IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Revenue Framework for Local Government

Other Industries — Final Report
December 2009

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1 Introduction and executive summary

Local government is the third tier of government in Australia, and councils play an important role in providing services and infrastructure within local communities. However, there is enormous diversity between councils in NSW in terms of the characteristics of the areas and populations they serve. In addition, the legislation that establishes councils' role provides them with flexibility to provide services that reflect their community's demands, so the range of services they provide is also diverse.

For the past 30 years, some sources of the revenue NSW councils raise to pay for service provision – primarily revenue from property rates – has been regulated through an approach known as rate pegging. The NSW Government has a long-standing commitment to this approach, primarily because it protects ratepayers from unreasonable increases in rates. There is also strong community support for this approach. But many councils have concerns about the current regulatory arrangements, and some strongly oppose rate pegging on the grounds that it limits their ability to provide the range and level of services their community demands.

In response to these concerns, the NSW Government asked the Independent Pricing and Regulatory Tribunal of NSW (IPART) to review of the current framework for regulating council rates and charges. In particular, it asked us to investigate and make recommendations on:

1. An appropriate inter-governmental and regulatory framework for setting council rates and charges that facilitates the effective and efficient provision of local government services.
2. A role for IPART in setting rates and charges in future years.
3. A framework for setting the charges levied by certain public authorities to enable them to recover costs for the provision of services normally provided by local government. These authorities include Sydney Harbour Foreshore Authority, Redfern Waterloo Authority, Sydney Olympic Park Authority and the Growth Centres Commission.[1]

[1] Subsequent to IPART receiving the Terms of Reference the scope of this review has been reduced to issues relating primarily to SOPA and SHFA. RWA does not provide typical local government services within its area and SHFA's role has been reduced with the establishment of the Barangaroo Delivery Authority and the transfer of its planning functions to the Department of Planning. The Government also abolished the Growth Centres Commission.

In undertaking this review, we were required to have regard to a wide range of matters. These include local government's role in delivering infrastructure and services to the community, its financial position, scope for efficiency improvements and revenue sources, and the differences between metropolitan, regional and rural councils. (See Appendix A for the full terms of reference.) In complying with this requirement, we undertook extensive public consultation. We also conducted considerable research and analysis on the current regulatory arrangements, including impact of rate pegging on NSW councils' financial performance and long-term sustainability (see Box 1.1 for an outline of our review process).

1.1 Overview of recommended framework for regulating council rate revenue

Based on the findings of our analysis and consultations, we have developed and recommended a new framework for regulating council revenue that retains the current rate pegging approach, but builds on and improves this approach particularly with the option of more autonomy for councils. This framework addresses many of stakeholders' concerns with the current framework, and also links to and builds on other elements of the broader framework for regulating councils, particularly the Integrated Planning and Reporting Framework.

Our recommended framework comprises 2 alternative options for regulating the increase in councils' rates revenue – Option A and Option B. Option A is the default regulatory mechanism for all councils under the recommended framework. It maintains the general rate pegging approach, but provides for greater transparency, rigour and independence in the process for setting regulated rate increases and assessing applications for variations to these increases. It also provides councils with a medium term focus for their revenue and expenditure planning.

Under Option A, councils' general income is regulated in one of 2 ways. First, they can increase their rates in line with an annual rate peg that is determined by the Minister, taking into account the change in a local-government-specific cost index and the potential for councils to achieve productivity gains. A key change in this framework is that the index is calculated transparently and would reflect movements in councils' costs. IPART would calculate and publish the index and estimate a productivity adjustment factor. Second, those councils that meet specified eligibility criteria can propose and gain approval to implement a medium-term revenue path (which incorporates variations to the rate peg). This medium-term approach to special variations provides incentives for councils to adopt longer planning horizons. The eligibility requirements improve the links between rate setting and strategic planning, and encourage councils to improve their accountability to the community and their efficiency and effectiveness.

Box 1.1 Review process

IPART undertook this review under Section 9 of the *Independent Pricing and Regulatory Act 1992*. As part of its review process, we conducted public consultation and our own analysis. In particular we:

- released an issues paper and invited submissions from all interested parties
- conducted a series of public workshops in Sydney and in regional centres
- considered all the submissions and analysed the information we received in submissions and at all public workshops
- undertook analysis of available data on council revenues, expenditures and financial positions in NSW and other states
- undertook detailed analysis of 11 case study councils
- prepared and submitted a draft report and recommendations to the Minister for Local Government, made this report publicly available and invited stakeholder submissions
- held a second series of public workshops in Sydney and in regional centres to provide stakeholders with further opportunities to comment on the draft report and recommendations
- considered all the submissions and comments in response to the draft report and recommendations before finalising our recommendations and preparing this draft report.

Appendices C and D list the stakeholders who provided submissions on the issues paper and the draft report and details of the public workshop.

Option B is an adjunct to Option A rather than a standalone regulatory mechanism. It provides an opportunity for councils to gain greater autonomy in setting rates. Councils must meet specified minimum performance requirements before they will be eligible to apply to operate under Option B. They must clearly demonstrate a community mandate for their proposed 4-year revenue and expenditure plans before they will be granted approval by the Minister.

The criteria for gaining rate setting autonomy under Option B are stricter than those for obtaining a medium term revenue path under Option A. Under Option B councils must meet higher performance requirements and demonstrate that they satisfy more stringent community engagement and accountability criteria. In addition, once they gain approval to operating under this option, they are able to set rates in accordance with their revenue and expenditure plans indefinitely, as long as they continue to meet the minimum performance requirements and satisfy the community accountability criteria. In contrast, a council operating under Option A must either apply the annual rate peg or obtain Ministerial approval to increase rates in line with a proposed medium-term revenue path every 4 years.

1.2 Overview of findings on the impact of rate pegging on councils' financial performance

One of stakeholders' main concerns about the current rate pegging approach is that it has constrained local government revenues and expenditures, particularly infrastructure expenditure. As a result, some stakeholders believe it has compromised the long-term financial sustainability of NSW councils and led to the problem of infrastructure backlogs. To consider this concern, we compared the trends in council revenues in NSW to those in other states and the Northern Territory (where there is no rate pegging) over the past 30 years. We found that:

- Rate pegging has limited the growth of NSW councils' rate revenue. However, they have been able to substitute other sources of revenue, such as user fees and charges, so the growth in their total revenues has been broadly in line with that in the other states.
- Over the last 10 years under rate pegging, half of the councils have increased their rates (per property) by more than the rate peg amount while the other half have increased rates by less than the rate peg amount.
- NSW councils' total revenue per capita has grown by more than NSW Gross State Product over the last 30 years and, except for the last 10 years, it has grown in line with that of councils in other states.
- NSW councils have generated larger surpluses and have tended to accumulate less debt (on a per capita basis) than councils in most other states.
- NSW councils' capital expenditure on new infrastructure assets is lower and has grown more slowly than in councils in other states, while their operating expenditure has grown more rapidly than in other states.

As stakeholders noted, and our own investigations found, there are a number of problems with the data on council revenues that cloud its interpretation. Nevertheless, we concluded that, on balance, the evidence does not show that the average financial position of councils in NSW is worse than in other states.[2] Overall revenue growth has been strong and debt levels have been contained. As a result, the growth in NSW councils' total revenues has been broadly in line with that in the other states for most of the time since rate pegging was introduced.

In relation to capital expenditure, there does appear to be a backlog of council infrastructure works in NSW that needs to be addressed. For some councils, the backlog may be so large that it threatens their financial sustainability. However, the

[2] A council's financial sustainability is based on a combination of its operating (or recurrent) performance and its capital performance. Therefore, we measured both recurrent sustainability and capital sustainability. Recurrent sustainability means that councils are able to fund their recurrent expenditures from recurrent revenues, and so avoid using capital revenues for this purpose or running recurring operating deficits. Capital sustainability means that councils are able to fund infrastructure (both new and renewals) and asset maintenance to a level sufficient to ensure they can provide affordable services that meet reasonable standards over a 10-year period.

same is true in other states, and there is not sufficient evidence to conclude that the infrastructure backlog is worse in NSW than elsewhere. We have concluded that that the evidence may suggest that rate pegging is a contributing factor to the infrastructure backlog in NSW. However, it more clearly indicates that it is not the only contributing factor.

In addition, NSW councils' lower spending on new infrastructure assets may reflect a range of factors other than rate pegging on revenue. For example, it may be related to different rates of economic growth across the states, councils' particular policies and asset management approaches, the level of grants, subsidies and developer contributions they receive, and the demand on their revenue from asset maintenance.

NSW councils' lower debt levels suggest they could make better use of debt to finance additional infrastructure programs within the current rate pegging framework. To the extent that rate pegging adds to councils' uncertainty about their future income levels, it may discourage councils from taking on additional debt financing burdens. However, there may also be other reasons for their reluctance of to take on debt.

Overall, based on the available evidence, we cannot find that rate pegging has had an adverse effect on the average financial position of councils in NSW, or on their long-term financial sustainability.

1.3 Changes since the draft report

We have considered the submissions we have received on our draft report and the comments made during public consultation. As a result, we have made a number of changes for this final report. The primary changes include:

- providing more flexibility for councils seeking a medium-term revenue path under Option A
- relaxing the minimum performance standards councils must meet to be eligible to apply under Option B
- including sample surveys among the suggested approaches councils may use to demonstrate they have a community mandate under Option B
- bringing forward our calculation and publication of the change in the Local Government Cost Index to November each year to facilitate councils' forward planning and budget preparation
- separating our estimation and advice on the productivity adjustment factor from the calculation of the change in the cost index.

In addition, in response to stakeholder comments on our analysis and draft findings on the impact of rate pegging on NSW councils' financial performance, we have further examined the reliability of the available data on councils' financial performance and the evidence on infrastructure backlogs. We have tried to express

and support our findings more carefully and clearly. However, our key findings remain substantially the same.

1.4 How the framework enhances accountability and transparency

The accountability of local government and the protection of ratepayers are policy objectives that are important to the NSW community. However, the current rate pegging system has created competing tensions between these objectives with ratepayer protection being delivered at the expense of transparency, accountability and responsibility of Councils to their electorates. IPART considers that in practice, these competing, but desirable objectives can be better balanced.

Stakeholders have also expressed a range of other concerns about the rate pegging arrangements, and the way they are applied. The majority of submissions to the review were from councils and most of the submissions argued that rate pegging should end. A number of other submissions, such as NSW Treasury's submission, also supported removal of rate pegging.

The key arguments against rate pegging, as it currently operates, are:

- it lacks transparency and weakens the accountability of councils to their communities for the rate setting process
- it does not necessarily reflect movements in council costs
- it encourages a short term focus and discourages medium term planning of expenditure and income.

No other state (with the exception of the Northern Territory) has had rate pegging in the last decade. We found that while other states (eg, Victoria) have at times controlled council rates, and that similar controls are used in some overseas jurisdictions, it is now more common for local government in Australia to have greater autonomy in rate-setting than is currently the case in NSW.

Against this, a number of councils recognised the primary benefit of rate pegging; that is, the protection of ratepayers from excessive increases in their rate bills. In addition, it was argued that rate pegging encourages the use of alternative revenue sources such as user charges, which, for users, have a more transparent link between their decision to use and pay for, council services.

On balance, whilst rate pegging plays an important role in ratepayer protection, it appears to have been at the cost of reduced transparency and accountability to ratepayers. However, this is not an 'all or nothing' decision between two alternatives. The majority of people are at the same time ratepayers, consumers and citizens, and the critical issue is to find the best institutional arrangements that will achieve a fair balance between the demands for reductions in revenue and increases in expenditure.

Based on our consideration of these concerns, we concluded that the current regulatory framework requires important reforms to better facilitate efficient and effective provision of local government services and infrastructure in NSW. In particular, we found there is a need to:

- Improve the transparency of the regulatory framework, and provide for greater rigour and independence in calculating the basis of regulated rate increases.
- Encourage councils to take a longer term approach to planning their revenue and expenditure, and link these budgeting processes to the Integrated Planning and Reporting framework.
- Provide incentives for councils to improve their engagement with and accountability to their community.
- Encourage councils to improve their efficiency and effectiveness.
- Encourage councils to improve their financial management and provide greater scope for them to improve their long-term financial sustainability.
- Take better account of the diversity among NSW councils.

We consider that our recommended framework addresses these needs. For example, determining the annual rate peg with reference to the change in a Local Government Cost Index calculated and published by IPART will help ensure that it is based on an accurate estimate of the change in council costs, and increase the transparency and independence of this decision. Requiring councils to meet minimum performance standards to be eligible to seek a medium-term revenue path under Option A or to operate under Option B will create strong incentives for councils improve their performance. In addition, the additional flexibility provided by Option B takes better account of the diversity among NSW councils.

We note that it has not been possible to address the diverse needs of all councils through the framework. In particular, the framework does not fully addressed the particular needs of small rural councils. We found that the characteristics of the area and populations these councils serve have led to a fundamental mismatch between their expenditure responsibilities and their revenue base. Providing them with more scope to increase rates will not address this mismatch and some alternative government action is required to improve the long-term sustainability of these councils.

We also examined the broader regulatory framework, including the inter-governmental arrangements between councils and the Division of Local Government. We found that although recently introduced reforms to the local government accountability arrangements in NSW – particularly the Integrated Framework for Planning and Reporting – will significantly strengthen these arrangements there is scope for further improvements. In particular, we found there is a need to:

- improve the current accountability arrangements to strengthen councils' accountability to their community and level of community engagement

- improve the current reporting requirements in relation to councils' financial performance and asset management
- improve the current reporting requirements in relation to councils' efficiency and effectiveness.

1.5 How the new framework would operate

Option A

Under Option A:

- each year, IPART would calculate and advise the Minister of the percentage change in a local government cost index, after an adjustment for productivity
- the Minister would then determine the increase in rates
- there would be a new process for councils to apply to the Minister to determine rates over a number of years, replacing the existing special variation process.

The current arrangements whereby councils seek variations of the rate peg would be enhanced with a mechanism that enables councils to seek Ministerial approval for multi-year revenue paths. Councils, including those who are seeking to improve their financial sustainability through, for example, higher revenue growth, would be able to request medium term revenue paths with rate increases above the regulated annual rate increase. Eligibility for a medium term rate path would be based on council compliance with the Integrated Planning and Reporting Framework including the development of an asset management plan.

We envisage that the two elements of Option A – regulated annual rate increases and multi-year revenue paths - would operate together. Some councils may not wish to increase rates by more than the regulated annual rate increase. Other councils may wish to increase rates by more than this to, for example, improve their financial sustainability, invest in capital expenditure and other programs to address backlogs, or expand services. Those councils that seek and fail in their requests for a medium term revenue path and rate increases beyond the regulated annual rate increase would revert to the regulated annual rate increase for that year. They would, however, be able to re-apply for a rate variation in subsequent years within the four year cycle. The combination of these elements is designed to provide flexibility for councils and certainty of outcomes.

Option B

Under Option B, councils would need to earn their independence by demonstrating:

- a track record of sound financial management
- a commitment to achieving recurrent financial sustainability over the 4-year term of council (or have already achieved financial sustainability) and have policies and practices in place to achieve capital financial sustainability
- that they have developed a medium term approach to revenue, expenditure and service delivery plans
- they have an audited asset management plan, and
- that their plans, including the council's proposed medium term revenue plan, have the support of their constituent communities.

We note that, in setting out what councils need to demonstrate to be eligible to operate under Option B, we have been less concerned with councils' capital sustainability. Rather we have addressed this through requirements for councils to develop audited asset management plans and a requirement to demonstrate how they propose to address their infrastructure backlog.

We note that the effectiveness of the accountability of local government to their electorates in ultimately achieving rate levels and revenue and expenditure choices that are efficient and equitable is at this stage unknown, and in this regard, the outcomes under Option A are more assured than under Option B. However, a model that incorporates a progressive move to Option B is theoretically more consistent with the achievement of accountability of local government through the electorate, greater community engagement and development, and the position of local government as a genuine third tier of government.

Further, a workable Option B can provide a better outcome for ratepayers than rate pegging (even with the use of special variations) given the diversity of councils and their needs.

Roles

The proposed framework envisages clear roles for the Minister for Local Government, the Division of Local Government and IPART.

Under either option within the proposed framework, IPART would establish, maintain and publish an independent cost index, the Local Government Cost Index, (LGCI). Changes in the index would reflect the changes in the average costs experienced by councils. IPART would also estimate a productivity adjustment factor.

The Minister would then determine the regulated annual rate of increase in rates after taking account of IPART's recommendations for this overall rate of cost increase. However, any increase as determined by the Minister that is either over or under IPART's recommended cost increase would be accompanied by a statement of reasons together with the announcement of the decision.

