Indexation of contribution rates

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1 Introduction

IPART is seeking stakeholder views on how councils should index contribution rates between the adoption of a local infrastructure contribution plan, and the revision of the contributions plan. In particular, we are seeking feedback on different approaches to indexing contribution rates to account for changing land costs.

Questions for stakeholders

1. In what circumstances should contributions plans adopt an index other than the CPI (All Groups) for Sydney to adjust contribution rates? Is there a need for different approaches in different contexts (eg, greenfield vs infill or metro vs non-metro)?
2. What indexes, other than CPI, might be appropriate for adjusting:
   - Contributions for the cost of works (ie, construction of transport and stormwater management infrastructure and open space embellishment)?
   - Contributions for the cost of land required for local infrastructure?
3. If a plan adopts a land value index (LVI):
   - Is it reasonable for councils to construct the LVI using independent land valuations?
   - Should the LVI be specific to the composition of land in the plan's catchment area (precinct specific), the local government area (LGA) or a broader region (eg, Greater Sydney house prices)?

For information on how to contact IPART's Local Infrastructure Contributions Team or make a submission on this paper, see page 8 of this paper.

Why is IPART considering this issue?

IPART assesses local infrastructure contributions plans that propose contributions above $30,000 per lot or dwelling in identified greenfield areas and $20,000 per lot or dwelling in other areas. We must assess whether the contributions plan meets the criteria set out in the Department of Planning and Environment's *Local Infrastructure Contributions Practice Note* (Practice Note).[1]

One criterion is whether "the proposed development contribution is based on a reasonable estimate of the cost of the proposed public amenities and public services." As part of our assessment of reasonable costs, we consider whether the council's proposed method of indexing contribution rates is reasonable.

IPART has been approached by a number of stakeholders seeking clarity about what indexes are reasonable, noting that contributions plans assessed to date have used different approaches.

We are seeking stakeholder input to help understand why councils have chosen different approaches and whether the differences are reasonable. We expect this will enhance the

1 Department of Planning and Environment, *Local Infrastructure Contributions Practice Note*, January 2019.

efficiency and consistency of our decision making, and enable us to provide guidance to councils that are preparing contributions plans.

What is indexation?

Indexation is a method of adjusting contribution rates to account for changes in the cost of land or infrastructure over time. It helps to ensure that contributions remain cost-reflective which means that:

- they signal the costs of developing different areas – which, in turn, can assist in ensuring that development occurs where it should (ie, where the benefits of the development are greater than its costs), and
- other parties (such as a council's ratepayers) do not have to fund any shortfall between the actual costs of providing local infrastructure and the revenue received from development contributions.

Escalating developer contribution rates by a representative index allows them to change broadly in-line with changes to the cost of land and works the council is providing, without the need for the council to amend the contributions plan every year.

Clause 32(3)(b) of the *Environmental Planning and Assessment Regulation 2000* (EP&A Regulation) permits changes to contribution rates, without the need to prepare a new contributions plan, to reflect quarterly or annual variations to:

- *readily accessible index figures adopted by the plan (such as a Consumer Price Index), or*
- *index figures prepared by or on behalf of a council from time to time that are specifically adopted by the plan.*

A contributions plan will specify a base contribution rate for each infrastructure category (and possibly separate rates for land and works). In accordance with the Regulation, the plan must specify the index that will be used to adjust the base contribution rate, and how frequently the adjustment will occur. Most plans include a formula for the adjustment.

Most councils in NSW prepare contributions plans in current dollar terms, which do not account for the time value of money, and then index values going forward. This method may not adequately account for the opportunity cost which arises due to the mismatch between the timing of infrastructure expenditure and receipt of contributions. To overcome this, councils would need to use a net present value (NPV) approach to calculate their contribution rates.[2]

This information paper is concerned with the indexation provisions in plans where councils have *not* used an NPV approach to calculate contribution rates.

What is the base contribution rate?

To derive the contribution rates in the base year of the plan (**base contribution rates**) for each infrastructure category in a plan, councils:

- estimate the total cost of land acquisition and works required as a result of development in the plan's catchment area, in current dollar terms, then

2 For guidance on this approach see IPART, *Modelling local development contributions in a present value framework, August 2018*

- divide this amount by the size of the catchment area, usually expressed in hectares (ha) of net developable area (NDA) or net increase in population.

Box 1.1 shows a general formula for calculating base contribution rates.

Box 1.1 Contribution rate formula for councils not using an NPV approach

$$DC_0 = \frac{C}{N}$$

Where:

- DC_0 is the base contribution rate (usually expressed in \$ per ha of NDA or \$ per person)
- C is the estimated cost of infrastructure apportioned to the development area
- N is size of the catchment (usually ha of NDA or net increase in population)

Note: the net increase in population is the total anticipated population in the area less any existing residents.

