2 November 2022

Our Ref: 22/317498
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2022-23 Rate Peg Methodology Review
Independent Pricing and Regulatory Tribunal (IPART)
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SYDNEY NSW 1240

Bayside Council Submission – IPARTs Review of the Rate Peg Methodology

Please find enclosed Bayside Council's submission to IPART's Issues paper on the Review of the Rate Peg Methodology dated 29 September 2022.

Overall, Council welcomes the review into the rate peg methodology, however, as set out in this submission, Council would like to emphasise that in addition to correcting the flaws going forward, the review also needs to address the rectification of pre-existing operating deficits across the sector which have been caused by the current rate pegging regime.

Council looks forward to reviewing the IPARTs proposed changes to the rate peg methodology and providing further feedback on the same.

If you require any further information please contact Council's Director City Performance, Richard Sheridan, on [redacted].

Yours sincerely

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Bayside Council

Submission – IPART Review of Rate Peg Methodology

Background:

During early 2022, the Minister for Local Government instructed IPART to review the methodology for setting the annual rate peg for NSW Councils.

On 29 September 2022, IPART released its Issues Paper on the Review of the Rate Peg Methodology, seeking feedback and submission from stakeholders.

Bayside Council have put together a submission responding to the questions asked by IPART in its Issues Paper dated 29 September 2022 as well as other relevant factors that are important considerations in the context of the rate peg review.

Responses to questions raised in IPARTs Issues Paper dated 29 September 2022:

1. **To what extend does the Local Government Cost Index reflect changes in councils' costs and inflation? Is there a better approach?**

2. **What is the best way to measure changes in council's costs and inflation, and how can this be done in a timely way?**

   Bayside Council response to question 1 & 2:

   It is widely known and accepted that the current method for calculating the Local Government Cost Index (LGCI) does not accurately capture the true changes in the cost of services for NSW councils let alone being an appropriate gauge in determining the adequacy of revenue. All other major sectors set their pricing to reflect the forecasted economic indexes while and having regard to historical trends whereas the LGCI uses historical data only.

   In addition to being a lagging indicator of changes in cost profile, the inputs to the LGCI as are also significant flawed (for example: Instead of factoring in the agreed NSW Local Government award to measure changes to employee costs, the LGCI uses the NSW Public Sector wage index which is almost always lower than the NSW Local Government Award).

   Basing the rate peg on a lagging indicator like the LGCI is problematic in periods where inflation is volatile. The reality is that in periods of large swings in inflation, Council still needs to incur the present-day costs to deliver services which is much higher than the LGCI whereas the rate peg only allows for revenue catch up from changes to costs profiles from previous periods. This creates a revenue shortfall in the present day and consequently constraints the actual growth required for operational expenditure. This then further perpetuates lower LGCI's given that the restrained cost base is then factored into future LGCI calculations and rate pegs.

   The current methodology for calculating the LGCI also does not appropriately factor in the true cost of current and future infrastructure renewals and maintenance.

Periodic revaluations and annual indexing of infrastructure assets are required under professional standards to reflect increases in the gross replacement costs of assets. The increased values from revaluations and indexing converts to depreciation expense in councils operating expenditure and broadly represents the rate at which council should be spending to renew (or set funding aside to periodically renew) its existing infrastructure asset portfolio.

The review of the rate peg methodology needs to address two fundamental flaws:

1. The lack of appropriate inputs in calculating the rate peg; and
2. Volatility in the rate peg.

Once the underlying flaws to the inputs to the LGCI is fixed, the volatility in the rate peg could be addressed by use a rolling 3-year average of the historical LGCI weighted at 50% and factoring in a forward-looking forecast for inflation weighted at 50%. The estimation uncertainty of the forward forecast will then correct itself by being factored into the next year rolling 3-year average.

3. **What alternate data sources could be used to measure the changes in council costs?**

   Bayside Council response to question 3:

   The rate peg calculation could benefit from using more forward-looking indexes and forecasts such as those available through RBA forecasts.

4. **Last year we included a population factor in our rate peg methodology. Do you have any feedback on how it is operating? What improvements could be made?**

   Bayside Council response to question 4:

   IPART has acknowledged that Councils must be able to scale up and provide additional services as local communities grow and while councils receive supplementary valuations as new rateable properties come online, it often results in councils receiving less income from rates on a per capita basis when compared to the growth in per capita expenditure.

