KG:dh
Our Ref: 3205051

3 November 2022

Scott Chapman
Independent Pricing and Regulatory Tribunal
PO Box K35
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Sent by email: ipart@ipart.nsw.gov.au

Dear Scott,

Snowy Valleys Council Submission to the IPART Review of the Rate Peg Methodology

Snowy Valleys Council (SVC) has considered the IPART issues paper, and the questions raised, and submits the following feedback for inclusion in this review.

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

There is evidence that the Local Government Cost Index (LGCI) is not changing to reflect the change in Council's costs – and that as a consequence NSW Councils are dropping service levels, increasing fees and charges and increasing rates through Special Rate Variations to address their immediate financial sustainability.

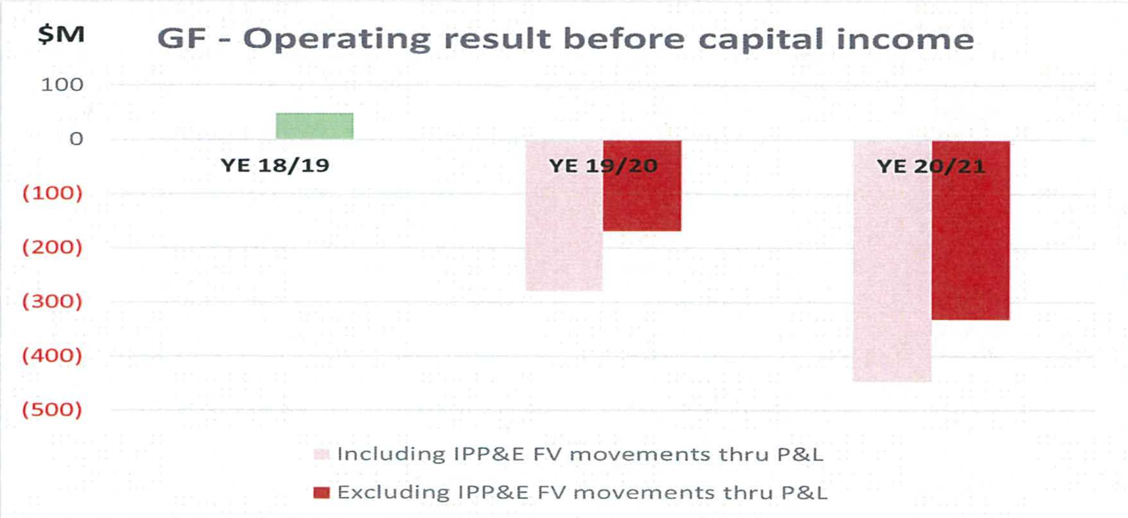
One of the critical expenses for SVC is the rapidly rising cost of contributions to other levels of government which is well in excess of the annual rate peg. This has seen these contributions increase by an average of 23.2% over five years from 2017/18 to 2021/22 as follows:

Trends	2017/18	2018/19	2019/20	2020/21	2021/22	Average	LGCI Average
Contributions to other levels of Government	455	622	1,005	1,234	1,049	23.2%	N/A

Additionally, the February 2021 Report by the Local Government Boundaries Commission to the Minister for Local Government titled 'Examination of a Proposal to Alter the Boundaries of the Snowy Valleys Local Government Area and Create a New Local Government Area' highlights the increased employee costs well in excess of Award increases and the rate cap as a result of the merger of Tumut Council and Tumbarumba Shire Council (page 18).

"Based on Deloitte's analysis, the average cost per FTE increased between 2015-16 and 2019-20 by 23.2%, from $79,800 to $98,400.13 Deloitte has estimated that of the $18,600 increase per employee, approximately $8,300 was due to award increases and $10,300 to other factors, in particular changes in the employee mix to higher graded roles."

Across the industry, NSW Council revenue has not been sufficient to keep up with rising costs. The following analysis by LG Solutions shows the general fund operating result (excluding water, sewer and other Council businesses) of all New South Wales (NSW) Councils over three years.



As can be seen above, the "Operating result (before capital income)" for NSW Councils has dropped from a $49M surplus to a $332M deficit.

This shows that collectively, NSW Councils are financially unsustainable, and the three-year trend indicates that it may not improve. What the Year End 20/21 results mean (Council by Council) is that:

- Overall there are now more Councils with a General Fund deficit (58%) than a surplus.
- 20 x General Fund Councils went from a last year surplus to a this year deficit.
- While 27 x General Fund Councils reported even larger deficits this year than last year.

Councils are using Special Rate Variations to 'catch-up' their revenue to meet the cost of service provision. Since IPART took over the rate peg in 2011 there have been 165 Special Rate Variation (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 rate peg has increased rates by 31.8% over the last ten 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 rates 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. Council's 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 significant 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.

Is there a better approach?

Yes. Limiting the maximum rate increase to application of a cost index to historical costs/rates revenue does not take into consideration provision of additional or improved services to the community. In essence it undermines the ability of the locally elected Council and the community they represent, to determine the facilities and service levels to be provided. Furthermore, it restricts the capacity of local government to contribute to local solutions in genuine partnership with the State.

Ideally the removal of rate capping in its entirety would allow the elected council the freedom to determine their own rate change (increase or decrease) and be held accountable by their own local residents.

The second best approach may be that the rate cap be tied to a fixed amount above a simple index that can be easily referenced such as the cpi or a modified cost index +/- 3% and:

- Would allow councils some flexibility to determine their service offerings and levels based on current local need and priorities
- Would be more efficient to administer, while continuing accountability and transparency through the annual operational plan and revenue strategy setting process already in place.
- Would put some level of decision-making power back with the communities who make decisions to vote in the local council every four years.

