4 November 2022

2022-23 Rate peg methodology review
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop, Sydney NSW 1240

Dear Tribunal Members

Thank you for the opportunity to provide feedback on the Review of rate peg methodology Issues Paper.

Local Government Professionals Australia, NSW is the leading association representing the professionals in NSW local government. We are committed to maintaining high professional and ethical standards throughout the sector and ensuring that our members are at the forefront of change and innovation.

Our response to the Issues Paper was prepared by our Finance Member Network made up of members representing the finance professionals working in NSW councils.

1. 1. To what extent 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 councils' costs and inflation, and how can this be done in a timely way?
3. What alternate data sources could be used to measure the changes in council costs?

Combined response to questions 1 and 2.

A better approach would be to utilise the existing NSW Local Government Integrated Planning and Reporting Framework to better effect. The current rate peg methodology is restrictive both on councils and the community, as the current rate peg approach does not support the achievement of the Council's draft four-year delivery program and the community strategic plan, although they are both underpinned by a robust community engagement process.

While it is incumbent on councils to demonstrate to our communities that we are effective and efficient in our operations, our experience has been that public submissions received have been focused on requests that councils do more for their community, rather than on limiting rate increases.

Whilst we understand the overall purpose of the rate peg is to prevent what IPART believe are unnecessary excessive rate increases the rate peg is impacting the long-term financial sustainability

of councils. The scope of this initiative needs to consider the long-term impact to councils and not just the short-term impact to the ratepayer.

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 significantly 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, councils still need 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.

There is evidence that the LGCI is not changing to reflect the change in council costs – and that as a consequence NSW councils are dropping service levels, increasing fees and charges and increasing rates through SRVs to address their immediate financial sustainability.

Across the industry, NSW Council revenue has not been sufficient to keep up with rising costs.

The current methodology for calculating the LGCI also does not appropriately factor in the true cost of current and future infrastructure renewals and maintenance as reflected in the rapidly rising cost of depreciation, which approximates councils annual cost to renew community infrastructure.

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.

Councils are using SRVs to 'catch-up' their revenue to meet the cost of service provision. Since IPART took over the rate peg is 2011 there have been 157 SRV applications approved. It has become a part of the normal way that councils manage their business to provide funding for the increasing costs of providing the level of service expected by local communities. As an outcome, while the rates peg has increased rates by 32% over the last 10 years, the average NSW council residential rates have increased by 57%. Indicating the extent of the difference in the LGCI and the required council rates over time.

Even if staggered over several years – the SRV catchup is less equitable and more inefficient than properly levied property tax as it:

- Causes price-shock to ratepayers. The impact on financially disadvantaged ratepayers is compounded because often the same external issues that impact council costs to create the financial urgency required for a decision to apply for an SRV are already affecting household, farming and business budgets.

- Creates inequity for ratepayers in different years. Councils need to be allowed to increase revenue to match costs so that current ratepayers aren't allowed to use up resources and push back the cost of operations to future ratepayers. Ratepayers suffer when price increases are delayed because of decreasing service levels and delayed investment in community services and asset renewal, as well as price rises that affect ratepayers in a different period.

- Makes rates inefficient and increases the administrative cost to council and ratepayers. Taxes should be easily understood, difficult to avoid and have low costs of compliance and enforcement. Property rates are generally one of the most efficient taxes because they are easy to administer compared with other forms of taxation as they rely on a clear information source – property values are hard to avoid because the Government holds comprehensive land ownership records. Conversely, the SRV process is a massive administrative burden and becomes a major job for council at all levels – community, councillors and administration.

There should be an annual performance measure on the LGCI that fails in any year where there are councils that have to apply for an SRV for financial sustainability or to maintain infrastructure or service levels.

The rate peg should be tied to a simple index that can be easily referenced such as the cpi +/- 2%:

- would allow councils to choose to set their rates below the rate peg with flexibility to deal with one-off issues and their own local circumstances,
- would be very efficient to administer, would create a level of accountability through the annual operational plan and revenue strategy setting process already in place
- and would put the decision-making power back with the communities who make decisions to vote in the local council every 4 years.

The timing of the rate peg release is not the issue in question, the inherent challenge is how the rate peg is calculated, that is, on historic inflation rather than forecast inflation. A forecast model would improve the alignment the rate peg with actual inflation experienced by councils.

The rate peg calculation could benefit from using more forward-looking indexes and forecasts such as those available through RBA forecasts. There are many predictive instruments in the marketplace that would help in the calculation of a more relevant rate peg %. Where the predictive measure is found to be inaccurate then the following year could include a revision/correction factor.

It must be accepted that there is no 'one-size fits all' approach for NSW local government, which provides a very broad range of services, and the rate peg must build in a level of flexibility that allows individual councils to do their own cost and revenue analysis based on local circumstances

including the cost of inputs and the types of services funded by ratepayers.

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?

The population change is an important aspect of the rate peg calculation – where there are high levels of population growth, without the offset of revenue growth in supplementary valuations, it is important that councils can action the needs of the municipality in a timely and proactive manner.