The Minister would be responsible for approving or rejecting any requests submitted by councils under Option A for medium term revenue paths or variations over the regulated annual rate increase. This would be a transparent process with clear criteria against which the submission would be assessed. The Minister would also be responsible for determining each council's eligibility to move to Option B. This would involve councils:

- demonstrating to the Minister that they meet financial performance, planning and reporting requirements
- seeking a mandate from the community and demonstrating to the Minister that they have a mandate from the community for proposed revenue and expenditure plans.

The Division would monitor the compliance with the regulated annual rate increase under Option A as well as compliance with the all performance and accountability criteria required in Options A and B.

Under the recommended framework for regulating council revenues, IPART role will be limited to:

- Establishing, maintaining and publishing a Local Government Cost Index, and calculating and publishing the annual change in this index in November each year.
- Calculating and publishing an annual productivity adjustment factor that reflects our estimate of the potential for NSW councils to achieve productivity gains in the medium term.
- Advising the Minister of the annual change in the Local Government Cost Index and the annual productivity adjustment factor each year, for consideration in setting the annual regulated rate adjustment.

1.6 Overview of recommended framework for statutory authorities

We have also developed and recommended an approach to enable some public authorities (such as SOPA and SHFA) to recover the costs they incur in providing services that would normally be provided by local government. We consider that this issue should be dealt with primarily by negotiation, supported by a mechanism for resolving disputes between these statutory authorities and the relevant councils that involves mediation and, if necessary, arbitration.

We have also developed pricing principles for use in any arbitration. Under these principles, the amount that an authority can recover from a council would be limited to the amount that the council saves because the authority is providing services that it would otherwise provide. The Government may need to amend the local government legislation to introduce this framework.

1.7 Recommendations

Providing services that reflect community demands

1 That the framework for regulating council revenues should encourage councils to provide services that reflect their community's demands. However, there needs to be a balance between the demands and expectations of local communities and their council's scope to raise revenue. 29

Improving inter-governmental arrangements between councils and the Division of Local Government

2 To improve councils' accountability to the community, that the Division of Local Government should: 45

- Expand the current requirements for developing a Community Engagement Strategy so that councils are also required to give due consideration to the expected levels of service expressed by the community. 45
- Require councils to circulate a short summary of their Draft Delivery Program that is designed to obtain community input on council decisions. 45
- Encourage councils to improve their community engagement to ensure this engagement encompasses all key stakeholders to whom they are accountable. 45
- Publish best-practice examples of Delivery Programs and their summaries, and best-practice examples and case studies of community engagement. 45
- Take a proactive role in encouraging and assisting councils to improve the quality of information included in annual reports – for example, by publishing best-practice examples, developing guidelines to improve consistency, and creating incentives for improvement. 45
- Develop an asset management manual that includes guidance and/or requirements to help councils develop asset management systems and plans. 45

Improving financial management and asset management

3 To facilitate more accurate measurement and interpretation of councils' operating results, that the Division of Local Government require councils to disclose their Net Operating Result (surplus/deficit), **excluding** capital revenues, as the principal measure of operating result. Capital revenues to be excluded from the result include: 89

- proceeds from asset sales 89
- developer contributions, and 89
- capital grants. 89

4 To enable accurate measurement and monitoring of the state-wide infrastructure backlog, and assist councils to address their individual backlogs, that the Division of Local Government require councils to: 115

- report maintenance costs relating to public works in their operating statements 115
- report actual annual expenditure on renewal of capital works within Special Schedule No. 7 of the published financial statements 115
- have asset management systems based on a common definition of asset condition. 116

5 That the Division of Local Government and local councils should develop consistent definitions of asset condition for use by all councils in asset management planning and asset management systems. 116

Improving the effectiveness of the provision of services

6 That the Division of Local Government require councils to report on both expected and realised productivity improvements. 131

7 To facilitate improvement in councils' efficiency and effectiveness, that the Division of Local Government: 131

- Require all councils to conduct a community satisfaction survey every 4 years to measure satisfaction with service delivery and infrastructure provision in key areas, and publish the results in their annual report. 131
- Together with the LGSA develop this survey for use by all councils. 131

Improving the transparency of regulated rate increases

8 That the framework for regulating council revenues should clearly explain the methodology used to determine the rate peg and the criteria used to assess applications for special variations. 135

9 That all applications for special variations should be publicly available on the Division of Local Government's website, along with a summary of the Minister's decisions and reasons for those decisions. 135

A new framework for regulating council rate revenues

10 That the NSW Government continue to regulate councils' general income (as defined for the purpose of regulating council revenue), and introduce a new regulatory framework that: 144

- provides 2 options for regulating council revenues (Option A and Option B) as outlined in Recommendations 11 and 12 144
- introduces 4-year rate setting horizons 144
- establishes a closer relationship between rate setting and councils' strategic planning. 144

11 That Option A be adopted as the new default arrangement for all councils, and that this option retains rate pegging and: 144

- provides for the Minister to determine annual regulated rate increases with reference to the change in a Local Government Cost Index (LGCI), which would be independently calculated and published, and a productivity adjustment factor 144
- retains the option for councils to apply for a special variation and establishes transparent criteria for assessing these applications 144
- provides that councils applying for multi-year special variations must develop medium-term revenue paths and meet other minimum eligibility requirements.144

12 That Option B be adopted as an alternative form of regulation that operates in conjunction with Option A, and that this option: 144

- provide eligible councils with greater autonomy over rate setting that is balanced with greater accountability to their community to ensure that rate setting is consistent with a community mandate 144
- be available only to councils that have sought and received Ministerial approval to operate under Option B on the basis that they meet specified minimum eligibility criteria. 144

The specifics of Option A

13 That IPART: 156

- develop, maintain and publish the LGCI, and calculate the change in this index on an annual basis 156
- estimate the productivity adjustment factor in 2010/11 for 2011/12, and then in the first year of every 4-year local government electoral cycle 156
- provide advice to the Minister on the annual change in the Local Government Cost Index and the annual productivity adjustment factor, and publish this advice and calculations. 156

14 That the Minister retain the discretion and flexibility to set the regulated annual rate increase at a higher or lower level than implied in IPART's advice and, when this occurs, be obliged to publish a statement of reasons for this decision. 156

15 That a council applying the annual rate peg automatically be entitled to 'catch up' rates income foregone when it adjusts rates by less than the annual rate peg in a particular year, provided it does so over the remaining years of the 4-year period. 156

16 That to be eligible to apply for a medium-term (4-year) revenue path (which incorporates special variations to regulated rate increases) under Option A, councils be required to meet minimum eligibility requirements. These requirements should reflect those under the Integrated Planning and Reporting Framework, and should include councils having developed: 160

- a 10-year Community Strategic Plan 160
- a detailed asset management plan 160
- a 4-year Delivery Plan 160
- annual resourcing plans. 160

17 That before applying for a medium-term revenue path under Option A, a council must: 161

- develop a medium-term revenue plan that aligns with its 4-year Delivery Program, sets out its detailed revenue requirements and expenditure plans for the period of the revenue path (in real terms), and indicates the implications for rate increases 161
- engage and consult with its community in developing this plan and obtain community support for the plan. 161

18 That applications for medium-term revenue paths under Option A include: 161

- The council's proposed revenue plan and 4-year Delivery Program. 161
- Adequate evidence and supporting material to demonstrate that the council meets the minimum eligibility requirements, and has consulted the community and received community support for the proposed revenue plan. 161

- Adequate evidence and supporting material to demonstrate that the application satisfies the assessment criteria. 161

19 That councils be required to lodge applications for medium-term revenue paths with the Division of Local Government by September 30 of the year following a council election. 161

20 That the Division of Local Government and the Minister be required to assess and decide upon such applications within 3 months of lodgement. 161

21 That applications for medium-term revenue paths under Option A be assessed against transparent criteria that include: 161

- A demonstrated need for the rate increases implied by the proposed revenue path due to 1 or more of the following: 161
  - Service provision requirements (eg, unmet demand for services, or community support for enhanced service standards). 161
  - A special or unique cost pressure faced by the council (eg, due to need to prepare audited asset management plans, or undertake financial restructuring as part of a longer term plan for achieving financial sustainability). 161
  - Infrastructure backlogs that have adverse implications for the amenity, safety and health of community. 161
- Demonstrated community support for the proposed revenue path. 161
- Demonstrated sustainable use of debt to address capital expenditure requirements. 161
- Reasonable impact on ratepayers. 161
- Adequate evidence of compliance with minimum eligibility requirements. 161
- An explanation of the productivity improvements the council has realised in past years, and plans to realise over the proposed revenue path. 161

22 That the Minister retain the flexibility to approve, vary or reject a council's application for a medium-term revenue path under Option A based on the extent to which the application satisfies the assessment criteria. Where a council's application is rejected, a statement of reasons must be provided and published on the Division of Local Government's website. 162

23 That where a council's application for a medium-term rate path under Option A is rejected, the council be subject to the regulated annual rate increase for the year, and may apply again for a one-off variation in subsequent years of the 4-year cycle.162

24 That at the end of an approved medium-term revenue path under Option A, a council's revenue base be reset to reflect the endpoint of that path, except where the revenue path was granted to enable the council to meet a non-recurrent cost. In this latter case, the revenue base would be adjusted to reflect the cumulative regulated rate increase for the period of the path. 162

The specifics of Option B

25 That to be entitled to apply to operate under Option B, a council be required to meet a specified set of minimum eligibiity requirements including: 173

- financial performance requirements, as outlined in Recommendation 26 173
- planning and reporting requirements, as outlined in Recommendation 27 173
- community engagement and consultation requirements, as outlined in Recommendation 28. 173

26 That the financial performance requirements under Option B include: 173

- Compliance with the Local Government Code of Accounting Practice and Financial Reporting. 173
- A responsible funding policy for capital works that uses a combination of sustainable debt levels and revenue funding. 173
- A track record of sound asset management practices, including having all assets valued at fair value. 173
- A track record of sound financial performance that indicates the council at least has the capacity to achieve recurrent financial sustainability over the current 4-year term and policies and practices in place to achieve capital sustainability, including: 173
  - a track record of generally balanced operating results over the economic cycle (eg, previous 5 years) 173
  - a reasonable liquidity ratio 173
  - demonstrated sustainable use of debt to address capital expenditure requirements. 173
  - a reasonable program of asset renewal to address infrastructure backlogs. 173

27 That the planning and reporting requirements under Option B include: 173

- meeting all requirements under the Integrated Planning and Reporting Framework 173
- reporting performance against the financial performance requirements outlined in Recommendation 26 to the Division of Local Government 173
- developing a detailed revenue and expenditure plan for the current 4-year term that aligns with the council's 4-year Delivery Program and includes: 173

- o a fully costed list of major capital projects to be funded via rates revenue (either directly or indirectly) 173
- o an audited asset management plan that defines the service levels, and 173
- o the estimated revenue requirements for implementing the revenue and expenditure. 173

28 That the community engagement and consultation requirements under Option B include developing a Community Engagement Strategy that outlines the approaches the council proposes to use to: 174

- – engage and consult its community on the proposed revenue and expenditure plan 174
- – measure the level of community support for the plan and demonstrate that it has a community mandate. 174

29 That to gain approval to operate under Option B, a council must: 174

- – First apply in writing to the Minister, demonstrating to the Minister's satisfaction that it meets the minimum eligibility requirements 174
- – Second, after being notified that approval to apply has been granted, apply in writing to the Minister, demonstrating to the Minister's satisfaction that it has implemented its Community Engagement Stategy and obtained a community mandate to implement its proposed revenue and expenditure plan. 174

30 That the specific approaches councils may use to demonstrate their community mandate under Option B not be prescribed, and that the Division of Local Government develop guidelines to assist councils in deciding on an appropriate approach. For example, the guidelines might outline: 174

- – Options for this approach, such as a sample survey option, a more comprehensive survey option and a voting option. 174
- – Guidelines for designing and conducting survey options. 174
- – Guidelines for determining what percentage of ratepayers should respond to the survey, and what level of support constitutes a mandate. 174

31 That councils that fail to gain Ministerial approval to apply to operate under Option B, or subsequently fail to gain Ministerial approval to operate under Option B be subject to the regulatory arrangements under Option A until the start of the next council term. 174

32 That councils that succeed in gaining Ministerial approval to operate under Option B not be required to gain further approval from the Minister to operate under Option B, provided that: 174

- – the Division of Local Government's annual monitoring of its performance shows that it continues to meet the minimum eligibility requirements 174

- it continues to satisfy the Minister (at the start of every 4-year term) that it has obtained a community mandate for its proposed revenue and expenditure plan. 174

33 Where annual monitoring shows that a council's performance has slipped below the minimum eligibility requirements in a given year, that the council be advised, and that it may revert to being regulated under Option A at the Minister's discretion. 174

34 Where a council does not continue to satisfy the Minister that it has obtained a community mandate, that the council revert to being regulated under Option A, and that its base revenue for regulated rate increases be the rate revenue at the time of reverting to Option A. 174

Calculating the LGCI

35 That the cost items listed in Table15.1 form the basket of cost items included in the Local Government Cost Index. 177

36 That a single set of weights based on aggregate state-wide costs be used in constructing the Local Government Cost Index unless systematic differences in expenditure weights for specific council groupings are demonstrated. 179

37 That the Local Government Cost Index be re-weighted every 4 years based on an analysis of actual council expenditures. 179

38 That the inflators listed in Table 15.2 be used to inflate the cost items in the Local Government Cost Index on an annual basis. 180

39 That the Local Government Cost Index should be constructed and the calculation of the annual change in this index should be based on September quarter data from the Australian Bureau of Statistics (where available) and should be published in November each year. 183

The role for the Minister for Local Government

40 In relation to the rate peg, that the Minister for Local Government would: 186

- consider IPART's advice on the Local Government Cost Index and the productivity adjustment 186
- determine the increase in rate peg, and providing a statement of reasons for any increase over or under the increase in the productivity adjusted cost index. 186

41 In relation to variations under Option A, that the Minister for Local Government's role should involve approving, varying or rejecting, applications by councils for rate variations under Option A, whether for a multi-year or single year increase. The Minister's decision should be accompanied by a statement of reasons. 186

42 In relation to variations under Option B, that the Minister for Local Government would: 186

- approve, or reject with a statement of reasons, councils' satisfaction of eligibility criteria to move into Option B of the framework 186
- approve, or reject (with a statement of reasons), councils' satisfaction of community engagement criteria to implement rate revenue plans under Option B of the framework. 186

The role for the Division of Local Government

43 That the Division of Local Government' would: 187

- Monitor council rate increases. 187
- Advise the Minister on variation proposals under Option A. 187
- Administer and analyse revenue requirements proposed by councils in Option A and monitor revenue requirements proposed by councils in B. 187
- Monitor and advise the Minister on compliance with eligibility, performance and accountability criteria in Option A and B. 187

The role for IPART

44 That IPART would: 188

- Develop, maintain and publish the Local Government Cost Index. 188
- Estimate and publish a productivity adjustment factor. 188
- Recommend to the Minister the Local Government Cost Index to be used for the regulated annual rate increase. 188
- Recommend to the Minister the productivity adjustment factor to be used for the regulated annual rate increase. 188
- Review the criteria used to approve requirements for councils achieving higher rate increases under Option A and Option B. 188

Implementation of the revenue framework

45 That the LGCI should be used for regulated annual rate increase from 2010/11. 190

46 That IPART should commence a survey of councils' costs during 2009/10 to determine the weightings for the cost index model to apply from 2010/11. 190

47 That councils may apply for the proposed medium term revenue plans under Options A and B from the 2010/11 financial year. 190

48 That IPART's proposed revenue framework and the existing rate-pegging arrangements operate in parallel until 2012/13 by which time all councils have implemented the IPRF. The new medium term (revenue plans) under Options A and B would fully replace the current framework by June 30, 2013. 190

49 That councils with existing special variation applications may continue to implement these beyond the starting point for our recommended revenue framework. 191

50 That councils may continue to apply for special variations under the existing revenue framework until 2012/13 provided these special variations do not extend beyond 30 June 2014. 192

51 That the time frames outline in Table 17.2 be adopted for the proposed framework. 192

The framework for statutory authorities

52 That the NSW Government should put in place arrangements, and if necessary enact legislation, that provide for a dispute resolution framework to enable special development authorities and relevant councils to reach a binding agreement on payment for local services provided by authorities. 208

53 That the dispute resolution framework should initially require the parties to undertake negotiations. Should negotiations not result in an agreement, then the process could require the parties to submit to mediation. Finally, if no agreement can be reached, the framework should require the parties to submit to a binding adjudication process similar to arbitration. 208

54 That the amount that the authorities can receive from councils should be limited to the amount that councils save because the authorities, and not councils, are providing the service. 208

55 That prior to the implementation of any legislative scheme councils, SHFA and SOPA should consider whether some local services would be better managed by council and transferred, where parties agree. 208

1.8 What the rest of this report covers

The following chapters and appendices explain our findings and recommendations in detail:

- Chapters 2 and 3 provide an overview of the local government sector in NSW and describe the current framework for regulation local government revenue in NSW
- Chapter 4 explains how councils are accountable under the current framework in NSW

- Chapters 5, 6, 7 and 8 discuss whether the current approach to regulation has had a negative impact on the financial position and sustainability of NSW councils, and contributed to the problem of infrastructure backlogs
- Chapters 9 and 10 explore whether other factors – such as cost shifting and councils' own efficiency and performance – have affected NSW councils' financial position
- Chapter 11 summarises the changes required to improve on the current framework for regulating council revenue
- Chapter 12 provides an overview of our recommended framework and explains how it incorporates these improvements
- Chapters 13 and 14 describe Option A and Option B of the recommended framework in detail
- Chapter 15 describes how we would calculate the Local Government Cost Index and the productivity adjustment factor
- Chapters 16 and 17 discuss the recommended roles for IPART, the Minister for Local Government, the Department of Local Government, and councils in the new framework, and the key issues related to implementing the new framework
- Chapter 18 explains our recommended framework for regulating the charges levied by the nominated statutory authorities
- Chapter 19 summarises the key issues raised in submissions and how we have addressed these issues.

