

Review of prices for land valuation services provided by the Valuer-General to councils

From 1 July 2014 to 30 June 2019

Other Industries — Draft Report
April 2014

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Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

Submissions are due by 28 April 2014.

We would prefer to receive them electronically via our online submission form <www.ipart.nsw.gov.au/Home/Consumer_Information/Lodge_a_submission>.

You can also send comments by fax to (02) 9290 2061, or by mail to:

Review of prices for land valuation services provided by the Valuer-General to councils

Independent Pricing and Regulatory Tribunal
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Late submissions may not be accepted at the discretion of the Tribunal. Our normal practice is to make submissions publicly available on our website <www.ipart.nsw.gov.au> as soon as possible after the closing date for submissions. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed on the previous page.

We may choose not to publish a submission—for example, if it contains confidential or commercially sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please indicate this clearly at the time of making the submission. IPART will then make every effort to protect that information, but it could be disclosed under the *Government Information (Public Access) Act 2009* (NSW) or the *Independent Pricing and Regulatory Tribunal Act 1992* (NSW), or where otherwise required by law.

If you would like further information on making a submission, IPART's submission policy is available on our website.

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1 Introduction and executive summary

The Independent Pricing and Regulatory Tribunal of NSW (IPART – hereafter referred to as "we," "us," or "our") is currently reviewing the prices the Valuer-General can charge for land valuation services provided to councils for rating purposes.¹

We do not have a standing reference to determine these prices. Rather, we conduct these price determinations when referred to us by the NSW Government under section 12 of the IPART Act.

The Premier wrote to IPART on 30 December 2013 to request a new price determination or determinations, so that determined maximum prices take effect from 1 July 2014. The Terms of Reference (ToR) for this review are included at Appendix A.

The current determination (2009 Determination) for the Valuer-General was released in July 2008.² It set maximum prices for the period 1 July 2009 to 30 June 2014. Before that, IPART made a determination in 1995, which prescribed maximum prices for the period from 1 July 1995.³

The purpose of this review is to determine the maximum prices the Valuer-General can charge councils for land valuation services for rating purposes over the 5 years from 1 July 2014 to 30 June 2019. This Draft Report explains our Draft Determination on these prices, including the rationale and analysis that underpin our draft decisions.

We are seeking submissions from stakeholders on the Draft Report and Draft Determination, which we will consider before making our Final Determination in May 2014. Details on how to make a submission are provided on page iii at the front of this report. The closing date for submissions is 28 April 2014.

¹ Under Part 5 of the *Valuation of Land Act 1916* (NSW) (Valuation of Land Act), the Valuer-General must provide valuation lists and supplementary lists to councils of areas under the *Local Government Act 1993* (NSW) (Local Government Act) for their rating purposes. These land valuation services to councils are declared as government monopoly services under section 4 of the *Independent Pricing and Regulatory Tribunal Act 1992* (NSW) (IPART Act).

² IPART, *Price review of rating valuation services provided by the Valuer-General to local government – Final Report and Final Determination*, July 2008.

³ Government Pricing Tribunal, *Valuer-General's Office Charges to Councils from 1 July 1995*.

1.1 Overview of the Draft Determination

We took all stakeholder submissions and comments made at the public hearing into consideration in making our draft decisions. We also took into account the Valuer-General's pricing submission, which we considered to be of high-quality – ie, sufficiently detailed and transparent for us to conduct our own research and analysis to determine draft prices.

Under our decisions in this Draft Report, the Valuer-General's maximum prices to councils for land valuation services decrease by 1.2% in 2014/15, compared to current prices, and remain constant in real terms thereafter (see Table 1.1). This excludes the effects of inflation.

We have decided to hold prices constant in real terms over the remainder of the determination period, as this results in a stable price path. We have smoothed prices to give no disadvantage to the Valuer-General or the users of these valuations, with the target revenue equal to the notional revenue requirement in NPV terms. In nominal terms, prices will change with inflation over the remainder of the determination period.

Table 1.1 IPART's draft decision on the Valuer-General's prices to councils (\$/per valuation, \$2013/14)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
IPART's draft decision						
Residential	5.37	5.30	5.30	5.30	5.30	5.30
Non-Residential	11.81	11.66	11.66	11.66	11.66	11.66
% change ^a		-1.2%	0%	0%	0%	0%

^a Based on pre-rounded results.

We note that our remit is to review prices charged for a specific portion of the services performed by the Valuer-General – ie, furnishing land valuations to councils for rating purposes. The Valuer-General's other land valuation functions are outside the scope of this review.

However, in setting prices we used the building block approach to calculate the Valuer-General's notional revenue requirement of providing land valuation services for both *rating and taxing* purposes for each year of the determination period. We then determined the portion of this revenue required by the Valuer-General to service councils (ie, land valuation services for rating purposes only).

The very small change in prices (and revenue) as compared to the 2.8% real increase in prices under the Valuer-General's proposal is due mainly to our draft decision to lower the allocation of costs to councils to 34% from the 40% proposed by the Valuer-General. This means that, despite the increase in the Valuer-General's costs, prices remain relatively constant.

In allocating costs to councils, we applied a bottom-up approach based on:

1. **usage share of mass valuations** - allocating *mass valuation contract costs* based on the number of valuations received by councils as a portion of the total number of valuations *issued* by the Valuer-General annually
2. **direct costs to councils** - allocating *other costs* on an activity basis or client specific basis, where possible
3. **frequency of valuations** - allocating *remaining costs* based on the number of valuations received by councils as a portion of valuations *conducted* by the Valuer-General.

We consider this to be a robust and transparent method of allocating costs to councils.

Over the 5-year determination period, the difference between the amount which the Valuer-General proposed to be recovered from councils and our draft decision is approximately \$15.4 million (see Table 1.2).

Approximately \$13.7 million of this difference is due to our draft decision to allocate 34% of costs to councils, rather than the Valuer-General's proposed 40%. This revenue should not be lost to the Valuer-General, but will need to be recovered from the Office of State Revenue (OSR), the Valuer-General's other customer. We note that changing the allocation between councils and OSR has budget implications for the NSW Government. This is because funding from OSR for the valuation services provided by the Valuer-General is based on a grant from Treasury.

The remaining amount, about \$1.7 million, is due to our draft decisions on operating costs, the Weighted Average Cost of Capital (WACC) and treatment of depreciation, tax and working capital.

Table 1.2 IPART's draft finding on the Valuer-General's notional revenue requirement for councils (\$'000, \$2013/14)

	2014/15	2015/16	2016/17	2017/18	2018/19
Valuer-General's proposal^a					
Operating Expenditure	17,265	17,265	17,265	17,265	17,265
Depreciation (regulatory)	796	882	961	1,043	1,130
Return on fixed assets	293	287	273	255	235
Return on working capital	-	-	-	-	-
Tax allowance	44	49	53	57	61
Notional Revenue Requirement	18,398	18,482	18,551	18,620	18,691
IPART's draft decisions					
Operating Expenditure	14,578	14,578	14,578	14,578	14,578
Depreciation (regulatory)	858	798	698	606	494
Return on fixed assets	163	150	138	132	131
Return on working capital	39	40	41	42	43
Tax allowance	25	24	21	18	16
Notional Revenue Requirement	15,663	15,590	15,477	15,376	15,262

^a Supplementary information supplied by the Valuer-General, 5 March 2014. These costs are a 40% allocation of the Valuer-General's total proposed costs shown in Table 4.1. With the exception of operating expenditure, they are consistent with Table 8-1 (p 62) of the Valuer-General's submission, adjusted from nominal to \$2013/14. The operating expenditure in that table is not consistent with a 40% allocation, and would result in only 39% of costs being recovered from councils.

Note: Totals may vary due to rounding.

We consider that our draft prices recover an appropriate level of revenue needed to support the Valuer-General's land valuation services to councils in an efficient and effective manner.

However, under section 12 of the IPART Act and our ToR, we have the ability to make a new determination or determinations at our discretion during the 5-year period. For instance, we could elect to make a new determination for maximum prices during this period in the event that the NSW Government reforms the valuation or land tax system in a way that significantly impacts on the Valuer-General's cost base.

1.2 List of draft decisions

Our draft decisions are:

- 1 To adopt a 5-year determination period from 1 July 2014 to 30 June 2019. 19
- 2 To set the Valuer-General's notional revenue requirement for land valuation services provided for rating and taxing purposes as shown in Table 4.1. 26
- 3 To set the efficient level of the Valuer-General's operating expenditure as shown in Table 4.2. 28

4	To accept the Valuer-General's actual capital expenditure over the period 2008/09 to 2012/13 and forecast capital expenditure for 2013/14 as shown in Table 4.4 as prudent and efficient.	37
	– This capital expenditure is to be used to establish the opening value of the RAB for the 2014 determination period.	37
5	To accept the Valuer-General's forecast capital expenditure over the period 2014/15 to 2018/19 as shown in Table 4.3 as prudent and efficient.	37
	– This capital expenditure is to be included in the roll forward of the RAB for the 2014 determination period.	37
6	To adopt a real post-tax WACC of 4.8% for the purposes of calculating the allowance for a return on assets.	41
7	To set an allowance for a return on assets as shown in Table 4.1.	41
8	To calculate regulatory depreciation using a straight line depreciation method for each asset class, applying the asset lives set out in Table 4.6.	42
9	To set an allowance for a regulatory depreciation as shown in Table 4.1.	42
10	To continue to not allocate fixed costs to minor users of the Valuer-General's land valuations services.	45
11	To allocate 34% of the Valuer-General's notional revenue requirement (as set out in Table 4.1) to councils.	47
12	To set the Valuer-General's maximum prices for land valuation services to councils as shown in Table 6.1.	54
13	To adopt an NPV neutral approach to setting prices that recover the target revenue shown in Table 6.2.	56
14	To use the forecast number of valuations shown in Table 6.3 as the basis for setting prices.	56
15	To retain the current price relativities between residential and non-residential properties.	57
16	To not use an indexation approach for this determination to set the Valuer-General's maximum prices to councils.	59

2 Context for this review

This chapter provides background and context to the review, including our review process, the matters we have considered, the Valuer-General's services and regulatory environment, and the Valuer-General's submission to the review.

In providing context for the review, we note that our remit is to review prices charged for a specific portion of the services performed by the Valuer-General – ie, furnishing land valuations to councils for rating purposes. The Valuer-General's other land valuation functions are not government monopoly services and therefore outside the scope of this review.

This review also does not address issues with the land valuation system itself, including the integrity of valuations. However, the methodology used to determine land values is outlined as background, as it influences the costs of undertaking land valuations

2.1 What has IPART been asked to do?

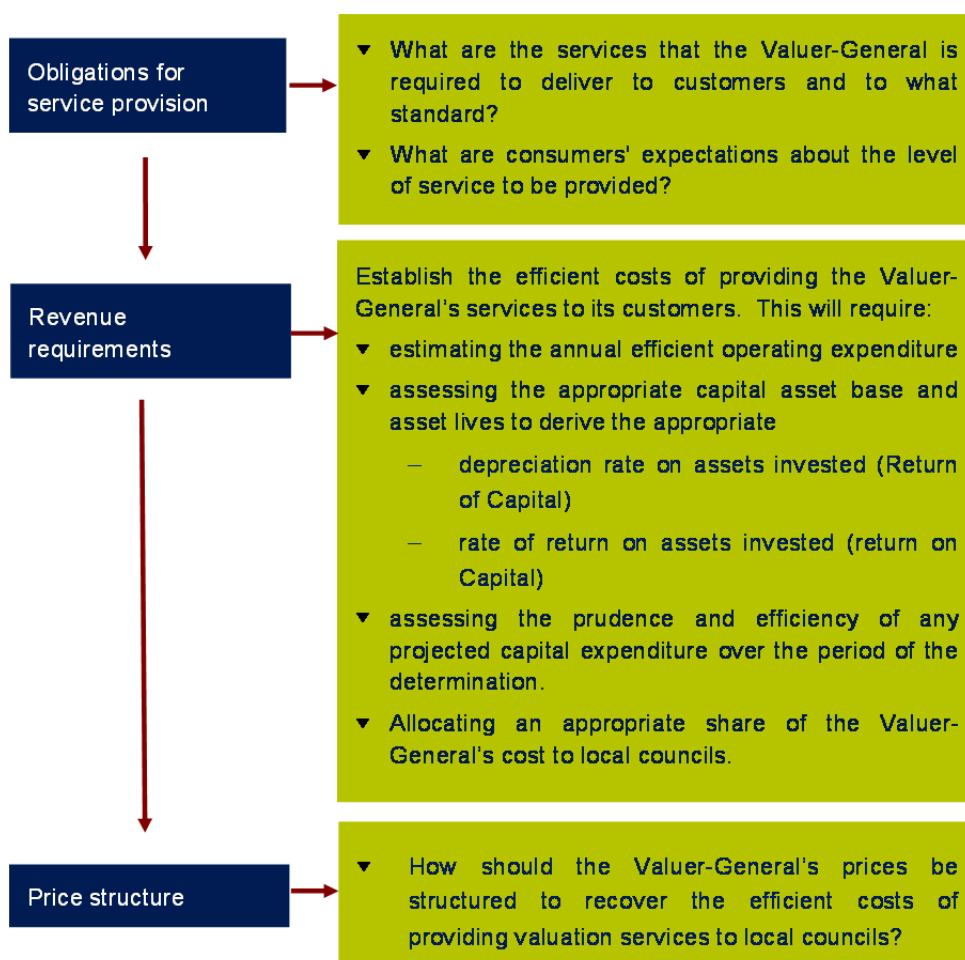
In accordance with our ToR, our proposed approach to the review involves:

- ▼ identifying the services provided by the Valuer-General to its customers (ie, the obligations for service and expected level of service provided)
- ▼ establishing the efficient costs of providing those services (ie, determining the revenue requirements), including consideration of the scope for efficiency savings
- ▼ allocating costs (revenue requirements) to the various user groups (in particular, councils)
- ▼ setting maximum prices for the valuation services provided to councils – by either determining a price path for the charges or a methodology for determining those charges in future years.

In making this determination, we are also to have regard to a range of matters under section 15 of the IPART Act (see Appendix B). This includes the protection of consumers from abuses of monopoly power, the standard of services, and the social impact of the determination.

In considering these matters, we aim to balance the diverse needs and interests of stakeholders, while also ensuring that the Valuer-General is adequately recompensed for the services he provides. Our general approach to determining monopoly prices for the Valuer-General is set out in Figure 2.1.

Figure 2.1 IPART's approach to the review



2.2 IPART's review process

As part of our review, we have undertaken an extensive investigation and public consultation process. We have:

- released an Issues Paper in January 2014 to assist in identifying and understanding the key issues for the review

- ▼ invited the Valuer-General to make a submission to the review detailing his pricing proposals, and requiring him to provide financial data on the future capital and operating expenditure necessary to maintain service levels and respond to regulatory demands⁴
- ▼ invited other interested parties to make submissions on the Issues Paper and the Valuer-General's submission⁵
- ▼ held a public hearing on 25 February 2014 to discuss key issues raised by the Valuer-General and other stakeholders
- ▼ released this Draft Report and Draft Determination.

We invite stakeholders to make submissions by 28 April 2014 to this Draft Determination and Draft Report. We will consider all matters raised in submissions, and then make our Final Determination in May 2014. The new charges are expected to apply from 1 July 2014.

IPART's Issues Paper, stakeholder submissions, and the transcript from the public hearing are available on IPART's website (www.ipart.nsw.gov.au).

2.3 Valuer-General's role and services

2.3.1 What is the role of the Valuer-General?

The Valuer-General is an independent statutory officer appointed by the Governor of New South Wales to oversee the valuation system.⁶ The Valuer-General sets the standards for the provision of a valuation system to meet the needs of various users, which include landowners, members of the public, ratepayers, land tax clients and state and local government. The Office of the Valuer-General is a small team of about 6 people.

The general role of the Valuer-General is to:⁷

- ▼ exercise functions with respect to the valuation of land in the State
- ▼ ensure the integrity of valuations
- ▼ keep a Register of Land Values, which must contain information on ownership, occupation, title, location, description, area, and value of the land.⁸

⁴ The Valuer-General's submission was received on 7 February 2014.

⁵ A total of 20 written submissions were received from other interested parties.

⁶ s 8, Valuation of Land Act.

⁷ s 8, Valuation of Land Act.

⁸ s 14CC, Valuation of Land Act.

The Valuer-General delegates operational responsibilities, under the Valuation of Land Act, to Land and Property Information (LPI), within the Department of Finance and Services (DFS).⁹ Accordingly, our determination of the Valuer-General's prices for land valuation services involves a review of LPI's efficient cost of service to the Valuer-General.

What is the role of Land and Property Information?

As noted above, LPI is a division of DFS. LPI manages land and property information services across government, including land titling, surveying, mapping and spatial information and land valuation. LPI is a non-budget dependent agency and operates under a similar framework to a government business enterprise.¹⁰

Each year, the Valuer-General enters into a service level agreement with LPI, which defines the services that LPI is required to deliver.¹¹ The service level agreement defines the separation of responsibilities and accountabilities between the Valuer-General and LPI and establishes clear performance goals within the valuation system. The majority of services under the service level agreement are provided by the Valuation Services business unit of LPI (VSLPI), with support from a range of other LPI business units.¹² VSLPI has about 125 Full-Time Equivalent staff (FTE) responsible for delivering land valuations.¹³

VSLPI manages the valuation system on behalf of the Valuer-General. This includes managing valuation contracts (that is, LPI engages external contractors to conduct mass valuations, though a competitive tender process) and maintaining a database of valuations (the Register of Land Values).

2.3.2 Governance of the valuation system

The statutory functions of the Valuer-General are set out in the Valuation of Land Act. The Valuer-General reports administratively to the Minister for Finance and Services and the Director-General, Department of Finance and Services (DFS).¹⁴

The Valuer-General may only be removed from office through a strict process:

- ▼ The Governor suspends the Valuer-General from office for misbehaviour or incompetence.