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 fully address the issue of additional costs of providing services to a growing population on a per capita basis. This is particularly evident in councils 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 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.

The revenue generated by supplementary valuations should not be discounted from the population indexed rate peg.

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

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.

We understand that it is challenging in coming up with a sector-wide productivity improvement measure to be considered in setting the rate peg. Councils are best placed to understand the significant financial challenges experienced by the sector and are judged on how they use the scarce resources that they have available by the ratepayer.

The LGCI should be reworked into a performance measure used annually be each council to value the unique mix of services delivered to the local government area. In this way, each council would annually value their outputs (instead of inputs) which would be published at the time of the annual operating plan and linked to the development of the annual revenue strategy.

The local government performance measure would become a reasonable and repeatable way of determining and reviewing the cost of services, that could reported by each council. This would assist councils by providing a reporting framework and methodology to determine the annual rate, within the rate peg limit. It would create a natural efficiency mechanism because all councils and their communities would be motivated to meet the benchmark, or other target set by Council that takes into account local factors.

This rate peg methodology would have to be auditable to ensure a consistent reporting approach across the sector. It would be used as a basis for each council to review the cost of service provision and community infrastructure, with transparency to report the difference between council costs and an industry benchmark, with an explanation for local factors.

By building flexibility into the rate peg – councils would be able to report on their own service costs for the first time – rather than the current budget method of reducing budgets to match real revenue decreases.

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

By using an audited local government performance measure reporting framework, IPART would have annual oversight of the cost of service provision and infrastructure for all councils, including narrations and explanations for change. The process would highlight cost pressures that impact individual councils or all councils across the sector. By benchmarking all councils annually, we would have an annual check of the effectiveness of the reporting methodology and be able to moderate back to the real world.

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).

Other factors may include:

- Lack of understanding of the demand for services delivered by Council for ratepayers, which may be impacted by the increasing financial constraints that a rate peg places on Council.
- Ageing infrastructure assets and the associated asset management plans and requirements
- The escalating depreciation expenses associated with increasing input costs for renewal and replacement of assets
- Changing nature of the workforce, generational change and Pandemic impacts on operational capability
- Climate adaption (as a proactive measure)
- Increasing natural disasters

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?

Combined response to questions 7, 8 and 9.

The implementation of a rate peg has definitely limited rate increases, but this has been at the expense of the financial sustainability of council services.

Under the current rate peg methodology the majority of NSW Councils apply for SRVs, but the SRV process is inefficient, and delays revenue, meaning that services may decline and infrastructure backlogs may develop before additional revenue is sought. These backlogs then require higher rate rises to build services back up to meet community expectations.

The size of the available rate rise has obviously been impacted by the rate peg. However, the impact of the rate peg has meant that councils have been impacted in the ability to generate sufficient income to deliver the services expected of them by their communities. The rate peg also has a significant impact on the long-term financial sustainability of Council, as Council needs to consider the impacts of depreciation and asset replacement, which doesn't appear to be a consideration of IPART in setting the rate peg.

In the last 10 years:

- 178 applications for special rate variations (SRVs) were made.
- 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 $1 billion and been a significant contributor to financial sustainability being the highest risk for NSW Councils for the last 5 years.

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.

The rate peg has not provided councils with sufficient income to deliver services to their communities, as it does not take into account the demand for services, ageing infrastructure, escalating depreciation expense and covid operational impacts, inert alia, and therefore places greater strain of the financial sustainability of Council.

The current rate peg has no flexibility for councils where costs increase beyond the 2 year lagging index. There have been numerous financial sustainability reviews on local government over several years that have sited the current rate peg methodology as a major contributing factor.

Most recently, the 2021 NSW Productivity Commission's Paper on Productivity Reform recognised a flexible rating system was the most efficient way of helping councils meet the risings costs of serving their communities. NSW's rate peg is being blamed for councils not having enough money to provide their rapidly growing communities with new infrastructure. The Report signalled NSW councils have foregone about $15 billion in rates compared with Victoria since 2000, and the NSW Productivity Commission says that except for raising user charges or extracting developer contributions, councils don't have alternative funding sources needed to service higher populations or maintain and operate a larger capital stock.

10. 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?

Combined response to questions 10 and 11.

While Councils share similarities, each council is different. Rural, regional, 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.

Differing cost indexes will recognise that not all councils are alike. IPART has access to existing data collected by IPART to assess expenditure profiles for different categories of councils ie metro, regional, and rural. This information should be considered in assessing the impacts of a 'catch-all' rate peg.

There exists an opportunity to include a factor of relative need, which could be based on the category of council applied by the NSW Grant Commission to recognise the financial sustainability challenges faced by councils.

NSW councils provide hundreds of different services to all types of communities with different service and infrastructure requirements and willingness and capacity to pay for services. There is no one-size fits all. Even councils within a classification (Regional, Rural, Metro) have an enormous amount of diversity because they provide a large range of local services and infrastructure specifically to meet the needs of their local communities.