The appendices provide more detailed information on the findings of our consultations, research and analysis on the matters we were required to consider in making our recommendations.

2 Local Government in NSW

Local government has been in existence in NSW for more than 160 years. The state currently has 152 councils, which are actively involved in economic and community life in their local area.

To help understand the context for our review, we looked at the characteristics of councils in NSW, as well as their role and sources of revenue and the range of services they provide. The section below provides an overview of our findings, while the following sections discuss these findings in more detail.

2.1 Overview of findings

There is enormous diversity between councils in NSW in terms of the characteristics of the areas and populations they serve. This diversity means their expenditure needs and scope to raise revenue to cover these needs varies markedly.

The legislation that establishes councils' role provides them with flexibility to provide services that reflect their community's demands, so the range of services they provide is ultimately a decision for each council. However, it also depends on an individual council's ability to raise revenue. Therefore, there needs to be a balance between the demands and expectations of local communities and the resources available to their council.

Councils obtain revenue from a number of sources. Only one of these – rates revenue – is currently regulated.[3] The importance of rates revenue varies significantly across councils but, on average, it makes up more than a third of councils' total revenue.

Over the last 10 years, most councils have increased the range of services they provide, moving into areas that may be considered non-traditional. But smaller councils still tend to spend a greater proportion of their expenditure on traditional services.

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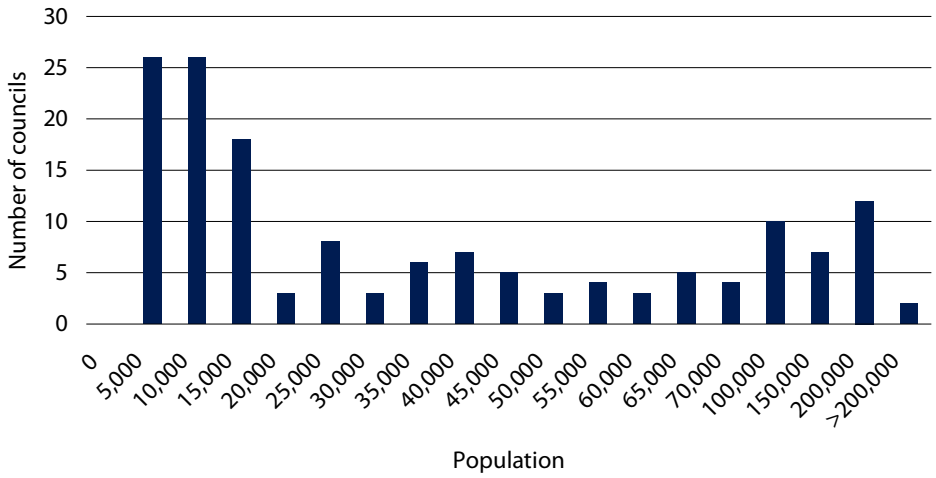
[3] A small number of annual charges such as drainage levies are also regulated under rate pegging. User fees and charges are not regulated. The Domestic Waste Management Levy must be tied to reasonable costs of providing the service. (See DLG, *Council Rating and Revenue Raising Manual,* p 49.) Certain fees for development and related functions are set under the Environmental Planning and Assessment Regulation 2000 (clauses 245-263) (see DLG, *Council Rating and Revenue Raising Manual,* p 95).

2.2 Diverse nature of councils in NSW

Councils in NSW differ significantly in terms of the size and population of the area they serve. Area size varies from 5.7 square kilometres (Hunters Hill Council) to 53,508 square kilometres (Central Darling Shire Council). The average area size is 4,658 square kilometres, and about 25% of all councils serve an area that is smaller than 200 square kilometres.[4] Population size varies from less than 1,300 people (Urana Shire Council) to more than 280,000 people (Blacktown Council).[5] The average population per council in NSW is 45,315,[6] while more than a third of councils serve populations of less than 10,000 people (Figure 2.1).

Figure 2.1 Frequency distribution of council population, 2007/08



Data source: Department of Local Government, *Comparative Statistics on New South Wales Local Government Councils, 2007/08*.

Councils also differ significantly in terms of the characteristics and location of the area they serve. Some (like Blacktown, Parramatta and Newcastle) serve areas that are considered to be major cities in their own right. Others serve areas that are almost entirely agricultural (like Balranald or Bourke Shire). Some serve areas located on the fringe of major cities, and yet others serve regional towns.

Due to a combination of these factors, the population in the area served by NSW councils also differs dramatically. Population density ranges from only 5 people per 100 square kilometre (Central Darling Shire Council), to about 6,600 people per square kilometre (Waverley Council in Sydney). In addition, some councils serve

4 Department of Local Government, *Comparative Statistics on New South Wales Local Government Councils, 2007/08*.

5 Department of Local Government, *Comparative Statistics on New South Wales Local Government Councils, 2007/08*.

6 This is lower than in Victoria (where the average population per council is 62,774), but higher than the national average (of around 28,432). See Department of Transport and Regional Services (DOTARS), *Local Government National Report 2005-06*, Table 1.2, 2007.

areas where the population is growing rapidly (often those located on the urban fringe), while others serve areas where the populations is declining (typically rural councils).

This diversity in the size and characteristics of councils means their expenditure needs can be very different. For example, councils are responsible for maintaining local and regional roads in their local government area.[7] In around 90 of the 152 local government areas in NSW, the total length of local roads is less than 1,000 kilometres.[8] However, in some areas the length of local roads is much higher, with the highest being 3,460 kilometres. While the federal and state governments provide some contributions towards the costs maintaining these roads, the variation in the total length of roads councils are responsible for has a significant impact on their expenditure needs.[9]

Similarly, this diversity also means councils' ability to raise sufficient own-source revenue to cover their expenditure needs varies markedly. For example, rural councils that serve an area with a small population have much less scope to raise revenue than those serving large populations. Yet their expenditure needs per capita can be higher due to the large size of the area they serve (and the long total length of the roads they are responsible for).

2.3 Legislative framework

Local government is not recognised in the Australian Constitution, so the Federal Government does not have legislative power with respect to councils.[10] The authority for and functions of local government are established under each state's legislation.

In NSW, the *Local Government Act 1993* (the Act) provides the regulatory framework for local government. The Act is administered through the Minister for Local Government by the Division of Local Government within the Department of Premier and Cabinet (formerly the Department of Local Government).[11] However, recent

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7 The management of the road network in NSW is shared between the State Government (through the Roads and Traffic Authority) and local government (through local councils). A 3-tier hierarchy is in place with the RTA managing state roads and councils being responsible for regional and local roads. (Source: RTA Website http://www.rta.nsw.gov.au/doingbusinesswithus/lgr/index.html)

8 NSW Local Government Grants Commission, Table of local road and bridge data for NSW councils, 2009/10.

9 The Commonwealth provides financial assistance grants to councils that include a significant roads component (based largely on road length and number of bridges). Each council receives an annual Regional Road Block Grant form the State government for regional roads. This grant is based on a formula that takes into account road length and traffic usage.

10 In November 2008, the Prime Minister reaffirmed the government's commitment for constitutional recognition of local government.

10 The term 'States' is used in this Report to encompass the activities of both States and Territories.

11 For convenience, we have referred to the Division of Local Government throughout this report, even when discussing matters dating from the period it was known as the Department of Local Government (except when identifying sources of data).

amendments[12] indicate that councils are directly accountable to the residents and ratepayers in their local government area, and that the Minister has a supervisory role in relation to councils. (See Chapter 4 for more information.)

2.4 Role and responsibilities

The Act sets out the functions and responsibilities of NSW councils. In particular, it requires councils to:

- provide (either directly or on behalf of other levels of government) adequate, equitable and appropriate services and facilities for the community
- manage the assets for which they are responsible
- exercise regulatory functions, and
- raise funds for local purposes by the fair imposition of rates, charges and fees, and by income earned from investments.[13]

Thus, rather than limiting the services local government can provide, the Act provides councils with the flexibility to provide services in response to the changing needs of their communities.[14]

2.5 Sources of revenue

The Act grants councils the power to raise revenue by imposing some specific taxes and charging for the provision of services. It also sets out arrangements for the regulation of council revenues.[15]

Under the current arrangements (which are described in Chapter 3), only councils' taxation revenue is regulated. This revenue comes from ordinary and special rates. Under the Act:

- Councils are required to make and levy an ordinary rate for each year on all rateable land in their area.
- They also have the discretion to levy a special rate for works or services provided or proposed to be provided or for other special purposes. Special rates can be levied on subgroups of ratepayers.

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12 *Local Government Amendment (Planning and Reporting) Act 2009* No 67 which commenced on 9 October 2009.

13 Section 8, *Local Government Act 1993*.

14 Chapter 6, Section 24, *Local Government Act 1993*.

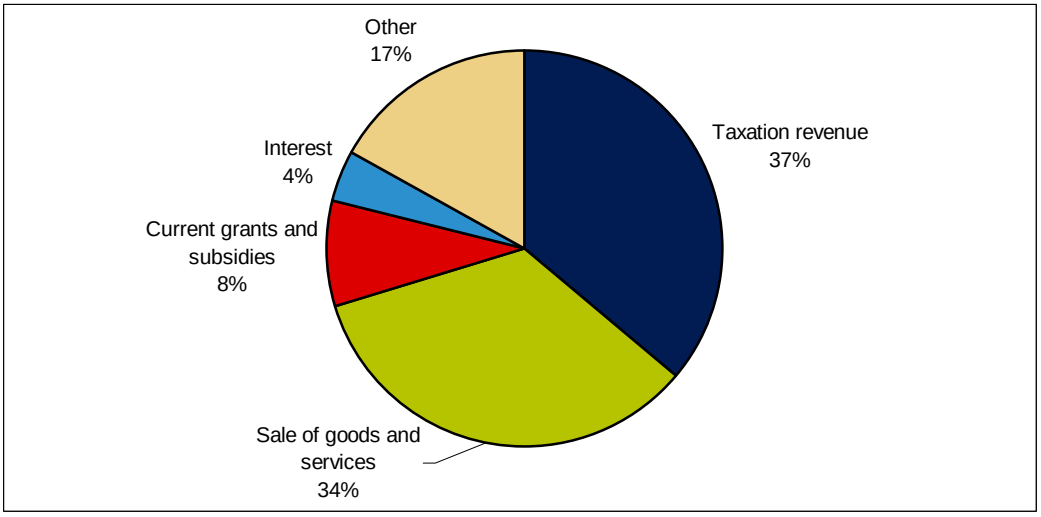
15 *Local Government Act 1993*, sections 505 to 513.

Councils' unregulated revenue comes from a variety of sources, including:

- Charges and fees they levy for providing goods and services:[16]
  - Councils may make and levy charges in relation to some specified services they provide, including water and sewerage services and garbage collection services. Charges may be annual or based on usage. A charge, when made, has the same characteristics as a rate concerning payment, accrual of interest and recovery of the charge.
  - Councils may charge a fee for any service they provide. Unlike charges, fees are not a debt on the land and are recoverable through civil proceedings.
- Interest which councils either earn on their investments or charge ratepayers for overdue rates.
- Grants and subsidies from the NSW and Federal Governments.
- Other revenue, including fines, investment income and developer charges.

Taxation or rates revenue[17] as a proportion of total revenue varies widely across councils in NSW. However, on average, this revenue represented 37% of NSW councils' total revenue in 2007/08 (Figure 2.2). Revenue from the sale of goods and services (or charges and fees) made up 34%, while grants and subsidies made up less than 10%. This suggests that councils, on average, are reasonably self-sufficient.

Figure 2.2 NSW councils' sources of revenue, 2007/08



Note: The data in this chart includes revenue relating to the Local Water Utilities.

Data source: ABS, *Government Finance Statistics 2007/08*, Cat No 5512.0.

16 Certain fees for development and related functions are set under the Environmental Planning and Assessment Regulation 2000 (clauses 245-263).

17 Taxation revenue is the term used by the Australian Bureau of Statistics. This is the same as 'rates' in local government terminology.

2.6 Range of services provided

Traditionally, councils in NSW have provided a range of governance, administration, transport and communication services, such as collecting rubbish, maintaining local road networks, maintaining public parks and sporting facilities, town planning and approving building applications. Many of these traditional services were regarded as property-based services. In some areas, councils have also provided a range of commercial services, including caravan parks, airports and shopping centres.

However, in its 2001 review of the *Local Government (Financial Assistance) Act 1995* (Cth),[18] the Commonwealth Grants Commission found that the composition of local government expenditure had changed over the past 30-35 years, reflecting a shift away from the provision of property-based services to human services.[19] In particular, there was an increase in the relative importance of expenditure on recreational and cultural services, housing and community amenities, and education, health welfare and public safety services.[20]

Figure 2.3 shows the expenditure by NSW councils by purpose since 1998/99. Over this period, councils' expenditure on general public services[21] has increased from 16.7% to 24.3% of total expenditure, while expenditure on transport and communications has declined from 36.0% to 19.6%.

Despite this shift, our analysis indicates that councils with a small population and rates revenue base have tended to contain the scope of their in-house services to a narrower range of services, most likely due to financial constraints. In a report for the Australian Local Government Association (ALGA), PricewaterhouseCoopers (PwC) observed that such small councils often try to provide better linkages to non-government organisations that are providing social and community services than provide these services themselves.[22] However, we note that this is not always possible and councils are often driven by community demands to provide a wider range of service, potentially at the expense of financial sustainability.

Our analysis has shown that there is great diversity between councils in NSW in terms of their size, characteristics, expenditure needs and scope to raise own-source revenue. We consider that the framework for regulating council rate revenues should take account of this diversity.

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18 Commonwealth Grants Commission, *Review of the Operation of the Local Government (Financial Assistance) Act 1995*, June 2001.

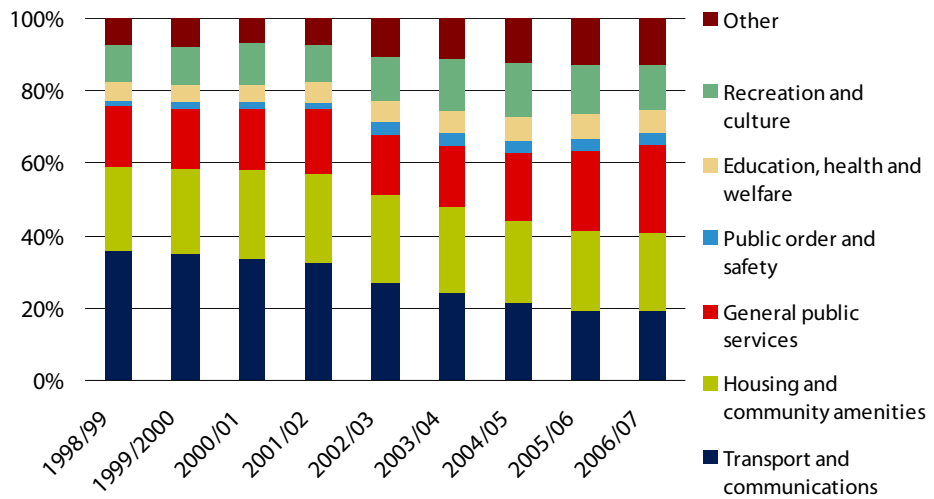
19 Commonwealth Grants Commission, *Review of the Operation of the Local Government (Financial Assistance) Act 1995*, June 2001, p 54.