⁹ s 8, Valuation of Land Act.

¹⁰ Valuer-General submission, 7 February 2014, p 18.

¹¹ Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and the eighth general meeting with the Valuer-General*, Report 2/55, May 2013, p 10.

¹² Valuer-General submission, 7 February 2014, p 18.

¹³ Valuer-General submission, 7 February 2014, p 41. LPI is forecast return to 125 FTE's by 2014/15 from about current level of 120 FTEs.

¹⁴ NSW Government, *Valuer-General's role*, accessed 26 November 2013 from http://www.lpi.nsw.gov.au/valuation/role_of_the_valuer_general.

- ▼ The Minister, within 7 sitting days, provides both Houses of Parliament with a full statement on the grounds of suspension.
- ▼ Each House of Parliament, within 21 sitting days, declares by resolution that the Valuer-General ought to be removed from office.
- ▼ If both Houses do so declare, the Governor shall remove the Valuer-General.¹⁵

The protections in place establish the structural separation of the valuation and rating/taxing functions of government.¹⁶

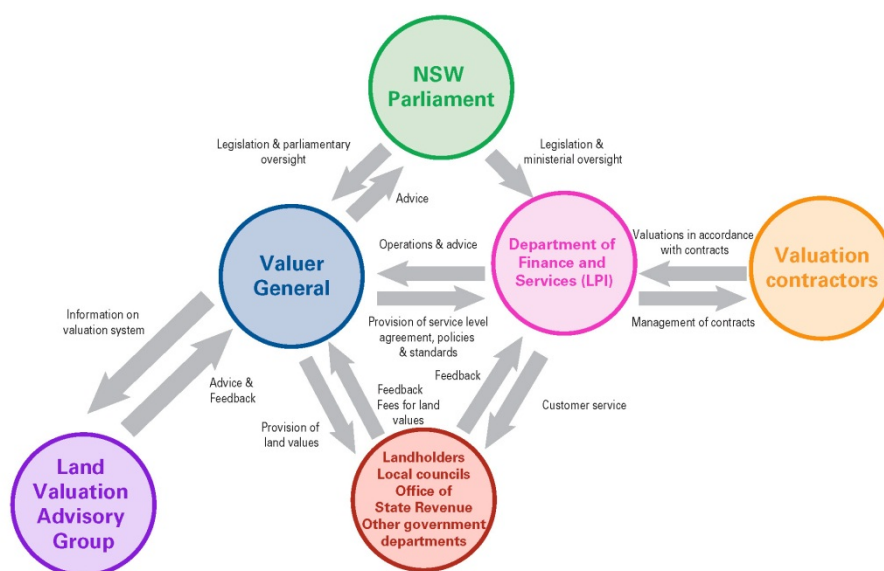
The Parliamentary Committee on the Office of the Valuer-General monitors and reviews the exercise of the Valuer-General's functions with respect to land valuations. The Parliamentary Committee was first established in 2003 as a statutory committee, and re-established in 2008 as a joint standing committee – the Joint Standing Committee on the Office of the Valuer-General (JSCOVG).¹⁷

The governance and administrative arrangements for the Valuer-General are presented in Figure 2.2.

¹⁵ s 8, Valuation of Land Act.

¹⁶ Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and the eighth general meeting with the Valuer-General*, Report 2/55, May 2013, p 2.

¹⁷ Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and the eighth general meeting with the Valuer-General*, Report 2/55, May 2013, p 3.

Figure 2.2 Governance of the NSW valuation system

Data source: Valuer-General's submission, 7 February 2014, p 16.

2.3.3 What valuation services does the Valuer-General provide?

The Valuer-General provides the following valuation services:¹⁸

- ▼ land values for rating and taxing purposes
- ▼ the determination of compensation following the compulsory acquisition of land
- ▼ an objections and appeals process against valuations
- ▼ specialist/private valuations and property advice to government.

In this review, we are setting maximum prices for only the land valuations services provided to councils for rating purposes.¹⁹ The Valuer-General's other land valuation services are outside the scope of this review. This includes valuation services provided to Government for taxing purposes.

¹⁸ NSW Government, *Valuer-General's role*, and *NSW land values*, accessed on 26 November 2013 from:

http://www.lpi.nsw.gov.au/valuation/role_of_the_valuer_general

http://www.lpi.nsw.gov.au/land_valuation/nsw_land_values.

¹⁹ These services are declared government monopoly services that are regulated by IPART.

However, in determining the Valuer-General's prices for valuation services to councils, we assess the Valuer-General's total required revenue for providing land valuation services for both rating and taxing purposes. We then allocate a proportion of these costs to councils for the purpose of setting prices. The components of the revenue required to provide valuation services are outlined in further detail in Chapter 3.

The different valuation services provided by the Valuer-General, including those to councils for ratings purposes, are outlined below.

Valuation of land for council rates and land tax

The principal purpose for assessing and recording values of land is to enable the levying of taxes, rates, and duties by the State and local governments.

The Valuer-General must issue land values to councils for rating at least every 4 years.²⁰ These land values are fixed for rating until new land values are issued to councils. The Valuer-General must also issue a Notice of Valuation to the landowner or any person liable to pay a rate in respect of the land.²¹

Land values are also provided each year to the OSR for the calculation of land tax under the *Land Tax Management Act 1956* (NSW).²² We do not regulate prices for these services and, remove the costs of providing these services from the Valuer-General's revenue requirement before setting prices for councils (see Chapter 3).

Those who receive a Notice of Valuation have a right of objection to the valuation by the Valuer-General. They have a further right to appeal to the Land and Environment Court if they are dissatisfied with the results of the objections process.²³ The costs associated with the objection process (and any revaluation required) are included in prices, as this process forms part of the land valuation service provided to councils.

Compensation for compulsory acquisitions

State and local government agencies may acquire land through a compulsory process for a range of purposes.

If a settlement cannot be negotiated between the acquiring authority and the landowner, the Valuer-General is to determine, in accordance with the *Land Acquisition (Just Terms Compensation) Act 1991* (NSW), the amount of

²⁰ s 48, Valuation of Land Act (The Valuer-General may furnish a valuation list for an area within 6 years if the Valuer-General is of the opinion that there has been so little movement in values in the area that a valuation within 4 years is not warranted).

²¹ s 29, Valuation of Land Act.

²² s 48, Valuation of Land Act.

²³ Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and eighth general meeting with the Valuer-General*, Report 2/55, May 2013, p 4.

compensation to be offered.²⁴ Relevant matters determining compensation include the market value of the land. LPI manages this process under delegated authority from the Valuer-General.²⁵

These valuations are charged on a fee-for-service basis. These fees are outside the scope of this review.

Private valuations and valuation services to other government agencies

The Valuer-General may make a valuation of land at the request of any person.²⁶ Other government agencies that use the Valuer-General's services include:

- ▼ **NSW Fire and Rescue:** to set levies on the insurance industry and local councils. Land values are provided for all rateable land within any area constituted as a fire district under section 5 of the *Fire Brigades Act 1989* (NSW).²⁷
- ▼ **NSW Maritime and Crown Lands:** use valuations for the calculation of leases (ie, rental of Crown land and Government property).
- ▼ **Local Government Grants Commission:** uses land valuations to assist in the allocation of general purpose grants to councils under the provisions of the *Local Government (Financial Assistance) Act 1995* (Cth).

Private valuations and the valuation services provided to other government agencies are generally charged on a fee-for-service basis. These fees are outside the scope of this review.

However, some stakeholders have questioned whether these minor users should be charged more than just on a fee-for-service basis and contribute to some of the joint costs of providing valuation services, currently recovered only from councils and OSR. We assess this issue in Chapter 5.

2.3.4 Land valuation process

Most land in New South Wales is valued using mass valuation, where properties are valued in groups called components.²⁸ The properties in each component are similar or are expected to reflect changes in value in a similar way.

²⁴ s 68, Valuation of Land Act.

²⁵ NSW Government, *Compulsory acquisition of land*, accessed on 26 November 2013 from http://www.valuergeneral.nsw.gov.au/compulsory_acquisitions.

²⁶ s 9A, Valuation of Land Act.

²⁷ The Valuer-General must provide these valuations under s 67, Valuation of Land Act.

²⁸ NSW Government, *Land valuation process*, accessed on 27 November 2013 from http://www.valuergeneral.nsw.gov.au/your_land_value/valuation_methodologies.

Representative properties in each component are individually valued as at 1 July each year to determine how much the land value has changed from the previous year.²⁹ The change is then applied to all properties in the component to determine their new land values. Sample valuations are then checked to confirm the accuracy of the new values.³⁰

Land values refer to the value of the land plus the land improvements (eg, clearing, levelling, drainage, and improvement of soil fertility).³¹ Capital improvements to the land are excluded from land valuations.³² Land value is also based upon the 'best use' of the land that the current zoning allows.³³

Property sales are the most important factor considered when determining land values. Valuers analyse sales of both vacant land and improved properties, making adjustments for the added value of improvements.³⁴ Finding a comparable sales base is difficult for certain, more specialised property types.³⁵

When comparing property sales to the land being valued, valuers consider factors such as:³⁶

- ▼ location of the land
- ▼ constraints on use such as zoning and heritage restrictions
- ▼ land size, shape and land features such as slope and soil type
- ▼ nearby development and infrastructure
- ▼ views.

²⁹ s 14B, Valuation of Land Act.

³⁰ NSW Government, *Land valuation process*, accessed on 27 November 2013 from http://www.valuergeneral.nsw.gov.au/your_land_value/valuation_methodologies.

³¹ s 6A and 4, Valuation of Land Act; and see http://www.valuergeneral.nsw.gov.au/__data/assets/pdf_file/0007/194074/Your_land_valu_e_factsheet.pdf

³² Therefore, the rent of land, which determines its value, is a pure surplus, not a consequence of any economic actions by the land owner. (Hefferan, M.J. & Boyd, T 2010, 'Property taxation and mass appraisal valuations in Australia – adapting to a new environment', *Property Management*, vol. 28, no. 3, p 4.)

³³ s 6A(2), Valuation of Land Act (ie, best use refers to the principle that a land valuation can be based on the purpose 'for which it could be used, at the date to which the valuation relates').

³⁴ NSW Government, *Land valuation process*, accessed on 27 November 2013 from http://www.valuergeneral.nsw.gov.au/your_land_value/valuation_methodologies.

³⁵ Hefferan, M.J. & Boyd, T 2010, 'Property taxation and mass appraisal valuations in Australia – adapting to a new environment', *Property Management*, vol. 28, no. 3, p 9.

³⁶ NSW Government, *Land valuation process*, accessed on 27 November 2013 from http://www.valuergeneral.nsw.gov.au/your_land_value/valuation_methodologies.

Our review does not address the integrity of land valuations nor how they are used (ie, as the basis for *ad valorem* taxes). We note that the land valuation process (ie, the basis on which land is valued, the frequency of valuations, and sampling methods used to determine land values) will influence the cost of undertaking mass valuations (eg, contractor costs) and ultimately prices charged to users of the Valuer-General's land valuation services.

2.4 Key developments since the 2009 Determination

This section outlines our understanding of the key developments since our 2009 Determination of the Valuer-General's prices to councils.

2.4.1 Inquiry into the land valuation system

The JSCOVG completed its inquiry into the land valuation system in January 2013. This inquiry reviewed the exercise of the Valuer-General's functions with respect to land valuations under the Valuation of Land Act and the *Land Tax Management Act 1956*.³⁷ The JSCOVG made 29 recommendations to address concerns that it identified with the:

- ▼ integrity of valuations and, in particular, their volatility
- ▼ transparency of valuation methodologies
- ▼ procedural fairness currently afforded to landholders.

The JSCOVG's main recommendations included:³⁸

- ▼ **New governance framework:** replace the Valuer-General with a Valuation Commission. The model involves 3 Valuation Commissioners (a Chief Commissioner to lead the valuation system, and separate Commissioners for general valuations and objection and compulsory acquisition valuations). The JSCOVG found that the independence of the valuation system from executive government has been undermined through LPI performing functions that should be performed by the Valuer-General.
- ▼ **Rules-based approach to valuations:** issue public guidelines for the valuation of land in New South Wales that bind valuers, and allow landholders to apply to use an alternative methodology for valuation reviews (but not initial valuations).

³⁷ This report addresses the terms of reference for the JSCOVG's inquiry into the land valuation system, as well as those for the JSCOVG's eighth general meeting with the Valuer-General. Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and eight general meeting with the Valuer-General*, Report 2/55, May 2013, p vii.

³⁸ Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and eight general meeting with the Valuer-General*, Report 2/55, May 2013, p ix.

- ▼ **Improving valuation integrity:** by introducing 3 year averaging for council rate valuations.
- ▼ **Fair and engaging process:** establish the right for landholders in objection valuations and compulsory acquisition valuations to make submissions, and for these rights to be statutorily protected.
- ▼ **Enhancing capability:** improving the IT systems required to maintain sufficient financial and operational data to audit, monitor and improve the valuation system. Also, that a strong dispute resolution capability be developed so that valuers have the skills to engage with landholders.

Further, the JSCOVG found that the valuation system is currently extremely cost effective, and that valuations show a strong correlation with the market.³⁹ Our 2009 Determination established efficient costs for land valuation services and set prices towards recovering the efficient costs of these services provided to councils by 2013/14.

What are the implications of the inquiry into the land valuation system for this review?

In its response to the inquiry, the NSW Government considered that further work needs to be undertaken, including consultation with stakeholders, before it can determine whether it supports some of the major recommendations.⁴⁰

We note that the major governance and procedural recommendations, if supported and implemented over the course of the determination period, could potentially change the nature and level of costs for land valuations services. We consider the implications of these potential reforms in deciding on the length of the determination period in Chapter 3.

We note that the NSW Government accepted some of the JSCOVG's recommendations that relate to improved transparency, reporting and capabilities.⁴¹ The Valuer-General is proposing to absorb the costs of implementing these recommendations through a combination of efficiency improvements (see below).⁴²

³⁹ Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and eight general meeting with the Valuer-General*, Report 2/55, May 2013, p ix.

⁴⁰ NSW Government, *Response to the Joint Standing Committee on the Office of the Valuer-General's inquiry into the land valuation system*, November 2013, mainly Recommendations 1, 5, 11.

⁴¹ For example, Recommendations 14 & 15. NSW Government, *Response to the Joint Standing Committee on the Office of the Valuer-General's inquiry into the land valuation system*, November 2013.

⁴² Valuer-General submission, 7 February 2014, p 7.

2.5 Overview of the Valuer-General's submission

The Valuer-General is proposing a notional revenue requirement that is 21% higher in 2014/15 (the first year of the 2014 Determination) than the revenue forecast in 2013/14 (the last year of the current determination).⁴³ The notional revenue requirement is projected to be constant thereafter.

Under the Valuer-General's proposal, the proportion of the total revenue requirement allocated to councils is 40%, which is consistent with the 2009 Determination.⁴⁴

The revenue requirement presented in the Valuer-General's submission has been calculated using a post-tax WACC of 5.8%.⁴⁵

The Valuer-General explains the increase in the notional revenue requirement as follows:⁴⁶

- ▼ 50% is due to transition to full cost recovery by 2018/19
- ▼ 10% to 15% is attributed to increased costs of mass valuations contracts
- ▼ 10% to 15% is attributed to introduction of allocated costs for spatial services, title searches and plan images
- ▼ 10% to 15% is due to a lower number of properties in the Register of Land Values, due to lower growth than expected
- ▼ 10% to 15% is due to changes in the treatment of return on and of capital.

To minimise the impact on the councils, the Valuer-General has proposed a price path that smooths the increase over the 5 year period (see Table 2.1). The Valuer-General is proposing to increase prices in real terms by 2.8% per annum⁴⁷ over the 5 year period and transition to full cost recovery by 2018/19 (ie, prices under recover required revenue in each year until the last). The Valuer-General's proposed prices are based on the current price structures and the relativity established in the 2009 Determination between residential and non-residential prices.⁴⁸

Table 2.1 The Valuer-General's proposed prices (\$/per valuation, \$nominal)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Residential	5.37	5.65	5.95	6.27	6.60	6.95
Non-residential	11.81	12.44	13.10	13.79	14.52	15.29

Note: Forecasts for 2014/15 to 2018/19 include a 2.5% per annum CPI increase.

Source: Valuer-General's submission, 7 February 2014, p 9.

⁴³ Valuer-General submission, 7 February 2014, p 7.

⁴⁴ Valuer-General submission, 7 February 2014, p 6.

⁴⁵ Valuer-General submission, 7 February 2014, p 49.

⁴⁶ Valuer-General submission, 7 February 2014, pp 8-9.

⁴⁷ Valuer-General submission, 7 February 2014, p 10.

⁴⁸ Valuer-General submission, 7 February 2014, p 9.

The Valuer-General notes that the majority of his costs are market tested or broadly in line with, if not below, comparable benchmarks.⁴⁹ He also notes that there have been a number of reports and inquiries into the provision of land valuations in New South Wales since the last IPART price review.⁵⁰ In particular, he notes that the JSCOVG found that “the valuation system is currently extremely cost effective” and that the International Property Tax Institute considered the Valuer-General to be a ‘low-cost’ service provider.⁵¹

The Valuer-General is also proposing to absorb likely cost increases associated with the implementation of recommendations accepted by the NSW Government from the JSCOVG inquiry into the land valuation system. In particular, those aimed at improving the objection process.⁵²

The Valuer-General notes that if the Government accepts the JSCOVG’s recommendations to change the governance of the valuation system, then the determination should be revisited over the 5-year period.⁵³

⁴⁹ Valuer-General submission, 7 February 2014, p 8.

⁵⁰ Valuer-General submission, 7 February 2014, p 20.

⁵¹ Valuer-General submission, 7 February 2014, pp 7-8.

⁵² Valuer-General submission, 7 February 2014, p 43.

