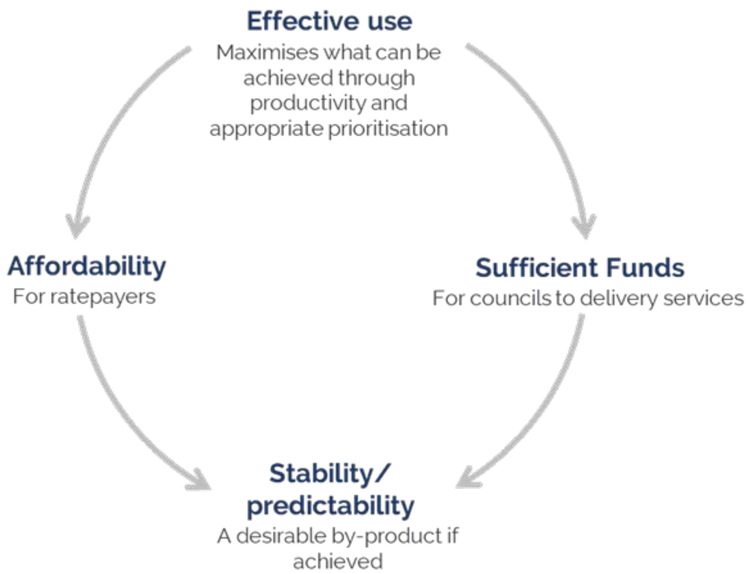
Each focus group included 8-9 participants.[284]

C.2.1 Key findings from the focus groups

The focus groups conducted with business and residential ratepayers took a deeper dive into the key considerations with regards to rates that ratepayers showed in the survey. Participants generally believed that the key outcomes of rates such as stability, affordability, council financial sustainability, and efficiency were interlinked rather than being separate priorities.[285]

First and foremost, efficiency was considered key to maximising the value of rates revenue at both the community and council level. By achieving a foundation of effective use of rates, ratepayer participants believed both affordability and council sustainability were very achievable goals. Although stability and predictability were of lesser importance for ratepayers, participants thought that this aspect of rates was a desirable by-product of achieving an effective use of rates.[286] This concept is demonstrated in **Figure C.2**.

Figure C.2 Ratepayers linked their key considerations for rates



Source: ORIMA. Rate Peg Focus Groups Research Report, May 2023, p 2.

The focus groups also found that:

- Ratepayers want a regulated rate setting framework to be *transparent, accountable, efficient* and *fair*.[287]
  - *Transparent:* Ratepayers felt a lack of control over how their rates are actually used. Ratepayers asked for information on how rates are used, and how and why rate changes have been approved.
  - *Accountable:* Ratepayers lacked trust in the integrity and competence of councils to use rates revenue as intended.
  - *Effective and efficient:* Ratepayers feel that councils could make much better use of the rates that they collect and therefore reduce the need for further rate increases.
  - *Fair and equitable:* Ratepayers sense that there is some inequity in what ratepayers pay and receive, and showed concerns for vulnerable members of the community. They asked for equity between different councils and within councils, and for an effective way to protect people who cannot afford their full rate.
- Business ratepayers wanted more business-like expectations of accountability and performance to be applied to councils.[288]

- "*My underlying feeling of inefficiency in councils comes from comparing them to private enterprise. What incentive is there for [councils] to be more efficient?*" [Small and medium business][289]
- "*Why are they not having the same trade-off discussions that families are having around Australia thinking, hey, we've got to cut our costs?*" [Micro business][290]

- There is a widely held view that councils do not use rates income effectively, and therefore ratepayers generally pay more than they need to.[291]
  - *"Regardless of whether there is enough money or not, we want them to use it effectively as we do.*" [Female aged 63, Rural][292]
  - *"I want them held accountable, you know. Do what you're meant to be doing. Use the money most efficiently and effectively, whatever that looks like. At the moment I think they're a little bit rogue, like they're self-governed."* [Female aged 43, Metro][293]
- There was also some support for providing councils with enough funds to maintain the quality and level of service that they provide. The opportunity to discuss issues and hear other opinions in an open forum allowed community ratepayers to better consider the value of paying rates to support council services.
  - *"Obviously council has got to be held accountable for their works and whatnot, but they're also not immune to labour increases, material increases and whatnot. So it's going to have to fluctuate year on year. If you want services provided you have to pay for them at the end of the day. Sorry."* [Micro business][294]
  - *"I actually really enjoy our Council. We have a lot of additional services in the area that we get. One of the things our Council does, I guess I see them giving back. They do give back to the community in different ways as well. Events is one."* [Female aged 48, Metro][295]

For more information on the focus groups please refer to ORIMA's Rate Peg Focus Groups Research Report.

Appendix D

Council financial sustainability

D

Councils are responsible for providing essential goods, services, and facilities for their communities. As a result, it is important for the new rate peg methodology to provide councils with sufficient income to enable them to provide ongoing goods, services, and facilities, while ensuring that ratepayers do not pay more than what is needed.

Through this review, councils and council organisations have expressed concerns about their ability to remain financially sustainable and simultaneously meet the growing demand for new and improved services from their communities. They have told us that the rate peg has constrained their ability to fully recover the costs of providing services, and this has negatively impacted their financial sustainability.[296]

This appendix presents our analysis in response to issues raised relating to councils' financial sustainability.

D.1 Our analysis suggests that councils' financial positions deteriorated from 2016-17 to 2020-21

Councils have told us that the current rate peg methodology compromises councils' financial sustainability. In this section, we investigate the concerns raised by councils by analysing how well NSW councils are able to contain their day-to-day expenses within their income.

D.1.1 We observed increases in the number of councils reporting operating deficits

Submissions to the Issues Paper stated that the rate peg has not historically provided councils with sufficient income as operating deficits are increasing and operating ratios are worsening.[297]

To investigate this, we analysed councils' operating positions using financial data from 2016-17 to 2021-22.

Table D.1 Summary of net operating position ($million, $nominal)

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Total operating income (**including** capital grants and contributions)	12,401	12,204	13,003	13,384	14,395	15,292
Total capital grants and contributions	2,145	2,483	2,442	2,596	3,039	3,351
Total operating income (**excluding** capital grants and contributions) *(a)*	10,256	9,722	10,561	10,787	11,355	11,941
Total operating expenses *(b)*	9,613	9,621	10,504	11,048	11,844	11,752
Net operating position for the sector *(a-b)*	643	100	57	-260	-489	189
Number of councils that reported an operating deficit	24	55	67	74	77	55
Number of councils that reported an operating surplus	101	69	59	52	49	67

Note: Figures based on councils' general funds.

The totals of councils which recorded a surplus and deficit does not equal the total number of councils in NSW because some councils did not report financial data in some years.

We excluded capital grants and contributions from the net operating position calculation because capital grants and contributions are generally used for specific infrastructure purposes rather than day-to-day expenses.

Source: Email to IPART, Office of Local Government, 26 April 2023 and IPART analysis.

Table D.1 shows that the number of councils reporting operating deficits increased over the 5 years from 2016-17 to 2020-21, which seems to be consistent with what councils have told us. The number of councils that reported operating deficits decreased from 2020-21 to 2021-22, mainly due to increases in grants and contributions for operating purposes received. It is unclear whether this increase is a one-off, or if it is expected to continue into the future.

We also calculated Operating Performance Ratios (OPRs) to determine whether the average operating deficit is increasing over time, and whether this is affecting all council groups.

Table D.2 Operating Performance Ratio by council group

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Metropolitan	5.2%	-0.6%	0.7%	-6.1%	-5.3%	1.8%
Regional	1.8%	-3.4%	-5.4%	-6.6%	-7.6%	-3.2%
Rural	12.4%	-1.6%	-4.4%	-5.1%	-5.5%	0.1%
State average	**7.5%**	**-1.8%**	**-3.4%**	**-5.8%**	**-6.0%**	**-0.4%**

Note: Figures based on councils' general funds.

