THE HILLS
Sydney's Garden Shire

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Independent Pricing and Regulatory Tribunal
PO Box K35
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SUBMISSION BY THSC - REVIEW OF RATE PEG METHODOLOGY

Dear Sir / Madam,

Thank you for the opportunity to provide feedback to IPART to assist in its review of the rate peg methodology as it is applied to local government in NSW. This submission is made by Council Officers and due to the limited timeframe provided, does not allow for the presentation of a report to Council for it to consider the submission before the deadline. IPART should be more mindful of these constraints in future when requesting Council input.

Council welcomes the review and understands that the terms of reference do not include a review of the effectiveness of rate pegging overall as a policy. Rate pegging has been in place in NSW since 1977 and its effects overall on the capacity and sustainability upon Councils are worthy of deeper consideration. It has had the effect of keeping rates affordable as it appears that the average rates in NSW are significantly lower than comparable average rates in other states and territories. Earlier in February 2022, the Herald Sun published an article that showed average rates for Victorian Councils (rate pegging only recently introduced) ranged from $1,244 per annum to $2,446 per annum. The average rate for The Hills Shire is $1,100. Given that rates make up about 50% of total revenue, a further $144 to $1,386 across our 70,000 rateable residential properties is a significant difference.

The downward pressure on rates has forced Councils into several measures that may not be in the best interests of their community, particularly vulnerable people. It has limited the range of services that may be provided by Councils, provided greater focus on user charges, incentivised the use of fines, resulted in increased user charges for assets such as paid parking, resulted in many Special Variation (SV) applications by Councils to make ends meet and potentially been a barrier for councils to invest. There are also significant infrastructure backlogs and while not all directly attributed to rate pegging as councils in other states where rates are not pegged have backlogs, it would appear from publicly available research that NSW Council infrastructure backlogs are bigger. The rate pegging is making it harder for Councils to meet the challenges of the future, particularly around increased governance, cyber security, and the impact of climate change.

The rate peg outcome for the current financial year and even the next financial year shows that the methodology is flawed. It is clear that all Councils will face cost increases well in excess of the rate peg, resulting in difficult decisions for Councils in the coming years. The rate peg is based on outdated data that in many cases does not reflect actual known cost increases. The methodology is rearward-facing and incapable of adapting to rapidly changing conditions as there is no reality check as to the conditions that will apply in the future where the peg applies. It also is based on weightings that ultimately produce a "one size fits all" answer, yet Councils across the State are characterised by great diversity in both their operations and the communities they serve.

It is accepted that there is a monopoly power for local government and rate pegging is a means to keep that in check however increasingly, community expectations are rising. Councils are asked to increase levels of service to meet modern standards, respond to increasing natural emergencies, deal with the deteriorating useful life of assets, manage population growth and withstand rising costs in many areas of the council operations well above inflation; power, gas, raw materials, labour to name a few.

It is understandable that residents wish to pay the lowest Council rates as possible. However, after the application of 45 years of rate pegging and the productivity gains that have been produced, Councils should be able to expect a modern methodology to keep pace with rising costs, maintain strategic capacity and be sustainable to provide for their communities. The Local Government Cost Index (LGCI) has shown itself to be an unreliable index for NSW Councils. The following is a summary of well-documented problems with the current methodology:

- The basket of goods is too narrow.
- It is too long between intervals to recalibrate the weightings of items.
- The index does not include indexes of known factors (award pay rises, audit costs, compliance costs).
- There is a significant delay between the announced rate and the year in which it applies without any consideration of forward inflationary projections.
- Councils are unable to deal with real-time global shocks.
- Takes a one-sized approach to Councils across the state which is ignorant of different costs in different regions, different compositions of councils and different asset bases to population.

There are several factors that the LGCI should include. There is actual wage data available for local councils. The costs of financial audits are known. The annual remuneration of Councillors is known. The costs of the basket of goods should be expanded and updated annually and an assessment should be made about the differences between councils based on their asset base, population, and proximity to markets. There needs to be room for judgement of forward estimates that are available to make sure the rate peg is fair to both residents and Councils.

In relation to your specific questions, the following is provided.

1. To what extent does the Local Government Cost Index (LGCI) reflect changes in Councils' costs and inflation?

It does not reflect changes.

