Response to "Issues Paper" on Rate Peg Methodology

A Ratepayers' Perspective by Kevin Brooks

1 To what extent does the Local Government Cost Index reflect changes in councils' costs and inflation? Question 1 in Issues Paper.

IPART states that Local Government Cost Index (LGCI) better reflects changes in Council costs than Consumer Price Index (CPI) inflation, but it does not explain why this should be the case?

The issues paper states that rate peg (and presumably therefore LGCI) increased 28% over the ten years 2010/11 to 2020/21. Yet, the Reserve Bank of Australia calculator shows CPI increasing only 20.3% over the same ten financial years 2010/11 to 2020/21.[1]

Why should LGCI increase so much faster than CPI inflation over such a long period?

As LGCI is designed to be more specific to the Local Government sector, Council costs make up a bigger proportion of the index than in an economy wide indicator such as CPI. Perhaps, therefore, Councils are contributing to increases in LGCI through their own cost management, i.e., to some extent passing on cost increases to rate peg that they have influenced. This reduces the incentive to control costs.

IPART needs to examine why LGCI has consistently outpaced CPI inflation and how much Councils are themselves contributing to this? Or is the index itself or its application flawed?

Basing rate peg on CPI would be a better option for ratepayers. It would better meet ratepayers' expectations and align with household budgeting which tends to be based on CPI. If rates exceed CPI over time, household budgeting much more difficult for ratepayers.

2 Has Rate Peg Protected Ratepayers from Unnecessary Rate Increases? Question 7 in Issues Paper.

As above, rate peg (LGCI) has risen faster than CPI which means rate peg certainly has not protected ratepayers from unnecessary rate increases.

Statistics quoted on page 13 of the issues paper shows that, in the decade 2010/11 to 2020/21:

- Income from rate peg (based on LGCI) increased 28%
- Income per capita from rates increased 45%

This means actual rates income has massively outstripped even rate peg, presumably because of special rate variations and population growth factors.

This translates into annual average increases in Council rates of 3.8% compared with an average annual increase in rate peg (based on LGCI) of 2.5% between 2010/11 – 2020/21. For comparison, average CPI inflation over the same period was just 1.9%.

Rates have therefore risen twice as fast as CPI over the decade 2010/11 -2020/21 and risen 52% faster even than rate peg based on LGCI.