Averages for each council types and for the state are unweighted. An unweighted average gives equal weight to each council rather than a higher weight to larger councils.

Source: Email to IPART, Office of Local Government, 26 April 2023 and IPART analysis.

Table D.2 shows that the unweighted state average deteriorated from 2016-17 to 2020-21, then improved in 2021-22. This trend can also be observed in the unweighted averages by council group.

D.1.2 More than half of NSW councils do not meet the infrastructure backlog ratio

Councils also argued that rate pegging constrains the capacity of councils to provide local services and contributes to higher infrastructure backlogs.[298] Campbelltown City Council stated that the large majority of NSW councils are balancing their operational budgets by underfunding their capital obligations.[299]

We have undertaken analysis of councils' infrastructure backlog ratios from 2016-17 to 2020-21.[a]

Table D.3 Infrastructure backlog ratio benchmark

	2016-17	2017-18	2018-19	2019-20	2020-21
Number of councils that did not meet the benchmark	63	65	69	69	68

Source: Office of Local Government, Time Series Data 2016-17 to 2020-21 and IPART analysis.

Table D.3 shows that over half of NSW councils do not meet OLG's benchmark of less than 2%.[300]

[a] Councils' infrastructure backlog ratios for 2021-22 have not been released yet.

Table D.4 Infrastructure backlog ratio (%)

	2016-17	2017-18	2018-19	2019-20	2020-21
Metropolitan	2.5	2.6	2.7	2.6	2.3
Regional	5.7	5.2	5.1	4.4	4.2
Rural	3.8	3.6	3.7	3.9	4.3
State average	**4.0**	**3.8**	**3.8**	**3.7**	**3.7**

Note: Averages for each council types and for the state are unweighted.
Councils' infrastructure backlog ratios for 2021-22 have not been released yet.

Source: Office of Local Government, Time Series Data 2016-17 to 2020-21 and IPART analysis.

We also examined councils' infrastructure backlog ratios by council group (**Table D.4**), and found that the average infrastructure backlog ratio for:

- metropolitan councils fluctuated between 2.3% and 2.7%
- regional councils recorded small but consistent improvements over the 5-year period[b]
- rural councils deteriorated in 2019-20 and 2020-21.

Our findings show that infrastructure backlogs are a problem for councils, as over half do not currently meet OLG's benchmark. On average, regional and rural councils tend to have higher infrastructure backlog ratios than metropolitan councils.

This suggests that some councils across the State do not currently spend enough on infrastructure renewal works. However, as the State average appears to be relatively consistent over the 5-year period we considered, councils' infrastructure backlog concerns may also reflect longstanding financial sustainability issues for select councils.

D.1.3 We consider that it may be appropriate for councils to hold some level of debt

The United Services Union's submission, supported by a commissioned research paper from Professor Brian Dollery, considered that the rate peg negatively impacts on councils' financial sustainability. The submission referenced results from several past studies to support its view, including:

1. Drew and Dollery (2015). The study considered the effects of rate capping on financial sustainability by considering local government liabilities per household for NSW and Victorian councils over the period 2009 to 2013 inclusive, and found that NSW had much greater levels of council debt per household.[c, 301]
2. Dollery and McQuestin (2017). The study found that over the 4-year period from 2013 to 2016 inclusive, NSW local authorities held – on average – 23% more debt than their South Australian counterparts.[302]

[b] A decline in the ratio reflects improvement.
[c] In 2015 the Victorian Government introduced a cap on rates to limit annual increases in rate revenue. The Minister for Local Government sets the rate cap each year based on the forecast Consumer Price Index and advice from the Essential Services Commission.

We acknowledge that rate pegging is likely to be a contributing factor to the relatively higher debt held by NSW councils, compared to councils in states not subject to rate pegging. This is consistent with anecdotal evidence that councils would prefer not to take on debt when alternative sources of funding such as rates income are available.

However, a higher level of debt does not necessarily indicate financial stress. Rather, it may be appropriate for councils to hold some level of debt, and councils with low or no debt may be placing the funding burden on current ratepayers when in fact it would be more appropriately spread across generations.

To better understand NSW councils' debt positions, we reviewed councils' debt service ratios from 2016-17 to 2020-21,[d] and found only 5 instances where councils exceed the OLG benchmark for this ratio, which is greater than 0% and less than 20%. This suggests that while debt levels for NSW councils may be higher compared to councils in other jurisdictions, the risks associated with council debt appear to be relatively low.

D.2 Councils rely on own source revenue as well as income from external fundings sources

As discussed in our Executive Summary, NSW councils receive most of their income from 3 main sources:

- rates and annual charges
- grants and contributions
- user fees and charges.

We found in our Issues Paper that income from rates represents around one third of NSW councils' total operating income.[303] Other sources of income include grants and contributions, user fees and charges, rental income, and other income.

Table D.5 shows how sources of operating income vary for different council groups.

[d] The debt service ratio is calculated by the cost of debt service (interest expense and principal repayments) divided by total continuing operating revenue (excludes fair value adjustments, net gain/loss on sale of assets, net share/loss on joint ventures) excluding capital grants and contributions.

Table D.5 Councils' operating income per capita by source (2020-21)

	Metropolitan		Regional		Rural		All councils	
	$2020-21	%	$2020-21	%	$2020-21	%	$2020-21	%
Rates and annual charges	737	53%	930	44%	1,052	26%	810	46%
Operating grants and contributions	87	6%	269	13%	1,265	31%	208	12%
Capital grants and contributions	280	20%	455	22%	1,001	24%	372	21%
User fees and charges	152	11%	319	15%	586	14%	225	13%
Rental income	58	4%	31	1%	43	1%	50	3%
Other income	88	6%	108	5%	154	4%	98	6%
Total	**1,402**	**100%**	**2,112**	**100%**	**4,100**	**100%**	**1,763**	**100%**

Source: Email to IPART, Office of Local Government, 26 April 2023 and IPART analysis.

We found that metropolitan councils receive less income per capita compared to regional and rural councils, though over half of their total income (53%) is collected from rates and annual charges. In contrast, rural councils collect only 26% of their total income from rates and annual charges, and receive over half of their total income (55%) from grants and contributions.

We heard through submissions that as the rate peg has not kept pace with the increases in costs, councils are becoming increasingly reliant on external funding sources such as grants for the delivery of essential services for their communities.[304]

To understand the level of reliance on external funding sources we looked at councils' own source revenue ratios, and how these have changed over the past 5 years.

OLG's own source revenue ratio measures councils' financial flexibility. Own source revenue includes rates, annual charges and user fees and charges. A council has improved financial flexibility with a higher level of own source revenue. OLG sets the benchmark for this ratio at 60% or greater.[305]

Table D.6 Own source revenue by council group (%)

	2016-17	2017-18	2018-19	2019-20	2020-21
Metropolitan	75%	75%	76%	75%	76%
Regional	68%	69%	71%	69%	67%
Rural	53%	56%	53%	52%	48%
State average	**63%**	**65%**	**64%**	**63%**	**61%**

Note: Figures based on councils' general fund.
Averages for each council types and for the state are unweighted.

Source: Office of Local Government, Time Series Data 2016-17 to 2020-21 and IPART analysis.

Table D.6 shows that from 2016-17 to 2020-21, rural councils consistently recorded own source revenue ratios below the OLG benchmark. This suggests that these council types find it more difficult to raise revenue from rates, annual charges and user fees and charges, and could face increased financial pressure if income from external funding sources decreases.

D.2.1 Some councils may currently collect an insufficient base level of rates income

In our Issues Paper we found that from 2010-11 to 2020-21, the average annual increase in councils' rates income per capita was around 3.8% per year.[306] However, the experiences of individual councils are varied, depending on whether they received any additional rates income through special variations and supplementary valuations.