⁵³ Valuer-General submission, 7 February 2014, p 7.

3 Approach to setting prices

For this review, we used our standard ‘building block’ approach to calculate the Valuer-General’s total notional revenue requirement for providing land valuation services for rating and taxation purposes.

We then determined the portion of this revenue required by the Valuer-General to service councils (ie, land valuation services for rating purposes only). We then converted this residual revenue requirement into prices.

The following sections provide an overview of our price-setting approach and discuss these decisions in more detail, including:

- ▼ the length of the determination period
- ▼ our approach to determining the notional revenue requirement
- ▼ our approach to converting the notional revenue requirement into prices.

3.1 Length of the determination period

Draft decision

1 To adopt a 5-year determination period from 1 July 2014 to 30 June 2019.

In accordance with our ToR, we are requested to undertake a new determination or determinations of the maximum pricing for monopoly services provided by the Valuer-General to apply in total for a period of 5 years, from 1 July 2014 (Referral Period).

The Valuer-General’s preference is for a single 5-year determination. This is on the basis that the cost of preparing and submitting a proposal is not insignificant for the Valuer-General. The Valuer-General notes that the costs of preparing a submission on an annual basis are likely to outweigh the benefits.⁵⁴

Overall, most stakeholders are supportive of a 5-year determination period, as it is administratively more efficient and provides councils with reliable pricing information for budgeting purposes.⁵⁵

⁵⁴ Valuer-General submission, 7 February 2014, p 66.

⁵⁵ For example: Ashfield Council submission, 5 February 2014; 3 February 2014; The Hills Shire Council submission, 14 February 2014; Penrith City Council submission, 18 February 2014.

Some councils preferred annual determinations on the basis that they would provide a more accurate reflection of costs, and could be linked to an index that reflects the CPI or the rate peg.⁵⁶ We discuss the option of using an indexation approach to pricing the Valuer-General's services to councils in Chapter 6.

In regards to potential changes to the valuation system arising from the recommendations made by the JSCOVG, the Valuer-General states that:

...it is not possible to quantify the impacts of such a decision at this stage, however, it may be necessary to review this price determination if the proposal proceeds.⁵⁷

In the event that the Government reforms the valuation system during the 5 year Referral Period, then most councils supported issuing a new determination.⁵⁸ The Division of Local Government also acknowledged a need to make a new determination if there is significant change in the Valuer-General's current arrangements that results in a major change in costs.⁵⁹

Given stakeholders' views, our draft decision is to adopt a 5-year determination period. However, under section 12 of the IPART Act and our ToR, we retain the ability to make a new determination or determinations at our discretion during the Referral Period.⁶⁰ Subsequent determinations are to be made on a date or dates to be agreed with the Premier. For instance, we could elect to make a new determination for maximum prices during the Referral Period should the Government's final position on the JSCOVG recommendations be judged to significantly impact on the Valuer-General's cost base. Alternatively, we could elect to make a new determination if the Government were to make any other changes to the valuation or land tax systems that significantly impacts on the Valuer-General's cost base.

3.2 Approach to determining the notional revenue requirement

The notional revenue requirement represents our view of the Valuer-General's full, efficient costs of providing land valuation services for rating and taxing purposes for each year of the determination period.

⁵⁶ Blacktown City Council submission, 7 February 2014; City of Ryde submission, February 2014; Shoalhaven City Council, 23 January 2014; Liverpool City Council submission, 29 January 2014.

⁵⁷ Valuer-General submission, 7 February 2014, p 17.

⁵⁸ For example: Bankstown City Council submission, 14 February 2014; Balranald Shire Council submission, 6 February 2014; Tamworth Regional Council submission, 4 February 2014; Penrith City Council submission, 18 February 2014.

⁵⁹ Division of Local Government (NSW Government) submission, 20 February 2014.

⁶⁰ Under the ToR and section 12 of the IPART Act.

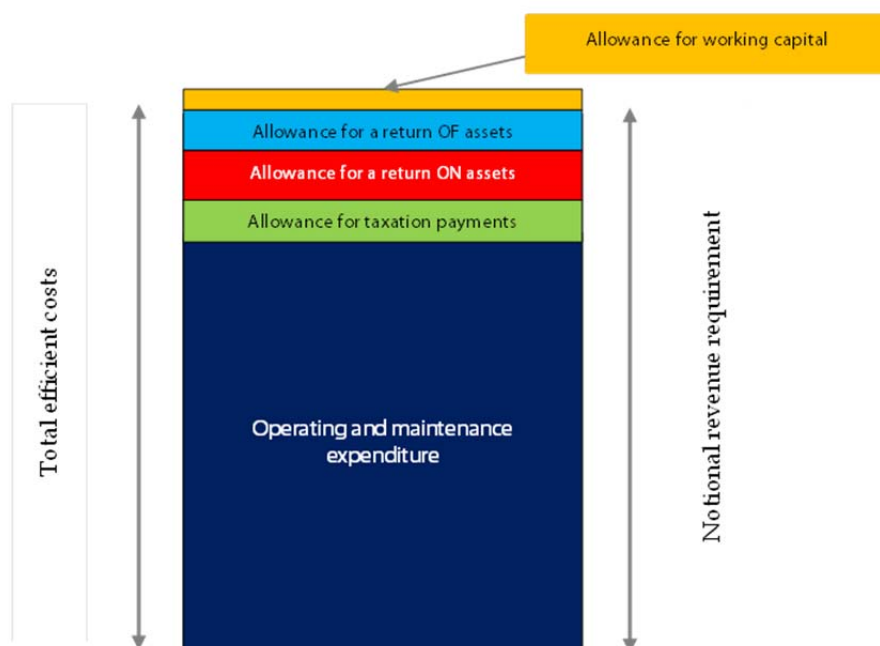
We have used the building block approach to calculate the Valuer-General's notional revenue requirement over the determination period. In doing so, we made draft decisions on the revenue the Valuer-General will require in each year of the period, including:

- ▼ The **revenue required for operating expenditure** over the period. This amount represents our view of the Valuer-General's forecast efficient operating, maintenance and administration costs.
- ▼ An **allowance for a return on the assets** used to provide the regulated services. This amount represents our assessment of the opportunity cost of the capital invested in the Valuer-General's operations by its owner, and ensures that it can continue to make efficient investments in capital in the future.
- ▼ An **allowance for a return of assets (regulatory depreciation)**. This allowance recognises that through the provision of services to customers, a business' capital infrastructure will wear out over time and, therefore, revenue is required to recover the cost of maintaining the Regulatory Asset Base (RAB).
- ▼ An **allowance for meeting tax obligations**. In the 2009 Determination, we used a real pre-tax WACC in calculating the returns on and of the RAB. For this review, we used a real post-tax WACC and calculated the Valuer-General's tax liability as a separate cost block.⁶¹ We consider this method more accurately estimates the tax liability for a comparable commercial business.
- ▼ An **allowance for working capital**. This allowance represents the holding cost of net current assets.

The sum of these amounts represents our view of the Valuer-General's total efficient costs over the determination period, or his notional revenue requirement (see Figure 3.1).

⁶¹ IPART, *The incorporation of company tax in pricing determinations – Final Decision*, December 2011.

Figure 3.1 IPART's building block approach



3.2.1 Should the Valuer-General be treated as a commercial business?

Some stakeholders have questioned the appropriateness of treating the Valuer-General as a commercial business and using a building block approach to set the prices for land valuation services to councils. In particular, concerns were raised about allowing provisions for a commercial rate of return, depreciation and tax.

Stakeholders based their views on the observations that:⁶²

- ▼ the Valuer-General provides a monopoly service and does not compete with the private sector, and therefore the principles of competitive neutrality should not apply
- ▼ the Valuer-General is part of the state's taxation system and not inherently a commercial service
- ▼ Councils do not earn a rate of return through the Local Government Cost Index (LGCI) set by IPART and are unable to pass through changes in valuation costs over and above the rate peg.

We address these concerns below.

⁶² Local Government NSW submission, February 2014, p 4; City of Ryde submission, February 2014; Dubbo City Council, 6 February 2014; Blacktown City Council submission, 7 February 2014.

The competitive neutrality principle and commercial policy framework

We have been referred this review by the Premier under sections 12(1) and (3) of the IPART Act, which is a reference with respect to the determination of the pricing of a government monopoly service. Under our terms of reference, we have been asked to identify the Valuer-General's full efficient economic costs of providing the monopoly services over the determination period (see Appendix A).

In setting prices, we aim to replicate, as closely as possible, competitive markets. That is, we seek to set prices to allow monopoly service providers to recover their efficient costs, including a rate of return on capital, a depreciation allowance and a tax allowance, while not allowing them to extract monopoly rents. Cost-reflective pricing is important in ensuring the optimal allocation of resources across society.

This approach to pricing monopoly services is implemented through the principle of competitive neutrality. The Hilmer Review introduced the principle of competitive neutrality to eliminate any advantages government-owned businesses may enjoy when competing with private sector firms.⁶³

Importantly, through the Competition Principles Agreement (1995), competitive neutrality was more generally adopted for government-owned businesses regardless of whether they are in competition with the private sector. Through the Competition Principles Agreement (1995), the Australian and all State and Territory Governments agreed that:

...the objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership.⁶⁴

LPI operates under the NSW Government's Commercial Policy Framework, which requires government businesses to:⁶⁵

- ▼ have a commercially appropriate capital structure
- ▼ pay dividends and make capital repayments
- ▼ pay tax equivalents and fees for government guaranteed debt
- ▼ ensure competitive neutrality with private sector businesses

⁶³ Prof Frederick Hilmer *National Competition Policy Review*, 25 August 1993, p 16.

⁶⁴ s 3.(1) *Competition Principles Agreement – 11 April 1995*. We note that the Australian and all State and Territory Governments have agreed to implement competitive neutrality policies as part of the National Competition Policy reform package. [Productivity Commission, *About competitive neutrality*, accessed on 14 March 2014 from <http://www.pc.gov.au/agcnco/competitive-neutrality>]

⁶⁵ Valuer-General submission, 7 February 2014, pp 18-19.

- ▼ be compensated explicitly for the costs associated with providing any non-commercial activities (social programs) on behalf of the government
- ▼ undertake financial appraisals of proposed projects to ensure the value of expected net cash flows exceed the weighted average cost of capital.

We note that these requirements on LPI are consistent with the Australian Government's approach for implementing competitive neutrality set out in its Competitive Neutrality Policy Statement of June 1996 and Competitive Neutrality Guidelines for Managers.⁶⁶

Land valuation costs and the rate peg

IPART determines the rate peg that applies to a part of council income, known as 'general income'. This is mainly rates income. Revenue from commercial activities of councils (eg, water services and airports) is not pegged, nor is grants income, fees and charges.

The rate peg is determined by using a LGCI and a productivity factor. The LGCI includes 26 cost components. The Valuer-General's charges would be reflected in a component of the basket, called 'Other Expenses'.

The underlying weights for the cost components included in the LGCI are updated periodically (every 4 years), based on data from a survey of actual expenditure from council financial accounts. Any changes in the Valuer-General's charges, therefore, would eventually be reflected in the rate peg. In any given period, the CPI is used as a proxy to reflect changes in the Valuer-General's charges (ie, the ABS All Groups Sydney is used to escalate the 'Other Expenses').

Stakeholders noted that while the prices set for the Valuer-General account for a return *on* and *of* capital, the rate peg does not. This is because the LGCI is intended to capture the changes to operational costs incurred by councils in ordinary council activity (ie, the rate peg applies to services funded through 'general income' and not commercial activities). Councils' commercial activities can earn a rate of return through separate charges, much like the Valuer-General's land valuation charges to councils for rating purposes.

⁶⁶ Productivity Commission, *About competitive neutrality*, accessed on 14 March 2014 from <http://www.pc.gov.au/agcnco/competitive-neutrality>

3.3 Approach for converting the notional revenue requirement into prices

Once we determine the Valuer-General's notional revenue requirement for the determination period, we then converted that requirement into prices for councils. To do this, we made a number of draft decisions, including:

- ▼ allocating a portion of the total revenue requirement to councils
- ▼ calculating the target revenue for each year
- ▼ determining the structure and level of the Valuer-General's prices to councils, including the revenue to be generated from various charges.

These decisions are outlined in detail in Chapters 4 and 5.

4 Revenue requirement

As described in Chapter 3, we used a building block approach to calculate the Valuer-General's notional revenue requirement in each year of the determination period. In this chapter, we outline our draft decisions on each building block component, including allowances for:

- ▼ operating expenditure
- ▼ a return on the assets
- ▼ a return of assets (regulatory depreciation)
- ▼ meeting tax obligations
- ▼ working capital.

These cost components represent our view of the Valuer-General's total efficient costs over the determination period for the provision of valuations for both taxing and rating purposes. That is, for servicing both councils and OSR.

Next, we allocate a portion of the Valuer-General's total efficient costs to the councils. Chapter 5 explains how we determine the portion of revenue allocated to councils.

4.1 Notional revenue requirement

Draft decision

- 2 To set the Valuer-General's notional revenue requirement for land valuation services provided for rating and taxing purposes as shown in Table 4.1.

Table 4.1 IPART's draft finding on the Valuer-General's notional revenue requirement (\$'000, \$2013/14)

	2014/15	2015/16	2016/17	2017/18	2018/19
Valuer-General's proposal^a					
Operating Expenditure	43,162	43,162	43,162	43,162	43,162
Depreciation (regulatory)	1,990	2,204	2,402	2,608	2,825
Return on fixed assets	733	717	681	638	588
Return on working capital	-	-	-	-	-
Tax allowance	110	122	132	142	152
Notional Revenue Requirement	45,995	46,205	46,377	46,549	46,727
IPART's draft decisions					
Operating Expenditure	42,877	42,877	42,877	42,877	42,877
Depreciation (regulatory)	2,524	2,347	2,054	1,782	1,453
Return on fixed assets	480	442	406	387	386
Return on working capital	115	118	121	124	127
Tax allowance	73	70	63	54	46
Notional Revenue Requirement	46,068	45,854	45,520	45,223	44,888

^a Supplementary information supplied by the Valuer-General, 5 March 2014.

Note: Totals may vary due to rounding.

The Valuer-General proposed to maintain the revenue requirement constant over the determination period. However, his proposed annual revenue requirement is about 21% (nominal) higher than the revenue forecast for 2013/14.⁶⁷

Our draft finding on the Valuer-General's notional revenue requirement is \$4.3 million (or 1.9%) lower than his proposal over the 5 years. The main reasons for this difference are our draft decisions to:

- ▼ slightly lower operating costs for corporate overheads (about \$1.4 million over the 5 years)
- ▼ use a WACC of 4.8%, which is lower than the Valuer-General's proposed WACC of 5.8% (about \$0.7 million).
- ▼ apply different treatment of depreciation (based on separate asset classes) in rolling forward the RAB, tax and working capital (\$2.2 million).

The sections that follow outline our considerations in reaching the draft decisions on the notional revenue requirement, including the Valuer-General's submission, stakeholder comments, and our own analysis and conclusions.

⁶⁷ Valuer-General submission, 7 February 2014, p 7.

4.2 Operating expenditure

Draft decision

- 3 To set the efficient level of the Valuer-General's operating expenditure as shown in Table 4.2.

Table 4.2 IPART's draft decision on the Valuer-General's operating expenditure (\$millions, \$2013/14)

	2014/15	2015/16	2016/17	2017/18	2018/19
Valuer-General proposal ^a	43.16	43.16	43.16	43.16	43.16
IPART's draft decision	42.88	42.88	42.88	42.88	42.88
difference	0.29	0.29	0.29	0.29	0.29

^a Supplementary information supplied by the Valuer-General, 5 March 2014.

Note: Totals may vary due to rounding.

We consider that the Valuer-General's proposed operating expenditure for the 2014 determination period to be generally efficient. However, we have made a slight downward adjustment to corporate overheads to account for an error in the allocation of these costs based on FTEs. Operating expenditure represents about 94% of the Valuer-General's notional revenue requirement.

To establish the efficient operating expenditure of providing valuation services, we assessed the costs associated with each of the following:

- ▼ Direct costs of VSLPI providing general valuation services, including but not limited to:
 - labour costs and on-costs (this includes the Valuer-General's office)
 - mass valuation contracts
 - other valuation contracts (for objections and appeals)
 - rent and postage (property value notifications to ratepayers)
- ▼ Allocated costs from LPI to VSLPI for corporate overheads and spatial, titling and graphic services.

4.2.1 The Valuer-General's operating expenditure for 2009 determination period

The Valuer-General reports that his operating costs were within 1% of the estimated cumulative efficient costs established for the 2009 Determination.⁶⁸ The efficient costs for the 2009 Determination were based on the estimate of efficient operating costs for the base year 2007/08, and included a 1% efficiency factor each year thereafter.⁶⁹

⁶⁸ Valuer-General, Public hearing presentation, 25 February 2014.

⁶⁹ IPART, *Price review of rating valuation services provided by the Valuer General to local government – Final Determination and Report*, July 2008, p 5.

Although overall costs are reported to be in line with estimated efficient costs, yearly variations do exist. Notably, mass valuation contract costs are reported to have increased by about 10% over 2012/13 and 2013/14 due mainly to increased insurance costs passed through in contracted prices.⁷⁰ Labour costs were lower than forecast due to a decrease in FTEs and a subsequent staff freeze.⁷¹

We consider the Valuer-General's operating expenditure over the 2009 determination period to be reasonable and in line with what was deemed efficient at our previous determination. We assessed increases in the proposed operating expenditure over the 2014 determination period using 2013/14 as base year costs.

4.2.2 The Valuer-General's operating expenditure for 2014 determination period

The Valuer-General proposed an increase in operating costs of about 7.4% in 2014/15 (ie, compared to the forecast operating expenditure for 2013/14). He attributes the step change to:

- ▼ an approximate 2.4% increase in mass valuation contract costs
- ▼ an increase in labour costs due to filling 5 vacant FTE positions
- ▼ the introduction of newly allocated costs from LPI for spatial services and transactions for title and image searches.