20 Hawker, (Chair), *Rates and Taxes: A Fair Share for responsible Local Government*, p 10.

21 The ABS categorises the services within all sectors of government. The group 'General public service' includes legislative and executive affairs; financial and fiscal affairs, external affairs, foreign economic aid, general research, general economic and social services, general statistical services, and government superannuation benefits.

22 PricewaterhouseCoopers, *National Financial Sustainability Study of Local Government*, November 2006, p 42.

Figure 2.3 NSW Expenditure by purpose 1998/99 to 2006/07



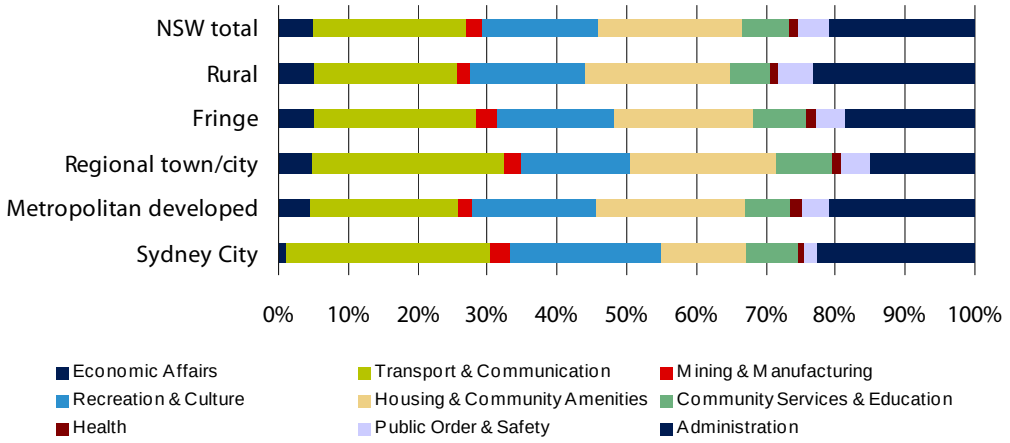
Data source: ABS, *Government Finance Statistics 2006/07*, Cat No 5512.0.

To help make comparisons, we grouped councils into 4 categories based on their location: metropolitan, urban fringe, regional or rural.[23] Sydney City Council has been placed into a separate category, due to its unique characteristics. For some of our later analysis we have grouped Sydney with the other metropolitan councils. Figure 2.4 shows that the composition of councils' expenditure varies significantly depending on their category, and also within categories:

- most councils spend more than 20% of their expenditures on transport and communications services, reflecting the importance of road construction and maintenance
- rural councils' expenditure on administration is relatively high compared to that of fringe and regional councils
- Sydney City Council has markedly different patterns of expenditure than other councils, with higher spending on administration and transport and communications services, and lower spending on housing and community services.

[23] This classification is based on location and follows that used by Brooks, J, 2006, NSW *Local government revenue and expenditure analysis*, for the Independent Inquiry into the Financial Sustainability of NSW local government. The Division of Local Government uses a higher number of categories as it takes account of population size as well as location.

Figure 2.4 NSW local government expenditure distribution, by council category 2006/07



Note: Excludes expenditure on water and sewerage services.
Data source: DLG, unpublished data 2006/07.

As part of our assessment of the financial sustainability of NSW councils, we analysed a sample of 11 case study councils. These councils included at least 2 councils from each category (except Sydney City). This analysis found that among metropolitan, urban fringe and regional councils, those that rely more on rates revenue[24] spend proportionately less on traditional services (61% of total expenditure) than councils that rely less on rates revenue[25] (74% of total expenditure).

We have observed a wide diversity amongst councils in NSW. Reflecting this diversity, councils should in general provide services that the community has indicated they want. Therefore, the framework for regulating council revenues should encourage councils to determine the services that the community wants.

Recommendation

1 That the framework for regulating council revenues should encourage councils to provide services that reflect their community's demands. However, there needs to be a balance between the demands and expectations of local communities and their council's scope to raise revenue.

24 That is, those where rates make up more than 50% of total revenue.
25 Those where rates make up less than 30% of total revenue.

3 The current framework for regulating councils' revenue

As Chapter 2 noted, the Act sets out the framework used to regulate NSW councils' revenue. This framework, which applies only to the revenues raised from council rates and (some) annual charges, enables the state government to control the amount by which these rates and charges increase each year.

The Act does not explicitly explain the goals and objectives of this regulation. However, the main objective appears to be to reduce the scope for excessive rate increases. The then Government made this objective clear when it introduced the current framework in 1976. The Minister for Local Government stated that it was intended to protect ratepayers from "unconscionable rate increases in the coming year".[26]

The key elements of the framework are the rate pegging process and the special variations process. The sections below describe each of these elements, and outline how council revenues are regulated in other jurisdictions.

3.1 The rate pegging process

Each year, the NSW Government announces the maximum percentage by which councils can increase their annual general income, which is largely derived from property rates and (some) annual charges (see Box 3.1). The percentage increase is known as the rate peg. Individual councils must set their rates and annual charges for the year so that their general income does not increase by more than the rate peg.[27]

The Minister for Local Government determines the rate peg based on the recommendations of an advisory committee that includes representatives from the Division of Local Government and Treasury.[28] The rate peg reflects the Government's estimates for projected annual increase in costs that a typical council delivering services at levels comparable to the previous year is likely to incur over this year.

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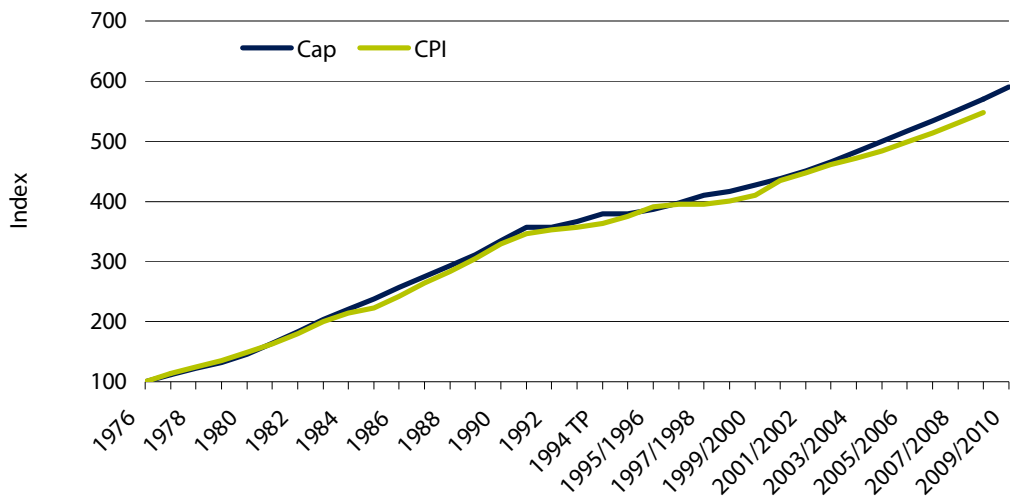
26 Second Reading Speech, *Local Government (Rating) Further Amendment Bill*, 1 December 1976.

27 Due to the way it is calculated, the rates cap is in effect calculated in per property terms so that rates revenues grow in line with the number of properties.

28 See Section 506, *Local Government Act 1993*.

We note that since the commencement of rate pegging, the Government has not clearly explained the methodology used to determine the rate peg, including what cost indices are used.[29] However, it appears to be generally based on the change in the Consumer Price Index (CPI) and Average Weekly Earnings.[30] This can be seen in Figure 3.1, which shows that the rate peg has closely tracked movements in the CPI over time.

Figure 3.1 Cumulative change in rate peg and the CPI, 1976 to 2009/10



Note: (1) Financial year rate peg percentages commenced in 1995/06. (2) The change in CPI for 1998/99 was 0%. (3) The change in the CPI for 2001/02 reflected the impact of the introduction of the GST which was not allowed for in setting the rate peg percentage for2002/03.

Data source: Department of Local Government and ABS *Consumer Price Index* Cat No 6401.0.

The Minister usually announces the annual rate peg in March each year. Councils can then submit their applications for a special variation to this percentage (discussed below). The Minister usually makes a determination on each application by June, to enable each council's new rate to take effect from 1 July.

We note that there is wide variation in rate revenue growth. Figure 3.2 illustrates the growth in rates per assessment for each council over the period 1997/98 to 2006/07.[31] The horizontal line represents the rate peg amount for the period.[32] It is expected that if councils were increasing rates in line with the rate peg amount, their total rate revenue per assessment would increase by a similar amount. The figure shows that there is a wide variation in rate revenue growth per assessment with an approximate

29 Abelson, P. (2006) *Local Government taxes and Charges, Applied Economics*, pp 1-9 www.appliedeconomics.com.au/pubs/pdf/06_taxes_and_charges.pdf

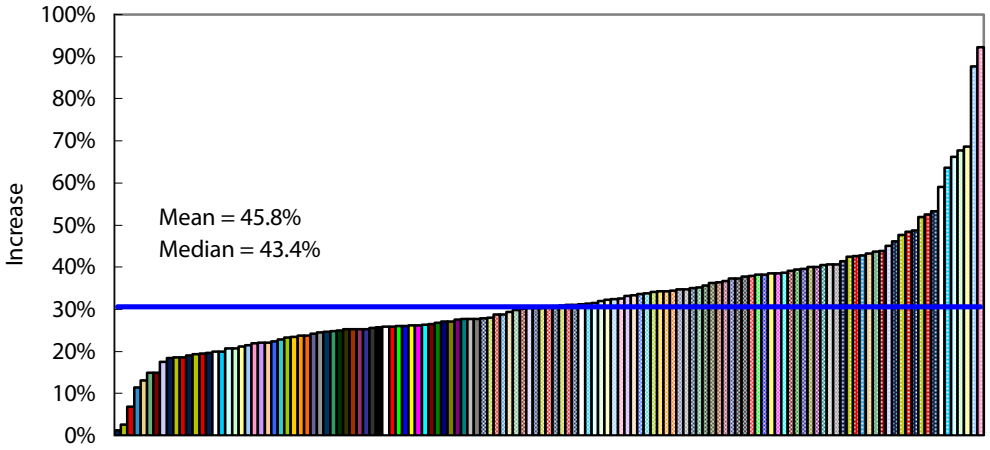
30 Local Government and Shires Associations of NSW, *NSW Local Government Rate Determination Model*, Prepared by the National Institute of Economic and Industry Research, trading as National Economics, in July 2003, p 3.

31 A number of councils were amalgamated during this period so they have been excluded from the analysis. The data in this analysis is for 133 councils.

32 Over the period the announced rate peg amounts represent a total growth in rates and annual charges of 30.6%.

50/50 split in growth above and below the rate peg amount. That is, the rate peg has not placed an absolute limit on growth of rates revenue over the period. This is because councils have the ability to apply for special variations in their general income, but can also substitute their total income with other less restricted revenue sources such as user fees and charges.

Figure 3.2 Increases in total rate revenue per assessment (%), 1997/98 to 2006/07 (nominal)



Note: Rate Cap increase over the period 1997/98 to 2006/07 was 30.6%. Excludes councils that were amalgamated during the period.

Data source: Calculated by IPART using DLG time series data: Comparative Data Time Series to 0607.xls, available from www.dlg.nsw.gov.au.

Sixty six of the 133 councils[33] increased rates by the rate peg amount or less. This is contrary to the expected outcome that the majority of councils would increase rates by at least the rate peg amount. However, this result may be due to one or more of the following:

- an individual council's assessment of rate-payers' capacity to pay
- growth in assessments being greater than the growth in rate revenue
- a significant reduction in rate revenue for one rating classification during the period.

[33] This analysis uses 133 councils and not 152 councils. During the period to which the analysis refers, there were a number amalgamations that make comparisons of rate increases over this period more difficult.

Box 3.1 Rate pegging – a cap on general income

Section 505 of the Act defines general income. For the purpose of rate pegging, this income largely comprises income derived from property rates and charges. It excludes certain rates and charges such as special rates for water supply and sewerage, charges for water supply and sewerage services and annual charges for waste management and storm water management services. It also excludes user charges, interest, grants, contributions and donations, and other revenues (eg, from fines and business activities).

Rate pegging applies to a council's overall general income, not to the rate for individual properties.[a] Therefore, it is possible for councils to increase some property owners' rates by more than the rate peg, and increase others' rates by less than the rate peg and still comply with the regulation. In some cases, rates for individual properties may decrease from the previous year.

The main factors that determine how rates on individual properties change are the council's rating structure and valuation changes. Rating structures can change significantly from year to year. However, the rate pegging process ensures that the average rate increase per property is no higher than the rate peg, unless a special variation to this increase has been approved.

a The change in general income is assessed from one year to the next by using the same number of rating assessments. Thus, in effect the assessment is done on a per property basis.

3.2 Special variations

The special variations process provides some flexibility for councils to increase their annual general income by more than the rate peg. Councils that consider they will be adversely affected by limiting the increase to the rate peg can apply to the Minister for one of 3 special variations.[34]

The Division of Local Government provides some guidance to councils wishing to apply for a special variation in its annual circular. However, we note that these guidelines are quite broad and non-specific. For example, the 2009 circular outlines the process for lodging applications, the format for applications and the reasons a council may apply, but does not list the criteria that are used to assess the applications.[35] However, the 2008 Councillor Guide prepared by the Division and the LGSA indicates that:

> When considering an application for a Special Variation the Minister takes into account issues such as how the variation will assist the council in meeting its long term strategic

34 When seeking a special variation, councils may apply for a single year special variation s508(2)) or for multi year variations (s508(A)) up to 7 years. They may also apply for an increase in the minimum rate above the rate peg amount.

35 DLG, Circular to Councils *Applications for Ministerial Approval for a Special Variation to General Income*, Circular No 09-07, 18 February 2009 and *Guidelines for the Preparation of an Application for a Special Variation to General Income 2009/2010*. (See www.dlg.nsw.gov.au)

objectives, the level of consultation undertaken by council, the community's response to the proposal and the financial position of the council.[36]

For 2009/10, 30 of the 152 councils in NSW applied for a special variation. The Minister approved 18 of the applications, did not approve 10, and 2 were withdrawn. These variations are for increases up to 10% (ie, 6.5% higher than the rate peg). Most of these applications were to enable the council to raise additional revenue for infrastructure renewal or maintenance.[37]

3.3 How are council rates and charges regulated in other states?

While other states[38] have used rate pegging at different times, NSW is currently the only state that uses this approach to regulate council revenues. Currently councils in most other Australian states have a higher degree of autonomy in setting their rates and charges than councils in NSW. The only exception is the Northern Territory.

In Victoria, the Minister for Local Government has the power to control local government rate setting under the *Local Government Act 1989* (Vic). However, the current government policy allows councils to determine rates. Under this policy, councils must prepare a Rates and Charges Impact Statement and undertake community consultation.

In Queensland, the procedures for rate setting are set out in the *Local Government Act 1993* (Qld), but the Queensland Government does not limit rate increases. Ultimately, each local council is responsible to its own constituencies.

In Tasmania, the *Local Government Act 1993* (Tas) places the onus on local government for setting rates and charges. However, it requires all councils to publish budgets and make all decisions about rates and charges at open meetings with well-publicised agendas. It also requires councils to prepare a 5-year strategic plan, and an annual operational plan that relates to the strategic plan, and to undertake community consultation in preparing these plans.

In South Australia, the *Local Government Act 1999* (SA) accepts that councils are responsible to their own constituencies for the taxes they set. It requires all councils to have and publish a rates policy. It also requires councils to undertake community consultation before making significant changes to this policy.

In Western Australia, the *Local Government Act 1995* (WA) does not provide the state government with powers to directly set council rates. However, it requires that councils develop their budget within a community consultation/planning framework. It also imposes conditions related to the rates a councils set, including

36 Department of Local Government and Local Government and Shires Associations, *Councillor Guide*, 2008, p 62.

37 Minister for Local Government, *Media Release,* 8 July *2009*.

38 The term 'States' is used in this Draft Report to encompass the activities of both States and Territories.

that the minimum rate cannot apply to more than 50% of properties. It also requires councils to seek Ministerial approval if the highest rate for an individual property is greater than twice the lowest rate within the LGA.