How are contribution rates indexed?

In the years between plan reviews, the base contribution rate is indexed using either one rate for both land and works or separate indexes for each sub-component. Box 1.2 below outlines the different methods.

Box 1.2 Indexation of contribution rates

Method 1 – index contributions by CPI

$$DC_1 = \frac{DC_0 \times CPI_1}{CPI_0}$$

Where:

- DC_1 is the contribution rate in the next period
- DC_0 is the base contribution rate
- CPI_1 is the value of the consumer price index in the next period
- CPI_0 is the value of the consumer price index in the base period

Method 2 – index contributions separately for land and works

$$DC_1 = DC_{works} + DC_{land}$$

$$DC_{works} = \frac{DC_0 \times WVI_1}{WVI_0} \qquad DC_{land} = \frac{DC_0 \times LVI_1}{LVI_0}$$

Where:

- DC_1 and DC_0 are as defined in method 1
- DC_{works} and DC_{land} are the contributions for works and land respectively.
- WVI is the value of a works value index
- LVI is the value of a land value index

What if the council has already incurred costs?

Clause 32(3)(b) of the EP&A Regulation allows changes to **contribution rates** to reflect movements in the CPI or other indexes if adopted by the plan.

Clause 25I of the EP&A Regulation applies when the council is **preparing a new contributions plan** (including formally amending an existing plan). It requires the council to index costs already incurred by the CPI (All Groups) for Sydney.[3] This means that when calculating the base contribution rate, the cost of land that the council already owns and has acquired for public infrastructure may not exceed the acquisition cost, indexed by the CPI (All Groups) for Sydney. Similarly, the cost of works completed may not exceed the actual costs indexed by the CPI (All Groups) for Sydney.

What are our preliminary views?

In addition to being compliant with relevant clauses in the EP&A Regulation, in our view, the indexation method chosen by council should be:

- suited to the context of the specific plan, which requires consideration of:
  - the composition of land and works in the plan
  - the type and location of development to which the plan applies (eg, greenfield vs infill and metro vs non-metro)
  - the stage of development within the plan's catchment
  - the stage of delivery of infrastructure in the plan
- balanced between the need to be cost reflective, transparent and easy to administer.

We acknowledge the balance or potential trade-off between the cost-reflectivity and transparency / ease of administration may need to be considered within the context of each plan. We also acknowledge that there are a range of potential approaches to indexing costs. When submitting plans to us for assessment, councils should clearly indicate why they have chosen a particular approach.

We consider that in all contexts it is reasonable for councils to index contribution rates using the CPI (All Groups) for Sydney for the cost of land, works and administration.

This approach is consistent with the Act, Regulation and policy guidance from DPE.[4] It is also easy for all stakeholders to understand and for councils to apply. Councils do not incur any cost in preparing the index, and changes in the contribution rates are likely to be less volatile than if an alternative approach was used. However, the CPI may not track the change in prices for land and works in a contributions plan as closely as other indexes.

When councils do not use CPI (All Groups) for Sydney, our preliminary position is that it is reasonable to:

- Escalate the cost of works using a representative Producer Price Index (PPI) published by the ABS.

3 *Environmental Planning and Assessment Regulation 2000*, cl 25I.

4 In addition to requirements from the Act and Regulation, clause 26(1) of the EP&A Regulation requires contributions plans to be prepared having regard to relevant Practice Notes adopted by the Secretary of the Department of Planning and Environment.

- Escalate the cost of land using a broad (preferably on a local government area basis), non-precinct-specific land value index that is transparent and either readily available or replicable.

In our view, it would be unreasonable to depart from CPI indexation when most of the expenditure on the land and/or works in the plan has already occurred, or where there is an agreement for it to be provided by a specific developer.[5] It would be reasonable for a council to adopt different indexes for the cost of works and/or land already incurred and for the cost of works and/or land yet to be incurred. However, this makes the calculation of contributions payable at a particular time more complex.

Box 1.3 The importance of regular plan review

Councils should periodically review contributions plans to ensure they adequately reflect the latest planning assumptions (including population estimates) and best estimates of the cost of providing infrastructure. Regular review helps to ensure that councils do not recoup too much or too little from developers.

The Department of Planning and Environment's *Development Contributions Practice Notes July 2005* (2005 Practice Notes) suggest councils commit to reviewing plans at least every five years, or more regularly where an area is growing rapidly.

While the indexation of contribution rates is an important consideration for councils when preparing plans, indexation should not replace the need to regularly review the contributions plan.