We consider that improvements to the rate peg methodology cannot address all issues, particularly for those councils with longstanding financial sustainability concerns. It is possible that some councils currently have an insufficient base level of rates income. We consider this could be better addressed through a mechanism that enables councils to reset their rates base through a one-off process to increase rates income. Any increases in rates income could be phased-in to manage bill shock for ratepayers. Box D.1 sets out this issue in further detail by comparing the experiences of two councils with different circumstances across the State.

Box D.1 Variation in the average residential rates across the State

From 2011-12 to 2021-22 IPART set the same rate peg for all councils in NSW, mainly based on the average costs faced by councils.

However, we know there is significant variation in the amount of rates income received by different councils across the State. Applying the same rate peg percentage increase leads to greater disparity in rates income over time, as councils with a higher rates base receive a greater amount in dollar terms, compared to councils with a lower rates base.

Under the current regulatory framework, councils with an insufficient rates base can apply to IPART for a special variation to increase their rates income by more than the rate peg.

While some councils have used the SV process to support their financial sustainability, we received feedback through consultation that other councils can be reluctant to apply for SVs, even when it is needed because the process is resource-intensive and it can be difficult to get agreement and support from the elected council.[307]

The following table presents information on two councils with different circumstances across the State.

	Council A	Council B
Council group	Regional	Rural
Average OPR from 2017-18 to 2021-22 (%)	3.6%	-2.3%
Average residential rate per year ($2021-22)	$1,505	$1,043
Median household income per year ($2021-22)	$67,577	$73,886
Average residential rate as a percentage of median household income (%)	2.2%	1.4%
Percentage of council's total operating income received from rates income (%)	39%	25%
SVs applied for/received from 2011-12	3	0

Source: Email to IPART, Office of Local Government, 26 April 2023; Office of Local Government, Time Series Data 2020-21; Australian Bureau of Statistics; 2021 Census data and IPART analysis.

In our Draft Report we note that some councils could be struggling to fund the costs of ongoing activities as a result of an insufficient base level of rates income. These councils' financial sustainability issues cannot be addressed through changes to the rate peg methodology alone.

We have made a draft recommendation to consider a mechanism that would enable councils that are determined to have insufficient base rates income to achieve financial sustainability.

Box D.1 Variation in the average residential rates across the State

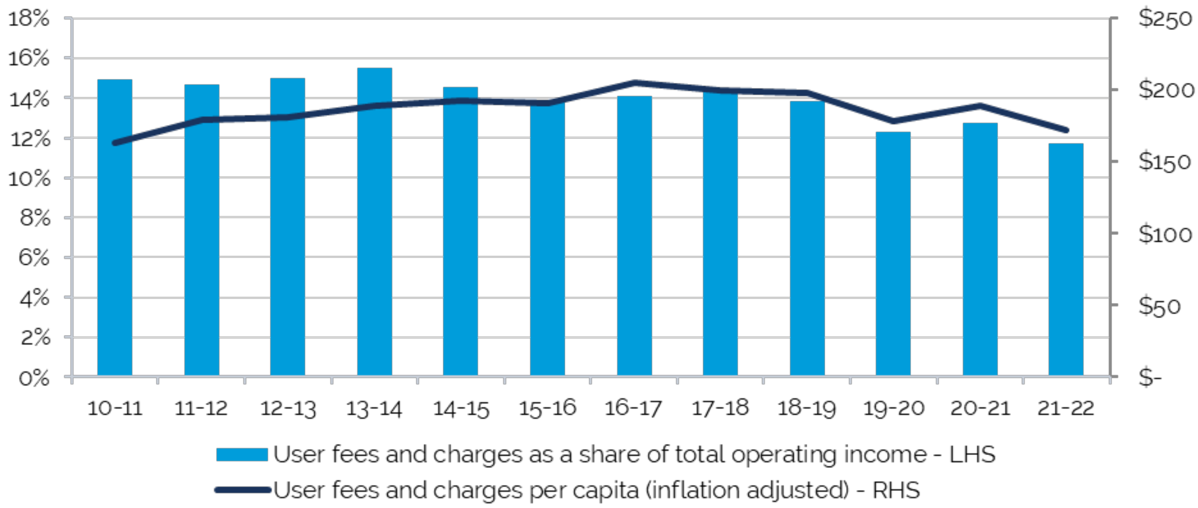
However, we also recognise the need to balance council financial sustainability and ratepayer affordability, and have recommended reviewing mechanisms available to alleviate cost pressures for disadvantaged or vulnerable communities, including pensioner concessions.

D.2.2 Councils told us that some user fees and charges have not been adequately indexed over time

Councils have varying abilities to raise revenue from user fees and charges. They have raised concerns that some user fees and charges have not been adequately indexed over time.[308]

Figure D.1 shows that user fees and charges per capita increased by around 6% in real terms from 2010-11 to 2021-22. Growth in this income source has not kept pace with growth in other sources of income, resulting in a decline in user fees and charges as a share of NSW councils' total operating income.

Figure D.1 User fees and charges have declined as share of total income



Source: Email to IPART, Office of Local Government, 26 April 2023 and IPART analysis.

Our Draft Report discusses examples provided by councils of statutory charges that have not been adequately indexed over time (see Draft Report, section 9.2). This could lead to councils being unable to recover the full cost of providing the services from the users of the service, and expose councils to financial pressure if they are required to use rates income to cover the funding shortfall.

D.2.3 Financial Assistance Grants per capita declined (in real terms) over the past 3 decades

While the amount and allocation of grant funding falls outside the scope of our review, grants and contributions are one of the main sources of income for councils, and changes in the amount received can impact councils' financial sustainability.

One of the main forms of grant funding councils receive for operating purposes are Financial Assistance Grants provided by the Commonwealth Government. The Financial Assistance Grant program consists of two components:

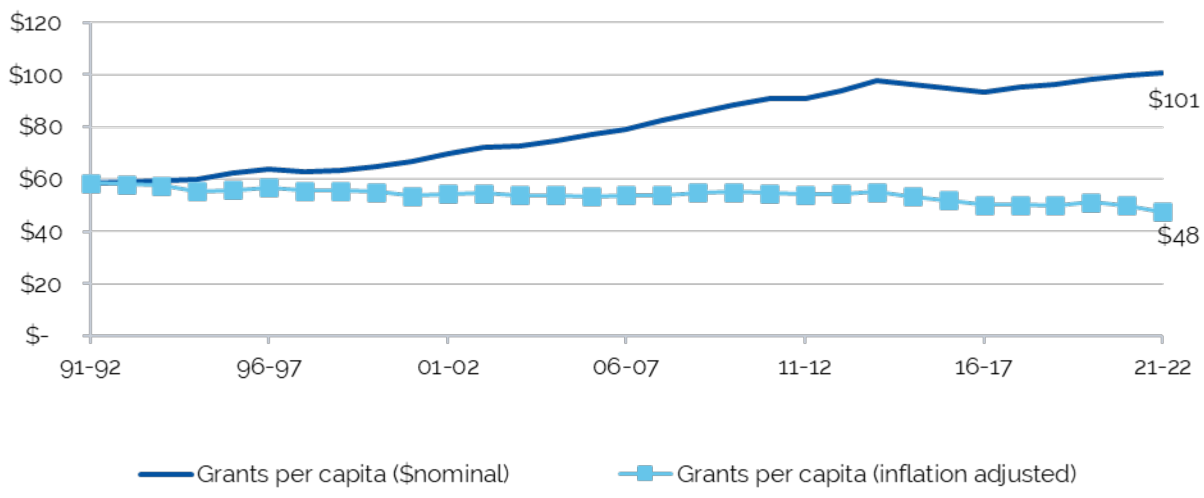
- a general purpose component distributed between the states and territories according to population (i.e. on a per capita basis), and
- an identified local road component distributed between the states and territories according to fixed historical shares.