Operating costs in subsequent years are forecast to remain constant in real terms.⁷²

Directly attributable costs - Labour

Labour costs represent about 30% of the Valuer-General's operating expenditure. The Valuer-General proposes a real increase in labour costs of 7% in 2014/15, and then for these costs to remain constant for the remainder of the determination period.⁷³

Over the 2009 determination period, LPI's FTE numbers, allocated to perform the Valuer-General's functions, declined to the current level of 120 FTE, following retirements and some positions remaining vacant due to a staff freeze.⁷⁴ The Valuer-General, on behalf of LPI, is proposing to fill 5 vacant LPI FTE positions

⁷⁰ Valuer-General submission, 7 February 2014, p 35. The 10% increase represents the cumulative increase in mass valuation contract costs in 2012/13 and 2013/14 in the table presented on p 33.

⁷¹ Valuer-General submission, 7 February 2014, p 34.

⁷² Valuer-General submission, 7 February 2014, pp 73-74.

⁷³ Valuer-General submission, 7 February 2014, p 42. We converted the Valuer-General's costs from nominal to real (\$2013/14). The increase in nominal terms is 9.6% in 2014/15.

⁷⁴ Valuer-General submission, 7 February 2014, p 41; Public hearing transcript, 25 February 2014, p 14.

and rebuild staff numbers to 125 FTE over the 2014 Determination period (this represents a 4% increase in staff numbers).

The Valuer-General considers that the current level of 120 FTEs is not sustainable.⁷⁵ He noted that if the positions are not filled, it will likely impact on service standards. He is looking to fill positions that actively monitor the quality of the valuation contractors and their operations.⁷⁶ The Valuer-General considers that the additional FTEs will offer benefits to the valuation system by:⁷⁷

- ▼ improving valuation succession planning
- ▼ enabling VSLPI to better oversee the work of valuation contractors
- ▼ encouraging competition for valuation services by enabling VSLPI to act as a 'last resort' valuation provider to address market failures.

In regards to the level of wages, the Valuer-General states that valuers' wages are governed by the labour market because these workers are free to move between the public and private sector. He noted that the difficulty he has experienced to fill some positions suggests that a competitive market exists. In addition, the Valuer-General has demonstrated, through high-level benchmarking, that his average wage is lower than the NSW average public sector wage.⁷⁸

On balance, we are satisfied with the evidence presented by the Valuer-General in regards to forecast labour costs. This is because the Valuer-General's level of wages track well against the wider NSW public sector and are consistent with market rates. We note that the Valuer-General's annual wage for 2012/13 is about \$70,267, which compares favourably to the NSW average public sector wage of about \$76,695.⁷⁹ We also consider the additional FTEs proposed over the period would fill vacancies required to maintain service standards.

Direct costs - Mass valuation contracts

Mass valuation contract costs comprise about 42% of the Valuer-General's forecast operating expenditure over the 2014 determination period. The Valuer-General (through VSLPI) has outsourced mass valuations for more than 10 years and notes that there has been a general increase in the number of tenders over recent years.⁸⁰

⁷⁵ Public hearing transcript, 25 February 2014, p 14.

⁷⁶ Public hearing transcript, 25 February 2014, p 53.

⁷⁷ Valuer-General submission, 7 February 2014, p 42.

⁷⁸ Valuer-General submission, 7 February 2014, p 57.

⁷⁹ ABS, *Average Weekly Earnings, Private and Public Sectors, New South Wales (Dollars) - Original - Persons* (TABLE 14A, series ID A2735973W), accessed on 31 March 2014 from <http://www.abs.gov.au/ausstats/abs@.nsf/detailspage/6302.0Nov%202013>

⁸⁰ Valuer-General submission, 7 February 2014, p 58.

However, the Valuer-General is proposing about a 2.4%⁸¹ real increase in mass valuation contract costs in 2014/15, as a result of cost drivers inherited over 2012/13 and 2013/14, including:⁸²

- ▼ higher professional indemnity insurance costs passed through to the Valuer-General by the valuers
- ▼ enhanced value verification requirements to meet stakeholders' expectations regarding the quality of valuation outcomes
- ▼ greater cost pressures in non-metropolitan areas due to greater travel time and often valuation complexity.

The Valuer-General considers that VSLPI is actively pursuing initiatives to encourage a competitive market and currently implementing changes to the tender process to achieve more efficient outcomes, including:⁸³

- ▼ splitting existing contract areas into smaller areas to remove a possible barrier to entry for smaller contractors
- ▼ packaging contract areas to give contractors options to bid for a group of contract areas and achieve economies of scale
- ▼ introducing options to quote for a longer fixed term of 4 years and 11 months to reduce initial start-up costs.

The Valuer-General is expecting these contracting changes to be phased in by the end of 2014/15 and, on this basis, is proposing no real increase in mass valuation contract costs after the initial 2.4% real increase in 2014/15.⁸⁴

We consider the Valuer-General's proposed costs for mass valuation contracts over the 2014 determination period to be reasonable. We note that the increased costs forecast for 2014/15 are outside the Valuer-General's (and VSLPI's) control because valuation contracts are outsourced through a competitive tendering process, which means that these cost are market driven (and tested).

We also note that the Valuer-General is proactively trying to offset some of the recent costs drivers by implementing changes to contract specifications. In addition, the tender process is overseen by relevant stakeholders, including Local Government NSW who is represented on the tender panel for contracts for the provision of land valuation services.⁸⁵

⁸¹ The Valuer-General proposed a 5% nominal increase in mass valuation costs in 2014/15. We have converted this increase into real dollars (\$2013/14). See Valuer-General submission, 7 February 2014, p 35.

⁸² Valuer-General submission, 7 February 2014, p 35.

⁸³ Valuer-General submission, 7 February 2014, p 58.

⁸⁴ Valuer-General submission, 7 February 2014, p 42. We have converted the Valuer-General's costs from nominal to real dollars (\$2013/14).

⁸⁵ Local Government NSW submission, February 2014, p 2.

Direct costs - Other valuation contracts

Other valuation contracts relate to objections that arise from the valuation process and account for about 7% of total proposed operating expenditure.

The Valuer-General is not forecasting an increase in the cost of other valuation contracts over the 2014 determination period despite volumes of objections expected to increase by 1% per annum.⁸⁶ He is proposing to absorb any additional costs incurred through efficiency improvements and utilising internal resources.

Some stakeholders questioned whether the Valuer-General should also absorb the costs of handling successful objection valuations.⁸⁷ In response, the Valuer-General noted (at the public hearing) that only 3,000 out of 2.4 million valuations are successfully contested each year. He also noted that objections are the product of a mass valuation system that is less costly than the alternative of individually valuing properties.⁸⁸

On balance, we consider that the Valuer-General's proposed costs for other valuation contracts are reasonable. These costs are market tested and the volume of objection valuations is being kept to reasonably low levels. In particular, stakeholders have noted significant improvements in the quality of valuations and a marked reduction in objections over recent years.⁸⁹ We also note that the Valuer-General's services have a high level of compliance with statistical measures of accuracy and that there has been a relatively low rate of change to the Register of Land Values due to error correction.⁹⁰

Direct costs - Rent, postage and other direct costs

Rental costs refer to government and market rents paid by the Valuer-General to accommodate valuation and land data staff in regional locations. We note that these costs are separate to the land and building costs included in the Valuer-General's asset base and therefore are not double counted (see capital expenditure below).

⁸⁶ Valuer-General submission, 7 February 2014, p 43.

⁸⁷ Penrith City Council submission, 18 February 2014; Dungog Shire Council submission, 10 February 2014.

⁸⁸ Public hearing transcript, 25 February 2014, pp 47-49.

⁸⁹ Local Government NSW submission, February 2014, p 2.

⁹⁰ The change to the Register of Land Values of has been approximately 0.12% per annum over the period between 2001 and 2011 as a result of objections, appeals and reascertainments, which benchmarks favourably against other jurisdictions. Valuer-General submission, 7 February 2014, p 26.

Rental costs are projected to remain at 2013/14 levels over the 2014 determination period.⁹¹ Although the Valuer-General's rental expenditure is approximately 8.6% higher than the NSW Government average, we acknowledge that the difference has reduced significantly (from about 36% in 2007/08).⁹² Much of the discrepancy is explained by the type of rental accommodation required by VSLPI, which includes larger sized rooms to accommodate the reading of maps. The Valuer-General has committed to continue to identify opportunities to consolidate and streamline office space requirements over the determination period.⁹³

Postage costs are also projected to remain constant over the 2014 Determination period, in line with 2013/14 levels.⁹⁴ The Valuer-General is looking to roll out the electronic delivery of Notices of Valuations to reduce costs and absorb growth in the valuations register expected over the determination period.

Other direct costs, such as motor vehicle leasing and travel expenses, are projected to decrease by 5% in 2014/15 and remain constant thereafter.

On balance, we consider the Valuer-General's forecasts for rent, postage and other direct costs to be reasonable.

Allocated costs - LPI and DFS corporate overheads and ITC operational costs

The Valuer-General has forecast an increase in corporate overheads allocated from LPI (of 15.4%) and DFS (of 8.4%) in 2014/15, contributing to the overall step change in operating expenditure.

Local Government NSW requested that we carefully review the allocation of corporate overheads to the Valuer-General, given that LPI and DFS do not have the same ability to recover these costs (ie, through regulated charges to councils).⁹⁵ It also requested that any allocation of corporate overheads to the Valuer-General takes into account VSLPI's activities that are unrelated to rating and taxing work.⁹⁶

⁹¹ Valuer-General submission, 7 February 2014, p 43. We have converted the Valuer-General's costs from nominal to real dollars (\$2013/14).

⁹² Valuer-General submission, 7 February 2014, p 60.

⁹³ Valuer-General submission, 7 February 2014, p 43.

⁹⁴ Valuer-General submission, 7 February 2014, p 43.

⁹⁵ Local Government NSW submission, February 2014, p 3.

⁹⁶ Local Government NSW submission, February 2014, p 3.

Under the Valuer-General's proposal, corporate costs (and ICT operational costs) are allocated to the Valuer-General on an FTE basis using the following 2-step process:⁹⁷

1. The number of VSLPI (and Office of the Valuer-General) FTEs as a proportion of LPI's total operational FTEs (15.3%). Non-operational FTEs are not included.
2. The proportion of time spent by VSLPI (and Office of the Valuer-General) staff on rating and taxing valuations (92%).

For example, DFS corporate costs for 2014/15 are forecast to be around \$2.8 million.⁹⁸ Based on FTEs, 15.3% of these costs are allocated to the Valuer-General, which is \$0.42 million. Of these costs, 92% are allocated to OSR and councils accounting for time spent by the Valuer-General's staff on rating and taxing valuations, which is around \$0.39 million.

We consider this cost allocation methodology to be reasonable. However, we requested FTE numbers from the Valuer-General to verify the allocation rates used. The Valuer-General provided the following information:

Relating to the VSLPI FTE for 2013/14, being 120 out of the LPI budgeted FTE of 949, compared to the 2014/15 projection; an increase to 125 whilst the LPI projection fell to 912. The LPI total FTE is based on the last approved budget for the respective years.⁹⁹

On this basis, we estimate of an FTE percentage of 14.3% for 2014/15, rather than the Valuer-General's figure of 15.3%.¹⁰⁰ We have applied 14.3% to the Valuer-General's estimates of LPI and DFS corporate overheads and ITC operational costs, and consequently made a \$285,000 per year reduction to these costs.

Allocated costs - Spatial services

Spatial services used in the valuation process were not included in Valuer-General's operating costs in the 2009 Determination. The Valuer-General states that at the time LPI did not have adequate information on the usage of these services and in effect subsidised these costs over the determination period.¹⁰¹

⁹⁷ Valuer-General submission, 7 February 2014, p 44.

⁹⁸ This represents DFS corporate costs allocated to LPI. We have converted the Valuer-General's forecasts to real dollars (\$2013/14). See: Valuer-General submission, 7 February 2014, p 45.

⁹⁹ Email correspondence with the Valuer-General, 5 March 2014.

¹⁰⁰ We arrive at 14.3% allocation rate based on the number of FTEs at Office of the Valuer-General (6 FTE) and VSLPI (125 FTE) as a proportion of total operational FTE (918) for 2014/15.

¹⁰¹ Valuer-General submission, 7 February 2014, p 47.

According to the Valuer-General, VSLPI and its contract valuers are heavy users of spatial data. Among other things, they use the information to identify land parcels and understand landforms and the built environment.¹⁰² LPI's spatial services costs have been allocated to Valuer-General (ie, VSLPI) in accord with the following principles:¹⁰³

- ▼ Where VSLPI and valuation contractors are major users of the data, the data is costed based on a share of usage.
- ▼ Where the spatial data is primarily created for another purpose and the valuation system is a secondary user, the data is costed at the marginal cost of supply to VSLPI (ie, the extra costs incurred from providing data to VSLPI).
- ▼ Where there is reciprocal exchange of data between LPI's spatial and valuation systems, those exchanges are offset.

We are satisfied with the rationale provided by the Valuer-General in regards to the allocation of costs for spatial services and accept the Valuer-General's forecasts.

Allocated costs - Titling and image searches

LPI is the official source of NSW land titling information and registered survey plans. This information is considered essential for the operation of the valuation system.¹⁰⁴

Over the 2009 determination period, access to this information was provided to the Valuer-General and his valuation contractors free of charge, while retail clients pay a price based on wholesale price of the search or plan plus delivery charge. We agree with the Valuer-General that this is effectively a cross-subsidisation of the valuation system by the Registrar General and fails to recognise the true cost of the Valuer-General's services.¹⁰⁵

In 2013/14, the Valuer-General was charged for titling and image services at wholesale prices (ie, the same basis as retail clients, but *less* the delivery charge). The Valuer-General considers 2013/14 as a normal year of operations and is proposing to maintain this level of costs over the 2014 determination period.¹⁰⁶ We consider the proposal to be reasonable.

¹⁰² Valuer-General submission, 7 February 2014, p 46.

¹⁰³ Valuer-General submission, 7 February 2014, p 46.

¹⁰⁴ Valuer-General submission, 7 February 2014, p 47.

¹⁰⁵ Valuer-General submission, 7 February 2014, p 47.

¹⁰⁶ Valuer-General submission, 7 February 2014, p 47. We have converted the Valuer-General's projection to real dollars (\$2013/14).

Allocated costs - Graphic services

Costs for graphic services have remained stable over the 2009 determination period and been allocated to the Valuer-General since 1 July 2010 using a job costing system (ie, activity-based costing method).¹⁰⁷ The Valuer-General is forecasting no real increase in these costs over the 2014 determination period,¹⁰⁸ which we consider to be reasonable.

4.2.3 The scope for efficiency savings over the 2014 determination period

We note that about 45% of the Valuer-General's operating costs are market tested, given that they are outsourced (ie, mass valuation contract costs, postage, and rent). For example, the Valuer-General (through LPI) invites tenders for contested contracts for the provision of valuation services. A Tender Evaluation Committee oversees the probity of the tender process, and currently the Valuer-General does not sit on this committee.¹⁰⁹

Approximately 18% of the Valuer-General's costs are also broadly in line, if not below, comparable benchmarks in 2008.¹¹⁰ Our high-level benchmarking of labour costs suggests that these costs are also efficient (ie, about 30% of total operating costs as shown above).

Furthermore, the efficiency of the Valuer-General's valuation services has been reviewed twice since the last determination period, including by the JSCOVG and the International Property Tax Institute (IPTI). The JSCOVG found that the valuation system is currently extremely cost effective and that valuations correlate closely with the market.¹¹¹ The IPTI benchmarking study indicates that the Valuer-General provides its valuation services at a lower unit cost than the average and median service providers.¹¹²

We also note that the Valuer-General has embedded efficiency savings over the forward period in his proposed operating costs. In particular, he has proposed to absorb increasing costs associated with:¹¹³

- ▼ implementing the JSCOVG recommendations regarding improving the dispute resolution process for objection valuations
- ▼ a forecast 1% per annum growth in the volume of valuations (ie, which impact contract costs, postage, and graphic services).

¹⁰⁷ Valuer-General submission, 7 February 2014, p 38.

¹⁰⁸ Valuer-General submission, 7 February 2014, p 48. We have converted the Valuer-General's projection to real dollars (\$2013/14).

¹⁰⁹ Joint Standing Committee on the Office of the Valuer-General, Parliament NSW, *Report on the inquiry into the land valuation system and eight general meeting with the Valuer-General*, Report 2/55, May 2013, p 9.

¹¹⁰ Valuer-General submission, 7 February 2014, pp 56-57.

¹¹¹ Valuer-General submission, 7 February 2014, p 56.

¹¹² Valuer-General submission, 7 February 2014, p 61.

¹¹³ Valuer-General submission, 7 February 2014, pp 64-65

In lieu of the above efficiency savings, we have not applied an additional productivity factor to the Valuer-General's operating costs. We consider that the savings embedded in the Valuer-General's proposal to be at least equivalent to the 0.2% productivity factor applied to councils through the LGCI, which some stakeholders have argued should also apply to the Valuer-General.¹¹⁴ In Chapter 6, we reconsider the appropriateness of a productivity factor in considering an indexing approach to setting the Valuer-General's prices.

4.3 Capital expenditure

Draft decision

- 4 To accept the Valuer-General's actual capital expenditure over the period 2008/09 to 2012/13 and forecast capital expenditure for 2013/14 as shown in Table 4.4 as prudent and efficient.
 - This capital expenditure is to be used to establish the opening value of the RAB for the 2014 determination period.
- 5 To accept the Valuer-General's forecast capital expenditure over the period 2014/15 to 2018/19 as shown in Table 4.3 as prudent and efficient.
 - This capital expenditure is to be included in the roll forward of the RAB for the 2014 determination period.