2 Indexation of contributions for works costs

In most plans assessed by IPART to date, councils have chosen to index the cost of works by the ABS CPI (All Groups) for Sydney, which we consider reasonable. [6] Alternatives include:

- the ABS Producer Price Indexes (PPI), and
- construction cost indexes produced by private companies.

We consider the better of these alternatives is using an ABS PPI for each specific category of works. Table 2.1 shows our preferred indexes for roads and stormwater management works, open space embellishment and community facilities.[7]

We prefer ABS indexes over those produced by a private company because they are publicly available and widely used in government contracts.

5 A works-in-kind or Planning Agreement will typically 'lock-in' a price for the works/land the developer agrees to provide.

6 The Hills Shire Council calculate contribution rates using a Net Present Value approach.

7 Community facilities are not on the Essential Works List in the *Practice Note 2019*.

Producer Price Indexes for indexing contributions towards works costs

Works category	Producer Price Index (PPI)
Roads	ABS PPI Road and Bridge Construction Index for NSW
Stormwater	ABS PPI Road and Bridge Construction Index for NSW
Open Space	ABS PPI Non-Residential Building Construction Index for NSW
Community facilities	ABS PPI Building Construction Index for NSW

Source: ABS, Producer Price Indexes, Australia, Table 17: Output of the Construction industries, subdivision and class index numbers, ABS Cat. No. 6427.0

3 Indexation of contributions towards land costs

On average, land costs represented 40 per cent of the reasonable costs in the plans IPART assessed between October 2011 and September 2018.

Unlike the cost of works, which are procured in a relatively homogeneous market with minimal regional price variation (within major cities), the price of land and property can vary significantly between locations. In April 2018, IPART published an Information Paper on our assessment process for land costs.[8] It focuses on the estimates that inform the base contribution rate in a contributions plan, but it does not go into detail about how the land component of contribution rates should be indexed.

Most plans that we have assessed include provisions to index contributions for land using the same index that is adopted to adjust contributions for works (usually the ABS CPI (All Groups) for Sydney). However, in several plans we have recently assessed or are assessing, councils have proposed using a land or property value index to adjust the contribution rate for land.

We expect this is in response to rapid changes in the price of land in some areas of Greater Sydney over the past few years. In recent years, the ABS CPI (All Groups) for Sydney has not tracked the increases in councils' land acquisition costs.

Box 3.1 Are property value indexes representative of changing land values?

Most headline indexes of the Australian residential property market measure change in the value of new dwellings and/or established dwellings (including the value of both land and improvements).

However, in greenfield development areas, land designated for acquisition for a public purpose to be bought by council often has few improvements – meaning the physical value of land makes up a larger proportion or most of the total value at acquisition.

This raises the question of whether property value indexes are representative of changes in underlying land values. While the relative shares of unimproved land value and improvements (i.e. the actual house structure) is likely to change over time, we expect that property value indexes are reasonable proxies for the magnitude and direction of unimproved land values.

8 IPART, *Contributions plan assessment: land costs – Information Paper,* April 2018.

There are a range of different methods councils could employ to account for changing land values. Approaches may include indexing contribution rates by:

- the ABS Established House Price Index for Greater Sydney
- an index of land or dwelling values developed by a property data provider on a city wide, LGA or other geographic definition basis
- an index constructed from precinct-specific land value appraisals undertaken on behalf of council
- an index of unimproved land values published by the NSW Valuer General or constructed using NSW Valuer General data.

Our preliminary position is that if councils choose not to index the land component of contributions using the ABS CPI (All Groups) for Sydney, then the most suitable alternatives are to use:

- the ABS Established Home Price Index for Greater Sydney, or
- a readily accessible index of prices across a broad geographic basis produced and published by a third party property data provider (e.g. CoreLogic Home Value Index)

These indices are readily available and understood by stakeholders.

We consider they are preferable to indexes constructed from local (precinct-specific) land value appraisals undertaken on behalf of the council. Local land valuations are likely to be affected by the rezoning and servicing of land and through improvements undertaken by developers. This means that the indexes are likely to be volatile and create uncertainty for the development industry.

4 How can you provide feedback?

We invite all interested parties to make a submission in response to this Discussion Paper, addressing the questions listed on page 1. The deadline for submissions is Friday,

3 May 2019. We prefer to receive submissions electronically:

https://www.ipart.nsw.gov.au/Home/Contact-Us/Make-a-Submission

You can also send us an email: localgovernment@ipart.nsw.gov.au or call Sarah Blackwell, Director – Local Infrastructure Contributions, on (02) 9113 7763.