Until recently, the Northern Territory *Local Government Act* allowed councils to set rates. However, it stipulated that councils should not budget for a deficit, and required councils to publish and publicise their budgeting process. Following a series of reforms for local government, the Minister now may cap rates for the first 3 years of the NT Government's New Local Government Reform Program.[39]

In the ACT, property owners pay rates and land tax to provide funding for municipal and other essential services. The imposition of rates and land tax are authorised and administered under the *Rates Act 2004* (ACT). The amount of rates payable has 2 components – a fixed charge and a valuation charge for each rateable property. In calculating rates payable different fixed charges and valuation charges are required to be applied to residential, commercial and rural properties.[40] The valuation charge is based on Unimproved Capital Value of the land.

39 Section 268 of the *Local Government Act 2008* (NT), permits the Minister to impose limits on rates for the 2008/09, 2009/10 and 2010/11 financial years. Rate limits were re-gazetted on 25 February 2009.

40 See www.revenue.act.gov.au/rates.

4 How are councils accountable in NSW?

As Chapter 3 discussed, the NSW Government has a long-standing commitment to rate pegging,[41] largely because the approach protects ratepayers from excessive increases in rates. However, in submissions to this review, councils expressed a range of concerns about the current rate pegging approach. (Our consideration of these concerns is discussed in Chapters 5 to 10.)

In addition, some councils argued that there should be no regulation of council revenues at all.[42] For example, they put the view that such regulation runs counter to the principles of democracy, and reduces councils' accountability and responsibility for their own financial affairs. They also suggested that regulation limits councils' ability to provide the level and type of services that meet their community's needs and demand.

Therefore, as part of our review, we considered the fundamental question of whether or not it is necessary to continue regulating councils' revenue at all. Since the primary objective of regulating rates revenue in NSW appears to be protecting ratepayers from excessive increases in rates, we reviewed the accountability arrangement for councils in NSW to determine whether these are sufficient on their own to provide this protection.

The sections below provide an overview of our findings, and discuss our assessment of the current accountability arrangements.

41 The NSW Government introduced rate pegging in 1977 and it has continued to operate since. In announcing this review the then Minister for Local Government stated that the Government remains committed to rate pegging.

42 See for example, the submissions from Bellingen Council, Camden Council, Central NSW Councils, City of Sydney.

4.1 Overview of findings on councils' accountability

In our view, some form of rates revenue regulation continues to be desirable in NSW to protect consumers from excessive increases in rates.

We accept that ideally, in line with principles of good governance and subsidiarity,[43] councils should be accountable primarily to their communities for the services they provide and the level of rates and charges they impose to fund this service provision. In general, we consider that local councils and their communities are well-placed to make decisions on local government activities and finances, such as:

- the appropriate balance between local government revenues and expenditures
- the types, quantity and standard of services that should be provided, and
- the level and type of revenue that should be collected to fund this expenditure.

However, we also consider that, for local government decisions to reflect community preferences, effective systems are needed to ensure community engagement and participation in council decision-making and community scrutiny of council performance.

Based on our assessment, we consider that accountability at the local government level is not currently strong enough to rely solely on the democratic process to protect ratepayers and other members of the community. More effective systems are needed to ensure that councils consult their communities about the type and quality of services they prefer and their willingness to pay for these services through higher rates, and to involve their communities in council planning and financial decision making.

4.2 Assessment of current accountability arrangements for NSW councils

As part of our review, we assessed the current accountability arrangements applying in NSW. In particular, we considered how well the existing regulatory framework enhances the accountability of local government to the community, and encourages its effectiveness, efficiency and sustainability. We also examined the arrangements applying in other states and selected other countries. The following sections outline the current arrangements (including proposed changes to these arrangements), and our findings on whether these arrangements are adequate, and how the arrangements can be improved.

[43] For example, the principle of subsidiarity is particularly relevant. This principle holds that a higher level of government should not exercise functions which can be carried out efficiently by a lower level of government.

4.2.1 What are the current accountability arrangements?

In NSW, councils are accountable to the state government and to their local community. Councils are accountable to the state government – via the Minister and the Division of Local Government – because local government is established through state-based legislation. A similar situation exists in all Australian states and territories, with legislation in each state providing powers to the state Ministers or state Parliaments to monitor council performance and intervene in council decisions or operations if councils are not performing effectively.

Under normal circumstances, NSW councils are required to hold elections every 4 years. This means they are ultimately accountable to their community. In addition, the Act requires them to inform their community on council activities and involve the community in council processes.

In several states including NSW, steps are being taken to redirect the accountability of local government more towards the local community, rather than to the state government. For example, recent amendments to the NSW Local Government Act[44] clearly indicate that councils are to be directly accountable to the residents and ratepayers in their local government area (for example, through elections, public consultation, and reporting) and that the Minister has a supervisory role in relation to councils.

These amendments also aim to improve councils' long-term strategic planning and resource management so they can provide better services to their communities. One of the key amendments is the recently introduced Integrated Planning and Reporting Framework (see Box 4.1).

4.2.2 Are the current arrangements adequate?

Having considered all of the available evidence, on balance, we consider that the current accountability arrangements are not strong enough for NSW to rely solely on their accountability to the community to protect ratepayers and other community members from unreasonable increases in council rates and charges.

We note that recently introduced reforms to the local government accountability arrangements in NSW will significantly strengthen current arrangements and address many of the weaknesses in the previous legislative requirements. In particular, we consider that the Integrated Planning and Reporting Framework includes a number of desirable changes, including a strong focus on community consultation and engagement processes, and the introduction of longer term strategic plans and resourcing plans including asset management plans. The framework also potentially provides a mechanism for councils and their communities to have

44 *Local Government Amendment (Planning and Reporting) Act 2009* No 67 which commenced on 9 October 2009.

Box 4.1 Key features of the Integrated Planning and Reporting Framework

The key elements of the Integrated Planning and Reporting Framework include:

- A 10-year strategic plan (to be known as a Community Strategic Plan), including social, ecological, economic and governance outcomes. This plan will be revised and rolled forward by the 30 June following each council election (ie, every 4 years).
- A 4-year Delivery Program, linked with state and regional plans to reflect joint priorities. It is proposed that councillors' be responsible for preparing this program, and that the program be reviewed by a combination of representatives from both state and local government.
- An annual Operational Plan with a budget that is uniformly presented across councils and consistent with the national approach. This document implements the Delivery Program and is the General Manager's responsibility to prepare.
- An Annual Report.

This framework is aimed at providing greater integration of strategic, service, asset and financial planning. It also potentially provides a mechanism for councils and their communities to have important discussions about funding priorities, service levels and preserving local identity, and to plan in partnership for a more sustainable future.

The figure below illustrates how the framework's elements work together.

Data source: Based on DLG, Planning a sustainable future, Planning and Reporting Manual for local government in NSW, Draft for public comment, May 2009.

important discussions about funding priorities, service levels and preserving local identity, and to plan in partnership for a more sustainable future.

However, for this framework to succeed, sustained improvements are needed in councils' engagement with their communities, as well as in their management capacity (particularly asset management), planning and financial systems. We consider there is scope to increase the likelihood of success by providing more explicit requirements, additional guidelines and support tools in these areas.

4.2.3 How can the accountability arrangements be improved?

We have identified a range of ways in which the accountability arrangements for local government can be further improved within the current system of representative democracy. In particular, we consider there is scope to improve:

- The level of community engagement and involvement in council planning and decision making.
- The standard of information provided to the community in terms of accessibility and meaningfulness, especially in annual reports.
- The compliance with requirements of councils to develop asset management plans.

Improving community engagement and involvement in council decision making

We recognise that it is not easy for councils to obtain truly representative community input. However, councils' decisions on how and where to spend money are most likely to be in line with the community's needs, values and priorities where community members have an opportunity to actively participate in council planning and decision making.

Under the Integrated Planning and Reporting Framework, councils are required to prepare a Community Engagement Strategy that sets out how they will engage and involve the community in developing and reviewing their Community Strategic Plan. But there is no prescribed format for this strategy – only a requirement for councils to identify stakeholders and plan how they will engage each of these groups. In addition, the minimum requirement for public consultation on the Delivery Program and the first Operational Plan is that they be placed on exhibition for 28 days and public comments considered by council.

We consider that the requirements related to developing a Community Engagement Strategy should be more explicit. In addition to existing requirements for councils to identify key stakeholder groups and how they will engage each of these groups, we consider councils should be required to give due consideration to the expected levels of service expressed by the community.

In our view, the requirements for consultation are at the lower end of the community engagement spectrum (see Box 4.2). Councils should also be encouraged to improve their community engagement further along the spectrum (eg, to the 'involve' level), and to ensure this engagement encompasses all key stakeholders to whom they are accountable. This would greatly enhance their accountability to their communities, and the democratic process in general. It would help ensure that community members can actively participate in council decisions – such as those about the services and infrastructure they provide, and their spending priorities. As a consequence, councils' decisions would be more equitable, transparent and acceptable to the community.

Councils could use a range of processes and mechanisms to improve their community engagement. For example, they could prepare and circulate short, concise summaries of key planning documents that are written in a way that is easy to understand and easy to respond to. These documents, which include Community Strategic Plans, Delivery Programs and key components of these plans (such as asset management plans and budgets), are key ways in which councils are accountable to the community other than through the ballot box.

The Division of Local Government could also support councils' efforts. For example, we consider it should collect and publish best-practice examples and case studies of effective community engagement approaches, as has been done in South Australia. It could also collect and publish best-practice examples of Delivery Programs and their summaries.

Box 4.2 Spectrum of community engagement (from low to high)

Inform One way communications – providing balanced and objective information to assist understanding about something that is going to happen or has happened.

Consult Two way communications – obtaining public feedback about ideas on rationale, alternatives and proposals to inform decision making.

Involve Participatory processes - inviting involvement to help identify issues and views to ensure that concerns and aspirations are understood and considered prior to decision making.

Collaborate Working together to develop understanding of all aspects of issues, work out alternatives and identifying preferred solutions.

Empower Providing opportunities and resources for communities to be part of solutions by valuing local talents and skills and acknowledging their capacity to be decision makers in their own lives.

Source: Government of South Australia and the Local Government Association of South Australia, *Community Engagement Showcase*, June 2007, p 2.

Of course, we recognise that community engagement neither can nor should replace the appropriate process of decision-making by elected, accountable public representatives. Central to any democratic system is the idea that the power to make decisions is linked with due process and is ultimately tested against public opinion in elections.

Improving the standard of information provided to the community, especially in annual reports

Currently, councils' annual reports are one of the key tools for holding them accountable to their community for how they manage their finances and assets. While council representatives who attended our public workshops on the Issues Paper for this review acknowledged that these reports are useful,[45] they also generally put the view that these reports are not currently an effective accountability tool. This is because:

- They don't engage the local community. For example, some councils noted that although they held community meetings it was difficult to get community input.
- They are produced to satisfy regulatory requirements and do not seem to be relevant to the community.[46]

We consider that the Division of Local Government should take a proactive role in encouraging and assisting councils to improve the quality of information included in annual reports, as well as in other publications designed to inform the community about the performance of councils and on council websites. In addition to any changes under the Integrated Planning and Reporting Framework, we consider the Division should consider:

- publishing sample 'best practice' financial reports
- publishing 'best practice' performance reports and guidelines to encourage publication of meaningful, readily understood performance information to the community
- improving the consistency of reporting and consistency of definitions across councils to enable comparison of councils' performance
- establishing incentives for best practice annual reports as part of the accountability framework – for example, in Queensland, the government issues an award to councils titled Minister's Best Practice Award for Community Reporting.[47]

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45 For example, they put the view that annual reports report where the money is spent, whether or not anyone is actually reading them. In addition to complying the regulatory requirements, annual reports provide a good reference point to the trend in the council's activities. They are also useful for internal reporting and benchmarking processes.

46 IPART, Maitland Public Workshop, Transcript, 2008, pp 12 and 17.

47 Queensland Government, *Minister's Best Practice Award for Community Reporting*, 2008, www.localgovernment.qld.gov.au/LocalGovernment/MinistersBestPracticeAward.aspx.

Improving compliance with requirements to develop asset management plans

Under the Integrated Planning and Reporting Framework, councils are required to produce an asset management plan (as part of their long-term Resourcing Strategy). We note that the Division of Local Government has also proposed introducing an asset management system that is consistent with the national framework for asset management and is integrated with the Integrated Planning and Reporting Framework. In particular, this system would include:

- requirements for councils to have a long-term asset management plan linked to a long-term financial plan (at least 10 years)
- condition assessment service levels determined in consultation with the community
- standardised reporting/terminology
- a phasing-in period with support tools, and
- peer review (rather than audit).

We support requirements for councils to develop asset management plans, and the direction of the Division of Local Government's proposed changes to asset management system. However, we also consider that the Division, together with councils, should develop and use consistent definitions of asset condition. These definitions should be used both in asset management planning and in the asset management system. (See Chapter 8, Recommendations 4 and 5.)

In addition, we consider that it is not sufficient that councils' asset management plans are peer-reviewed. Given the importance of asset maintenance and renewal for councils' budgets, it is imperative that these plans are also audited to ensure that cost estimates are accurate, robust and based on affordable standards. (See Chapter 14, Recommendation 27.)

We note that the Division of Local Government's own analysis indicates that in 2006, despite the fact that it had encouraged the adoption of asset management plans for several years:

- only 20% of councils had adopted asset management plans
- 30% intended to have asset management plans within the next 2 years, and
- the remaining 50% had no intention of preparing asset management plans.[48]

Our case study analysis for this review found that many councils were unable to provide data on asset maintenance expenses. It was evident that many councils did not have a sufficient understanding of the level of maintenance costs or the future level of costs required to maintain assets. We consider this to be unsatisfactory given the importance of maintenance costs, both in terms of their significance to

[48] DLG, *Position Paper on Asset Management Planning for NSW Local Government* prepared in 2006.

operational expenses and importance for enabling stakeholders to understand and monitor how a council's assets are managed.

In our view, a significant number of NSW councils may need technical assistance in developing asset management systems and plans. Some may also need incentives. In the first instance, the Division of Local Government might consider providing an asset management manual. The asset management guidelines could incorporate requirements and/or guidelines for:

- consistent accounting practices and reporting (eg, it could expand on the fair asset valuation principles set out in the March 2009 Council Circular)[49]
- depreciation methodology for existing assets
- infrastructure backlog indicators
- capital versus non capital expenditure
- service level assessment
- renewal/replacement cash flow projections
- principles and practices for the use of debt funding consistent with intergenerational equity.

IPART findings

1 NSW council revenues should continue to be regulated in some way, as councils' accountability to their local community is currently not strong enough to rely solely on the democratic process to protect ratepayers and other residents.

2 The framework for regulating council revenues should continue to focus on council's general income, as this approach protects ratepayers (who have no discretion over whether or not they pay rates) while providing councils with some autonomy in setting user fees and charges and fines.

3 There is scope to improve councils' accountability to their community by setting more explicit requirements and providing additional guidance and support tools to increase:

   - The level of community engagement and involvement in council planning and decision making.
   - The standard of information provided to the community in terms of accessibility and meaningfulness.
   - The compliance with requirements of councils to develop asset management plans.

[49] DLG, Recognition of Certain Assets at Fair Value, Circular 09-09, 17 March 2009.

Recommendations

2 To improve councils' accountability to the community, that the Division of Local Government should:

- Expand the current requirements for developing a Community Engagement Strategy so that councils are also required to give due consideration to the expected levels of service expressed by the community.
- Require councils to circulate a short summary of their Draft Delivery Program that is designed to obtain community input on council decisions.
- Encourage councils to improve their community engagement to ensure this engagement encompasses all key stakeholders to whom they are accountable.
- Publish best-practice examples of Delivery Programs and their summaries, and best-practice examples and case studies of community engagement.
- Take a proactive role in encouraging and assisting councils to improve the quality of information included in annual reports – for example, by publishing best-practice examples, developing guidelines to improve consistency, and creating incentives for improvement.
- Develop an asset management manual that includes guidance and/or requirements to help councils develop asset management systems and plans.

5 Has rate pegging had a negative effect on NSW councils' revenues and expenditures?

One of the main concerns about the current rate pegging approach expressed by stakeholders and commentators is that it has constrained local government revenues and expenditures, particularly infrastructure expenditure. As a result, some stakeholders believe rate pegging has compromised the long-term financial sustainability of NSW councils and led to the problem of infrastructure backlogs.