   It needs to be recognised that supplementary rates do not <u>fully</u> address the issue of additional costs of providing services to a growing population on a per capita basis. This is particularly evident in Councils like Bayside where growth in rateable properties is largely through high/medium density dwellings (i.e., apartment units). In most cases, these new dwellings only attract a minimum rate due to the rating burden being distributed based on unimproved land values. Therefore, while the new dwelling may accommodate average of 2-4 individuals, it still pays a minimum rate which then dilutes the average rates per capita as population on a per head basis grows at a faster rate that the rates collected per new dwelling. This demonstrates that the percentage growth in population does not have a direct correlation to the percentage growth in rates from supplementary valuations.

   Therefore, if IPARTs intention for introducing the population growth factor was to allow councils to maintain or increase its rate on a per capita basis, then the current methodology of reducing this factor by the growth in rates from supplementary valuations, fails to achieve that outcome.

It is Councils view that the growth in rates from supplementary valuations should not be used to reduce the population growth factor in the current rate peg methodology.

It should also be noted that there is already an existing gap between per capita rate and per capita costs as a result of the historical rate peg regime and which continues to place stress on council budgets. This is not addressed by the introduction of a population factor or any other review on the rating revenue system. A one-off catch-up adjustment should be considered through this review to address this historical restriction to Councils general revenue.

5. **How can the rate peg methodology best reflect improvements in productivity and the efficient delivery of services by councils?**

Bayside Council response:

It is difficult to measure productivity and efficiency using a singular metric / methodology as there are a number of variables that need to be considered in making the assessment.

Due regard must be given to the following factors:

- Changes to service offerings over time.
- Changes to population (volume and demographics).
- Sufficiency of operating revenue and underlying operating results over time.
- Financial position, liquidity, and cash levels.
- Asset sustainability indicators (i.e., backlogs and asset conditions)
- External factors and cost pressures
- One-off events (e.g., impact of severe weather)

One way to measure efficiency and productivity improvements at a high level could be to measure the changes in per capita expenditure of councils over time having regard to changes in its service profiles.

For instance, if a councils per capita operating expenditure grows at a rate lower than its rate of population growth in an inflationary environment, that could be attributed to efficiency and productivity gains assuming no changes in service offerings.

It should be noted however that per capita expenditure may not be the best indicator of efficiency as a low growth in operating expenditure could be (and often is) attributed to the inadequacy of operating revenue to allow for growth in expenditure (i.e., operating expenditure is being contained due to revenue restrictions).

Ultimately, the best indicator of productivity and efficiency would be where a council is able to generate sufficient revenue to provide the desired levels of service to its community and doing so in a financially sustainable manner without undue financial and operational stress.

6. **What other external factors should the rate peg methodology make adjustments for? How should this be done?**

   Bayside Council response to question 6:

   The revised rate peg methodology needs to take into account the changes to councils' costs profiles driven by the following external factors:

   - Global Economic Forecasts and Supply Chain Delays
   - Changes in costs and pricing trends of private sector industries that have a high degree of interaction / engagement with the local government sector (e.g., building construction, waste management, specialist contractors, infrastructure, etc.)
   - Impact of natural disasters and severe weather events
   - Cost of non-value add compliance activities (e.g. detailed data returns, high scrutiny audits, detailed acquittals and increased regularity of reporting on grants, YoY changes to the LG Code of Accounting Practice, Changes in accounting standards, changes in legislation, etc).

7. **Has the rate peg protected ratepayers from unnecessary rate increases?**

8. **Has the rate peg provided councils with sufficient income to deliver services to their communities?**

9. **How has the rate peg impacted the financial performance and sustainability of councils?**

   Bayside Council response to question 7,8, & 9:

   In the last 10 years:

- 178 applications for special rate variations (SRVs) were made.
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- 165 SRV applications were approved in full or in part.

- 142 SRV applications rationalised based on one or all of the following:
    - To address financial sustainability.
    - To address existing infrastructure backlogs.
    - To address future infrastructure expenditure obligations.