Both components of the grant are untied, allowing councils to spend the grants according to local priorities.[309]

Murrumbidgee Council submitted that the value of Financial Assistance Grants provided to local government has declined over the past 3 decades from around 1% of Commonwealth taxation revenue to around 0.55%, which means that the council needs to seek funding from other sources to replace some of the lost income.[310]

We examined the amount of funding received by NSW under the Financial Assistance Grants program from 1991-12 to 2021-22 and found that entitlements per capita on a state basis have decreased in real terms over this period, from around $59 per person in 1991-92 to around $48 per person in 2021-22 (see **Figure D.2**).

Figure D.2 Financial Assistance Grants per capita



Source: NSW Local Government Grants Commission, Tables of Financial Assistance Grant Allocations for NSW Councils 1992-2022 and IPART analysis.

Once Financial Assistance Grant funds are allocated to NSW, the NSW Local Government Grants Commission is responsible for making recommendations to the Minister for Local Government on how they should be allocated between NSW councils.[311] The NSW Local Government Grants Commission uses 5 measures of councils' relative disadvantage/advantage to apportion the total allowance between councils.[312]

This means that while the amount per capita received via Financial Assistance Grants decreased at the state level over the past 3 decades, individual councils may have had varied experiences.

Capital grants can lead to higher expenses for councils

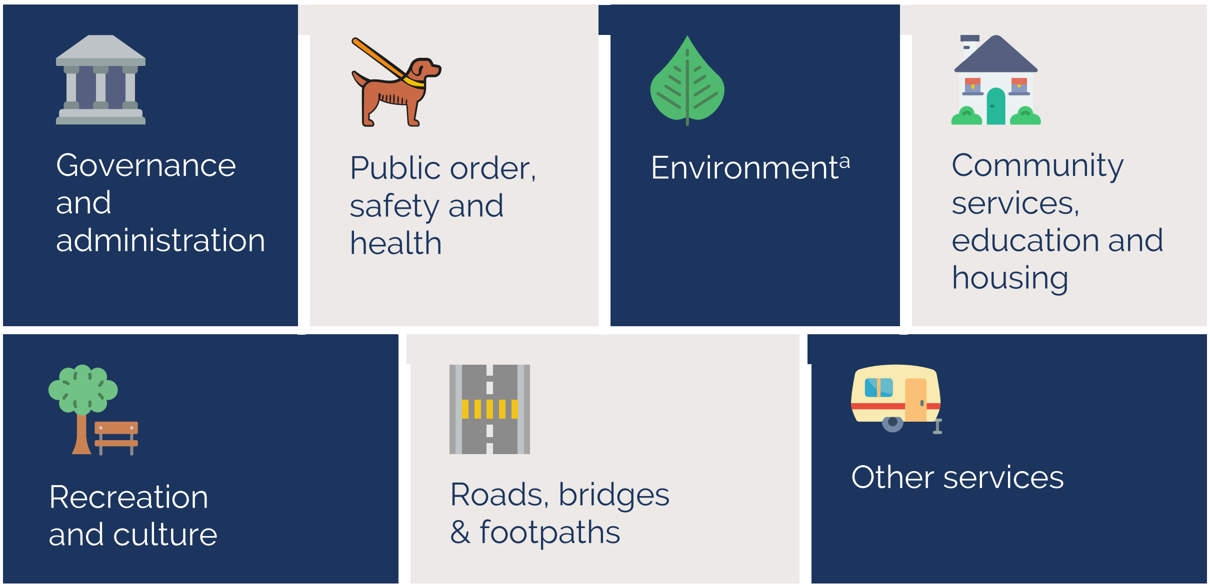
Around two-thirds of all grants and contributions received are capital grants and contributions.

We have heard from councils that income from capital grants and contributions is typically tied to specific infrastructure projects. This means that it cannot be used to cover councils' day-to-day expenses, and could lead to additional maintenance costs for councils once the capital projects are constructed.

Capital grants and contributions received can create a misleading impression of a council's operating position, making this appear to be more favourable than it is in reality.

D.3 Councils have discretion to decide what services to provide, and the appropriate service level

NSW councils provide a range of services for their communities, including:



a. Environment services include noxious plants and insect/vermin control, environmental protection, solid waste management, street cleaning, drainage and stormwater management.

Source: Office of Local Government, Your Council – NSW Overview – Services.

Each council has discretion to determine what services to provide, and the appropriate service levels, in consultation with its community.

Table D.7 shows that expenditure by service type varies by council group, affected by the circumstances of different councils and the preferences of their communities.

Table D.7 Operating expenses per capita by service type and council group (2020-21)

Service type	Metropolitan	Regional	Rural	All councils
Governance and administration	21%	18%	16%	19%
Public order, safety and health	5%	5%	5%	5%
Environment	21%	20%	10%	19%
Community services, education, housing and community amenities	13%	8%	10%	11%
Recreational and cultural	20%	16%	12%	18%
Roads, bridges and footpaths	12%	18%	29%	16%
Other Expenses	8%	14%	18%	11%
Total	**100%**	**100%**	**100%**	**100%**

Source: Office of Local Government, Time Series Data 2020-21.

We observed that around 29% of operating expenses per capita for rural councils are spent on the provision of roads, bridges and footpaths. This is likely because rural councils are generally responsible for managing greater kilometres of roads, and need to spend more on the maintenance of this asset category compared to metropolitan and regional councils. In contrast, metropolitan and regional councils are required to spend less on roads, bridges and footpaths. This enables these councils to allocate a greater share of operating expenses per capita to the environment, and recreational and cultural services.

D.4 Our Draft Report discusses options to address financial sustainability concerns through the rate peg methodology and the broader regulatory framework

Our findings on council financial sustainability show that some councils do not currently meet OLG's financial performance benchmarks and are reliant on external funding sources to maintain the delivery of essential services for their communities.

In our Draft Report, we have made a number of draft decisions on changes to the rate peg methodology, to improve the way we measure how councils' costs are changing year-on-year. This involved assessing the merits of a range of options and available data sources to develop a methodology that:

- reflects inflation and the costs of providing council services
- is more timely
- better recognises the differing needs and circumstances of councils across the State
- includes a separate adjustment factor to account for changes in each council's contribution to the Emergency Services Levy.

Through our analysis we have also identified some councils with longstanding financial sustainability issues, which cannot be addressed through changes to the rate peg methodology alone. We consider that these councils have consistently collected less rates income than what is needed to provide ongoing services, and could benefit from a mechanism to reset their rates base to achieve financial sustainability (see Draft Report, section 9.3). We consider this process should also take into consideration the different circumstances of councils and the preferences of their communities.

Additionally, rates income represents around one third of NSW councils' total operating income. This means that changes in the amount of income received from other funding sources such as grants and contributions, and user fees and charges, would also impact councils' financial sustainability. While these funding sources are outside the scope of this review, we recognise that stakeholders have also expressed concerns about these sources of income, and we have recommended that the NSW Government consider appointing an independent body to investigate and review the broader regulatory framework to deliver better outcomes for all stakeholders (see Draft Report, Chapter 9).

Appendix E

Climate change cost considerations

E

Climate change is a significant global challenge created over decades since the industrial revolution and the adverse effects are now evident. To deal with these effects and to keep global temperature rise well below 2°C, urgent and collective action is needed. Climate change will impact the lives of people of NSW (taxpayers and ratepayers) now and into the future. This is seen in weather across the state becoming more variable, and extreme events such as bushfires, storms and floods becoming more frequent and severe, with impacts on health, safety and productivity of local economies. Immediate action with innovative management and collaboration can turn things around.

Local government plays an important role in addressing climate change through reducing emissions, adapting to climate change, building resilience and managing development sustainability. This is recognised by Local Government NSW (LGNSW) who supports an integrated approach to climate change mitigation and adaptation strategies, including shared responsibility and collaboration across all levels of government, industry and the community.[313]

In undertaking our review of the rate peg methodology, we reviewed councils' cost drivers and how to best reflect these in the rate peg. While climate change means that councils are faced with external costs (discussed in Chapter 5), we consider that climate change is a broader, complex, and unique issue that will affect how councils operate, for example, how they transition towards a low-carbon economy, and contribute to climate change resilience in their communities. Costs related to climate change are large and pervasive, involving human, natural and financial capital and involving a larger policy framework.