To examine the legitimacy of this concern, and understand the implications for any future framework for regulating council revenues, we undertook extensive consultation, research and analysis. This included:

4. Comparing NSW council revenues, operating expenditures and capital (or infrastructure) expenditures with those of councils in other states (where there is no rate pegging).
5. Reviewing previous assessments of the financial sustainability of local government in Australia to determine whether NSW councils' position is notably different to councils in other states.
6. Undertaking our own assessment of the financial sustainability of NSW councils, taking into account both recurrent and capital sustainability.
7. Reviewing previous assessments of the infrastructure backlog, and undertaking our own analysis of infrastructure backlogs in 11 case study councils in NSW to identify the extent of the problem and what councils and the NSW Government (through regulation) can do to address the problem.
8. Examining other factors that affect the long-term financial sustainablity of councils, including cost shifting between levels of government and councils' own efficiency and effectiveness.

This chapter focuses on the first area of analysis – comparing the trends in NSW councils' revenues and expenditures with those in other states to understand the impact of rate pegging. Chapters 6 to 10 discuss the remaining areas.

5.1 Overview of findings on the impact of rate pegging on NSW councils' revenues and expenditures

Our analysis of the trends in local government revenues and expenditures in NSW and the rest of Australia over the period since rate pegging was introduced has led us to conclude that rate pegging has not had a significant negative effect on NSW councils' revenues and expenditures. In particular, we found that:

- While rate pegging may appear to have acted as a constraint on NSW councils' revenues, their overall revenue growth has been similar to the average for other Australian councils (excluding NSW).
- On average, NSW councils' operating expenditure has grown at a higher annual rate than that of other Australian councils.
- On average, NSW councils' infrastructure expenditure has grown by a lower annual rate than that of other Australian councils. However, due to the lumpy nature of infrastructure spending and the range of other factors that can affect this spending, a link between rate pegging and lower average infrastructure expenditure in NSW could not be established.

The sections below discuss the key findings that led us to reach each of these conclusions and respond to the stakeholder comments we received about our analysis in this area. For further detail, see our information paper.[50]

5.2 How do NSW council revenues compare to those in other states?

We examined the historical trends in NSW councils' total revenue growth per capita over the period since rate pegging was introduced, and compared them to those in the other states.[51] We also examined trends in the main sources of NSW councils' revenue over this period, and compared them to those in the other states. In addition, we looked at the importance of different sources of revenue for different council types in NSW. The sections below summarise our analysis and findings.

5.2.1 Trends in total revenue per capita

Figure 5.1 shows the trends in NSW and other Australian councils' revenue per capita, and the trends in NSW and other Australian states' Gross State Product (GSP) over the 30 or so years since rate pegging was introduced in NSW. The figure shows that, in terms of dollars per capita, NSW councils' total revenue has been very similar to that in other states for most of this time. It is only since 2003/04 that NSW councils' revenue per capita has diverged substantially from that in other states.

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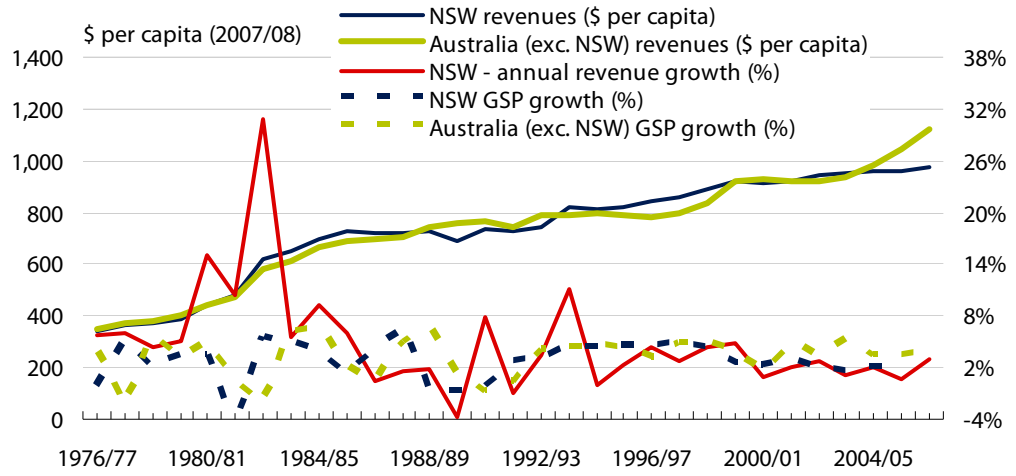
50 IPART, *Comparative Analysis of Local Government Revenue and Expenditure in Australia*, available from IPART's website.

51 The analysis in this chapter uses the trends in the other states of Australia as a proxy for what might have happened in NSW had the policy of rate pegging not been in place.

Figure 5.1 Real growth in local government revenue per capita and GSP since rate pegging was introduced, NSW and rest of Australia (excluding NSW)



Note: The 1995/96 NSW revenue figure in this chart incorporates a proxy 'other revenue' value based on the 1994/95 nominal 'other revenue' level (plus the CPI) because of a significant road network asset transfer of $12.6 billion captured in that year's figures.

Data source: ABS and Harris, P. and Harris, D. , (1992),'Interstate Differences in Economic Growth Rates in Australia, 1953-54 to 1990-91' *Economic Analysis and Policy*, September 1992, p 147 for GSP at factor cost figures from 1976/77 to 1989/90 ('Harris and Harris EAP Paper (1992)').

The NSW Government's rate pegging decisions may have been a factor leading to this divergence. However, it may also have been due to the slowdown in economic growth that occurred in NSW at around the same time. As Figure 5.1 shows, growth in NSW GSP fell below the average growth in GSP for the rest of Australia in around 2001/02.

The red line on Figure 5.1 shows the real annual growth in NSW councils' revenue per capita. The figure shows significant variation in this annual growth since 1976/77. The significant increase in annual growth shown by the red line around 1982/83 was driven by a large increase in sales of goods and services revenue. This experience was common across the other states and is most likely due to a change in reporting methods. These changes make it difficult to compare year-to-year variations in revenue growth. However, we are only interested in the long-term trends in revenue growth -- ie, what the situation was at the beginning of the series and what the situation was at the end of the series. So we calculated the compound average growth rates to smooth the annualised growth over the time period and reduce the impact of volatility in individual year values.[52]

52 All growth rates calculated were based on the compound annual growth rate (CAGR) formula equal to: $(FV/OV)^{(1/n)} - 1$ where FV is the future or most recent value, OV is the original value and n is the number of years from the original to the future value.

This analysis indicates that NSW councils' total revenue per capita has increased by a real average annual rate of 3.5% since 1976/77, compared to 4.0% in the rest of Australia. When we looked at the compound average growth rates over shorter periods, we found that:

- In the first 10 years of rate pegging in NSW (1976/77 to 1985/86), NSW councils' revenue per capita grew faster than in the other states (by a real average annual rate of 10%, compared to 9.4% in the other states).
- Growth was particularly strong from 1980/81 to 1984/85, when NSW councils' revenue per capita grew by a real average annual rate of 12.4%.
- In the first half of the 1990s, the real average annual growth in NSW councils' revenue per capita remained for the most part higher than in the other states.
- However, from 1996/97 to 2006/07, NSW councils' revenue growth slowed significantly. The real average annual growth rate over this time was 2.4% in NSW, compared to 5.2% in the other states.

In response to our draft report, the LGSA raised some concerns about our use of ABS data in the above analysis.[53] In particular, it noted the volatility in the data on annual NSW council revenue growth (the red line on Figure 5.1). The LGSA pointed out that we had not explained the large spikes in this growth, and argued that this unexplained volatility discredits the reliability of the data. In response, we have identified the drivers of these spikes in this final report (see above). We also note that we are concerned with the historical trends in revenue and the annual spikes in revenue data do not affect the reported compound annual growth rates. For this reason we consider the ABS data to be the best available data for these purposes. Further, we assessed trends in revenues over periods of at least 10 years, which we consider to be reasonable given known economic and policy trends.

5.2.2 Trends in the main sources of council revenue

As Chapter 2 discussed, councils generate revenue from a range of sources, including taxation (or rates), the sale of goods and services (or fees and charges for council services), grants and subsidies from state and federal governments, interest and other sources. The 2 main sources of this data on local government revenues come from the Division of Local Government (DLG) and the Australian Bureau of Statistics (ABS). We have used data from both sources throughout this report and we note that DLG and ABS use slightly different categories of revenue with slightly different definitions. Table 5.1 compares the components of local government revenue as classified by DLG and ABS. This section uses the ABS figures.

53 LGSA submission, pp 7-8.

Table 5.1 Components of NSW local government revenue in 2006/07, based on ABS definitions

ABS revenue category	DLG revenue category	Revenue $m	% share of total revenue
Taxation revenue	Rates	2,843	42.3
Sale of goods and services (G &S Sales)[a]	Annual charges, user charges and fees, water and sewerage fees, fees for regulatory services, rental income	1,626	24.2
Grants and subsidies	Grants	667	9.9
Interest	Revenue from financial assets	397	5.9
Other revenue	Fines, developer contributions and donations	1,197	17.8
Total revenue		6,729	100.0

[a] G&S Sales revenue excludes 'Water Supply' and 'Sanitation and Protection of the Environment' fees and charges.
Note: Grants and subsidies, interest income and 'other revenues include revenues to water utilities and thus these shares are overstated. Data from DLG suggests that this would constitute around 2% of revenue in 2006/07.' Columns may not add due to rounding.
Source: ABS Cat No. 5512.0

Table 5.2 shows the real average annual growth in each of these revenue sources between 1976/77 and 2006/07.

Table 5.2 Real average annual growth in main sources of council revenue – NSW and the rest of Australia, 1976/77 to 2006/07, (%)

Source of revenue	NSW	Rest of Australia
Taxation	3.0	4.9
Sales of goods & services[a]	8.7	6.4
Grants & subsidies	4.1	4.7
Interest income	7.3	6.0
Other	6.8	6.5

[a] Excludes water supply and sanitation and protection of the environment levies in all states and the NT.
Source: ABS Cat No 5512.0

The trends in the most important sources of revenue – taxation and the sale of goods and services – are discussed below. Together, these sources accounted for more than 70% of NSW councils' total revenue in 2007/08. The information paper outlines the trends on the other revenue sources.[54]

[54] Interest income and other revenues are indirectly related to the revenue framework and represent a smaller share of council's total revenue, while grants and subsidies are determined by the higher levels of government.

Trends in taxation revenue per capita

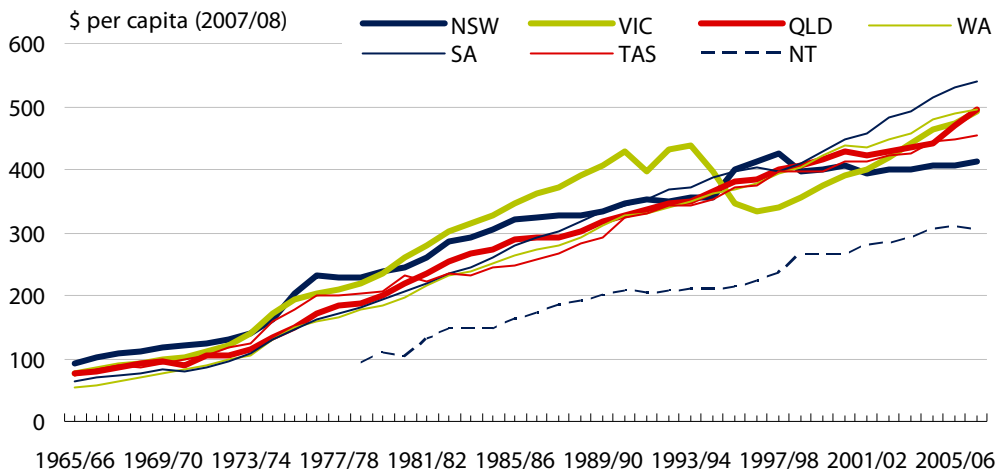
Taxation revenue (which, under the ABS definition, is principally rates revenue) is the major source of revenue for councils in all states of Australia, including NSW. However, as section 5.2.3 will discuss, it represents a smaller share of total revenue for rural councils than for other types of councils.

Figure 5.2 shows local government taxation revenue per capita over the past 40 years for NSW and the other states.[55] The figure indicates that this revenue increased substantially in all states in the few years prior to the introduction of rate pegging, and increased most sharply in NSW. Between 1973/74 and 1976/77, taxation revenue per capita increased by real average annual rate of 16% in NSW, compared to 14% in the rest of Australia.

However, after rate pegging was introduced, taxation revenue per capita increased at a slower rate than in other states. Between 1976/77 and 2006/07, this revenue increased by just 1.9% in NSW, compared with 3.4% for the rest of Australia.[56] Most of this difference is due to the almost flat growth in taxation revenue in NSW over the last 10 years.

This analysis suggests that rate pegging has constrained the growth of NSW councils' taxation revenue.

Figure 5.2 Local government taxation revenues per capita (real) -- All states and NT, 1965/66 - 2006/07



Note: Northern Territory local governments collected revenues from 1978/79.
Data source: ABS Cat No 5512.0, ABS Cat No 3105.0.65.001.

55 The values are expressed in 2007/08 dollars.
56 Per capita, annual average, real rates.

Trends in revenue from sales of goods and services per capita

As Table 5.2 indicated, in aggregate, revenue from sales of goods and services has been the fastest growing source of council revenue in NSW since rate pegging was introduced, and has tended to grow at a faster rate than in the rest of Australia. In 1976/77, NSW councils collected $135 million from sales of goods and services; in 2006/07 this had increased to $1.63 billion in real terms.[57] This represents real average annual growth of 8.7%, compared with 6.4% in the other states.

As Figure 5.3 shows, in the year rate pegging was introduced (1976/77), NSW councils collected an average of $27 in sales revenue per person, compared to an average of $41 per person in the rest of Australia. However, in 2006/07, NSW councils' average sales revenue was $236 per person, compared with an average of $170 per person in the other states.

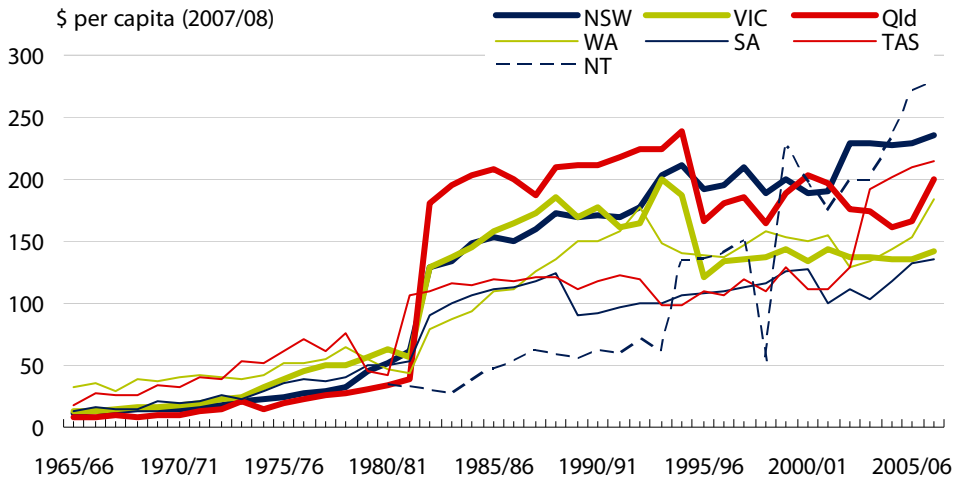
When we looked over shorter time periods we found that:

- Over the 10 years from 1976/77 to 1985/86, sales revenue per capita grew by a real average annual rate of 21% in NSW, compared to 16% in the other states. Much of this growth occurred in the early 1980s, when the rate of growth accelerated strongly both in NSW and the other states.
- Over the following 10 years (1986/87 to 1995/96), the growth in sales revenue slowed significantly in NSW to a real average annual rate of 2.8%. However, this was still faster than in the other states, where real average annual sales revenue per capita declined by 1.6%.
- Over the most recent 10 years for which data are available (1996/97 to 2006/07), the growth in sales revenue slowed further in NSW, to a real average annual rate of 1.9%. Again, this was still faster than in the others states (1.6%).

As previously noted, the LGSA raised concerns about our use of ABS data. Again, we consider that our focus on long-term trends using compound annual growth to reduce the impact of volatility in the time series has addressed this concern with the data.

57 ABS, in real terms, 2006/07 dollars.

Figure 5.3 Local government revenue from the sale of goods and services per capita – All states, 1965/66 – 2006/07



Note: Northern Territory local governments collected revenues from 1978/79. Also, the annual spikes in revenue between 1976/77 and 2006/07 do not affect reported compound annual growth rates.

Data source: ABS Cat No 5512.0, ABS Cat No 3105.0.65.001.