The LGCI is only reflective of costs and inflation for Councils that have cost weightings that are closely in line with the overall average basket of goods, and during times when inflation remains stable over a few years. This means for many councils, the LGCI is simply reflecting someone else's cost movements resulting in an outcome that bears little resemblance to the actual operating cost conditions for the individual Councils in the year that it would apply.

In the current inflationary environment, there is a significant gap between the LGCI and inflation for all Councils. Even for employment costs, being the biggest component of costs for Councils, the LGCI fails to reflect the actual Local Government Award increases, let alone the current labour shortage. Why is the index based on anything other than known Local Government State Award increases?

As the LGCI is based on historic data and lag indicators, future Local Government financial sustainability is questionable. 70% of Councils have needed to apply for SV mainly to balance the books. Only 9 metropolitan councils have not applied for a SV in the last 10 years. They are The Hills Shire Council, Bayside, City of Canada Bay, Cumberland, Inner West, Northern Beaches, City of Parramatta, Strathfield, and City of Sydney. This shows there is a fundamental flaw in the LGCI formula.

As set out in the TCorp report, “A local government will be financially sustainable over the long term when it is able to generate sufficient funds to provide the levels of service and infrastructure agreed with its community”. Rate Pegging does not support this fundamental principle.

Although SV can be applied to fund a particular need and its recurrent costs, Councils should not have to undergo this tedious and resource-intensive task to raise sufficient funds to manage day-to-day operations.

Is there a better approach?

An index is useful, but it must be nuanced to include a greater range of items local government buys and must consider that weightings will be different for Councils based on their population, average age of the population, asset base, population change and geographical location. It must be based on known inputs for the years the peg is to apply. It must have a method of “ground truthing” by looking at future forecasts for a reality check. The methodology for the FY22/23 rate peg produced a result excluding a population of 0.7% as it was based on a very low inflationary period in FY20/21. Even when the peg was announced there were forecasts of inflation rising from 0.9% to 5 maybe 6%. By the time the year started, it was already over 7%. What makes it even more ridiculous is the rate peg of FY23/24 is still only 3.7%.

In business, a fundamental rule in setting prices is to look at costs so that a fee can be set to recover costs, and in the private sector to earn a profit. In NSW Local Government it’s back to front, where the income is capped, and expenditure must fall in line. This is contrary to the Integrated Planning and Reporting (IP&R) process where Councils have to take community priorities into consideration when preparing the Delivery Program and the required funding to deliver. Furthermore, one size cannot fit all as it is based on the ‘average’ Council and does not take into account the different challenges and relative needs of metropolitan, regional, and rural Councils.

Yes, there are better approaches.

One approach is to allow Councils to apply their own weightings based on their forecast expenditure as per their Long-Term Financial Plan (LTFP) and apply IPART published forward-looking indexes to arrive at their Cost Index (CI). This will ensure that the cost index is Council-specific rather than an NSW average. This is more relevant to address the community priorities identified in Councils’ Delivery Programs as reflected in their LTFP. Perhaps IPART can set an upper limit of 5% and anything above this will require IPART approval. This method only changes the cost weightings in the formula to be more relevant to the individual Council’s Delivery Program. The responsibility of providing the forward-looking indexes and the overall rate peg formula still rests with IPART.

Additionally, it is recommended that a simple mechanism be introduced for Councils to incorporate an adjustment % to the Rates Peg for known and well-supported Council-specific factors detailed in the exhibited IP&R documents.

Furthermore, where any external factors that have an impact across the industry should be reflected in an adjustment factor (e.g. compliance with new legislation, climate change, and others as noted in Q6).

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

Changes in a Council's cost weightings are best measured by looking at its Forward Estimates and LTFP. Weightings can be over the 10-year projections or over four years in line with the delivery program. Allowing Councils to base their cost weightings on LTFP will ensure that anticipated changes in delivery requirements are reflected timely as there is no need to collate historic data from all Councils.

Known costs increase (e.g. State Award) should be reflected timely in the formula as the information is released years in advance.

The use of forward-looking indexes should improve the relevance and timeliness of inflation measures than rearward data.

Anticipated costs and factors that would impact local government need to be incorporated into the rate peg timely (e.g. legislative changes or new targets set by other levels of government, macro-economic trends). Monitoring of factors affecting Local Government should be performed regularly by IPART and form part of the rate peg process since rates income is the main source of revenue for the industry.