Any successful rate peg methodology needs to build in sufficient flexibility to allow a council to choose to set a rate lower than the maximum rate peg in any year. Instead of comparing councils and attempting to identify a common level of cost increase across NSW, a local government performance measure could be used to assist councils to value the mix of services they provide to their own local communities.

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?

Combined response to questions 12, 13 and 14.

The priority should be for the rate peg to reflect volatility, rather than leave councils short.

The current rate peg methodology does manage volatility by using an average of two (2) financial years. However, this is an historic average, up to two (2) years prior to the year in which the rate peg is applied, which does not address the issue of long-term sustainability.

A better approach to improving the accuracy of the rate peg to the year it is applied would be to apply a forward-looking forecast. The estimation uncertainty of the current period forecast will then correct itself by being factored into the next years adjusted forecast.

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).

The preference should be for the rate peg to support the long-term financial sustainability of councils.

The benefit of a longer term rolling average rate peg is certainty, however, it is likely the risk of this approach would outweigh the benefits. For example, the current inflationary economic environment would see a long-term rate peg having a negative impact on the financial sustainability of councils.

Councils would prefer better alignment with changes in costs over certainty over future rate pegs. However any methodology should be designed with the timing of council integrated planning and reporting as provided by the OLG Guidelines.

Volatility in the rate peg is not a problem – as the rate peg needs to rise and fall to allow councils sufficient revenue to pay for changing costs of infrastructure and services. There is no benefit in setting a long term rate peg – as it would not be able to anticipate the changing needs of councils and their communities.

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

The volitivity of the rate peg is not a concern when it is done in real-time, or at least close to real-time. A two-year lag means that the volatility is felt by councils two years before it is felt by the ratepayers. Councils subsidise the ratepayer in time of rising inflation and then is seen to raise rates unfairly during times of decreasing inflation. The issue is that the rate peg is determined on historical data/information and the timing of the release of the rate peg.

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 a pre-determined level (i.e. 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.

16. How should we account for the change in inefficient labour costs?

Any productivity improvements noted in the Award should be taken into account, but it is important to also take into account the increases in the superannuation guarantee and the costs associated with activating different workforce models such as the use of contractors to supplement existing resources due to current workforce resourcing issues experienced.

17. Should external costs be reflected in the rate peg methodology and if so, how?

It is noted that adjustments are made by IPART to the rate peg to take into account some external costs outside of the control of councils such as emergency services levy increases by the NSW Government.

However other external costs and examples of cost shifting do not seem to be considered, that increase the financial burden on councils and the community.

***18. Are council-specific adjustments for external costs needed, and if so, how could this* be achieved?**

Council-specific adjustments are currently reviewed and assessed under the Special Variation regime. Unfortunately, this is a burdensome, resource-intensive process on Council and an additional financial burden for the community. A Special Variation could also increase rate rise volatility, which seems to be misaligned with the purpose of the implementation of a rate peg.

A change to the process could include the consideration for service demand/ageing infrastructure based on council category (metro, regional, rural) to reduce the need to undertake a Special Variation to rates.

Costs of individual council need to be considered but in a simpler process to enable the revision of the rate peg assigned

19. What types of costs that are outside councils' control should be included in the rate peg methodology?

Costs that are not in councils control and should be considered when setting the peg include:

1. Aging infrastructure assets and the associated asset management plans and requirements
2. The escalating depreciation expenses associated with increasing input costs for renewal and replacement of assets
3. Changing nature of the workforce, generational change and Pandemic impacts on operational capability
4. Climate adaptation (as a proactive measure)
5. Increasing natural disasters and
6. costs shifting from differing levels of government without compensating funding

There has been significant narrative in the sector on 'cost shifting' - the introduction of legislation or regulation to meet the government's social or environmental policy agenda, then imposing the delivery of those ideals through underfunded or unfunded regulatory services mandated for delivery by local councils. Those nett costs, or annualised change in nett costs, should feature in rate peg calculations.

While both governments bear the broader cost of response and recovery associated with natural disasters, the nett 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.

20. How can we simplify the rate peg calculation and ensure it reflects, as far as possible, inflation and changes in costs of providing services?

The process could be streamlined by not applying a rate peg. Alternatively, the 26 Local Government Cost Index categories established by IPART could be reduced, especially if there are less material categories that have not significantly varied from CPI over a period of time. It is noted there are at least nine of the categories that are directly attributable to Sydney ratepayers leading to a Sydney-centric calculation so the reduction of Sydney-centric categories could also be considered.

Ideally most taxation systems are premised on simplicity, transparency, ease of administration etc. As councils need to illustrate consideration of the various principles of revenue raising (capacity to pay, beneficiary, intergenerational, community service obligation), perhaps in converse, the rate peg methodology may delineate the metrics used against those principles.

Should you require further information, please contact our Chief Executive Officer, Vicki Mayo on [redacted] or [redacted]

Yours faithfully

[redacted]

Stewart Todd
President