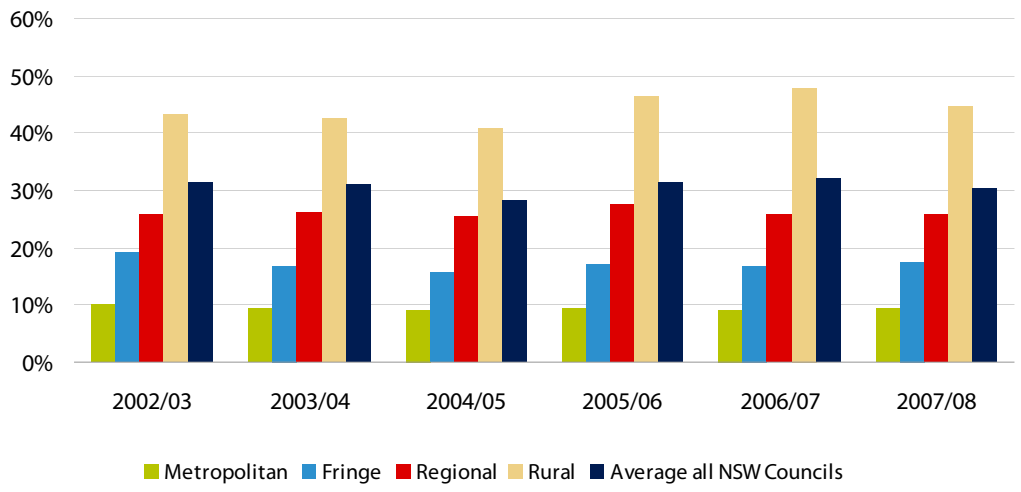
5.2.3 Importance of different sources of revenue for different council types

To understand the impact of rate pegging on different types of councils ability to raise revenue, we considered the importance of different sources of revenue for different council types in NSW, particularly the importance of revenue from grants and subsidies. We compared average grants revenue as a percentage of total revenue for all councils in the state with that for all councils in each council category (metropolitan, fringe, regional and rural). We also examined changes in the composition of total revenues among our case study councils.

Average grants revenue as a percentage of total revenue for all NSW councils

Figure 5.4 shows average grants revenue as a percentage of total revenues for all NSW councils and for NSW councils in each category over the period 2002/03 to 2007/08. This figure indicates that there is wide variation in the extent to which councils of different types rely on grants revenue. The general pattern is that the further a council is located from the metropolitan areas, the greater its reliance on grants.

Figure 5.4 Revenue from grants as percentage of NSW councils' total revenue, 2002/03 to 2007/08



Data source: DLG, *Comparative Information on NSW Local Government Councils*, 2002/03 to 2007/08.

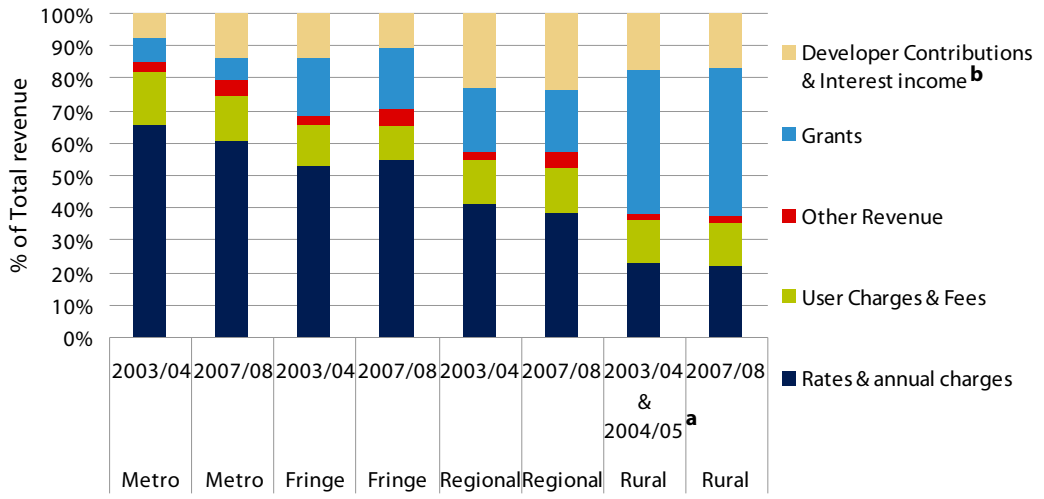
Over the whole of this period, metropolitan councils' grants revenue had the lowest reliance on grants revenue, which represented approximately 10% of total revenues. Fringe councils had the next lowest reliance (17% of total revenues), followed by regional councils (26%). Rural councils had the highest reliance on grants revenue (44%).

Changes in the composition of total revenues among case study councils

Our analysis of changes in the composition of total revenues among our 11 case study councils supports the above findings. Figure 5.5 shows the major components of each case study council's total revenue in 2003/04 and in 2007/08. It indicates that grants revenue is a very important and growing source of funds for rural councils. From 2003/04 to 2007/08, this revenue represented between 40% and 50% of the rural case study councils' total revenue.

In contrast, grants were a relatively small and falling revenue source for the metropolitan case study councils. On average, these councils sourced 9.5% of their total revenues from grants over the period, while fringe and regional case study councils sourced an average of 17.2% and 26% of their total revenues from grants respectively.

Figure 5.5 Composition of total revenue -- Case study councils, 2003/04 and 2007/08



a Due to council amalgamations analysis started from 2004/05 for some councils.

b Developer Contributions and interest income are excluded from further discussion of revenue composition as these revenue sources are considered to be volatile both across time and councils.

Note Uses the DLG classification of operating revenues, which is slightly different to the ABS classification.

Data source: Individual Financial Statements for each Council.

IPART findings

4 Analysis of the trends in council revenues in NSW compared to those in other states indicates that rate pegging has not had a significant impact on NSW councils' total revenue growth. While it may have constrained growth in rates revenue, councils have been able to substitute other sources of revenue, such as sales of goods and services. As a result, the growth in NSW councils' total revenues has been broadly in line with that in the other states for most of the time since rate pegging was introduced.

5 Over the last 10 years, growth in NSW councils' revenue from sales of goods and services has slowed, which may indicate that councils have taken up available opportunities to increase their revenue from this source. If this were the case, NSW councils may not be in a position to maintain growth in total revenues in line with other states in future.

6 There is a significant diversity across NSW councils in terms of the relative importance of different sources of revenue. Rural councils, in particular, are much more reliant on grants and subsidies than other councils, and less reliant on rates revenue and user charges. This suggests that they are less able to raise their own revenue.

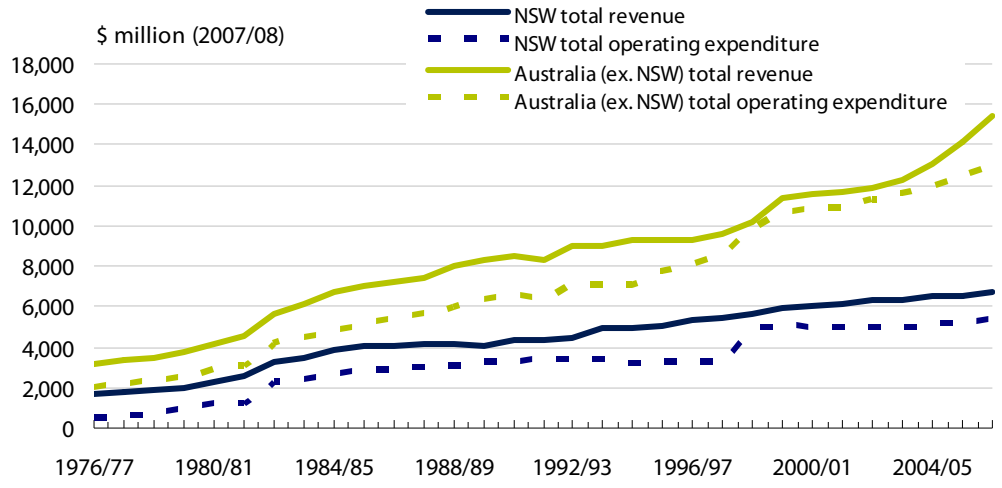
5.3 How do NSW council operating expenditures compare to those in other states?

To help understand whether rate pegging has constrained NSW councils' operating expenditures, we compared the trends in these expenditures[58] to the trends in other states. We also examined the differences in operating expenditure patterns among individual councils of different types, using data from our case study councils.

5.3.1 Trends in operating expenditure

Figure 5.6 shows that at the aggregate level, councils' total revenues have been higher than their operating expenditure in both NSW and the other states since 1976/77. This is not surprising, since councils need additional revenue to fund capital expenditure (eg, for the repayment of loans or to provide for spending on infrastructure).

Figure 5.6 Local government revenue and operating expenditure -- NSW and Australia (excluding NSW), 1976/77 to 2006/07



Note: The revenue figures exclude 'water supply' and 'sanitation and protection of the environment' levies and the operating expenditure figures exclude the operating expenses associated with implementing these services (in all states and the NT).

Data source: ABS Cat No 5512.0.

Looking at total operating expenditures, councils' expenditures in NSW have grown faster than in other states over the period since rate pegging was introduced. From 1976/77 to 2006/07, NSW councils' total operating expenditure grew by a real average annual rate of 8.3%, compared 6.4% in other states.

58 Operating expenditure is the on-going cost of running the council's business. It is the total expenditure minus capital expenditure.

Looking at operating expenditures per capita, councils' expenditures in NSW have also grown at a faster rate than in other states. In 1976/77, average council operating expenditure in NSW was $99 per person, which was 56% lower than in the other states ($224 per person). By 2006/07, this difference had been significantly reduced average operating expenditure was $777 per person in NSW, 17% lower than in the other states ($932 per person).

5.3.2 Differences in operating expenditure patterns among individual councils and council types

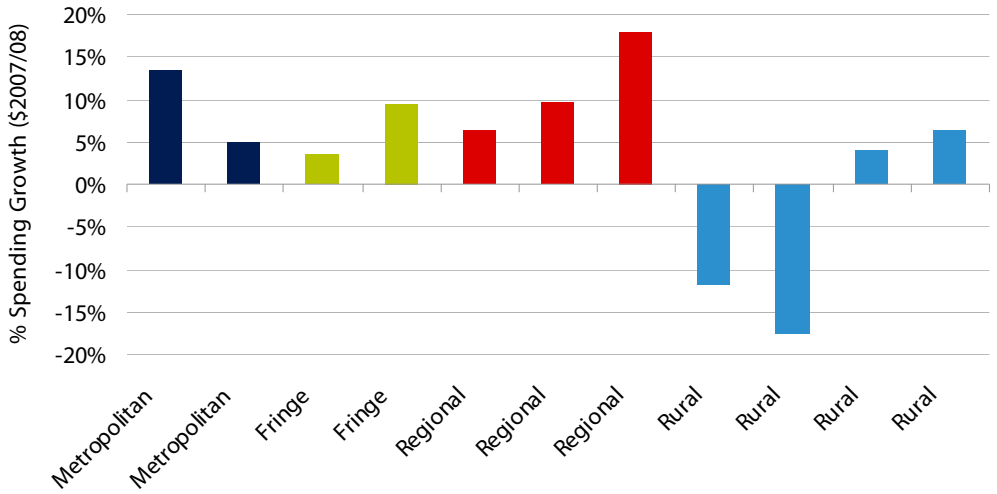
Differences in councils' operating expenditures can reflect differences in the types and standards of services they choose to provide, or differences in their financial capacity. We examined the differences in operating expenditure patterns among our 11 case study councils to help understand the diversity between different types of councils. Diversity across councils would suggest a need for a flexible revenue framework.

Differences in operating expenditure growth

Expenditure growth, like revenue growth, varies significantly by council and by council type. Figure 5.7 shows the variation in nominal operating expenditure growth per rate assessment for the 11 case study councils over the period 2003/04 to 2007/08. Rural councils tended to have the lowest operating expenditure growth over the period, and 2 rural councils recorded negative growth per rate assessment. This may reflect financial pressures faced by this type of council.[59]

[59] In particular, rural councils are responsible for a large network of roads with a small ratings base to fund these extensive infrastructure assets.

Figure 5.7 Percentage growth in operating expenditure per rate assessment – Case study councils, 2003 to 2008



Note: Due to council amalgamations analysis started from 2004/05 for some councils.
Data source: Individual Council's Financial Statements for each of the 11 Case Study Councils.

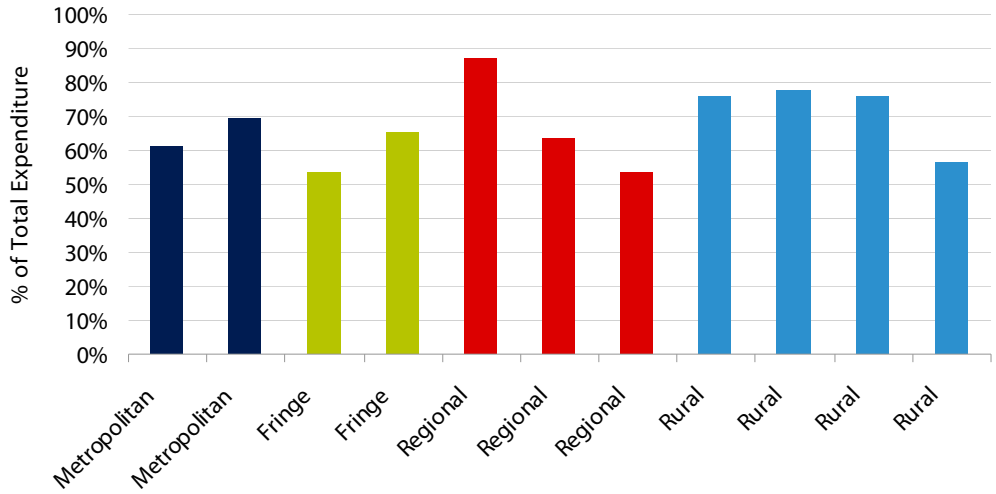
Differences in composition of operating expenditure

The composition of operating expenditure also varies among different councils and council types. For each case study council, we looked at proportion of total operating expenditure on 'traditional services' and 'non traditional services'.[60] Traditional services include governance, administration, public order and safety, transport, communication/amenities. Non traditional services include health services, community and education services, recreation and culture, economic affairs and mining and construction.

Figure 5.8 shows these councils' spending on traditional services as a percentage of total operating expenditure in 2007/08. It indicates that all the case study councils spent more than 50% of their operating expenditures on traditional services. While most of the councils spent between 50% and 70% of total expenditure on traditional services, 3 of the rural councils spent close to 80% on traditional services.

60 This classification comes from PwC (see Appendix E).

Figure 5.8 Percentage of total operating expenditure on traditional services – Case study councils in 2007/08



Data source: Individual Council's Financial Statements for each of the 11 Case Study Councils.

IPART findings

7 At the aggregate level, there has been relatively strong growth in local government operating expenditures over the period of rate pegging, and average growth has been stronger in NSW than in other states. This indicates that rate pegging has not constrained local government expenditures.

8 More detailed analysis of the expenditure trends in NSW indicates that the growth of expenditure varies by council type, as does the composition of expenditure. Rural councils tended to record lower growth in operating expenditure and spend more on traditional services than other types of council. The lower expenditure patterns of rural councils may reflect financial pressures on these councils.

5.4 How do NSW council infrastructure expenditures compare to those in other states?

Councils' infrastructure facilities tend to be long lived assets that are fixed in place, costly and time-consuming to plan and build, and require routine maintenance and periodic upgrading to prolong their lives.[61] Therefore, councils need to constantly spend on infrastructure at least in line with the rate of consumption of the assets. State and national governments have previously expressed concern that councils are not devoting sufficient resources to preserving and renewing their infrastructure assets, particularly the local road networks.[62]

61 DOTARS (2007), *Local Government National Report 2005-2006*, p 62.
62 DOTARS (2005), *Local Government National Report 2003-2004*, pp 80-83.

We examined the trends in NSW councils' capital expenditures and compared them to the trends in other states over the period since rate pegging was introduced to understand whether rate pegging has adversely affected council spending on infrastructure in this state. We used ABS estimates of gross fixed capital formation[63] in NSW and the other states.

The sections below summarise our findings and conclusions. Our information paper[64] provides more detailed analysis.

5.4.1 Trends in capital expenditure per capita

Our analysis indicates that in the period since rate pegging was introduced, councils' aggregate capital expenditure has grown at a slower rate in NSW than in other states. On a per capita basis, the real average annual growth in NSW councils' capital expenditure was 1.9% over the period 1974/75 to 2006/07, compared with 3.5% for the rest of Australia.