In this Appendix, we present further analysis for considering external costs associated with climate change in the rate peg methodology. This includes what we heard from stakeholders regarding climate change costs and analysis on capturing climate change-related costs in the rate peg methodology. We have identified indicative climate change impacts on councils, indicative types of climate change costs for councils and explored who should fund climate change costs.

More work is needed to assess the most appropriate model for funding climate change and other sustainability related costs.

E.1 We heard from stakeholders on climate change costs

There are mixed views about funding climate change through the rate peg. Feedback to our Issues Paper and workshops showed several council stakeholders supported the consideration of cost changes related to climate change in the rate peg methodology and mentioned the challenges of funding these increased costs. Many councils considered these external factors are currently not included in the rate peg methodology. Feedback from some ratepayers also indicated the need for councils to consider ecologically sustainable development when setting rates. Results from our survey of ratepayers showed limited support for rates being used to fund climate change measures.

E.1.1 Councils described a range of cost increases due to climate change

Several council stakeholders described examples in submissions to our Issues Paper of increased costs due to climate change often out of their control. Many of these costs were associated with adapting to climate change and natural-related disasters. The Hills Shire Council describes how its exposure to floods and fires have added costs through unplanned additional workload and damage to assets requiring earlier repair.[314] Woollahra Municipal Council and Blacktown City Council explained the impact of climate change and wet weather leading to increased maintenance of parks and open spaces and increasing the amount of pothole repairs for roads.[315] Similarly, Mid-Coast Council described failing infrastructure due to climate change impacts.[316] The Hills Shire Council and Woollahra Municipal Council mentioned the impacts of natural disasters and severe weather events, leading to accelerated depreciation and deterioration of assets.[317] Wollondilly Shire Council described additional capital works expenditure and staff costs following weather events and increases in other major expenses including, building materials, utilities and insurances.[318]

At our public workshops, councils raised the issue of the impacts of climate change and the costs of contractors, for example, some councils in disaster affected areas in need of labour were facing contractor shortages. Councils also mentioned that state coordination is needed to manage these costs.[319]

Some councils also raised costs associated with mitigating climate change. Newcastle City Council and Coffs Harbour City Council noted significant costs due to the transition to electric vehicles such as capital costs and the need for particular skills sets and infrastructure.[320] At our public workshops, stakeholders similarly told us about the need to provide infrastructure such as electric vehicle charging stations to meet net zero emissions targets and supporting renewable energy zones.[321] Some stakeholders also described the costs associated with resilience for councils as well as supporting resilience in communities.[322] At our technical workshops, councils expressed concerns about increasing responsibilities from the State government's climate change policies.[323]

E.1.2 Councils raised funding climate change costs

At our public workshops, councils mentioned that they are mostly acting to respond to climate change and must seek a balance when dealing with climate change and other council activities. Councils considered climate change initiatives are often above and beyond planned works and day to day requirements. However, stakeholders also supported these initiatives, that such activities should be encouraged to reduce disaster recovery and further financial impacts. One rural council stakeholder at our workshop mentioned that due to large emissions from council waste management facilities, it was very difficult to consider being carbon neutral.[324]

Council described challenges of funding these costs including that rate pegging is making it harder to meet the challenges of climate change. Campbelltown City Council described the financial and resource barriers to meeting community expectations for councils to address climate change.[325] Albury City Council argued that in the context of climate change the rate peg does not take into account depreciation of infrastructure assets, the impacts of natural disasters, and other sustainability challenges.[326]

At our public workshops, councils expressed that they have different capacities to invest, for example, in long lasting materials for roads. Instead, councils continue to repair older roads with less efficient materials. For councils with low rate bases, it was considered that no rate peg increase would cover the costs of maintaining rural roads and assets affected by increased wet weather.[327]

While funding exists through grants, council stakeholders described the limitations including that funding is often competitive, contentious, often for capital projects and often not reflective of the user needs as well as being subject to unrealistic timing constraints. Nambucca Valley Council submitted that funding "is not always sufficient to meet the costs required to adequately repair the damage experienced."[328] Mid-Western Regional Council, argued that similarly, "whilst we acknowledge that funding is available to restore essential public assets [due to natural disasters], this workload will impact and delay Council's usual planned asset management." The council stated that "some allowance could be made to support the community, improve resilience or catch-up on delayed works."[329]

Northern Beaches Council described how funding to cover natural disaster costs is limited to declared events, despite the council also experiencing undeclared events.[330] Gunnedah Shire Council also submitted that such funding does not cover other costs such as increasing insurance premiums and while funding is often allocated to capital projects, it does not cover maintenance and upgrades of infrastructure.[331] Hawkesbury Council suggested including in the rate peg the costs associated with responding and recovering from natural disasters that are not funded by grants.[332] Local Government Professionals Australia and Canberra Region Joint Organisation supported this, acknowledging that "while both [state and local] governments bear the broader cost of response and recovery associated with natural disasters, the net cost (to councils) of those, and other undeclared events that occur (storms, floods) that redirect resources and impede normal asset and service regimes, should also be considered in peg methodology or as a streamlined process for SRV [Special Rate Variations]."[333]

City of Sydney submitted that "it is imperative that the level of rate income generated by local government is sufficient to ensure it can provide the planning and action required" for providing adequate and timely response during natural disasters.[334] At our public workshops, one council stated however that there are reasonably good Natural Disaster Restoration and Recovery Arrangements in place to cover the costs of restoring assets and further that rates have never been expected to cover these costs.[335]

E.1.3 Stakeholders made suggestions on how to include climate change costs in the rate peg

Several councils submitted that the revised methodology needs to be agile enough to rapidly adapt to changes driven by forces outside councils' control particularly climate change.

- City of Sydney recommended that the rate peg include a resilience factor to respond to the growing need for local governments to plan for and respond to natural disasters and pandemics while continuing and significantly advancing the long overdue efforts to address the impacts of climate change. It also acknowledged the difficulty in quantifying these costs.[336]

- The Hills Shire Council recommended that for resilience, councils be given the freedom to add a percentage (within an upper limit) to the rate peg without the need to apply for a special variation.[337]
- Blacktown City Council suggested a local government-based insurance cost index, that tracks the movement (and forecast future movement) in the cost of insurance for infrastructure assets having regard for impacts such as natural disaster, war and global economic conditions.[338]
- Southern Sydney Regional Organisation of Council's suggested that the additional costs imposed on councils be reflected in forward costs (such as the need for flood mitigation and other climate change adaptation measures).[339]

Other stakeholders supported a component of the rate peg to address climate change resilience, adaptation, including maintenance and natural disasters.[340] Stakeholders, however recognised that costs may differ between councils.

We considered the options suggested by stakeholders and are seeking feedback on developing a process for making adjustments to the rate peg to capture specific external costs, such as climate change related costs.

One stakeholder raised concerns about councils contributing to climate change and proposed a 2-step process by which councils would need to qualify for an increase to rates through the rate peg. The first step would require councils to demonstrate their costs are efficient both financially and from a resource management perspective and consult the public on these costs. The process would involve councils quantifying their contribution to global warming caused by different council activities and measuring a range of indicators on resource impacts (related to, for example, land clearing or local food growing capacities). These would be reflected in a revised Local Government Cost Index (LGCI) and made publicly available. The second step would require councils to make a submission to IPART to apply for a rate peg increase.[341]

While it would be important for councils to measure the impacts on climate change from their activities, the rate peg cannot be used to enforce climate change action. This is better suited to other mechanisms and agencies.