In addition to this, the last 3 years:

- 79 councils reported an infrastructure renewal backlog of greater than 2%
- 56 councils consistently reported an infrastructure backlog of greater than 2%
- 99 Councils reported an infrastructure renewal ratio of less than 100%
- 33 Councils consistently (over 3 years) reported an infrastructure renewal ratio of less than 100%
- 74 Councils reported an infrastructure renewal ratio of less than 100% over a 3-year average

The above statistics clearly show that a large majority of NSW councils are balancing their operational budgets by underfunding its capital obligations.

Based on the number and size of Special Rate Variation (SRV) applications in the last 10 years and the deterioration of councils' asset sustainability indicators over the least 3 years, it can be said that the rate peg has prevented necessary rate increases.

The rate peg has been effective to decrease rates and average rate paid in last 10 years is 2.5%. This policy has resulted in reducing rates collected compared to Victoria of over $1b and been a significant contributor to financial sustainability being the highest risk for NSW Councils for the last 5 years.

As outlined in Q7 the rate cap has created a significant reduction in rates being collected. An example of how this has reduced community services would be the ability to acquire land to invest in land for open space, sporting fields and community buildings. Rates are a levy against land, but the rates have only increased on average of 2.5% in the last 10 years while land has increased at a rate of 10% per year. As a result of this, Councils are no longer able to acquire land and invest in open space, sporting fields and community facilities due to the $1b shortfall in rates across NSW. Therefore, the opportunity costs of rate capping is that income in now lost forever and the ability to purchase land is also now lost, especially as the demand for open space, sporting fields and community facilities is now increasing as housing is now predominately becoming multi-unit dwellings.

10. **In what ways could the rate peg methodology better reflect how councils differ from each other?**

11. **What are the benefits of introducing different cost indexes for different council types?**

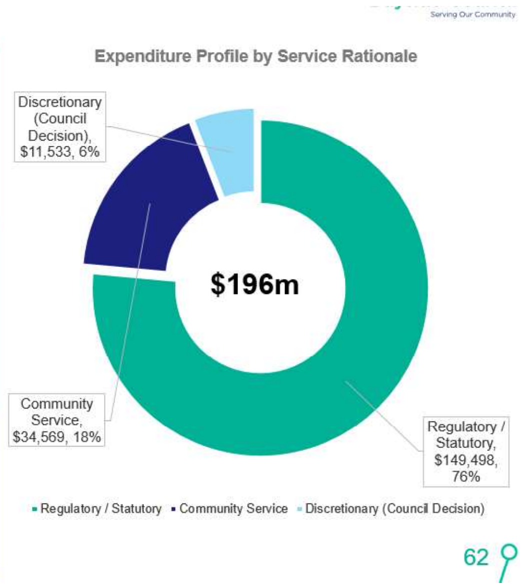
Bayside Council response to question 10 & 11:

While Councils share similarities, each council is different. Rural, Metro, Remote, and Coastal councils all have different challenges and resulting cost implications. The service burden of each council is also different depending on its location, community needs and economic profile. In most cases, there is not a lot of choice or discretion available to Councils.

The figure below shows the categorization of Bayside Councils budgeted operating expenditure (excluding capital expenditure) based on the service rationale for the FY2022/23 financial year.

It can be seen that 76% of Council expenditure is attributable to services / functions that are required due to regulatory or statutory obligations and there is very little allocation available for services that are truly discretionary.

Category	Description
Regulatory / Statutory / Essential	The provision of these services are mandated through requirements derived from regulations, required as a result of statutory requirements derived from legislation, or are essential services required to be provided by Council. *E.g. Certification, Councilor Support, Compliance, Infrastructure & Asset management, Workplace Safety, Planning & Strategy, Financial Management & Reporting, Governance, Audit, etc*
Community Services	Services or functions which are not legislated but are expected to be provided by Council or has been agreed with the Community through the CSP. It would be very difficult for council to exit these services. *E.g. Community Facilities, Parks and Open Space maintenance, Public Amenities and Street Scape Cleansing Services, Civil Maintenance, and Other Community Services*
Discretionary	A service that is purely at the discretion of council and is being provided through a council resolution or has been historically provided to the community. These are services that other organizations are willing to provide and may be better placed to provide. *E.g. Events, Economic Development, Commercial Waste, Childcare, Local History.*



12. Is volatility in the rate peg a problem? How could it be stabilised?

13. Would councils prefer more certainty about the future rate peg or better alignment with changes in costs?

14. Are there benefits in setting a longer-term rate peg, say over multiple years?

Bayside Council response:

A better approach to addressing the volatility issues would be to use a rolling 3-year average of the historical LGCI weighted at 50% and factoring in a forward-looking forecast for the current period inflation weighted at 50%.