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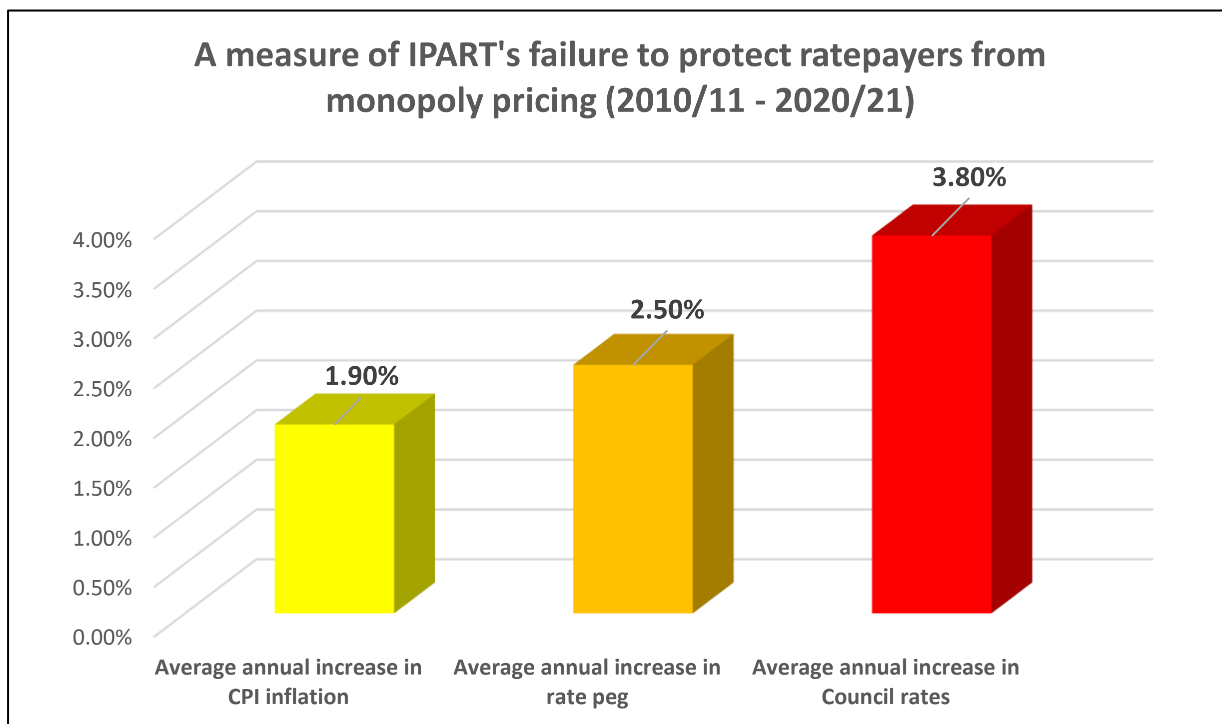
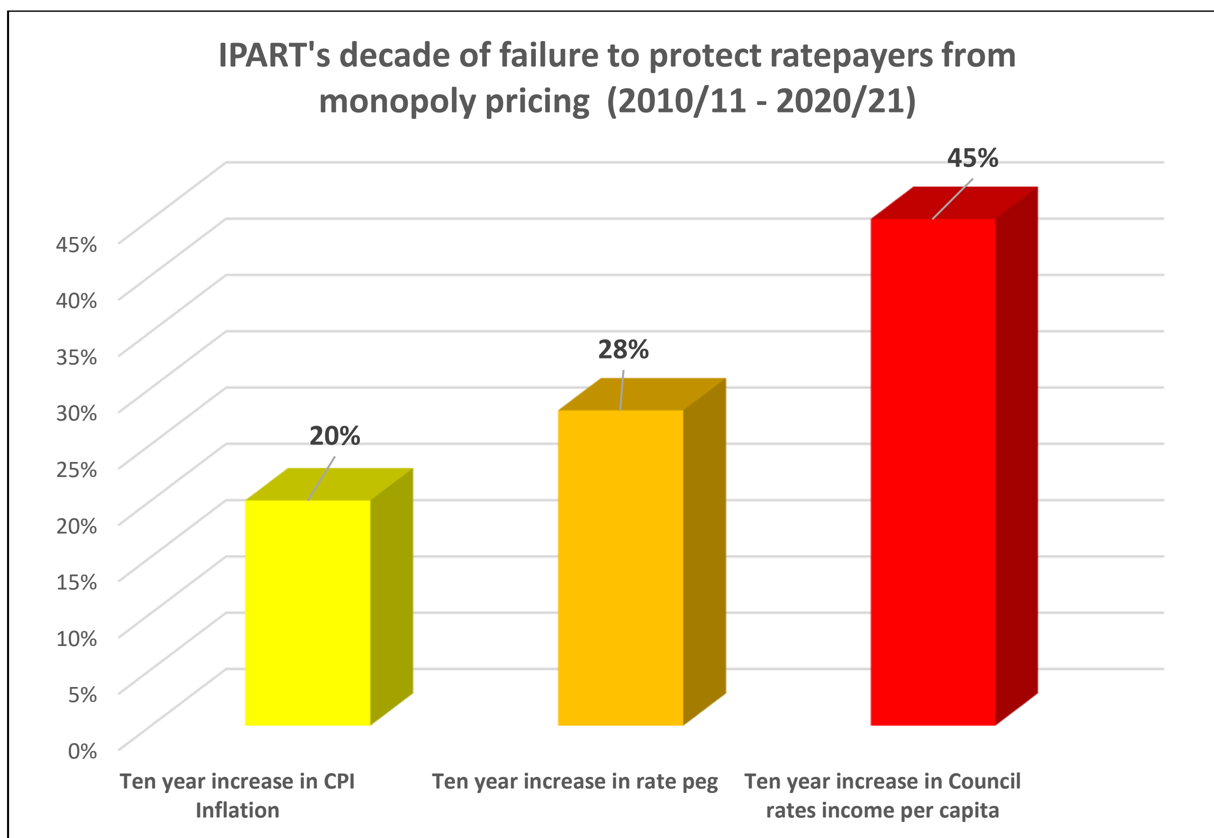
[1] https://www.rba.gov.au/calculator/financialYearDecimal.html

How can this possibly be justified?