4.3.1 Valuer-General's capital expenditure for 2009 determination period

Our draft decision is to include the Valuer-General's actual capital expenditure over the 2009 determination period and forecast capital expenditure for 2013/14 in the opening value of the RAB (see below).

In the 2009 Determination, the Valuer-General proposed capital expenditure of approximately \$2.3 million (\$2007/08) per annum over 5 years.¹¹⁵ We note that over 2007/08 to 2012/13, the Valuer-General's total capital expenditure has been broadly in line with forecasts.¹¹⁶

We note that there has been some volatility in expenditure in individual years and a shift of expenditure from intangibles to plant and equipment. The Valuer-General attributes this to classification issues regarding information projects that include electronic equipment (plant and equipment) and software and data (intangible assets).¹¹⁷

¹¹⁴ City of Ryde submission, February 2014; Dubbo City Council submission, 6 February 2014.

¹¹⁵ IPART, *Review of prices for valuation services provided by the Office of the Valuer General for local councils – Issues Paper*, February 2008, p 10.

¹¹⁶ Valuer-General submission, 7 February 2014, p 39.

¹¹⁷ Valuer-General submission, 7 February 2014, p 39.

The Valuer-General expects valuation related capital expenditure in 2013/14 to be \$2.6 million, which is similar to actual expenditure in 2012/13.¹¹⁸ We note that the prudence and efficiency of the Valuer-General's actual capital expenditure for 2013/14 will be reassessed in the next pricing review, and the RAB may be readjusted at that time to reflect our findings.

4.3.2 Valuer-General's capital expenditure for 2014 determination period

Our draft decision is to include the Valuer-General's forecast capital expenditure over the 2014 determination period in the roll forward of the RAB (see below).

The Valuer-General's forecast capital expenditure for VSLPI is based on an allocation of capital expenditure from LPI. He notes that although LPI's capital expenditure is forecast to grow from \$21 million in 2013/14 to \$22 million in 2018/19, the proportion of LPI capital projects that is expected to directly affect VSLPI is forecast to decline to levels below those assumed in the 2009 determination period.¹¹⁹ The Valuer-General attributes the decline to the changing capital program and because the VSLPI workforce, as a proportion of the total LPI workforce, has fallen.

We consider the Valuer-General's proposed capital expenditure to be reasonable, noting that expenditure proposed in 2104/15 is 26.9% lower than that for 2013/14 (see Table 4.3). His proposed expenditure in each year thereafter remains relatively constant at around \$1.6 million to \$1.8 million per year.

Table 4.3 Valuer-General's proposed capital expenditure (\$000', \$2013/14)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Land ^a and Buildings	34	74	72	90	72	71
Plant and Equipment	982	969	981	960	1,213	1,252
Intangibles	1,583	837	603	565	500	488
Total	2,599	1,880	1,657	1,615	1,786	1,811

^a There is no proposed expenditure on land.

Source: Adapted from Valuer-General submission, 7 February 2014, p 52. IPART has converted the Valuer-General's proposed capital expenditure from nominal figures to \$2013/14.

We requested that the Valuer-General provide us with a list of items included under intangibles, as they have previously only been provided as a single line item.

¹¹⁸ Valuer-General submission, 7 February 2014, p 39.

¹¹⁹ Valuer-General submission, 7 February 2014, p 52.

We have reviewed this list, which consisted of various computer software applications for valuation services. According to the Australian Accounting Standards Board,¹²⁰ software essential to the operation of a computer would be classified as 'plant and equipment', while other software would be reasonably classified as 'intangibles'.

From the descriptions provided by the Valuer-General, all the items appear to be software applications and correctly classified as intangible assets. For example, the system that manages digitised historic plans is an application rather than a component of the computer's operating software. On this basis, we have included these capital items in the RAB.

4.4 Establishing the opening value and rolling forward the RAB

To determine allowances for a return on assets and regulatory depreciation, we must calculate the value of the Valuer-General's RAB in each year of the determination period.

To establish the opening value of the Valuer-General's RAB (as at 1 July 2014), we have rolled forward the 1 July 2008 RAB to 30 June 2014 by:

- ▼ including the prudent and efficient capital expenditure that the Valuer-General spent between 1 July 2008 and 30 June 2014, using forecast values for 20013/14
- ▼ deducting regulatory depreciation using year-end values
- ▼ indexing the annual closing RAB for actual inflation, and using a forecast for inflation for 2013/14.

In carrying out the above calculations, we assume that half the capital expenditure occurs at the beginning of the year (and therefore receives a full year of indexation), while the other half occurs at the end of the period (and therefore is not indexed). The annual values of the Valuer-General's RAB for the 2009 determination period are shown in Table 4.4 below.

¹²⁰ Australian Accounting Standards Board, AASB 138 Intangible Assets, 3 August 2010, Section 4 (p 14).

Table 4.4 Closing RAB from the 2009 determination period (\$millions, \$nominal)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Opening RAB	10.28	9.98	9.07	7.66	8.38	8.94
Plus: Actual Capex	2.27	2.07	1.95	2.76	2.62	2.60
Less: Cash Capital Contributions	0	0	0	0	0	0
Less: Asset Disposals	0	0	0	0	0	0
Less: Allowed Depreciation	2.74	3.32	3.71	2.16	2.29	2.53
Plus: Indexation	0.16	0.34	0.35	0.11	0.23	0.29
Closing RAB	9.98	9.07	7.66	8.38	8.94	9.30

Our modelling arrived at an opening RAB at 1 July 2014 of \$9.3 million. This compares to the Valuer-General's proposed opening RAB at 1 July 2014 of \$12.2 million.¹²¹ The difference is due to:

- ▼ **Removing working capital from the RAB:** In our 2009 Determination, we established the Valuer-General's closing RAB for the 2007/08 year as \$12.5 million,¹²² which included \$2.1 million of working capital (\$2007/08). Although maintaining this assumption, the Valuer-General rightfully questioned the rationale for including and depreciating working capital in the roll-forward of the RAB.¹²³
- ▼ **Using separate depreciation rates for each of the 3 asset categories:** The Valuer-General¹²⁴ has rolled forward the RAB adopting our approach in the 2009 Determination of using a weighted average asset life to calculate depreciation.¹²⁵ We have decided to split assets into their separate classes for this review as it facilitates a more accurate calculation of assets with differing asset lives.
- ▼ **Slight differences between inflation figures used:** We have adopted actual inflation according to June quarter CPI indices for the 8 capital cities as published by the ABS. The most notable difference is that we have adopted a forecast inflation for 2013/14 of 2.8% based on the Bloomberg mean consensus forecast (extracted 7 Feb 2014).

We used a consistent approach to roll forward the RAB to the end of the 2014 determination period (ie, 30 June 2019). In particular, we used our draft decisions on capital expenditure outlined above. The annual values of the Valuer-General's RAB for the 2014 determination period are shown in Table 4.5 below. The closing value generally decreases over the period because capital expenditure is lower than depreciation.

¹²¹ Valuer-General submission, 7 February 2014, p 52.

¹²² IPART, *Prices for valuation services for local councils - Final Report*, July 2008, p 19 (footnote 33).

¹²³ Valuer-General submission, 7 February 2014, p 51.

¹²⁴ Valuer-General submission, 7 February 2014, pp 50-51.

¹²⁵ Supplementary information supplied to IPART by the Valuer-General, 5 March 2014.

Table 4.5 IPART's draft decision on the annual value for the RAB for the 2014 determination period (\$millions, \$2013/14)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Opening RAB	8.94^a	9.30	8.60	7.85	7.36	7.32
Capital expenditure	2.60	1.88	1.66	1.61	1.79	1.81
Capital contributions	0	0	0	0	0	0
Asset disposals	0	0	0	0	0	0
Regulatory depreciation	2.53	2.58	2.40	2.10	1.82	1.49
Indexation	0.29	0	0	0	0	0
Closing RAB	9.30	8.60	7.85	7.36	7.32	7.65

^a Opening RAB for 2013/14 is in \$2012/13 and indexed for closing RAB in \$2013/14.

4.5 Calculating allowances for a return on assets and regulatory depreciation

4.5.1 Return on assets

Draft decision

- 6 To adopt a real post-tax WACC of 4.8% for the purposes of calculating the allowance for a return on assets.
- 7 To set an allowance for a return on assets as shown in Table 4.1.

We calculate the allowance for a return on assets by multiplying the rate of return by the value of the RAB in each year of the determination period. As for previous reviews, we used the Weighted Average Cost of Capital (WACC) approach to calculate the rate of return. In the 2009 Determination, we used a real pre-tax WACC. Following a consultative review of our WACC methodology, this time we adopted a real post-tax WACC estimate.¹²⁶

Using market parameters as at 27 February 2014, our estimate of the current real post-tax WACC range for the Valuer-General is between 4.4% and 5.2%. Under our new WACC methodology, we estimate the real post-tax WACC range by establishing the midpoint of 2 WACC estimates based on current and long-term average data. We also compute an uncertainty index to assess if current economic conditions warrant a move above or below the midpoint of these 2 WACC estimates. Our decision rule is that we consider a move if the uncertainty index is more than 1 standard deviation away from the long term average of 0.¹²⁷

¹²⁶ IPART, *The incorporation of company tax in pricing determinations – Final Decision*, December 2011.

¹²⁷ IPART, *Review of WACC Methodology – Final Report*, December 2013, p 4.

We have found that the uncertainty index is currently within 1 standard deviation of the mean. Therefore, we have decided to use the midpoint estimate for the WACC of 4.8% to calculate the return on assets. This is lower than the Valuer-General's proposed WACC of 5.8%.¹²⁸

A detailed discussion of our findings on the WACC and the Valuer-General's proposed WACC is presented in Appendix C.

4.5.2 Regulatory depreciation

Draft decision

- 8 To calculate regulatory depreciation using a straight line depreciation method for each asset class, applying the asset lives set out in Table 4.6.
- 9 To set an allowance for a regulatory depreciation as shown in Table 4.1.

The Valuer-General proposed depreciating assets included in the RAB by using an estimate of the weighted average asset life. He estimated a weighted average remaining asset life of 6.2 years for assets as at 1 July 2014, and a weighted average asset life of 8.0 years for forecast capital expenditure to 2018/19.¹²⁹

In our modelling, we have maintained 3 separate asset classes, and therefore separately calculated depreciation for each using the asset lives in Table 4.6. Asset lives for existing and new assets are sourced from our 2009 Determination, and proposed by the Valuer-General.¹³⁰

We used a straight line depreciation method to calculate the allowance for regulatory depreciation.¹³¹ Under this method, the assets in the RAB are depreciated by an equal value in each year of their economic life, so that their written down value follows a straight line over time, from the initial value of the asset to zero at the end of the asset's life.

We note that although the Valuer-General has land in his asset base, it is treated as a non-depreciable asset. Therefore, it only earns a return on its value. We discuss the appropriateness of depreciating intangibles below.

¹²⁸ Valuer-General submission, 7 February 2014, p 49.

¹²⁹ Valuer-General submission, 7 February 2014, p 53.

¹³⁰ Supplementary data provided to IPART by the Valuer-General, March 2014.

¹³¹ For the purposes of calculating the revenue requirement, we also use a mid-year value for depreciation, which differs slightly to the year-end value used for rolling forward the RAB.

Table 4.6 IPART's draft decision on the Valuer-General's asset lives (years)

Asset class	Remaining life of existing assets (from 1 July 2007)	Expected asset life of new assets
Buildings	44.6	83
Plant and equipment	2.8	5
Intangibles	3.2	4

Intangibles

We depreciated intangibles, based on an economic life of 4 years.

At our public hearing, a stakeholder¹³² questioned if the depreciation of intangibles is contrary to accounting standards. The Australian Tax Office (ATO), in its *Guide to Depreciating Assets*¹³³ concurs that "most intangible assets are... excluded from the definition of a depreciating asset". However, the ATO does list several categories of intangibles as being included as depreciating assets including in-house software, intellectual property and various rights and licenses.

We consider that the categories of assets submitted by the Valuer-General are consistent with the category of 'in-house software'.¹³⁴ The ATO has published effective lives for various specific intangible assets, with in-house software having an economic life of 4 years.¹³⁵

4.6 Other building block components

4.6.1 Working Capital

As mentioned above, we have removed working capital from the RAB, meaning that working capital is no longer depreciated. We separately calculate a return on working capital as a component of the notional revenue requirement. Working capital has a value of \$2.4 million for 2014/15.

¹³² IPART, Public hearing transcript, 25 February 2014, pp 32-33.

¹³³ Australian Tax Office, *Guide to Depreciating Assets* 2013, June 2013, p 3.

¹³⁴ Australian Tax Office, accessed on 13 March 2014 from:
http://www.ato.gov.au/Business/Capital-allowances/In-detail/Schedules-and-guides/Guide-to-depreciating-assets-2012-13/?anchor=In-house_software#In-house_software

¹³⁵ Australian Tax Office, accessed on 11 March 2014 from:
<http://www.ato.gov.au/Business/Capital-allowances/In-detail/Schedules-and-guides/Guide-to-depreciating-assets-2012-13/?page=10>

4.6.2 Tax allowance

In December 2011, we decided to move to the use of a real post-tax WACC because we consider it provides a superior estimate of the tax liability that a similar, well-managed, privately owned business would pay. The previous real pre-tax methodology overestimated the tax liabilities of the regulated businesses and hence over-compensated them (primarily for capital gains tax, which was not being incurred, as a result of indexing the RAB). The decision to adopt a post-tax WACC methodology was subject to a public process.¹³⁶

In calculating a regulated business's costs for the purposes of setting prices, we allow an amount to reflect the tax paid by the business.¹³⁷

We calculated tax allowances in each year of the determination period by applying a 30% statutory corporate tax rate adjusted for gamma¹³⁸ to the Valuer-General's (nominal) taxable income. To calculate his taxable income, we deducted the Valuer-General's operating cost allowances, tax depreciation, and interest expenses from the notional revenue requirement (excluding tax allowance).

To calculate taxable income we:

- ▼ calculated tax depreciation forecasts based on the 3 asset classes, whereas the Valuer-General used a weighted average asset life¹³⁹
- ▼ based interest expense on the parameters used to calculate the WACC (ie, gearing ratios, nominal risk free rate and debt margin).

The tax allowance is shown in Table 4.1.

¹³⁶ IPART, *The incorporation of company tax in pricing determinations – Final Decision*, December 2011.

¹³⁷ IPART, *The incorporation of company tax in pricing determinations – Final Decision*, December 2011, p 1.

¹³⁸ Under a post-tax framework, the value of imputation (franking) credits (gamma) enters the regulatory decision only through the estimate of the tax liability.

¹³⁹ Valuer-General submission, 7 February 2014, p 54.

5 Allocating costs to councils

The final step in determining required revenue (and prices) is to allocate costs to councils. There are a number of ways that the costs for the Valuer-General's services can be recouped from users, such as through using an average cost or marginal cost approach.

Under an average cost approach, all users make a contribution towards the fixed costs of providing a service. Under a marginal cost approach, fixed costs are borne by the principal users of a service and other users are charged the marginal or avoidable cost of extending the service to them.

In the 2009 Determination, the costs of providing valuation services were split 40:60 between councils and OSR. All other users were either not charged, or paid the additional (marginal) cost of extending the service to them.¹⁴⁰

In this chapter, we outline our draft decisions on the allocation of the Valuer-General's costs (established in Chapter 4) between councils, OSR and other users.

5.1 Should minor users of valuation services contribute to fixed costs?

Draft Decision

10 To continue to not allocate fixed costs to minor users of the Valuer-General's land valuations services.

As noted in Chapter 2, the Valuer-General may make a valuation of land at the request of any person.¹⁴¹ In addition to OSR and councils, he provides valuation services to a number of minor users, such as:

- ▼ private brokers and the general public
- ▼ other government agencies that use the Valuer-General's services.

These users are generally charged on a fee-for-service basis.

¹⁴⁰ IPART, *Price review of rating valuation services provided by the Valuer General to local government – Final Determination and Final Report*, July 2008, pp 9 and 23.

¹⁴¹ s 9A, Valuation of Land Act.

A number of stakeholders raised the issue of whether some of these other users should bear more of the costs of providing the Valuer-General's services.¹⁴² In particular, stakeholders questioned whether these users should be charged on an average cost rather than a marginal cost basis, which would mean allocating some of the fixed costs to them.

Stakeholders considered that minor users should contribute to fixed costs because they use the Valuer-General's valuation services for essentially the same purposes as councils and OSR. For example, Local Government NSW noted that:

...other government clients are using the data as the basis for raising revenue through taxation (rate or levy) or commercial leases. While smaller users than the Office of State Revenue or councils in aggregate, they are essentially using the data for the same purposes. It would be unfair to expect local government to subsidise these users, particularly when valuations are being utilised for commercial purposes by government business units. For example, NSW Maritime and other government agencies such as the Department of Finance and Services are moving towards commercial rentals for private leases.¹⁴³

At the public hearing, the Valuer-General confirmed why minor users were charged on a marginal cost basis. He noted that these users essentially use the data because it exists, they are not responsible for the creation of fixed costs, and the number of valuations provided to these users is relatively small.¹⁴⁴

We consider that, in order for there to be a change to the current charging arrangements for minor users and a greater share of costs recovered from them, 2 conditions should be met:

- ▼ **Similar use** - the minor users should use the valuation services in a similar way to councils and OSR - ie, for a revenue or commercial related purpose.
- ▼ **Materiality** - the quantity of valuations used by these minor users as a percentage of total yearly valuations should be significant in order for them to contribute towards the Valuer-General's fixed costs and be charged on an average cost rather than marginal cost basis.

We consider that none of the minor users meet both of these criteria. Minor users that have a similar use for the Valuer-General's services, include:

- ▼ NSW Fire and Rescue
- ▼ NSW Roads and Maritime
- ▼ NSW Crown Lands
- ▼ Local Government Grants Commission.