Introducing a simple mechanism for Council to incorporate an adjustment percentage to the Rates Peg for known and well-supported Council-specific factors detailed in the exhibited IP&R documents would also assist in this regard.

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

There is a range of actuals and forward-looking data to be used: 1) Actual wages increases - LG Award; 2) Forecast CPI (RBA); 3) Forecast PPIs (Trading Economics); 4) State and Federal Government budget papers; 5) Forecast by consultants such as Access Economics; 6) Actual costs increases such as audits fees, audit committee fees etc; 7) Documents relating on new legislative or target requirements.

Different indexes may need to be applied between regional, rural, remote, and metropolitan Councils.

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?

It is too early to comment. Even though a population factor was given, it was reduced to zero for most Councils who applied for the SV up to 2.5% so it would appear there are some concerns with this index. Increasing population is a cost factor, however, the methodology appears to be producing some perverse results across growth Councils. It is hard to imagine the population factor is working effectively.

What improvements could be made?

This is another indicator that is looking backwards for population growth. It needs to look at the future forecast population and not the past data.

In addition, as a big proportion of population growth is occurring in strata units, there is a need for the minimum/base rates paid by strata to be more in line with residential rates. The current NSW legislation (the Local Government Act 1993 and the Valuation of Land Act, 1916) cultivates an in-equitability in the rating of strata, in comparison to single dwelling properties as it is based on the unimproved land values (UV). It is considered that most strata owners pay much lower rates than people with a single dwelling or a singularly valued commercial property.

Councils mainly use base and minimum amounts to spread the rating burden resulting from disproportionate ad valorem rates calculated on the UV method, particularly those for strata. The ad valorem rate levied on the majority of strata is very low and although the occupants of the strata may use the same, or more Council services than the occupants of a single dwelling, their rates are usually much lower. Levying a higher base charge spreads the rate burden more evenly amongst the ratepayers.

As it is not clear how some Councils have a base and others have minimum rates, it may be appropriate to look at lifting the cap on Base (50%) to allow a more equitable spread of costs among residential and strata to allow a one-off increase in the notional income to realign these costs.

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

It is impractical to measure improvements in productivity across Councils. Different Councils provide different services. E.g. one may have childcare and the other may not. Each council also has its own demographic and community expectations. Hence it may be difficult to compare productivity and efficiencies. Cost per capita may be used but it can be deceiving. For example, the community may demand a higher level of service and supporting special rates resulting in a higher cost per capita. This does not mean that the council is inefficient but simply increasing costs to meet agreed community expectations.

Even for standard services, such as development applications, it is not easy to compare productivity and efficiency across Councils due to the varying complexity and nature of applications faced by different types of Councils. E.g. Growth Councils vs maintenance Councils, or Remote vs Rural vs Regional vs Metropolitan Councils.

Process improvements and efficiency gains should be encouraged. However, this usually requires upfront investments into systems and processes. The current rate peg does not allow room for innovation unless Council finds an alternative source of funding for this.

As noted in Question 1, it is recommended that councils be allowed to apply an adjustment % to the rates peg to meet its own specific needs, including improving productivity and efficiencies, to achieve long-term sustainability.

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

Other external factors the rate peg should make adjustments for include:

- New and amended legislation changes impacting on the existing level of services.
- Global Economic Forecasts.
- Supply Chain and labour shortages.
- Changes in costs that could have industry-wide impact (e.g. electricity, material, Cyber security (IT), construction etc.).
- Impact of natural disasters and severe weather events, including impact on assets as depreciation/deterioration accelerates.
- Resilience – both to help the community to be resilient and for Council itself to be resilient

How should this be done?

1. For industry-wide factors, it is recommended that IPART include an adjustment factor in the LGCI.
2. As per point 1, it is recommended that Councils be given the freedom to add a percentage (within an upper limit) to the rate peg without the need to apply for SV to address other Council-specific needs.

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

No, it has not.

Many councils have applied for SV, some by big percentages. Also, the downward pressure on rates has forced Councils into several measures that may not be in the best interests of their community, particularly vulnerable people. It has limited the range of services that may be provided by Councils, provided greater focus on user charges, incentivised the use of fines, resulted in increased user charges for assets such as paid parking, resulted in many SV applications by Councils to make ends meet and potentially been a barrier for Councils to invest. There are also significant infrastructure backlogs and while not all directly attributed to rate pegging as Councils in other states where rates are not pegged have backlogs, it would appear from publicly available research that NSW Council infrastructure backlogs are bigger. The rate pegging is making it harder for Councils to meet the challenges of the future, particularly around increased governance, cyber security, and the impact of climate change.