An independent review would be asking IPART how it could possibly have allowed this to happen?



And on a ten-year cumulative basis with compounding ….



IPART's methodologies are flawed. The current rate peg methodology reduces the incentive for better cost control and greater efficiency. And the special variation process, heavily dependent on the "financial need" criterion (based on operational performance ratio), reduces the incentive for better financial management and improved productivity.

Confining this review to the rate peg and population factor, whilst excluding special variations, also makes no sense because the two have worked together to open a large gap between average rates paid by customers, and CPI inflation.

The question as to whether ratepayers have been protected from unnecessary rate increases cannot be fully answered without including special variations in the review.

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

This is difficult to answer because neither IPART nor Councils appear to have any quantifiable means of measuring productivity (output per employee).

The more important question is: How can rate peg methodology incentivise productivity and efficiency improvements?

4.1 So, how can rate peg incentivise productivity?

The only way the rate peg can incentivise higher productivity and efficiency is to set rate peg lower than LGCI (the gap to be made up by improvements in productivity and efficiency).

If Councils get extra revenue to match increased costs through the current rate peg methodology, then what incentive do they have to reduce costs through higher productivity and efficiency?

IPART can also take a big step to promote higher productivity by developing a credible way to measure productivity (output per employee) across Councils. At present, there is no credible measure of Council productivity. To quote Peter Drucker, "what gets measured gets managed." This operates in reverse.

A credible measure of Council productivity would also incentivise better productivity if the results were published annually. It would also help IPART properly assess productivity as one of its five criteria for Special Variations – an area where IPART is currently floundering badly.

4.2 Why is IPART's productivity factor at zero?

It appears that IPART never had a high expectation of productivity improvements given its own productivity factor between 2011/12 and 2017/18 ranged from 0.0 to 0.2.

Even worse, since 2018/19 it has been set at zero because IPART claims *"improvements in productivity are already reflected, to an extent, in the ABS price indexes we use to measure price changes in LGCI cost categories."*

For transparency, can IPART explain its reasoning here?

Without further explanation, IPART's thinking is hard to understand.

The LGCI cost index reflects the prices Councils pay for employees, goods, services, and supplies. In the case of goods, services and supplies, the price charged to Council may reflect improved productivity by suppliers of these services, but why does IPART think it reflects improved productivity by Councils?

In the case of employees, their cost alone has nothing to do with productivity. Productivity is a measure of output per employee, not how many there are or how much they are paid.

Please explain, IPART?

A productivity factor set at zero effectively means there is no productivity factor. It means the current rate peg automatically compensates Councils for any increase in their costs as measured by LGCI regardless of productivity. This means there is no incentive for Councils to improve productivity or efficiency.

4.3 IPART currently disincentivises productivity and efficiency improvements

Not only does IPART fail to incentivise productivity and efficiency, but it also actually disincentivises productivity and efficiency improvements through the "financial sustainability" criterion it uses for special variations. Lower productivity and inefficiency contribute to a lower Operating Performance Ratio (OPR) which assists Council arguments for extra revenue through special variation. In short, lower productivity and inefficiency create a "financial need" for extra revenue through special variation – thereby incentivising lower productivity and efficiency.

Whilst IPART may claim it has included productivity as a separate Special Variation criterion, this is worthless if IPART has no reliable method of measuring productivity (output per employee) across Councils. Instead, it takes at face value anecdotal examples provided by Councils which rarely tell the whole story.

This is another reason that IPART should develop a credible measure of productivity (output per employee) that can be applied to all Councils. IPART would be doing something useful for its taxpayer dollars if it developed such a measure for Councils and published the results annually.

5 Is Volatility in Rate Peg a Problem? Question 12 in Issues Paper.

One of the drivers of this review seems to be a "concern" that, because of a lag between the time rate peg is set and the time it is applied, inflation is higher this year than the date when the rate peg was set. The monopolies never complain when it works the other way – i.e., when inflation *decreases* between the time the rate peg is set and when it is applied.

Over time this time lag evens out.

Whilst I can understand, in principle, if we were starting from scratch, a shorter time lag between setting and applying rate peg would be desirable, it is important that any change in methodology does not lead to a price advantage for the monopolies due to the way the change is introduced, and its timing.