The estimation uncertainty of the current period forecast will then correct itself by being factored into the next years rolling 3-year average.

This approach can provide stability in smoothing of the long-term revenue to match the growth in long term expenditure and any resulting efficiency gains through economies of scale.

IPART can also remove the volatility by guaranteeing that the rate peg will not drop below the 10-year long term average (i.e. the rate peg should be the higher of, the calculated rate peg under the revised methodology and the 10-year long term average).

Simple example to demonstrate concept *(excluding the impact of population growth or current population growth factor)*

	Base[1]	Yr - 1	Yr - 2	Yr - 3	Yr - 4	Yr - 5	Yr - 6	Yr - 7	Yr - 8	Yr - 9	Yr - 10
Rolling 10-year Average	*2.8%*	*2.8%*	*2.9%*	*2.1%*	*2.9%*	*2.7%*	*2.6%*	*2.8%*	*2.7%*	*2.7%*	*2.8%*
Forecast Inflation	2.8%	2.8%	2.8%	2.9%	2.2%	2.5%	2.4%	2.8%	2.7%	2.8%	3.2%
Actual LGCI	2.8%	3.0%	0.7%	3.7%	2.8%	2.0%	3.4%	2.9%	3.2%	3.8%	2.5%
Rate peg [2]	2.8%	2.8%	2.8%	2.9%	2.9%	2.3%	2.9%	2.7%	2.8%	2.8%	3.0%
Impact on operating budget											
Revenue ($m)	100.0	102.8	105.7	108.7	111.8	114.4	117.7	120.9	124.3	127.7	131.5
Expenditure ($m)	100.0	103.0	103.7	107.6	110.6	112.8	116.6	120.0	123.8	128.5	131.8
	-	**- 0.2**	**2.0**	**1.1**	**1.3**	**1.7**	**1.1**	**0.9**	**0.4**	**- 0.8**	**- 0.2**

$$\text{Rate Peg (Yr5)} = \frac{\text{Average LGCI (Yrs 1-3)} + \text{Forecast Inflation Yr 4}}{2}$$

nb: Rate peg = the higher of the rate calculated using the above formula or the **10-year long term average**

Average LGCI over 10-yrs	**2.8%**	*Equalises in the long run and has YoY stability*
Average Rate-Peg over 10-yrs	**2.8%**	

Long term impact on:	**Average**	**Total**
Revenue *($m)*	$ 117	$ 1,166
Expenditure *($m)*	$ 116	$ 1,158
Variance	**$ 1**	**$ 7**
Percentage variance	*0.6%*	*0.6%*

Revenue remains slightly ahead of expenditure over the long term providing ability to absorb shocks or expand service offerings

Assumptions

[1] Base year is assumed to be in equilibrium.

Volatility in LGCI is introduced from year 1 onwards to demonstrate the impact of using a rolling 3 year average.

Forecast LGCI from Yr 1 onwards is based on a rolling 3 year historical average.

[2] Rate peg methodology based on a rolling 3-year average of the historical LGCI weighted at 50% and factoring in a forward-looking forecast for the current period inflation weighted at 50%

15. Should the rate peg be released later in the year if this reduced the lag?

Bayside Council response:

Councils need to commence the preparation of its budgets and long-term financial forecasts early in the new financial year in order to meet public exhibition and council adoption timelines. Thus, a late release of the rate peg may not be beneficial for councils unless IPART can remove the forecasting uncertainty to Councils by guaranteeing that the rate peg will not drop below the 10-year long term average (i.e. the rate peg should be the higher of, the calculated rate peg under the revised methodology and the 10-year long term average). This will allow councils to plan ahead and prepare their budgets with certainty that a late release of the rate peg will not negatively impact their original forecasts.