2) What is the best way to measure changes in councils' costs and inflation, and how can this be done in a timely way?

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 three fundamental flaws:

a) The lack of appropriate inputs in calculating the rate peg.

b) Volatility in the rate peg.

c) the geographical variation in costs between metropolitan, regional, rural and remote councils which suggests that different cost indexes should be used on the basis the mix and weighting of the basket of items in the index.

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 three-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 three-year average.

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

The rate peg calculation could benefit from using more forward-looking indexes and forecasts such as those available through Reserve Bank of Australia (RBA) forecasts.

The following relevant information should be considering when checking and testing any proposed NSW LG rate peg, and the industry should be canvassed for a complete list that is specific to the industry:

- LG Award.
- Insurance costs – e.g. property, motor vehicle, public liability, workers compensation.

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- Total gross assets x required maintenance factor from the NSW LG consolidated Infrastructure note from the audited financial statements.
- Any relevant taxation changes – e.g. the increase in compulsory superannuation.
- Building and Construction Index NSW.
- Road and Bridge Construction Index NSW.

It must be accepted that there is no 'one-size fits all' for NSW LG, 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?

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 metropolitan and regional council areas 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.

SVC is a minimal growth Council, and the cost of population growth has been built into our long-term forecasts. We have planned to reinvest increased revenue from growth into service expansion to provide for the expanding population and new areas of development. The adopted financial strategy also considered the expansion of Council's asset base to provide additional community infrastructure to cope with the service demands of the growing population.

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There have now been two rate pegs announced with a population factor, and SVC received nil additional income in both years. We have annual population growth of 0.4% and our council's required asset maintenance and renewal costs are increasing exponentially on a growing asset base.

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?

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.

The LGCI should be reworked into a performance measure used annually by 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 LG 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.

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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.

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, year on year changes to the LG Code of Accounting Practice, Changes in accounting standards, changes in legislation, etc).

By using an audited LG 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.

7) Has the rate peg protected ratepayers from unnecessary rate increases?

No. 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.

In the last ten 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.

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In addition to this, the last three 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 three years) reported an infrastructure renewal ratio of less than 100%.
- 74 Councils reported an infrastructure renewal ratio of less than 100% over a three-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 ten years and the deterioration of councils' asset sustainability indicators over the least three 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 ten 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 five years.

As outlined in Q7 the rate peg 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 ten years while land has increased at a rate of 10% per year. As a result of this, Councils have limited opportunity 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 the rate peg are 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.

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

No. SVC has been granted an SRV of 35.95% over two years in order to be financially sustainable.

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

The current rate peg has no flexibility for councils where costs increase beyond the two-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.

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

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

Different rate pegs should be calculated for councils falling in the four main categories in NSW local government (metropolitan, regional, rural and remote) based on regional variations in the LGCI. This will more accurately reflect the different operating environments facing these categories of councils.

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

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, Metropolitan) 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.

A rate peg range provided to each category of local government would be appropriate so that decision-makers are able to utilise their local knowledge of circumstances faced by their communities to set appropriate rate increases.

Instead of comparing Councils and attempting to identify a common level of cost increase across NSW, the LG performance measure should 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?

A better approach to addressing the volatility issues would be to use a rolling three-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 three-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 ten-year long-term average (i.e. the rate peg should be the higher of, the calculated rate peg under the revised methodology and the ten-year long-term average).

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

Yes. Councils may prepare their financial plans on 'known' rate peg movements (subject to decisions on setting an asset and service rate peg), and model scenarios with changes to asset standards, public benefit services, and levels of service that may be subject to respective SRVs or pricing paths for private benefit services.

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

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.

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 ten-year long-term average (i.e. the rate peg should be the higher of, the calculated rate peg under the revised methodology and the ten-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.

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 IP&R 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.

16) How should we account for the change in efficient labour costs?

Draw on data available to the sector, including:

- Labour costs reflect known award and super movements.
- Movement in employment insurance costs moderated by advice from local government insurance pools and mutuals.
- Skills disadvantage by council cohort (e.g. access to skills, distance from metropolitan, market premiums applicable to short term staff or consultants).

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

By survey, council cohorts may elicit the nett cost (through underfunding) of public and private programs devolved by Government, with the change in that annualised cost becoming a feature of the three-year rolling average.

Similarly, the nett cost of underfunded projects prompted by grant stimulus or natural disaster grants, may feature as an element in the methodology. In this case 'grant stimulus' means projects and programs that were not proposed within council asset or service plans, or forecast in the financial plans, but were introduced through agency or local member initiative.

Net costs of maintenance and renewal of assets that are the subject of transfer of ownership to Government (e.g. regional roads and emergency service facilities).

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

Refer to response in question 17.

19) What types of costs which are outside Councils' control should be included in the rate peg methodology?

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. In many circumstances, Government mandates the fees below cost or without regulatory impact assessments, and with little scope for indexation.

Those net costs, or annualised change in net costs, should feature in rate peg calculations.

While both 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.

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?

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 published by IPART may delineate the rate peg performance against those principles (capacity to pay, intergenerational equity etc).

Thank you for the opportunity to provide a submission into the IPART Review of the Rate Peg Methodology.

Yours sincerely

[redacted]

Ken Gouldthorp
GENERAL MANAGER

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