Rate peg over the long term should still match inflation over the long term. There should be no windfall for the monopolies from the timing of the change or the way in which it is introduced.

IPART should be transparent and publish figures to show this is not the case.

6 How is the Population Factor Working? Question 4 in Issues Paper.

The issue paper asks how the population factor is working?

The answer is simple. The population factor is yet another part of the IPART methodology driving higher rates relative to inflation over time.

6.1 Economies of scale in service delivery

There should be no need for Councils to charge more just because their population increases.

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. There is no incentive for them to do so, however, if they are simply handed extra rates income every time their population rises.

Now, a question IPART has never answered.

If Councils really do need more rates income when their populations increase, why does IPART not reduce rates income when their populations decrease?

Currently IPART's population growth formula only allows changes in rates where populations increase, not where they decrease. Over time, this can only drive average rates to rise even faster than average inflation.

6.2 Supplementary Valuations

The issues paper states:

"Historically, councils have funded these additional costs (population increase) through supplementary valuations where land had been rezoned or subdivided to accommodate the growing population…."

This suggests Councils always had the means to fund population growth without needing a higher rate peg for population growth. The population growth factor therefore seems unnecessary.

7 In what way can the rate peg methodology better reflect how Councils differ from one another? Question 10 in the Issues Paper.

The Issues Paper states:

"The LGCI is designed to measure cost changes experienced by the average council in NSW, and as a result probably does not reflect the exact actual cost changes of any individual council."

By simple logic, if some Councils experience higher costs than the LGCI average, then it follows that other Councils will experience lower costs than the LGCI average.

Ratepayers will find it utterly deplorable if any changes to methodology here follow the approach to population growth where Councils with higher populations can charge more, but those with declining populations do not have to charge less.

If rate peg is to be set higher for some Councils where their costs increase more than the LGCI average, then it should be set lower for other Councils with cost increases below the LGCI average.

If LGCI is higher than average for some Councils, it must be lower for others.

If changes to rate peg methodology are made here, the average rate peg across all Councils in NSW should still equal the average increase in LGCI costs.

In the interest of transparency, IPART should publish data after any changes confirming that this is the case.

8 How should we account for the change in efficient labour costs? Question 16 in the Issues Paper.

8.1 Local Government (State) Award versus NSW Public Sector Wages Index

The issues paper suggests basing increases in labour costs within rate peg on the NSW Local Government (State) Award rather than the NSW Public Sector Wage Index.

This is strongly opposed. It is a terrible idea.

Given that Councils (as employers) collectively negotiate the Local Government (State) Award, there will be no incentive for them to negotiate lower wage increases if they can simply recoup increases in salaries from the ratepayer through a higher rate peg.

As employee costs make up almost 40% of the Local Government Cost Index (LGCI), the impact of this change on rates could be very significant

Salary increases from the Award are not outside Councils' control because they collectively negotiate this pay increase. The proposal will simply encourage even poorer cost control by Councils.

8.2 Councils Driving Up Employee Costs

Other employee costs within Council control include:

- Executive remuneration (which has been rising rapidly, causing considerable community concern, but is rarely if ever mentioned by IPART);
- Staff restructures and internal promotions increasing the proportion of senior staff and therefore higher salaries;
- Benefits and working conditions (which can be negotiated at individual Council level) which can impact total employee costs and - with respect to conditions - create inflexibility that acts as a drag on productivity.

With respect to the third bullet, Central Coast Council, whose CEO David Farmer was appointed on a salary more than $500,000 (higher than the Premier at the time), allows all managers to use motor vehicles provided by Council for personal use including the cost of petrol. CCC managers could take their family on a holiday to North Queensland and ratepayers (facing exorbitant petrol price increases themselves) would foot the bill for petrol and other motoring costs.

Ratepayers are increasingly funding a "nose in the trough" culture from Council senior managers. Councils have plenty of scope to reduce these costs and should be incentivised to do so.

8.3 The link between employee remuneration and productivity

In the real world, increases in employee remuneration (salaries and benefits) are paid for by productivity improvements. This has been the case throughout economic history.

Sadly, Councils do not pay for their real salary increases through higher productivity but through applications to IPART for rate hikes.

IPART needs to get a grip on this and especially the massive increases in Executive remuneration.

It is vital that real increases in employee costs (i.e., increases after the devaluation of money as measured by CPI inflation), are paid for by productivity improvements – not special variations.