E.1.4 There was limited support from ratepayers to fund climate change through rates

We did not receive feedback from ratepayers on issues of climate change costs through submissions to our Issues Paper. At our technical workshops, some ratepayers placed a high value on ecologically sustainable development and that environmental considerations should be reflected in the rate peg methodology.[342]

We consulted on preferences to fund climate change costs through rates in our ratepayer survey. Our survey revealed a lack of support for rates to fund climate change costs, with less support from ratepayers in rural areas. At most, 34% of residential ratepayer respondents and 34% of business ratepayer respondents to our survey indicated that rates should fund climate change costs. Of the types of climate measures to fund, there was a preference towards funding adaptation measures than mitigation measures.[343]

E.2 Climate change can impact councils' costs

Councils play an important role in addressing climate change.[a] Their communities are being affected by higher temperatures, changing rainfall patterns and rising sea levels. Natural disasters and extreme weather events such as droughts, bushfires, floods, and storms are becoming more intense and frequent. Councils, and the infrastructure and services they manage, are at the forefront of some of these impacts. They may be facing higher costs in both adapting to these changes, and mitigating climate change impacts by reducing carbon emissions.

Some of these costs include for instance:

- Mitigation activities including switching to renewable energy sources such as through installing solar panel systems or setting up windfarms[b], adopting electric vehicles and providing electric vehicle infrastructure, or managing emissions from landfill and waste treatment sites.
- Adaptation activities including increased maintenance, repair and replacement of assets due to increased storms, increased investments in infrastructure, planning and management of stormwater, floods, coastal erosion, and extreme heat. This may also include natural disaster planning, response and recovery, and community support programs.

Increased costs may also result from changes to council processes to improve climate change readiness and resilience (e.g. undertaking climate risk assessments, and climate scenario modelling), education programs and higher insurance premiums to reflect increased climate change risks. There may also be implicit costs from the impacts of climate change, for example, on land use and the economic value of land and the potential for the decline in industry and population.

Table E.1 below presents some indicative climate change impacts on council services and activities which may drive increased council costs.

[a] When making decisions, councils should consider the long-term and cumulative effects of actions on future generations and the principles of ecological sustainable development: *Local Government Act 1993*, section 8A(2)(c) and (d).

[b] Reducing emissions through energy efficiency and installing own energy sources (solar panels) however may generate savings.

Table E.1 Climate change impacts on council services and asset activities

Climate change variable	Impact on council services/asset activities
Rising mean temperature	• increased demand for online work and remote working systems • increased demand for remote voting services to avoid heat and discomfort • increased demand for air conditioning, cooling and higher frequency of HVAC replacement in council buildings • increased demand for reducing urban heat island effect (e.g. planting more vegetation) • increased stormwater pipe breakages (e.g. tree roots seeking water due to low soil moisture causing pipe breakages) • increased need to retrofit buildings, facilities, playgrounds • increased costs to maintain public spaces, gardens and increased water use
Greater number of extreme heat days and heatwaves	• increased energy use for cooling systems and water use • increased demand for air conditioning, cooling and higher frequency of HVAC replacement in council buildings • increased costs to provide more shade • increased demand for health services • increased risks of power failure increasing the need for alternative power sources • increased health risks for employees that work outside
Increasing frequency and intensity of bushfires	• increased demand for safe places, refuges, and evacuation centres • increased demand for fire and emergency response services and protocol and emergency planning • increased demand for support services including health services • increased need to protect buildings from fire and reduce fire hazards (maintenance of vegetation) • closure of council assets (e.g. parks) and potential loss of revenue (e.g. parking fees) • increased restoration and repair of assets affected by fire, replacing damaged signs • increased clean-ups and waste removal • delays or increased difficulty for ratepayers to pay their rates and increased demand for programs to address vulnerability due to household disruptions
Changes in mean rainfall (including drought and floods)	• increased demand for services to deal with increased water-borne diseases and pests including health services and education programs • increased damage to roads, increased potholes and need for increased maintenance for kerb and gutter, table drain clearing, increased pipe blockages • decreased rainfall leading to agriculture productivity, loss of farming and economic decline • delays to maintenance and service schedules (increased wet weather means delays to servicing parks) • increased demand for remote voting services during floods • increased demand for flood planning controls • delays or increased difficulty for ratepayers to pay their rates and increased demand for programs to address vulnerability due to household disruptions
Sea level rise, coastal erosion and inundation	• increased demand for coastal protection such as building a sea wall, increased maintenance of existing sea walls, increased costs to protect against erosion • increased demand for levees and maintenance
Frequency and intensity of extreme storms (winds & hail)	• delays or increased difficulty for ratepayers to pay their rates and increased demand for programs to address vulnerability due to household disruptions • increased repair or replacement of assets affected by storms/hail damage • increased drainage capacity issues and need for new stormwater infrastructure • increased demand for flood and emergency services and protocol and emergency planning • increased need for landscaping • increased clean-ups and waste removal • delays to maintenance and service schedules (increased wet weather means delays to servicing open spaces) • increased costs to maintain parks, cemeteries and other open and public spaces, and to maintain assets (e.g. repairing footpaths) • increased incidences of ratepayer property issues (removal of heavy fallen branches)

Note: Many of the impacts on council services and assets listed could arise from a range of different climate change impacts.

E.2.1 We identified indicative types of climate change-related costs

Table E.2 below lists some indicative climate change-related costs that may borne by councils but may be also funded through other means such as government funding. We identified 3 main categories and 5 types of these costs based on these categories.[c]

Table E.2 Climate change costs

Climate change costs	Description
Mitigation	Costs of activities to reduce greenhouse gases in the atmosphere both directly and indirectly.
Direct mitigation	Costs associated with efforts to reduce greenhouse gases going into the atmosphere by reducing sources of gases or by increasing the absorption of gases. Activities may include: • renewable energy projects to reduce operational emissions (e.g. installing solar panels, replacement of vehicle fleet with electric vehicles, reducing emissions from waste treatment) • renewable energy projects to reduce enabled emissions (community emissions) such as building electric vehicle charging stations to support uptake of electric vehicles in the community • energy efficiency measures to avoid emissions (e.g. installing LED lights) • projects to increase absorption of greenhouse emissions (e.g. increasing tree canopy).
Indirect mitigation	Purchasing of carbon offsets where emissions may not be reduced at a point in time.
Adaptation	Costs of activities to respond, manage and reduce the consequences of climate change.
Increased costs of core or existing services	Increased costs as a result of climate change impacting the provision and delivery of existing core services. These reflect costs that are required to ensure existing services and assets continue to meet existing regulatory obligations as well as community needs. Some examples include: • road and maintenance costs as a result of frequency of potholes from increased wet weather • watering of community gardens • maintenance, repair and replacement of infrastructure and assets and increased depreciation costs due to early replacement of assets (e.g. replacement of HVAC systems) • retrofitting buildings and assets (e.g. playgrounds). Costs can also include those associated with meeting increased safety standards and increased insurance to reflect changes in climate risks.
New/additional costs	New costs because of climate change, due to the need to respond to and prepare for climate change impacts including new investments. These reflect costs that are in addition to those related to the delivery of existing services and emerging because of climate change. These may depend on a council's choices about adaptation which may include changes to how services are provided. These costs may include: • building new infrastructure to manage impacts of climate change such as a sea wall or flood levees • raising a dam wall • increasing tree canopy • new buildings e.g. safety refuge during an emergency • costs associated with floods, coastal or bushfire management under climate change scenarios • costs to remove/retire infrastructure (emissions producing infrastructure). New costs can be associated with building council and community capacity and preparedness projects to collect climate change data for informed decision making: • community education programs to drive behavioural change • research and development • costs to improve planning processes to include climate change (result in higher wages for climate skilled staff) • installing heat sensors.
Natural disaster planning, recovery, response	Costs associated with preparing and responding to natural disaster emergencies • clean-up costs • repair and replacement of assets including essential/critical infrastructure

c These costs are consistent with those identified by the Queensland Competition Authority's current Climate change expenditure review 2022–23.

Climate change costs	Description
	• increase response and support services, and community support programs.