However, having a rate peg removes the responsibility of initiating and determining a rate increase by individual Councils. It is important to have an appropriate methodology to calculate the rate peg. If the decision is left for individual Councils to determine the rate increase and the Council is reluctant to increase its rates to keep up with cost increases and inflation in a timely manner, it can create a generational inequity issue. This means that future generations will have to pay much higher rates to make up for the lost income and the compounding impact arising from any delays in addressing the shortfall.

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

No, it has not.

Depending on each Council's financial objectives, it will either cut costs to balance budgets or apply for a SV. The Hills Shire has implemented a disciplined approach and managed a property portfolio to increase revenue outside of rate revenue. Although a growth Council such as The Hills has sufficient funds now, LTFP projections are indicating funding shortfalls in the next 7 to 8 years when maintenance is required on new infrastructure that is currently being developed. Rate peg in the long-term is hindering the financial sustainability of Councils.

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

It would appear overall the rate cap has had a negative impact over time on levels of service and the financial sustainability of Councils. Debt levels, cash reserves, infrastructure backlogs and the need for SVs indicates that the rate peg has been a negative impact on the sector.

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

As mentioned in Question 1 and 2, the use of each Council's Forward Estimates and IP&R documents in the calculation of expenditure weightings would be a good starting point. Allowing Councils to adjust for council-specific needs as documented in their IP&R (see Question 1) would also enable the rate peg methodology to better reflect the differences between Councils.

Different indexes may also need to be considered for different types of Councils with varying proximity to markets.

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

It will allow taking individual Council needs into account.

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

Possibly. Whilst we prefer the rate peg to better reflect changes in Council costs, it is important to 'smooth out' excessive changes in rates (increases and decreases) over time.

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

Councils would prefer better alignment with their own Council's changes in Costs.

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

No. The economic and operating environment changes rapidly. Setting a longer-term rate will expose Councils to greater financial risk as changes to cost and operating factors will not be reflected in the rate peg until a few years later.

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

Yes. It is recommended that preliminary guidance on indexes be given by January, and final after the March quarter data are available.

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

Productivity factors cannot be accurately measured in a sector as diverse as local government. For example, quite often change in efficient labour costs are absorbed by other cost-increasing factors such as compliance with new legislations, labour shortages driving up costs to attract talent and other factors. Hence it is recommended that efficient labour costs should not be accounted for in the Rate Peg calculation. It is more important to ensure that the Rate Peg adopts the Local Government State Award to reflect the true employment costs.

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

Yes, refer to Question 6. External costs that apply to all Councils should be included.

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

Refer Question 1 and 2.

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

There are several costs that councils cannot control completely that have a huge impact on Council's budget position. Our exposure to street lighting costs is significant yet there is very little competition and prices are rising dramatically -et the LGCI has electricity costs as a negative. Our exposure to floods and fires is also something out of Council's control and these events have added costs through unplanned additional workload, damage to assets that require repair well before the end of useful life, community support and other costs are very difficult to predict in normal budget planning under the current rate peg methodology. While there are capital grants, the cost of managing the grants is often borne by the rate base and not recoverable through the grant funds.

Further, there are several costs arising out of Government Policy. For example, in parts of our The Hills Shire, the government's policy on rezoning areas like North Kellyville has a different response to water quality management. The policy resulted in streets containing vegetated urban swales along the street verges and medians. These swales are in lieu of more traditional streetscapes, and their maintenance and renewal regimes are significantly more costly than traditional methods. The stormwater levy that has not been indexed since its inception almost two decades ago would be a solution.

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

It is recommended that IPART publish the relevant forward-looking indexes guidance in January (final by April) for each Council to calculate its own costing weightings (based on their 4 years forward estimates) in order to calculate their own overall index for the rate peg.

There should also be a simple mechanism for Council to add a percentage (up to an IPART determined upper limit) to address any Council-specific needs (such as innovation, process improvement, and weather event impact on assets). Industry and worldwide factors (such as legislative changes and requirements, cyber security, etc) should be factored in by IPART within the adjustment factor.

Rate Peg = (Individual Council Cost weightings x IPART published forward-looking indexes) + individual council specific adj (within upper limit) + population growth factor + industry wide factors