¹⁴² See for example Albury City Council submission, Balranald Shire Council submission, 6 February 2014, and Blacktown City Council submission, 7 February 2014.

¹⁴³ Local Government NSW submission, 14 February 2014, p 5.

¹⁴⁴ IPART Public Hearing on the Review of Prices for Land Valuation Services Provided by the Valuer-General to Councils, 25 February 2014, p 44.

The Valuer-General provided us with information on the nature and quantity of valuations used by these minor users.¹⁴⁵ For these minor users, access to information is essentially either by read-only system access or alternatively in the form of analysis of valuation totals.

With the exception of NSW Roads and Maritime and NSW Crown Lands, we consider that these valuation services represent a much more basic service than that provided to councils or OSR, with no individual valuations being provided by the Valuer-General's office. As such, we consider it is not appropriate to allocate any fixed costs to these users. For example, NSW Fire and Rescue is supplied with the total land value of all properties in an LGA within the fire district, which is separated into rateable and non-rateable.¹⁴⁶ This is an aggregate value and no individual land values are provided. It is therefore only appropriate to charge this user the marginal cost of providing these valuations.

NSW Roads and Maritime and NSW Crown Lands obtain individual valuations from the Valuer-General for the calculation of leases on domestic waterfront tenancies.¹⁴⁷ However, the number of valuations used on an annual basis is less than 0.5% of the total valuations provided to local councils and OSR. For example, NSW Roads and Maritime and NSW Crown Lands currently use approximately 8,400 valuations per year. This compares to the 800,000 valuations used by councils each year, and the 2.4 million valuations used by OSR.

We do not consider this usage to be material enough to share fixed costs and therefore consider the Valuer-General's current charging system to be appropriate. However, in the future, if NSW Roads and Maritime and NSW Crown Lands increased their usage of valuations so that it reached a material level, for example 5% of the total valuations used by local councils and OSR, then there may be grounds for these government agencies to contribute to the Valuer-General's fixed costs. This would equally apply to other users.

5.2 What is the appropriate cost allocation to councils?

Draft Decision

- 11 To allocate 34% of the Valuer-General's notional revenue requirement (as set out in Table 4.1) to councils.

¹⁴⁵ Email correspondence with the Valuer-General, 18 March 2014.

¹⁴⁶ Email correspondence with the Valuer-General, 18 March 2014.

¹⁴⁷ IPART, *Review of method for determining rents for domestic waterfront tenancies in NSW – Final Report*, December 2011, p 30.

The Valuer-General has proposed to retain a 40% allocation of total costs to councils, as established at the 2009 Determination. He considers that the:

...current methodology for allocating costs to councils is reasonable as there has been no fundamental change in the cost or customer base in the last five years.¹⁴⁸

In the 2009 Determination, the costs of the providing general valuation services were split 40:60 between councils and OSR. The 40% of costs allocated to councils was an on balance decision, based on the proportion of total valuations received per annum by councils (about 25%) and, among other things the:¹⁴⁹

- ▼ benefits received by the councils from the fact that valuations for OSR are conducted annually
- ▼ different level of accuracy of land valuations required by councils and OSR
- ▼ standalone costs of providing services to councils
- ▼ costs identified by the Valuer-General that are directly attributable to the councils.

Stakeholders have requested that IPART reconsider the allocation of costs to councils for this review. In particular, councils were of the view that a 40% allocation is too high. For example, Campbelltown City Council requested that:

The allocation of costs be reduced subject to a further review and suggests an amount closer to 25% rather than 40% as contained within the report.¹⁵⁰

Local Government NSW also maintains the cost allocation to councils should be less than 40%.¹⁵¹

We have applied a bottom-up approach to allocating costs to councils based on the following:

- ▼ **usage share of mass valuations** - allocating mass valuation contract costs based on the number of valuations received by councils as a portion of the total number of valuations *issued* by the Valuer-General annually
- ▼ **direct costs to councils** - allocating other costs on an activity basis or client specific basis, where possible
- ▼ **frequency of valuations** - allocating remaining costs based on the number of valuations received by councils as a portion of valuations *conducted* by the Valuer-General.

¹⁴⁸ Valuer-General submission, 7 February 2014, p 71.

¹⁴⁹ IPART, *Price review of rating valuation services provided by the Valuer General to local government - Final Determination and Final Report*, July 2008, pp 23-24.

¹⁵⁰ Campbelltown City Council submission, 3 February 2014, p.4.

¹⁵¹ Local Government NSW submission, February 2014, p 5.

We note that the first 2 methods are identical to what we applied in the 2009 Determination and together allocate about 19% of costs to councils. The remaining costs have been allocated to councils based how frequently the Valuer-General's services are used. This allocates a further 15% of costs to councils.

In total, we estimate that 34% of the Valuer-Generals' total efficient operating costs should be allocated to councils (see Table 5.1). Since operating expenditure represents about 94% of the total building block base, we consider it appropriate to apply the 34% to the Valuer-General's notional revenue requirement (in Table 4.1) to establish the total revenue required from councils and the base on which to set prices.

The process of allocating different portions of different cost items to councils is consistent with the Valuer-General's approach. His allocations per cost item are shown in Table 5.1.

In the sections that follow, we outline our cost allocation method in detail, considering stakeholder views. We seek stakeholders' comments on our cost allocation method.

Table 5.1 Allocation of costs to councils by cost item (% of total cost for each cost item)

Cost items	Valuer-General proposal ^a	IPART draft decision
Labour costs	40%	33%
Mass valuation contract costs	30%	25%
Other valuation contracts costs	50%	50%
Postage	100%	100%
Rent	40%	33%
Other direct costs	44%	33%
LPI corporate costs	40%	33%
DFS corporate costs	40%	33%
ICT operation costs	40%	33%
Graphic	100%	100%
Spatial	40%	33%
Title and Images	40%	33%
Total operational expenditure	40%	34%^b

^a The cost allocation to councils is calculated by IPART using the information provided by the Valuer-General in his submission, 7 February 2014. We calculated a cost allocation of 39.2% to councils, however we note that the Valuer-General has proposed a 40% allocation to councils.

^b Rounded to whole number.

Note: Totals may vary due to rounding.

5.2.1 Usage share of mass valuation costs

As in the 2009 Determination, we have allocated 25% of the mass valuation contract costs to councils. This is on the basis that each year the Valuer-General issues about 3.2 million valuations, of which 800,000¹⁵² (or 25%) go to councils (That is, the Valuer-General conducts 2.4 million valuations each year. He issues about 2.4 million valuations to OSR and 800,000 to councils).

Allocating mass valuation costs on a usage share basis effectively means that councils and OSR pay the same unit cost per valuation received.

5.2.2 Attributing costs directly to councils

Also consistent with the 2009 Determination, we have allocated 100% of postage and graphic services costs to councils. Graphic services produce and print Notices of Valuations, which are provided for ratings purposes only. The Valuer-General does not print valuation notices for OSR. Similarly, the postage costs are only for Notice of Valuations posted to councils' ratepayers.

Some councils noted that postage and graphic services do not benefit councils, but are used for a notification process purely for landholders as it provides them with information about their properties.¹⁵³ We note that, on furnishing a valuation list to the council, it is a legislative requirement for the Valuer-General to issue a Notice of Valuation to the landowner.¹⁵⁴ Further, valuation notices to landowners facilitate the issuing of council rates notices, given that land valuations are a determinant or driver of rates paid by individual landowners.

We have also maintained the 50:50 split between councils and OSR for other valuation contract costs (ie, objection valuations). Some councils considered that they should pay less than 50% of the costs related to objection valuations, as the bulk of these valuations are raised in response to land tax.¹⁵⁵ Local Government NSW noted that valuations for taxing purposes are far more contentious and more sensitive to accuracy than those for rating purposes issued to councils.¹⁵⁶

¹⁵² We note that the Valuer-General has estimated about 850,000 notices to councils in 2013/14 by averaging notices over the period 2008/09 to 2012/13 (see Valuer-General submission, 7 February 2014, p 67). However, we have not used this estimate in the cost allocation exercise, because we cannot reconcile why notices to councils would change from 800,000 to 850,000 from the last determination period, while the total number of valuation notices remains at 2.4 million.

¹⁵³ Albury City Council submission, 7 February 2014; Campbelltown City Council submission, 3 February 2014; Local Government NSW submission, February 2014, p 5; Penrith City Council submission, 18 February 2014; The Hills Shire Council submission, 14 February 2014.

¹⁵⁴ s 29, Valuation of Land Act.

¹⁵⁵ Bankstown City Council, 14 February 2014; The Hills Shire Council submission, 14 February 2014; Dungog Shire Council submission, 10 February 2014; Campbelltown City Council submission, 3 February 2014.

¹⁵⁶ Local Government NSW submission, February 2014, p 5.

At the public hearing, the Valuer-General provided the following justification to allocate 50% of objection valuation costs to councils:

The bulk of the numbers we saw were in local government-related valuations, the greater complexity was in OSR, and through a not particularly scientific process, we traded those two things off against each other and concluded that a 50:50 split was an appropriate way to do it.¹⁵⁷

We note that most objections seem to be in response to rates and not tax. However, objections related to tax are more complex. Given this balance, we consider that the Valuer-General has taken a pragmatic approach to allocating these costs by splitting them equally between OSR and councils.

5.2.3 Accounting for the frequency of valuations

Unlike mass valuation contract costs, the remaining costs should be allocated to councils and OSR to reflect how frequently the services are used.

We have allocated the remaining costs to councils based on the number of valuations they receive as a portion of valuations *conducted* by the Valuer-General. Given that the Valuer-General undertakes about 2.4 million valuations per annum and the councils receive approximately 800,000 valuations per annum, this approach allocates about *one-third* of the remaining costs to councils and therefore *two-thirds* to OSR.

We consider that allocating the remaining costs on this basis is a reasonable way of accounting for the different effort of servicing OSR and councils. That is, it takes into account that councils are only provided valuations every 3 to 4 years, on average.¹⁵⁸ Therefore, cost items such as rent, labour and corporate overheads are only ‘used’, on average, once every 3 years by councils. OSR is issued valuations on a yearly basis and therefore ‘uses’ these resources more intensively. This was one reason cited by councils for why OSR should contribute more than it does under the current pricing structure (and therefore why the 40% allocation rate was too high).

Furthermore, we note that allocating the remaining costs on this basis also provides a proxy for the benefit councils receive from the fact that valuations are conducted annually for OSR (ie, economies of scale in unit valuation costs).

We consider that this method to allocate remaining costs to councils is more robust and transparent than that used in the 2009 Determination, which was essentially an *on balance* decision to reach 40% in line with the Valuer-General’s proposal.

¹⁵⁷ Public Hearing Transcript, Mr Gilkes, 25 February 2014, p 41, line 1-6.

¹⁵⁸ City of Wagga Wagga, 6 February 2014; Liverpool City Council; 29 January 2014, City of Ryde submission, 17 February 2014; The Hills Shire Council submission, 14 February 2014; Local Government NSW submission, February 2014, p 5.

Some councils argued for further reductions in the cost allocation to councils to recognise their contributions of providing regular updates of names and addresses to LPI so that the Valuer-General's office has current data for its valuation notices.¹⁵⁹

However, we consider the costs to councils of providing this service is likely to be minor. We also note that the councils ultimately benefit from providing this service to the Valuer-General. The service is provided by the councils to ensure that the Valuer-General is able to send the Notices of Valuations to the councils' ratepayers. If the councils did not provide this service, the Valuer-General would have to obtain the information using other (probably higher cost) means, which the councils would at least have to partly pay for. On this basis, we have decided not to make a further reduction to the cost allocation percentage.

5.3 What is the required revenue from councils?

Applying the 34% cost allocation to the notional revenue requirement in Table 4.1, we arrive at the required revenue from councils in Table 5.1. Over the 5-year determination period, the difference between the amount which the Valuer-General proposed to be recovered from councils and our draft decision is approximately \$15.4 million.

Approximately \$13.7 million of this difference is due to our draft decision to allocate 34% of costs to councils, rather than the Valuer-General's proposed 40%. This revenue should not be lost to the Valuer-General, but will need to be recovered from OSR, the Valuer-General's other customer. We note that this change in the cost allocation between councils and OSR has budget implications for the NSW Government. This is because funding from OSR for the valuation services provided by the Valuer-General is based on a grant from Treasury.

The remaining amount, about \$1.7 million, is due to our draft decisions on operating costs, WACC and treatment of depreciation, tax and working capital as discussed in Chapter 4 (ie, representing the proposed 40% share of the \$4.3 million difference between the Valuer-General's proposed total notional revenue requirement and our draft decision).

¹⁵⁹ Penrith City Council submission, 18 February 2014.

Table 5.2 IPART's draft finding on the Valuer-General's notional revenue requirement for councils (\$'000, \$2013/14)

	2014/15	2015/16	2016/17	2017/18	2018/19
Valuer-General's proposal^a					
Operating Expenditure	17,265	17,265	17,265	17,265	17,265
Depreciation (regulatory)	796	882	961	1,043	1,130
Return on fixed assets	293	287	273	255	235
Return on working capital	-	-	-	-	-
Tax allowance	44	49	53	57	61
Notional Revenue Requirement	18,398	18,482	18,551	18,620	18,691
IPART's draft decisions					
Operating Expenditure	14,578	14,578	14,578	14,578	14,578
Depreciation (regulatory)	858	798	698	606	494
Return on fixed assets	163	150	138	132	131
Return on working capital	39	40	41	42	43
Tax allowance	25	24	21	18	16
Notional Revenue Requirement	15,663	15,590	15,477	15,376	15,262

^a Supplementary information supplied by the Valuer-General, 5 March 2014. These costs are a 40% allocation of the Valuer-General's total proposed costs shown in Table 4.1. With the exception of operating expenditure, they are consistent with Table 8-1 (p 62) of the Valuer-General's submission, adjusted from nominal to \$2013/14. The operating expenditure in that table is not consistent with a 40% allocation, and would result in only 39% of costs being recovered from councils.

Note: Totals may vary due to rounding.

6 Price structures and paths

Our ToR require us to:

- ▼ develop an efficient, effective and transparent pricing framework for the land valuation services provided to councils
- ▼ ensure full recovery of the Valuer-General's efficient costs of providing these services over the relevant determination period
- ▼ ensure that prices efficiently allocate the costs of the services between councils in accordance with relevant economic and pricing principles.

In this chapter, we present our pricing framework for the Valuer-General's land valuation services to councils. This includes the appropriate pricing structures and price paths to recover efficient costs, and their potential impact on councils. Maximum prices are set to recover the revenue requirement established in Chapter 5. We also propose a potential indexing approach to setting prices for future determinations and seek stakeholder comments on this proposal.

6.1 Draft decisions on prices

Draft decision

12 To set the Valuer-General's maximum prices for land valuation services to councils as shown in Table 6.1.

Except the first year, we have decided to hold maximum prices constant in real terms over the course of the determination (see Table 6.1). We have smoothed prices to produce a stable price path, and give no disadvantage to the Valuer-General or the users of these valuations, with the target revenue equal to the notional revenue requirement in NPV terms.

There is a very small downward step in prices (1.2%) from the last year of the current determination period (2013/14) to the first year of the 2014 determination period (2014/15), which should be outweighed by the effects of inflation in this year.

In reaching our draft decision on prices, we compared prices that would result if target revenue equalled notional revenue requirement in each year (ie, prices set to recover costs in each year). We note that under this scenario, there would be a step increase in 2014/15, followed by a decrease in prices over the remaining years of the determination. Prices in the last year would end up being lower in real terms than current prices. Prices would trend downward over the determination period due mainly to the projected growth in the number of valuations (see below).

Table 6.1 IPART's draft decision on the Valuer-General's prices to councils (\$/per valuation, \$2013/14)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Cost recovery by year						
Residential	5.37	5.47	5.39	5.29	5.21	5.12
Non-residential	11.81	12.02	11.85	11.64	11.45	11.25
% change		1.8%	-1.4%	-1.8%	-1.6%	-1.7%
IPART's draft decision						
Residential	5.37	5.30	5.30	5.30	5.30	5.30
Non-Residential	11.81	11.66	11.66	11.66	11.66	11.66
% change ^a		-1.2%	0%	0%	0%	0%

^a Based on pre-rounded results.

The very small change in prices and revenue under our Draft Determination as compared to the 2.8% real increase in prices under the Valuer-General's proposal is due mainly to our decision to lower the allocation of costs to councils to 34% from the 40% proposed by the Valuer-General. This means that, despite the increase in the Valuer-General's costs, prices remain relatively constant.

We also note our draft prices are less than the 2.3% council rate peg to apply in 2014/15.¹⁶⁰ Most councils considered that the price path should not exceed the rate peg, given the limited ability they have to pass through cost increases above the rate peg.¹⁶¹ Some councils requested that a glide path be used to minimise impacts if prices did increase above the rate peg.¹⁶² Our draft prices will increase by less than CPI in 2014/15 and then in line with inflation to 2018/19.

We did not change price structures due to overwhelming stakeholder support for the current 2:1 ratio between residential and non-residential prices (see below). We propose an indexing approach to setting prices for future determinations and seek stakeholder comments on this (see Appendix D).

¹⁶⁰ IPART, *Local Government Rate Peg 2014/15 – Information Paper*, December 2013, p 1.

¹⁶¹ For example: Blacktown City Council submission, 7 February 2014; Penrith City Council submission, 18 February 2014; Balranald Shire Council submission, 6 February 2014; City of Ryde submission, February 2014; City of Wagga Wagga submission, 6 February 2014.

¹⁶² Dungog Shire Council submission, February 2014; Liverpool City Council submission, 29 January 2014; Tamworth Regional Council submission, 4 February 2014.

6.1.1 Price path and forecast target revenue

Draft decision

13 To adopt an NPV neutral approach to setting prices that recover the target revenue shown in Table 6.2.

The target revenue is the expected amount of money raised by the Valuer-General through the charges we set. We have adopted a NPV neutral approach to setting prices, which means the Valuer-General's target revenue recovers the notional revenue requirement from councils, as set out in Table 6.2.