The key difference between the types of adaptation costs is the degree to which a council has control over these costs. For example, due to climate change, councils may need to spend more to deliver the same services - these are increased costs to existing services. But they may also need to provide more services or deliver new infrastructure that may not have been needed under a scenario with no climate change - these are new costs.

E.3 We considered who should pay for climate change costs

Climate change is one of the most significant issues that will impact the lives of people in NSW now and into the future. We all play a role in addressing climate change and contributing towards the costs of mitigating and adapting. In considering whether external costs associated with climate change should be captured in the rate peg methodology, we considered who should pay for the costs of climate change. The broader community has contributed to climate change including councils, their ratepayers and their community. Apportioning the costs of climate change accurately is a complex task.

Communities that may face higher costs and climate risks, such as those affected by recent disasters, are likely to be increasingly vulnerable with a diminishing capacity to pay. Federal, State and Local Governments all play a role in addressing climate change and sharing the costs with the community and ratepayers.

We analysed whether it is appropriate for ratepayers to pay for climate change costs and how. For example, we considered whether those that cause climate change should pay for mitigating and adapting services. We also considered whether those that benefit from receiving more resilient services should pay. We consider that the "impactor, beneficiary, or taxpayer-pays hierarchy" is appropriate to use to determining who should pay for climate change.

Ratepayers, their councils and the broader community have contributed to climate change and would benefit from actions to address climate change, both to mitigate and adapt to climate change. It is reasonable for ratepayers to share the costs to address climate change.

E.4 An integrated approach to climate change across all levels of government is required

We consider an integrated approach to addressing the impacts of climate change is required with shared responsibility and collaboration across all levels of government, industry and the community. We also need more information to understand the role of the local government within state, federal and private sector to gain agreement on the appropriate funding model. However, our analysis suggests that some costs should be captured by the rate peg, others through the special variation process.

We considered how councils could fund climate change costs through rates and found that, where adaptation costs related to the delivery of existing services are increasing and communities support and expect continued delivery of these services, there is a case for addressing changes in these costs through the rate peg.

Where councils propose to introduce new services or provide new infrastructure to adapt to climate change, councils should consult with their communities and where this leads to councils needing greater income, the special variation (SV) process is an appropriate mechanism for seeking greater income to cover these costs.

Government grants and funding are available for councils to meet some climate change costs particularly funding to support emissions reduction projects, large capital projects and natural disaster recovery. There have been a number of funding programs and grants available to support councils to meet climate change costs across all mitigation, adaptation and natural disaster-related costs. Some examples include road repair funding, electric vehicle charging station infrastructure funding and the Federal Government's Disaster Ready Fund.

We recognise that some ratepayers would support their councils to address climate change and would be willing to fund these costs. Councils should consult with their communities on funding these costs. Councils may also seek government funding to cover increased costs due to climate change.

We are considering options for developing a process for making adjustments to the rate peg for external costs. We consider that such an adjustment could go towards covering climate change related costs where all councils or a group of councils are impacted, provided we have sufficient information from councils about these costs.

Due to a lack of specific climate change-related cost information, uncertainty of costs, and the variability of costs across councils, at this stage it is not feasible for us to include a generic adjustment to the rate peg methodology that would accurately reflect changes in climate change costs for all councils. We would require further work on this, including seeking information and evidence of the impact of climate change on council costs and on ratepayers.

Further information is needed to understand these costs. Climate change costs vary across NSW councils depending on how climate change affects each council, the types of services and assets they provide and their current state, how resilient councils and their communities are and to what extent are they seeking to improve their resilience. There would be differences between coastal councils that may need to respond to changes in sea levels and inland councils that may need to respond increasingly to drought. There would also be differences in costs for those councils with well-maintained infrastructure. Depending on resources and level of skills and expertise, the capacity to deal with climate change would also vary across councils, leading to varying costs.

Access to data on specific climate change costs faced by councils is the main challenge for developing an adjustment and is not readily available or accessible across all councils. We also recognise that climate change costs may not be easily separated from overall council costs.

We considered potential data sources for climate change costs including insurance data to potentially quantify costs as requested by council stakeholders. Some data sources include quantified climate risks for local government areas and value of insurance claims. While useful, it is not clear how to translate insurance data which reflects risk profiles to an appropriate increase in funding for climate change costs for councils.

Councils should consider processes to identify, and record changes to their costs due to climate change. This could support potential future adjustments to the rate peg or councils to apply for an SV. This could include defining specific council outcomes in relation to addressing climate change (such as part of a climate risk assessment and adaptation planning process) and the costs of achieving these outcomes. It could also include information about how costs have deviated from planned budgets due to climate change.

Such information would help councils understand the impact of climate change and assist with planning and implementing climate change actions, and incorporating climate change actions into their business-as-usual. This could especially assist councils in improving their engagement with their communities on addressing climate change including communicating the costs and benefits of climate change actions to understand their communities' preferences.

This information would help us better understand impacts of climate change on the local government sector. This could in turn enable us to define climate change-related costs faced by councils and to assess the potential to calculate an adjustment to the rate peg for these costs.

We acknowledge the work that is currently being done by councils to respond to and recover from recent natural disasters and councils that are working towards addressing climate change and improving resilience, such as City of Sydney's Environmental Strategy and the Resilient Sydney program.

The Office of Local Government and the NSW Government provide a range of resources to assist councils in addressing climate change and improving their climate risk preparedness and resilience. Hunter Joint Organisation has recently released a Climate Change Integrated Planning and Reporting (IP&R) Package which may support councils in incorporating climate change in strategic planning and consulting with their communities.

Appendix F

Terms of Reference

F

The Hon. Wendy Tuckerman MP
Minister for Local Government

Our Ref: A830508
18 August 2022

Ms Carmel Donnelly PSM
Chair
IPART
PO Box K35
HAYMARKET POST SHOP NSW 1240

Email: ipart@ipart.nsw.gov.au

Dear Ms Donnelly

The Premier of NSW, the Hon. Dominic Perrottet MP, has approved, pursuant to section 9(2) of the *Independent Pricing and Regulatory Tribunal Act 1992*, for the Independent Pricing and Regulatory Tribunal (IPART) to review the local government rate peg methodology, including the Local Government Cost Index.

I have attached a copy of the Premier's approval and the Terms of Reference (ToR).

The ToR require IPART to provide a final report on the outcomes of the review to myself, as Minister for Local Government, within 9 months of receiving the ToR. It is also requested that IPART provide Terms of Engagement, including a proposed program and timetable of works and an estimate of fees and/or disbursements for completing the work set out in the approved ToR.

Should you require further advice or assistance in relation to this matter, please do not hesitate to contact Melissa Gibbs, the Office of Local Government's Director Policy and Sector Development on [redacted] or by email at olg@olg.nsw.gov.au.

Yours sincerely

The Hon. Wendy Tuckerman MP
Minister for Local Government

Encl: 1. IPART review of the rate peg methodology - Premier approval - Tab 1
2. IPART review of the rate peg methodology - Signed Terms of Reference (ToR) – Tab

New South Wales

Dominic Perrottet MP
Premier of New South Wales

Ref: A5440532

The Hon Wendy Tuckerman
Minister for Local Government
52 Martin Place
SYDNEY NSW 2000

Dear Minister,

Thank you for your correspondence of 18 May 2022 regarding a proposed arrangement for the Independent Pricing and Regulatory Tribunal (IPART) to review the local government rate peg methodology, including the Local Government Cost Index.

I approve the arrangement as set out in your letter and proposed terms of reference, pursuant to section 9(2) of the *Independent Pricing and Regulatory Tribunal Act 1992.*

Thank you for taking the time to bring this matter to my attention.

Yours sincerely,

Dominic Perrottet MP
Premier

22/06/2022

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TERMS OF REFERENCE - Review of rate peg methodology

I, Wendy Tuckerman, Minister for Local Government, with the approval of the Premier, have entered into an arrangement for the provision of services by the Independent Pricing and Regulatory Tribunal (IPART) under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992* to investigate and report on the rate peg methodology in accordance with this Terms of Reference.