This brings us back to the point raised earlier re the pressing need for IPART to develop a credible means of measuring productivity (output per employee) across Councils.

9 Additional Services and External Costs Questions 17, 18, and 19 in Issues Paper.

The Issues Paper, no doubt in response to Council lobbying, asks whether rate peg should be further inflated by the inclusion of "additional services" and "external costs." The latter are defined as costs supposedly outside a Council's control.

Additional services should be funded through greater efficiency and regular re-prioritisation of all services to ensure resources are matched with strategic priorities and community expectations.

As community priorities changes, there may be a need for additional services or an increase in service provision across specific priorities. At the same time, there will be other services where provision might be decreased. There should not be any net increase in rates because of such regular re-prioritisation.

Over time, total service provision for any given level of resources should increase because of greater efficiency, higher productivity, and innovation. These same factors could also lead to lower rates for a given level of services. It is a sign of poor management if Councils are saying they cannot deliver any improvements unless rates are increased.

Increasing rate peg to accommodate service improvements will merely increase yet further the gap between rate peg and CPI inflation.

History also tells us that service improvements promised in return for higher rates are often not delivered. How will all this be tracked and verified?

Similarly, external costs (defined as cost supposedly outside Councils' control) should not lead to any further increases in rate peg.

All organisations face increased costs outside their control - as do households. This is just a fact of life. There is nothing special about Councils.

Most organisations, and indeed households, deal with this within existing their budgets. Councils should adjust existing budgets and reprioritise. Councils will also better insulate themselves from such cost pressures if they improve efficiency and productivity.

Councils can also benefit from windfall savings and cost reductions outside their control. Rather than over complicating rate peg by seeking to adjust for everything (which will inevitably lead to higher rates because Councils will complain about cost increases whilst keeping quiet about windfalls), Councils should focus on better management of existing budgets, prioritisation, efficiency and productivity.

Overall, additional services and so called "external costs" should not be allowed to further inflate rate peg. Otherwise, such changes will drive average rates to outstrip inflation even faster.

In the interests of transparency, IPART should publish data to show how any changes have impacted the level of rate peg compared with what rate peg would have been without such changes.

10 The link between rate increases and performance

IPART too often accepts the fallacy, especially in special rate variations, that rate increases are needed to fund service improvements.

Does IPART have any evidence that service delivery has improved commensurate with the 45% increase in rates income between 2010/11 – 2020/21 (more than double CPI inflation over the same period – 25% in real terms)?

Again, the Central Coast is an example of services continuing to decline despite a 15% three-year special rate variation that commenced in 2021/22. This was extended to ten years just 12 months later after Central Coast effectively appealed the decision limiting the rate hike to three years, submitted the exact same application twelve months later whilst engaging in relentless lobbying of IPART behind the scenes.

This resulted in Central Coast being granted $253M extra rates income over ten years despite saying it only needed $110M from rates to pay off loans from a previous financial crisis of its own making (asset sales funding the rest of the loans).

Despite all this extra money pouring into Council coffers since July 2021, services have continued to decline. For example, In July 2022, a Council report admitted that development applications (DAs) outstanding more than a year had doubled in the previous six months. Median determination times for DAs shot up to 71 days – by some distance the worst quarterly result in the six years covered by the report.

Indeed, ratepayer bailouts can have a detrimental effect on Council performance because they remove the incentive for under-performing councils to reform. Councils find it easier to apply to IPART for higher rates than implement harder reforms to improve productivity and efficiency.

By being so generous with ratepayers' money, IPART is incentivising poor performance and low productivity. It is creating a culture of ratepayer bailouts when it should be encouraging Councils to improve their performance through:

- better management;
- tighter cost control;
- higher productivity;
- greater efficiency;
- improvements in culture;
- innovation;
- better prioritisation;

to name just some of the measures that are used by organisations that must earn their revenues in competitive markets.

IPART often displays an ignorance of real-world economics, and in particular the way economic incentives work. Unless it changes its approach, the gap between inflation and rate increases will grow even wider next decade. Eventually there will be a public backlash, and politicians who use IPART to keep their own fingerprints off unjustifiable rate increases (whilst appointing Tribunal members and setting the methodologies), will happily throw IPART under the bus. When that happens, ratepayers will rejoice.