Table 6.2 IPART's draft decision on Valuer-General's target revenue from councils (\$millions, \$2013/14)

	2014/15	2015/16	2016/17	2017/18	2018/19	NPV
Notional revenue requirement	15.7	15.6	15.5	15.4	15.3	67.3
Target revenue	15.2	15.3	15.5	15.7	15.8	67.3
Difference	-0.5	-0.3	0.0	0.3	0.6	0.0

Note: Totals may vary due to rounding.

6.1.2 Number of valuations

Draft decision

14 To use the forecast number of valuations shown in Table 6.3 as the basis for setting prices.

The Valuer-General proposed an estimate of 1% per annum growth in the number of properties on the Register of Land Values from 2014/15 to 2018/19.¹⁶³

While the Register of Land Values only grew by an average of 0.55% per annum during the current period, the Valuer-General noted that subdivision activity during that period was diminished by the impact of the global financial crisis.¹⁶⁴ He considers that the property industry is showing signs of recovery and he expects that the market will return to more typical levels of subdivision and property growth during the 2014 determination period.

At the public hearing, City of Sydney Council commented that it was expecting 14% growth over 18 months, yet the Valuer-General had assumed a 1% annual growth rate. The Valuer-General responded that he does not assess individual apartments, but the strata under the base, which accounts for the difference in growth rates. The Valuer-General also explained that the 1% annual growth is across NSW and therefore would be different to that in Sydney.¹⁶⁵

¹⁶³ Valuer-General submission, 7 February 2014, p 21.

¹⁶⁴ Valuer-General submission, 7 February 2014, p 21.

¹⁶⁵ Public Hearing Transcript, 25 February 2014, pp 18-19.

We consider that a 1% per annum growth rate is a reasonable estimate and use the Valuer-General's estimates in Table 6.3 to set prices.

Table 6.3 IPART's draft decision on the total number of valuations (000')

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Residential Valuations	2,160	2,177	2,198	2,220	2,242	2,265
Non-Residential Valuations	310	313	316	320	323	326
Total	2,470	2,490	2,514	2,540	2,565	2,591

Note: We have accepted the Valuer-General's forecasts of residential and non-residential valuations as per his submission (Valuer-General submission, 7 February 2014, p 22). The total number of valuations in this table is the sum of these 2 categories, which differs from the totals provided by the Valuer-General.

6.2 Price Structures

Draft decision

15 To retain the current price relativities between residential and non-residential properties.

6.2.1 Residential and Non-Residential Prices

Based on the considerable support for the current residential and non-residential price structure, we have decided to retain this structure for the 2014 Determination.

The current price structure aims to reflect the costs incurred in providing the service and acknowledges the higher costs involved in valuing non-residential properties. These higher costs are primarily due to the complexity of the valuations and the uniqueness of these properties. The Valuer-General considers that current relativities between the 2 types of prices, established at the last determination, still reflect the differences in complexity of valuations.¹⁶⁶

Stakeholders were also overwhelmingly supportive of the current price structure.¹⁶⁷ The only support for a single price per valuation came from Ryde City Council, although it noted that this may not be fair to some councils.

¹⁶⁶ Valuer-General submission, 7 February 2014, p 62.

¹⁶⁷ For example: Ashfield City Council submission, 7 February 2014; Penrith City Council submission, 18 February 2014; The Hills Shire Council submission, 14 February 2014; Campbelltown City Council submission, 3 February 2014.

Moving to a single price for all land valuation services would potentially shift costs between councils (ie, councils with more non-residential properties could potentially pay less under this price structure and those councils with predominantly residential properties could pay more). For example, Ashfield Council stated that:

Council strongly supports the current price structure of residential and non-residential prices and does not support a move to a single price structure. Compared to most LGAs Ashfield LGA is relatively simple in terms of property structure and valuation. The majority of properties in the Ashfield Council LGA are residential and a single price will be disadvantageous. Ashfield Council residents should not have to pay more in order to facilitate a more simple price structure for government or to subsidise other areas with more complex valuations.¹⁶⁸

Shoalhaven City Council argued that prices could be set based on the current categories defined in the Local Government Act - ie, residential, business, farmland and mining.¹⁶⁹ It considered that pricing on this basis would be more equitable and regional councils would be charged less given that farmland would be more dominant.

We consider that this pricing structure would add complexity to the current framework without obvious gains for regional councils. We note that the increases in mass valuation contract costs over recent years is partly due to greater cost pressures in non-metropolitan areas due to non-residential property types that require greater analysis and are less suited to the mass valuation techniques.¹⁷⁰

The Valuer-General has noted that a price based on zones may be more viable once all councils adopt the standard Local Environment Plan zoning table.¹⁷¹ This alignment is expected to be completed by the end of this determination period. If the Valuer-General advances a case for prices based on zones in the next price review, we will consider this issue at the time of that review.

6.2.2 Differential prices for councils

The Valuer-General did not propose the introduction of differential pricing for councils. He stated that a common charge for councils is administratively simple and allows predictable prices for councils.¹⁷²

¹⁶⁸ Ashfield Council submission, 5 February 2014.

¹⁶⁹ Shoalhaven City Council submission, 23 January 2014, p 1.

¹⁷⁰ Valuer-General submission, 7 February 2014, p 35.

¹⁷¹ Valuer-General submission to IPART, 7 February 2014, p 63.

¹⁷² Valuer-General submission to IPART, 7 February 2014, p 71.

Stakeholders who responded to this issue voiced their support for the current arrangements, whereby all councils pay the same charges. For example, Blacktown City Council stated that:

...[it] does not believe certain councils should be levied a higher or lower charge than others.¹⁷³

Similarly, City of Ryde Council expressed the view that:

...it is not in favour of moving to a more specific differential pricing model for Councils, as the current structure is fairer to all Councils. A differential pricing may see that Regional Councils would have higher pricing, due to the nature of the land that Valuers need to inspect to determine valuations.¹⁷⁴

Based on the feedback received from stakeholders, and the absence of a strong case being advanced for differential pricing, we have decided to maintain the current price structure for the 2014 Determination, under which all councils are charged the same price for residential and non-residential valuations.

6.3 Using an index as an alternative approach to setting prices

Draft decision

16 To not use an indexation approach for this determination to set the Valuer-General's maximum prices to councils.

In our Issues Paper, we raised the possibility of using an index as an alternative approach to setting prices, once an efficient cost base is established (eg, via the building block methodology).

Among stakeholders, there was some support for the use of an indexation approach. The Valuer-General noted that given operating expenditure accounts for over 90% of total efficient costs and these costs are reasonably predictable, a strong case could be made for setting prices using an indexation approach in the next regulatory period.¹⁷⁵

Councils were primarily concerned that any increase in prices for the Valuer-General's services would not exceed the level of the rate peg. Both, City of Ryde Council and Dungog Shire Council considered that an indexation approach could be used to set prices, and that the index could be the rate peg set by IPART.¹⁷⁶

¹⁷³ Blacktown City Council, submission to the *Review of Prices for Land Valuation Services Provided by the Valuer-General*, 7 February 2014, p 4.

¹⁷⁴ City of Ryde submission, 17 February 2014.

¹⁷⁵ Valuer-General submission, 7 February 2014, p 63.

¹⁷⁶ City of Ryde submission, 17 February 2014; Dungog Shire Council submission, 10 February 2014.

We considered using an indexation approach to set prices for the Valuer-General's land valuation services to councils (see Appendix D). However, for this determination, we decided to set prices based on a building block approach to ensure that prices are cost-reflective.

Given that the Valuer-General has a stable cost base and the majority of his costs are accounted for by 2 or 3 cost items, an indexation approach could be used in future determinations. However, that decision would need to be made by the Tribunal at that time under the relevant ToR.



Appendices

A Terms of reference



2013-515987

Dr Peter Boxall AO
Chair
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

30 DEC 2013

Dear Dr Boxall *Peter,*

I am writing regarding the pricing of rating valuation services provided by the Valuer-General to local government.

Under Part 5 of the *Valuation of Land Act 1916*, the Valuer-General must provide local councils with land valuation and supplementary lists, which are used by councils for rating purposes. As you are aware, the services are declared as government monopoly services under section 4 of the *Independent Pricing and Regulatory Tribunal Act 1992* (the IPART Act) and the *Government Pricing Tribunal (Valuer-General's Services) Order 1993*, and the maximum prices which may be charged by the Valuer-General for the government monopoly services are subject to an IPART pricing determination in effect.

I am advised that IPART's last determination of these prices applies until 30 June 2014.

I therefore request, pursuant to sections 12(1) and (3) of the IPART Act, that the Independent Pricing and Regulatory Tribunal (IPART) make a new determination of the maximum pricing for the rating valuation services provided by the Valuer-General, to apply from 1 July 2014.

The investigation relating to the pricing determination is to be conducted in accordance with the attached Terms of Reference.

If you require further information, please contact Tim Hampton, Director Economic Policy, Department of Premier and Cabinet, on 02 9228 5293.

Thank you for your assistance in this matter.

Yours sincerely

A handwritten signature in blue ink, which appears to read 'Barry O'Farrell'.

Barry O'Farrell MP
Premier

TERMS OF REFERENCE PRICE REVIEW OF RATING VALUATION SERVICES PROVIDED BY THE VALUER-GENERAL TO LOCAL GOVERNMENT

I Barry O'Farrell, Premier - pursuant to sections 12(1) and (3) of the IPART Act, request that the Independent Pricing and Regulatory Tribunal (IPART) make a new determination of the maximum pricing for the rating valuation services provided by the Valuer-General, to apply from 1 July 2014. In making its recommendations IPART is to consider the Terms of Reference set out below.

Background

By the *Government Pricing Tribunal (Valuer-General's Services) Order* dated 11 August 1993 and made under section 4 of the *Independent Pricing and Regulatory Tribunal Act 1992* (the IPART Act), the following services provided by the Valuer-General were declared as government monopoly services:

"Furnishing valuation lists and supplementary lists under Part 5 of the *Valuation of Land Act 1916* by the Valuer-General to a council of an area under the *Local Government Act 1993*" (**Monopoly Services**).

On 7 December 2007, the Premier requested that, pursuant to section 12 of the IPART Act, the Independent Pricing and Regulatory Tribunal (IPART) make a determination of the pricing for the provision of the Monopoly Services to apply for a period of 5 years

In July 2008, IPART released its determination of maximum prices for the Monopoly Services provided by the Valuer General.¹ These maximum prices apply until 30 June 2014.

Reference to the Tribunal

IPART is requested by the Premier, under sections 12(1) and (3) of the IPART Act, to undertake a new determination or determinations of the maximum pricing for the Monopoly Services provided by the Valuer-General to apply in total for a period of 5 years (**Referral Period**). Under section 12(3) of the IPART Act, this referral may extend to an annual or other periodic determination of the pricing of the Monopoly Services during the Referral Period.

In doing so, IPART is requested to:

- ▼ Identify the Valuer-General's full efficient economic costs of providing the Monopoly Services over the determination period or periods;
- ▼ Develop an efficient, effective and transparent pricing framework for the Monopoly Services;
- ▼ Ensure full recovery of the Valuer-General's efficient costs of providing the Monopoly Services over the relevant determination period or periods;
- ▼ Ensure that prices efficiently allocate the costs of the Monopoly Services between the users of those services in accordance with relevant economic and pricing principles;

¹ IPART, *Price review of rating valuation services provided by the Valuer-General to local government*, Final Determination No.2, 2008.

- ▼ Consider the scope for the Valuer-General to achieve efficiency savings in providing the Monopoly Services;
- ▼ Consider any relevant NSW Government policies; and
- ▼ Specify the duration of the relevant determination period or periods.

In addition, IPART may take into account any other matters it considers relevant.

IPART should consult with key stakeholders, including government agencies responsible for management of the land valuation and rating systems. IPART is to submit its final report and determination to the Premier by 31 May 2014 and is to submit any subsequent reports and determinations to the Premier on such other date or dates as agreed.

It is intended that the determination or, in the event of a periodic determination of pricing, the first determination, will commence on 1 July 2014.



The Hon Barry O'Farrell MP

Premier

B Matters to be considered by IPART under section 15 of the IPART Act

In making pricing determinations, we are required by the IPART Act to have regard to the following matters (in addition to any other matters IPART considers relevant):

- a) the cost of providing the services concerned
- b) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies and standard of services
- c) the appropriate rate of return on public sector assets, including appropriate payment of dividends to the Government for the benefit of the people of New South Wales
- d) the effect on general price inflation over the medium term
- e) the need for greater efficiency in the supply of services so as to reduce costs for the benefit of consumers and taxpayers
- f) the need to maintain ecologically sustainable development (within the meaning of section 6 of the *Protection of the Environment Administration Act 1991*) by appropriate pricing policies that take account of all the feasible options available to protect the environment
- g) the impact on pricing policies of borrowing, capital and dividend requirements of the government agency concerned and, in particular, the impact of any need to renew or increase relevant assets
- h) the impact on pricing policies of any arrangements that the government agency concerned has entered into for the exercise of its functions by some other person or body
- i) the need to promote competition in the supply of the services concerned
- j) considerations of demand management (including levels of demand) and least cost planning
- k) the social impact of the determinations and recommendations
- l) standards of quality, reliability and safety of the services concerned (whether those standards are specified by legislation, agreement or otherwise).

C Weighted average cost of capital

In the 2009 Determination, we calculated the return on assets by basing the Valuer-General's WACC on Sydney Water's WACC at the time.¹⁷⁷ In our Issues Paper, we proposed calculating a WACC from first principles for the 2014 Determination.

It is important that the WACC has regard to the risk characteristics inherent in the Valuer-General's business. In our Issues Paper, we asked the Valuer-General to comment on the appropriate equity beta and gearing ratio for the WACC. The Issues Paper also invited the Valuer-General to propose an appropriate rate of return.

C.1 Valuer-General's proposed WACC

The Valuer-General considers that there is a case to reconsider the risk and gearing assumptions previously adopted by IPART in the 2008 Determination. This is because, unlike Sydney Water (and Hunter Water), VSLPI is not a capital intensive business and is more akin to an electricity retailer.

Given this line of reasoning, the Valuer-General considers a more realistic position would be to:¹⁷⁸

- ▼ Adopt the assumptions underpinning the rate of return for Hunter Water as a lower bound scenario, but update the market parameters.
- ▼ Adopt the assumptions underpinning the rate of return that IPART normally applies for electricity retail businesses as an upper bound scenario, but update the market parameters. In IPART's market update, the equity beta range for electricity retail businesses was 0.90 to 1.0, with a gearing ratio of 20%.

¹⁷⁷ Sydney water's real pre-tax WACC was 7.5% in its 2009 Determination. We deducted 0.5 percentage points to set a 7% real pre-tax WACC for the Valuer-General. IPART, *Review of Prices for Sydney Water Corporation's Water, Sewerage, Stormwater and other services - Final Report*, June 2008, p 156; and IPART, *Price review of rating valuation services provided by the Valuer General to local government – Final Determination and Final Report*, July 2008, p 17.

¹⁷⁸ Valuer-General submission, 7 February 2014, p 49.

Based on these assumptions, the Valuer-General proposed a WACC of 5.8%.¹⁷⁹ All else being equal, we note that the equity beta and gearing values proposed by the Valuer-General would result in an increase in the WACC compared to our last decision.

C.2 WACC parameters for the Valuer-General

The WACC is our estimate of the efficient cost of capital for a benchmark firm operating in competitive market and facing similar risks to the regulated business. The WACC range is established by the following process:

- ▼ estimating a range based on long-term averages
- ▼ estimating a range based on current market data
- ▼ using the midpoints of these 2 ranges as the upper and lower bounds of a final WACC range.

In determining the WACC, our default position is to choose the midpoint of the final WACC range as our point estimate. We construct an uncertainty index, however, to inform our decision on the WACC point estimate within the final range (see below).

We have adopted the mid-point of the real post-tax WACC range of 4.8%, as the point estimate for the Valuer-General. We have chosen the parameters (notably gearing and equity beta) having regard to the nature of the Valuer-General as a business services provider. We note that these parameters happen to be the same as those used in our latest metropolitan water pricing determinations.¹⁸⁰

The WACC parameters for the Valuer-General are outlined in Table C.1. The sections below explain how we estimated the WACC for this draft determination.

¹⁷⁹ Valuer-General submission, 7 February 2014, p 49.

¹⁸⁰ For example see: IPART, *Hunter Water Corporation's Water, Sewerage, Stormwater, Drainage and Other Services – Final Report and Determination*, June 2013, p 83; IPART, *Essential Energy's water and sewerage services in Broken Hill – Draft Report and Determination*, March 2014, p 137.

Table C.1 Draft WACC parameters, ranges and midpoint

	WACC using current data			WACC using long-term averages			Final WACC range		
	Low	Mid	High	Low	Mid	High	Low	Mid	High
Nominal risk free rate	4.2%	4.2%	4.2%	5.1%	5.1%	5.1%			
Inflation	2.8%	2.8%	2.8%	2.9%	2.9%	2.9%			
Debt margin	1.0%	1.6%	2.1%	2.5%	2.5%	2.5%			
Gearing	60%	60%	60%	60%	60%	60%			
MRP	7.3%	7.9%	8.6%	5.5%	6.0%	6.5%			
Equity beta	0.6	0.7	0.8	0.6	0.7	0.8			
Cost of debt (nominal pre-tax)	5.2%	5.8%	6.3%	7.6%	7.6%	7.6%			
Nominal Vanilla WACC	6.6%	7.4%	8.2%	7.9%	8.3%	8.7%	7.4%	7.8%	8.3%
Real post-tax WACC	3.7%	4.4%	5.3%	4.9%	5.2%	5.6%	4.4%	4.8%	5.2%

Note: IPART analysis.