Context

IPART has set the rate peg under section 506 of the *Local Government Act 1993* (the Act) under delegation from the Minister for Local Government since 2010. The rate peg is the maximum percentage amount by which a council may increase its general income for the year. The primary purpose of the rate peg is to protect ratepayers from excessive increases in their rate bills. Section 506 of the Act enables different rate pegs to be set for different councils.

IPART calculates the rate peg by applying a methodology that comprises the Local Government Cost Index (LGCI), a productivity factor and a population factor (the methodology). Currently, the LGCI and productivity factor are the same for all councils, and IPART's approach to determining these components of the rate peg has been broadly consistent since 2010. The population factor was introduced in 2022-23 and varies depending on population growth in each council area.

While IPART uses the latest available cost indicators from the Australian Bureau of Statistics, there is up to a two-year lag between the time period these changes are measured over and when councils apply the rate peg to their general income. This means that the 2022-23 rate peg is based on the changes in costs experienced by councils between 2019-20 and 2020-21.

The local government sector has raised concerns that when inflation is more volatile, such as during the COVID-19 pandemic, councils have difficulty forecasting and planning for a low inflation rate peg outcome.

The task

I am requesting IPART to deliver a report recommending a rate peg methodology that allows the general income of councils to be varied annually that is reflective, as far as possible, of changes in inflation and costs incurred by the local government sector and that continues to include a population growth factor.

Specifically, I am requesting IPART to investigate and make recommendations to the Minister on:

1. Possible approaches to set the rate peg methodology to ensure it is reflective of inflation and costs of providing local government goods and services;
2. Possible approaches to stabilising volatility in the rate peg, and options for better capturing more timely changes in both councils' costs and inflation movements;
3. Alternate data sources to measure changes in councils' costs;
4. Options for capturing external changes, outside of councils' control, which are reflected in councils' costs;
5. The effectiveness of the current LGCI approach;
6. Whether the population growth factor is achieving its intended purpose.

In undertaking the review, IPART should have regard to:

- The Government's commitment to protect ratepayers from excessive rate increases and to independently set a rate peg that is reflective of inflation and cost and enabling financial sustainability for councils.
- The differing needs and circumstances of councils and communities in metropolitan, regional and rural areas of the State.
- Ensuring the rate peg is simple to understand and administer.

Process and timeframe

IPART should consult with relevant stakeholders including councils, the Office of Local Government, relevant NSW Government agencies, Local Government NSW and the public in carrying out this review, including by publishing a draft report.

The Tribunal will provide a final report to the Minister for Local Government within 9 months of receiving the terms of reference.

The Hon. Wendy Tuckerman MP
Minister for Local Government

Glossary

ABS	Australian Bureau of Statistics
Ad valorem rate	A Latin term meaning "according to value." In this context it refers to the component of rates based on the unimproved value of land.
Base Cost Change (BCC) Model	IPART's proposed new model to measure the base cost change for 3 groupings of councils – metropolitan, regional and rural. It includes 3 components – employee costs, asset costs and other operating costs.
Capital improved value (CIV)	The total market value of the land plus buildings and other improvements.
Consumer Price Index (CPI)	Measures the overall change in consumer prices based on a representative basket of goods and services over time.
The CIE	The Centre for International Economics
Developer contributions	Developer contributions are monetary payments or works-in-kind agreements that supply or contribute towards the cost of local infrastructure. They are charged by councils when new development occurs and provide land and infrastructure including open space, parks, local roads, footpaths, and stormwater drainage.
Draft BCC	IPART's draft decision to use a BCC model, but without specifying whether we use the Award, WPI forecasts or another method to calculate the change in employee costs.
Emergency Services Levy (ESL)	Councils pay contributions to the NSW Government through the ESL to support emergency services in NSW. These contributions contribute to the funding of Fire and Rescue NSW (FRNSW), the NSW State Emergency Service (SES) and the NSW Rural Fire Service (RFS).
Essential Services Commission (ESC)	The Essential Services Commission, the independent regulator for essential services in Victoria.

Estimated residential population (ERP)	An estimate of residential population based on the concept of usual residence published annually by the Australian Bureau of Statistics.
External costs	External changes, outside of a council's control or that councils are constrained in recovering the cost of, that are reflected in a council's costs.
Financial Assistance Grants (FAG)	The Financial Assistant Grant program provides funding support from the Australian Government to local governments across Australia. Local government grants commissions in each state and the Northern Territory recommend the distributions of the funding under the program in accordance with the *Local Government (Financial Assistance) Act 1995* (Cth) and the National Principles for allocating grants formulated under that Act.
FRNSW	Fire and Rescue NSW
General income	Income from ordinary rates, special rates, and annual charges, other than special rates and charges for water supply services and sewerage services, annual charges for waste management services, annual charges for stormwater management services, and annual charges for coastal protection services and certain other charges. See section 505(a) of the Local Government Act.
IPART	The Independent Pricing and Regulatory Tribunal of NSW
IP&R	Integrated Planning and Reporting
Local Government Act	*Local Government Act 1993* (NSW)
Local government area (LGA)	A local government area is an administrative division that a local government council is responsible for.
Local Government Cost Index (LGCI)	An index used by IPART in setting the rate peg which measures price changes over time for cost items relevant to NSW councils.
LGNSW	Local Government New South Wales
Metropolitan councils	Councils in OLG groups 1, 2, 3, 6 and 7

Minimum rate	A minimum amount of a rate specified under section 548 of the Local Government Act.
OLG	Office of Local Government
Permissible General Income (PGI)	Permissible General Income is the notional general income of a council for the previous year as varied by the percentage (if any) applicable to the council under the rate peg or a special variation, as adjusted for supplementary valuations and estimates of increases in land value from the Valuer-General. A council must set rates and charges for a year so as to produce general income of an amount that is equal to or lower that the PGI. See section 509 of the Local Government Act.
Population Factor	A factor included in the current rate peg methodology that accounts for each council's population change over time. It is designed to give councils the additional revenue required to keep revenue per capita (before inflation) consistent, as populations grow.
Preferred BCC	Our draft BCC model as described in Section 3.2, using the Award to calculate the change in employee costs.
Producer Price Index (PPI)	Measures the overall change in prices for domestic producers based on a representative basket of goods and services over time.
Productivity Factor	An explicit factor included in the current rate peg methodology to account for productivity gains in the local government sector.
Rate peg	The term 'rate peg' refers to percentage or methodology specified for each council in the annual order published by IPART (under delegation from the Minister) in the Gazette under s 506 of the *Local Government Act 1993*.
RBA	The Reserve Bank of Australia
Regional councils	Councils in OLG groups 4 and 5
RFS	NSW Rural Fire Service

Rural councils	Councils in OLG groups 8 to 11
Socio-Economic Indexes for Areas (SEIFA)	Socio-Economic Indexes for Areas (SEIFA) is an index developed by the ABS that ranks areas in Australia according to relative socio-economic advantage and disadvantage. The indexes are based on information from the five-yearly Census. It consists of four indexes, the Index of Relative Socio-economic Disadvantage (IRSD), the Index of Relative Socio-economic Advantage and Disadvantage (IRSAD), the Index of Economic Resources (IER), and the Index of Education and Occupation (IEO).
SES	NSW State Emergency Service
Special Variation (SV and SRV)	The percentage by which a council's general income for a specified year or years may be varied as determined by IPART under delegation from the Minister for Local Government. Councils apply to IPART for special variations in accordance with guidelines published by OLG.
Supplementary valuation	Supplementary valuations are issued by the NSW Valuer General between general valuations when changes to property are recorded on the Register of Land Values. This can happen when properties or parcels of land are physically changed, subdivided or rezoned; or to correct a previous error.
Wage Price Index (WPI)	An index included in the current LGCI that measures changes in the price of labour.

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