Source: Thomson Reuters, Bloomberg and SFG.

C.2.1 Estimating industry specific parameters

The Valuer-General is a low risk business with stable costs and demand

The Valuer-General considers that his business is less capital intensive than a water utility and more akin to an electricity retailer.¹⁸¹ Accordingly, the Valuer-General established his preferred equity beta and gearing values, Table C.2, by taking the midpoint between the parameter values used in our 2013 Hunter Water and electricity retail price reviews.¹⁸²

Table C.2 Valuer-General's proposed equity beta and gearing ratio

	Equity beta	Gearing (%)
(A) Hunter Water 2013	0.7	60
(B) Electricity Retail 2013	0.9	20
(C) Valuer-General proposed ((A+B)/2)	0.8	40

Note: Adapted from the Valuer-General submission, 7 February 2014, p 50.

¹⁸¹ Valuer-General submission, 7 February 2014, p 49.

¹⁸² Valuer-General submission, 7 February 2014, p 49.

We consider that the absolute value of capital invested does not matter when considering the efficient gearing level. The gearing level measures how much of the capital invested is financed using debt and how much is financed using equity. The efficient allocation of different financing sources will, in reality, depend on the level of systematic risk – the equity beta and the levels of systematic and unsystematic risks – for the debt costs.

For example, in IPART's 2013 review of electricity retail prices, we noted that:

Whether or not an electricity retailer would carry less or more debt than a typical retailer is debatable. On the one hand, we view that an electricity retailer would be able to sustain more debt than a typical retailer as customer demand for electricity is more stable. Although we consider that sales will be still contingent on market conditions and competition from other electricity retailers, it is not like a typical retailer selling a product in which its entire market can evaporate when a competitor makes its product obsolete. On the other hand, electricity purchase costs are volatile, so the risk to the electricity retailer depends very much on the effectiveness of its hedging arrangements and this could affect its gearing ratio.¹⁸³

Accordingly, 2 types of risk would influence the efficient gearing level of a business:

- ▼ demand
- ▼ input factor cost volatility.

With respect to demand risk, we consider that the Valuer-General faces less risk than a typical electricity retailer, as it is the monopoly provider for land valuation services to councils. With respect to the second risk, we are unaware of any significant input factor cost volatility the Valuer-General may face now or in the future. Indeed, at the public hearing the Valuer-General noted that:

In relative terms or real terms we are predicting that our operating costs, going forward, will be pretty stable over the coming years through to the end of this determination.¹⁸⁴

Overall, we consider that the electricity retail gearing level and equity beta are not good proxies for the Valuer-General.

Suitable proxies for the Valuer-General

We attempted to identify suitable proxy businesses to estimate the efficient gearing level and equity beta for the Valuer-General. While it is difficult to find suitable proxy firms, we consider that services provided by the Valuer-General most closely match the industry classification of 'business support services'. There are a limited number of professional business services firms traded on the Australian and overseas stock exchanges.

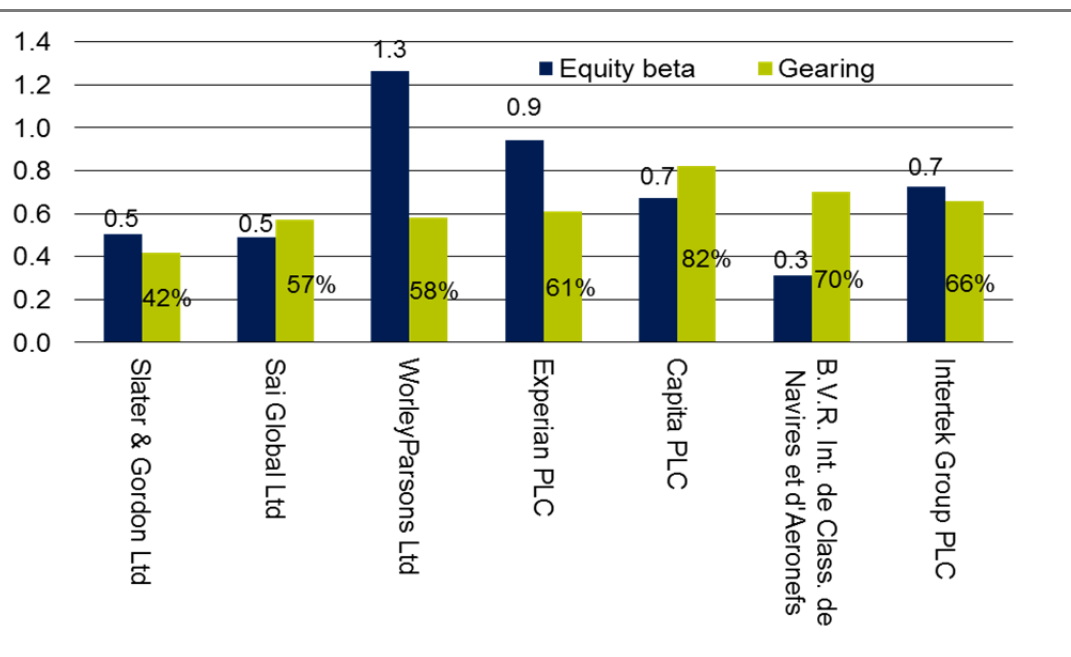
¹⁸³ IPART, *Review of regulated retail prices for electricity, 2013 to 2016 – Draft Report*, April 2013, p 200.

¹⁸⁴ Public Hearing Transcript, 25 February 2014, p 14.

The average gearing ratios for professional business services firms traded on the ASX 200 and the STOXX Europe 600 is 62% (see Figure C.1). Similarly, the equity beta of the proxy businesses is lower than the 0.8 proposed by the Valuer-General. The average is 0.7, with a low of 0.3 and a high of 1.3.

On this evidence, we adopted an equity beta of 0.6 to 0.8 and a gearing ratio of 60%.

Figure C.1 Gearing ratios and equity betas for business services



Data source: Thomson Reuters, Accessed 3 March 2014.

WACC decision-making framework – selecting the WACC point estimate

As part of our 2013 review of the WACC methodology,¹⁸⁵ we decided to use the following decision rule to choose a WACC from within the final range:

- ▼ If the uncertainty index is within or at 1 standard deviation from the long-term average of 0 (ie, economic uncertainty is neutral), we will select the midpoint WACC.
- ▼ If the uncertainty index is more than 1 standard deviation from the long-term average of 0, we will consider moving away from the midpoint WACC. In deciding whether and how much the WACC point estimate should deviate from the midpoint, we have regard to the value of the uncertainty index and additional financial market information, including debt and equity transaction data, interest rate swap curves, equity analyst reports and independent expert reports.

¹⁸⁵ IPART, *Review of WACC Methodology - Final Report*, December 2013, p 23.

The uncertainty index is currently within 1 standard deviation from the long-term average of 0 (see Figure C.2). Therefore, we have adopted the mid-point of the real post-tax WACC range as the point estimate WACC for the Valuer-General.

Figure C.2 **Uncertainty index**



Note: IPART analysis.

Data source: Thomson Reuters and Bloomberg.

D A proposed index to set prices

In this appendix, we set out how an index could be applied practically for future determinations. Given the relative stability of the Valuer-General's costs over time, we consider there may be a case for using a cost index from 2019/20 to reduce regulatory burden. However, that decision would need to be made by the Tribunal at that time under the relevant ToR.

The price index could be constructed based on the following assumptions:

- ▼ the last year of the 2014 Determination period could be used as the base year (2018/19)
- ▼ the index could be used to adjust prices in each year of the determination period
- ▼ if an index were used, the determination could be written as a methodology.

The index would need to be reviewed periodically to ensure that it continued to reflect the Valuer-General's costs. Below we outline the components of the Valuer-General's efficient costs that any future index would need to reflect.

D.1 Components of the index

In implementing the index, we could include 3 cost components to represent the Valuer-General's costs to servicing councils:

- ▼ labour costs
- ▼ mass valuation and other valuation contract costs
- ▼ all other costs.

The weights of each of the components of the index could reflect the base year of 2018/19 and remain unchanged over a determination period. For example, weights could be assigned as set out in Table D.1 below.

Table D.1 Cost weightings for index (% of total notional revenue for 2018/19)

Cost Item	Weight
Labour Costs	30%
Mass Valuation Contracts	42%
Other Valuation Contracts	7%
Remainder	21%

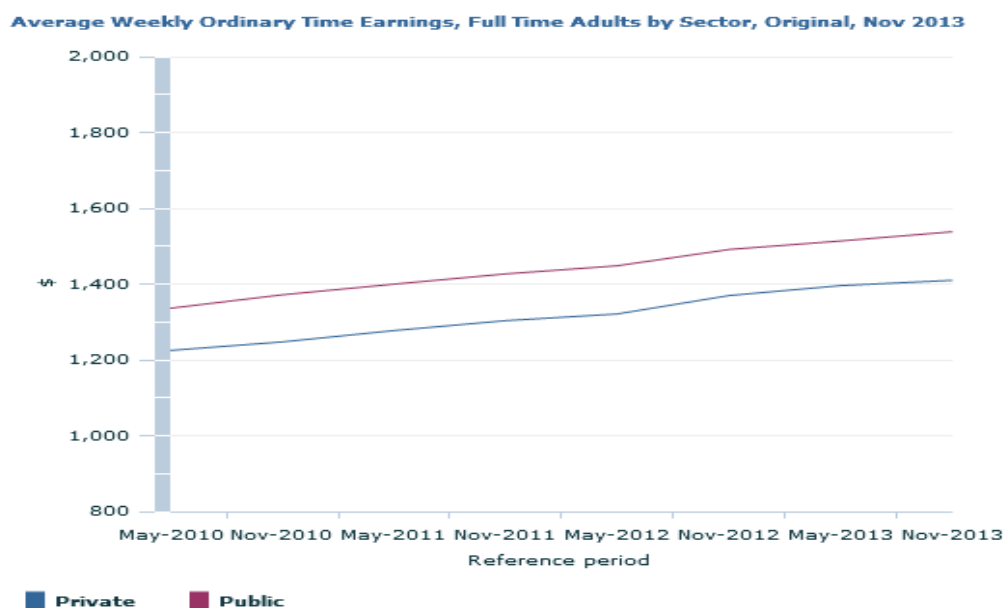
We could also apply a productivity factor to the index. The productivity factor would reflect efficiency gains that would be expected to be made by firms operating in a competitive market. We could, for example, apply the productivity factor used for the rate peg, with an appropriate adjustment, where necessary, to reflect industry specific factors.

In the sections that follow, we outline appropriate indicators that could be used to reflect the movement of each of the cost components of the index and the productivity factor.

D.1.1 Labour costs

For labour costs, we could use an index that is based on information that is publicly available, from a reputable source and updated on a regular basis.

We consider that data published by the Australian Bureau of Statistics (ABS) provides a reliable and transparent source of information on which to base price increases. The ABS publishes average weekly earnings according to whether individuals work in the private sector or public sector - see Figure D.1 below.

Figure D.1 Average weekly ordinary time earnings, full time adults by sector

Data source: ABS, *Private and Public Sector Earnings*, 6302.0, accessed at:
<http://www.abs.gov.au/ausstats/abs@.nsf/Lookup/6302.0main+features5Nov%202013>

We consider that changes in public sector wages could be used to determine changes in the wages component of the cost index used for the Valuer-General's services because:

- ▼ the prices we set for the Valuer-General's services should reflect the prices of his labour costs
- ▼ the growth rate in wages has been very similar, with changes in public sector earnings reflecting changes in private sector earnings
- ▼ the Valuer-General has used the average public sector wage benchmark in his submission to compare average wages within the Office of the Valuer-General and VSLPI with average wages within the public sector.¹⁸⁶

We note that the ABS public sector wages are currently reported in nominal terms, so they would need to be converted to real. We would also need to establish a base for the wage level and then measure the percentage change in wages in the following years.

D.1.2 Valuation contract costs

For this determination, the Valuer-General has proposed that the cost of mass and other valuation contracts remains constant over the period. However, for the next determination period, these costs could change from year to year.

¹⁸⁶ Valuer-General submission, 7 February 2014, p 57.

We consider that the contribution of mass and other valuation contracts to the change in the index could be based on the actual cost of these contracts in each year of a determination period. We consider that a 'light-handed' approach to the Valuer-General's valuation costs may be appropriate given that:

- ▼ mass valuations are outsourced through a competitive tendering process, which means this cost is market tested
- ▼ the tender process is overseen by relevant stakeholders¹⁸⁷
- ▼ the Valuer-General's valuation system is subject to constant review and benchmarking.

We would need to set a value for the real annual average change in the costs of mass and other valuation contracts. This would be based on our assessment of the yearly change in costs of these contracts at the time of next determination. In order to be confident that these costs are efficient, we would review the tender process to ensure that it is achieving competitive outcomes.

D.1.3 Other costs

We consider that the remainder of the index could be based on the CPI, as the other components of the Valuer-General's costs represent relatively small shares.

The Valuer-General noted that if a further review of prices has not been completed by the end of 2018/19, then an annual price increase in line with CPI from 2019/20 onwards would be appropriate.¹⁸⁸ This indicates that the Valuer-General's costs are relatively stable and reasonable to use CPI to index his remaining costs.

D.1.4 Productivity factor

We could base the productivity factor on the most recent factor used for local government in the rate peg, and then adjust it for any factors specific to the Valuer-General's business.

In our calculation of the rate peg for councils, we include a productivity factor to allow ratepayers to share the efficiency gains made by councils. It is based on the long-term annual average increase in the ABS measure of aggregate gross output market-sector multifactor productivity and a consideration of specific factors affecting councils.

¹⁸⁷ Local Government NSW submission, 14 February 2014, p 2.

¹⁸⁸ Valuer-General submission, 7 February 2014, p 63.

For the 2014/15 rate peg, we maintained the productivity factor for councils at 0.2%, which was based on:¹⁸⁹

- ▼ a benchmark productivity factor of 0.3% using the 15-year annual average increase in the ABS multifactor productivity
- ▼ discount of 0.1 percentage points to reflect factors that are specific to the councils.

However, the ABS no longer publishes the multifactor productivity index. We will review the methodology for determining a benchmark productivity factor during 2014.

D.2 An example of how the index could work

For this example, we will assume:

- ▼ public sector earnings to increase by 2.5% per annum
- ▼ mass valuation contracts to increase by 1%
- ▼ other valuation contracts are assumed to increase by 1%
- ▼ all other costs stay constant in real terms
- ▼ a productivity factor of 0.2%, being the benchmark productivity factor based on our local government rate peg.¹⁹⁰

Based on the weightings assigned to the cost items and the above assumptions, we could compile the index to reflect changes in the Valuer-General's annual costs as shown in Table D.2 below. Including the productivity factor, 2018/19 prices would be increased by 1.1% in real terms for the 2019/20 year. This process would then be repeated for each year thereafter of the determination period.

¹⁸⁹ IPART, *2014/15 Rate Peg, Local Government – Information Paper*, December 2013, pp 8-9.

¹⁹⁰ In setting a productivity factor of 0.2%, we have deducted 0.1 percentage points from the benchmark multifactor productivity factor of 0.3% to reflect that productivity gains would already be factored into the labour cost index and that labour would account for about one-third of the multifactor productivity factor.

Table D.2 Worked example of proposed price index for the Valuer-General for future determinations

Cost Item	Weight	Inflator	Inflator Value	Change
Labour Costs	30%	Public Sector Earnings	2.5%	0.8%
Mass Valuation Contracts	42%	IPART determined average annual increase	1%	0.4%
Other Valuation Contracts	7%	IPART determined average annual increase	1%	0.1%
Remainder	21%	Constant in real terms	0%	0%
Total cost index	100%			1.3%
Productivity Factor				0.2%
Price index				1.1%

Glossary

2009 Determination	IPART's Determination No. 2, 2008 entitled " <i>Price review of rating valuation services provided by the Valuer General to local government</i> " for the period 1 July 2009 to 30 June 2014.
2014 Determination	Refers to the upcoming price period – ie, prices from 1 July 2014 to 30 June 2019 (unless the 2014 Determination is replaced by a subsequent determination during the referral period).
ABS	Australian Bureau of Statistics
<i>Ad valorem</i> tax	A tax based on the value of real estate or personal property.
ATO	Australian Tax Office
Council	Councils of areas under the Local Government Act
Declared services	The services declared to be government monopoly services under the <i>Government Pricing Tribunal (Valuer-General's Services) Order 1993</i> (Gazette No. 89, 13 August 1993, page 4571): "Furnishing valuation lists and supplementary lists under Part 5 of the <i>Valuation of Land Act 1916</i> by the Valuer-General to a council of an area under the <i>Local Government Act 1993</i> ".
DFS	Department of Finance and Services
Glide path	A method of setting prices such that they transition towards cost-recovery over the determination period.
IPART	The Independent Pricing and Regulatory Tribunal of NSW

IPART Act	<i>Independent Pricing and Regulatory Tribunal Act 1992 (NSW)</i>
JSCOVG	The Joint Standing Parliamentary Committee on the Office of the Valuer-General that monitors and reviews the exercise of the Valuer-General's functions with respect to land valuations.
LPI	Land and Property Information is part of the Department of Finance and Services, and manages the valuation system on behalf of the Valuer-General.
Local Government Act	<i>Local Government Act 1993 (NSW)</i>
NPV	Net present value
RAB	Regulatory asset base
Referral period	The period over which the determination(s) is to apply - ie, from 1 July 2014 to 30 June 2019. The ToR require that new determination(s) of maximum pricing for the Valuer-General's land valuation services to councils apply in total for a period of 5 years.
Valuation of Land Act	<i>Valuation of Land Act 1916 (NSW)</i>
Valuer-General	An independent statutory officer appointed by the Governor of New South Wales to oversee the valuation system.
VSLPI	Valuation Services business unit of LPI, which provides the majority of valuation services to the Valuer-General.
WACC	Weighted average cost of capital