In dollar terms, councils' capital expenditure per capita is also lower in NSW than in the other states. In 2006/07, NSW councils spent $273 per person, which was 23% lower than the average of $356 per person spent by councils in the other states.

Figure 5.9 and Table 5.3 compares the gross fixed capital formation per capita for councils in NSW and the rest of Australia over the period of rate pegging (the columns). It also shows the trends in councils' gross fixed capital formation as a percentage of their total expenditure over this period (the lines). The figure indicates that councils' capital expenditure per capita has been variable in both NSW and the rest of Australia over the period of rate pegging. This partly reflects the 'lumpy nature' of major capital investments.

When we looked at smaller time periods, we found that:

- Between 1974/75 and 1985/86, capital expenditure per capita grew by a real average annual rate of 1.2% in NSW, compared to 3.9% in the other states.
- From 1986/77 to 1995/96, capital expenditure per capita declined by a real average annual rate of 2.5% in NSW, while in the other states it increased by a real average annual rate of 0.1%.

63 The ABS publishes gross fixed capital formation for each state's local government sector. This is the change in value of assets before depreciation, changes in inventories or other transactions. It includes spending on capital assets like cars or equipment as well as infrastructure, and also includes renewal or replacement capital in addition to new capital expenditure. While not exactly capital expenditure, gross fixed capital formation has been used as a measure of capital expenditure for this analysis.

64 IPART, *Comparative Analysis of Local Government Revenue and Expenditure in Australia*, available from IPART's website.

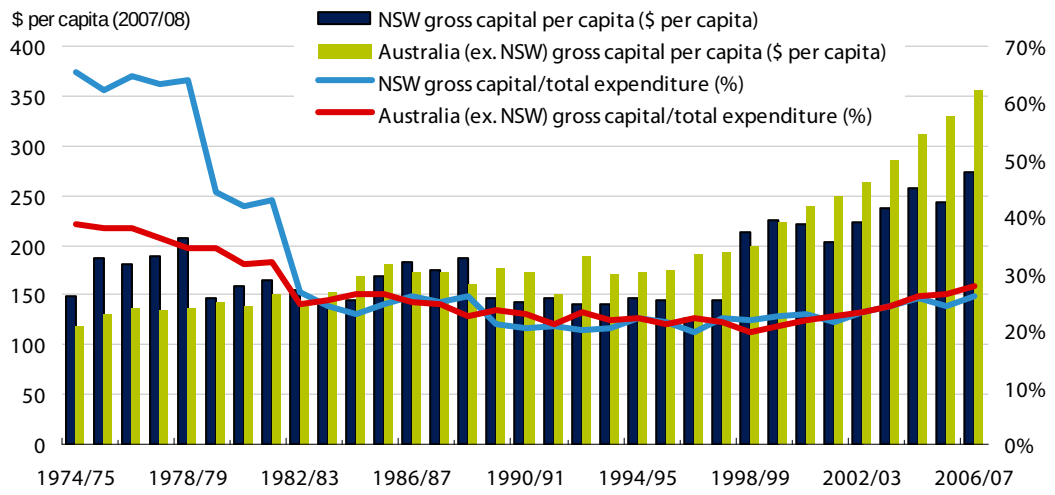
- From 1997/98 to 1998/99, the real capital expenditure per capita in NSW increased significantly (by 48%), possibly due to preparations for the 2000 Sydney Olympic Games. The average growth in NSW councils' capital expenditure per capita was above that for the rest of Australia during this period.
- Since then, growth has been relatively slow, and in 2006/07, the real capital expenditure per capita by councils in NSW was lower than the average in the rest of the states. However, it was higher than in Victoria and South Australia.

Table 5.3 Local government capital expenditure per capita and growth (2007/08 dollars) – All states and Australia (excluding NSW), 1974/75 to 2006/07

	NSW	VIC	QLD	SA	WA	TAS	NT	Australia (ex NSW)
1974/75								
Capital expenditure per capita	$148	$122	$131	$69	$158	$73	na	$118
1974/75 to 1985/86								
Average capital expenditure per capita	$166	$141	$170	$109	$163	$105	$53	$144
Average annual growth	1.2%	1.6%	6.1%	7.7%	2.2%	5.5%	na	3.9%
1986/87 to 1995/96								
Average capital expenditure per capita	$155	$121	$251	$134	$201	$136	$170	$171
Average annual growth	-2.5%	-4.5%	1.2%	-0.4%	0.0%	1.0%	24.5%	0.1%
1996/97 to 2006/07								
Average capital expenditure per capita	$215	$190	$355	$182	$302	$219	$355	$258
Average annual growth	8.0%	10.4%	6.4%	5.3%	4.0%	4.8%	-7.9%	6.4%
2006/07								
Capital expenditure per capita	$273	$264	$525	$247	$350	$287	$325	$356

Source: ABS based on Gross Fixed Capital Formation figures.

Figure 5.9 Local government gross fixed capital formation – NSW and Australia (excluding NSW), 1974/75 - 2006/07



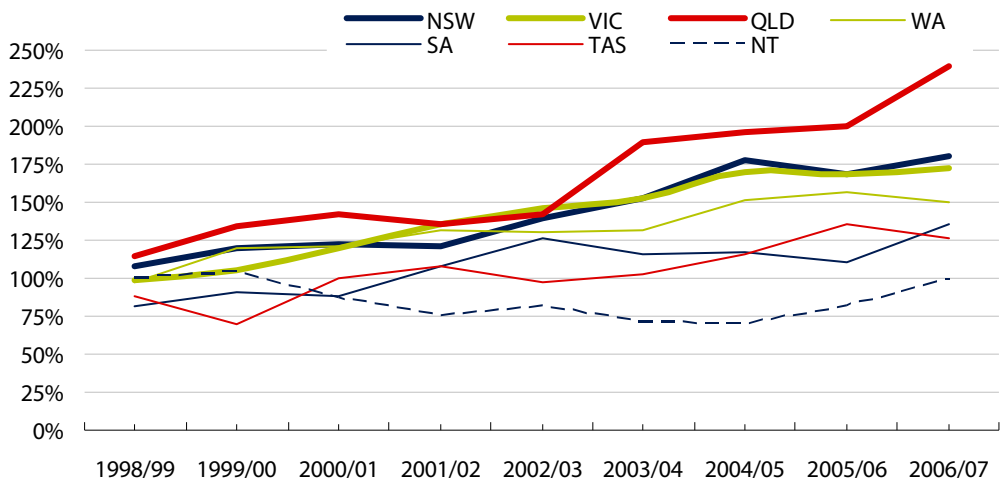
Data source: ABS.

5.4.2 Trends in capital expenditure ratio

The capital expenditure ratio, which is capital expenditure divided by depreciation is the best available indicator for estimating any potential infrastructure backlog. We examined capital expenditure ratios, calculated as total capital expenditure (gross fixed capital formation) divided by depreciation expenses at the state-level to compare the NSW councils' position relative to other states. A council's capital expenditure ratio is an indicator of whether it is at least maintaining its existing asset stock. The minimum benchmark for this indicator is 1.0.

The results (see Figure 5.10) indicate that over an 8-year period (1998/99 to 2006/07), NSW councils' capital expenditure ratio has been higher than councils' in most other states. Since 2003/04, it was higher than in all other states except for Queensland and Victoria. However, when the impact of the lower depreciation levels in NSW (and thus higher capital expenditure ratios) is taken into account, it is likely that NSW councils' capital expenditure ratios are in line with those of councils in the other states. In any case, the results don't indicate that NSW councils' capital expenditure ratios are significantly lower than other states.

Figure 5.10 Local government capital expenditure ratios – All states, 1998/99 - 2006/07



Note: The capital expenditure ratio is calculated by dividing state-level total gross fixed capital formation by state-level total depreciation expenses.

Data source: ABS.

It was difficult to compare the NSW councils median capital expenditure ratios with the results of other states' median council capital expenditure ratios because of the variations in data availability and reporting methods among the states. However, we examined other states' ratios where possible:

- In South Australia, we calculated the capital expenditure ratios for 2006/07 based on councils' reported renewal/replacement capital expenditure divided by their depreciation expenses. This excludes capital expenditure on new and upgraded assets and will be lower than the estimated ratios for NSW councils, all else being equal. The median council renewal/replacement capital expenditure ratio in 2006/07 was 80% in 2006/07, and the total estimated asset funding shortfall was $90 million or $1.3 million per council (based on 68 councils in South Australia).[65]
- In Queensland, like in NSW the reported capital expenditure ratio is based on total annual capital expenditure divided by depreciation. Based on these reported ratios (rather than the ratios that we have calculated), the median ratio for Queensland councils was 0.99 in 2004/05, 1.21 in 2005/06 and -0.21 in 2006/07 (as capital expenditure appeared to be scaled back by many councils in this year).[66]

65 Local Government Association of South Australia, 2006/07 council financial statement information, www.lga.sa.gov.au.

66 QLD Department of Local Government, Sport and Recreation, *Queensland Local Government Comparative Information Report 2006-07*.

- Victoria publishes infrastructure renewal ratios which compare spending on capital renewal of existing infrastructure assets to an average annual consumption of capital (AAC), rather than depreciation expenses. Once again, these ratios would be lower than NSW councils' estimated capital expenditure ratios, all else being equal. The median ratios reported were 56% in 2005, 58% in 2006 and 67% in 2007.[67]
- In Tasmania, the reported capital expenditure ratios for councils in 2006/07 (based on capital expenditure on existing assets like in South Australia and Victoria) indicated a median ratio of 65%.[68]
- Western Australia and NT do not publish any similar ratio figures.

This compares with the estimates for NSW councils renewal/replacement capital expenditure/depreciation ratios of around 50% to 60% in 2004/05 by Roorda and Associates[69]. These interstate comparisons suggest that South Australian, Victorian and Tasmanian councils, at least, may be marginally out-performing NSW councils in funding their asset renewal and replacement needs. However, the median ratios compared refer to different years, and there may be a number of other inconsistencies evident between different states' reporting methodologies.

Further, this is inconsistent with our results in Figure 5.10, comparing state-level capital expenditure ratios from 1998/99 to 2006/07 (when all capital expenditure is included). This shows that there are shortcomings in the available data and this is discussed further in Chapter 8.

IPART findings

9 Analysis of published material on aggregate trends in local government's capital investment indicates that on average, councils' infrastructure investment per person has been lower in NSW than in the other states over the period of rate pegging. However, infrastructure investment tends to be lumpy and there have been significant changes in rates of investment in both NSW and the rest of Australia over this period. Therefore, the link between inadequate spending on infrastructure by councils in NSW and the policy of rate pegging is not established by this analysis.

10 A number of other factors are likely to have contributed to a council's level of infrastructure investment – including economic growth, its policies (eg, choices to forgo maintenance to provide funding for new capital works), asset management approach, the level of grants, subsidies and developer contributions it receives and the demands on its revenue associated with asset maintenance.

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67 Victorian Grants Commission, Victorian Local Government Data, email correspondence.

68 Tasmanian Department of Premier and Cabinet, *Measuring Council Performance in Tasmania 2006-07 KPI Report*, www.dpac.tas.gov.au/divisions/lgo.

69 Roorda, J., 'The Present Condition and Management of Infrastructure in Local Government', Allan Inquiry Research Report, January 2006, p 8.

11 On balance, despite rate pegging, the trends in NSW councils' revenues and expenditure have been largely similar to those in other states over the past 30 years. This indicates that other factors are driving council's financial performance, and this performance cannot be directly linked to rate pegging.

6 What have previous reviews of councils' financial sustainability found?

A number of recent studies have focused on the financial sustainability of local government in NSW and other states, including studies undertaken by:

- Access Economics (NSW and other states)
- Financial Sustainability Review Board (South Australia)
- Municipal Association of Victoria (MAV) (Victoria)
- PricewaterhouseCoopers (PwC) (national study)
- FiscalStar Services Pty Ltd (FiscalStar) (NSW)
- Queensland Treasury Corporation (QTC) (Queensland).

We reviewed these studies to determine whether their results indicate that rate pegging is a critical factor driving the financial sustainability of councils in NSW, including infrastructure backlogs. (An infrastructure backlog is an important indicator of local government's financial sustainability as it indicates the extent to which the council has not been meeting its past financial obligations.) The sections below provide an overview of the studies' findings, and then summarise the results of each study. Chapter 8 examines the issue of infrastructure backlogs (including findings of previous studies) in more detail.

6.1 Overview of previous studies' findings on councils' financial sustainability

The previous studies we reviewed used different approaches to defining and measuring councils' financial sustainability. However, their results are reasonably similar for all states. They indicate that financial sustainability is a concern in all states, not just NSW. They also indicate that infrastructure backlogs are a concern in all states, not just NSW. Nevertheless, most councils have sustainable financial positions,[70] low debt levels and high liquidity.

The results of one study (by PwC) suggest the infrastructure backlog problem may be worse in NSW than in the other states, while other studies such as Access Economics' tend to suggest that the infrastructure backlogs are at similar levels. However, we note that all previous studies had difficulty finding reliable data on

70 PwC, p 12. The percentage of councils found to be unsustainable was generally between 25% and 40%, depending on the study.

infrastructure backlogs because many councils in Australia do not collect and report consistent data on asset management. For these councils, it is not possible to quantify the extent of any annual shortfalls against the optimal level of capital expenditure on renewal and replacement of existing assets.[71] For example, Access Economics found that:

> Deficient policies and practices were evident across local government in Australia at present include those relating to under funding of depreciation, the outdated measurement of asset values and depreciation, poor asset management systems and policies, and the inadequate monitoring and reporting of a council's financial position.[72]

In addition, we note that our more detailed analysis of previous studies findings on infrastructure backlogs, including the PwC study, clearly indicates that the unreliability and inconsistency of the data used means estimates of state-wide backlogs and comparisons between these backlogs are inconclusive (see section 8.3).

The previous studies also found significant differences between the financial circumstances of individual councils, even within similar categories of council. But in general, rural and remote councils and councils in areas with high population growth included a higher percentage of councils found to be under financial stress or unsustainable.

We note that the approaches used in previous studies were based on councils' revenue and expenditure policies at the time the research was undertaken, irrespective of the quality or appropriateness of those policies in current circumstances. These reviews tend to define financial sustainability in terms of whether services and infrastructure levels and standards are being met without disruptive increases in rates and charges or disruptive cuts to services.

However, we consider that in practice, most councils have the capacity to adapt their revenue, expenditure, liquidity or debt policies as part of a dynamic response to changing circumstances. Those least able to adapt are rural and remote councils, because they tend to have a narrower revenue base than other councils. Councils experiencing rapid population growth, such as some fringe councils in NSW, may also have less flexibility because of demand growth.

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71 For example, see *South Australian Local Government Sector Financial Indicators Report 2009*, p 3.

72 Access Economics, 2006, *Local Government Finances in Western Australia*, for the Systemic Sustainability Study, p 71.

6.2 Access Economics

6.2.1 New South Wales (2006)

Access Economics[73] undertook an assessment of the financial sustainability of NSW councils in 2006 for the Allan Inquiry. It defined a council's finances as financially sustainable in the long term if its:

> Financial capacity is sufficient – for the foreseeable future – to allow [it] to meet its expected financial requirements over time without having to introduce substantial or disruptive revenue and expenditure adjustments.

It examined key financial indicators[74] over the period 2000/01 to 2004/05 to assess the current financial performance and position of NSW councils. In 2004/05, it found that councils' operating deficits averaged 3% of their own source revenues. For the councils showing operating deficits, their average deficit was 11% of their own source revenue, with almost 50% of councils reporting operating deficits greater than 10%.[75]

Access Economics' also projected councils' operating surpluses as at 2015/16.[76] This analysis was based on the assumption that councils make no policy changes in response to emerging changes in their financial circumstances.

Table 6.1 summarises Access Economics' findings for key groups of councils. It shows that 26% of all NSW councils (serving 17% of the state's population) were found to have unsustainable long-term finances at the time of the study. The highest percentages of council assessed as unsustainable were found in the 'regional', 'above average growth' and 'smallest 25%' categories.

Access Economics' projections indicated that on a 'no-policy-change basis' (ie, regardless of rate pegging), the financial capacity of NSW councils per capita will increase in real terms over coming years. This reflects the capacity of councils to raise additional revenue from sources other than rates. However, Access Economics found that this scope may be limited for councils with high reliance on grants funding, because these councils are likely to have relatively low levels of additional financial capacity.

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73 Access Economics, 2006, *Local Government Finances in NSW – An Assessment, for the Independent Review Panel*.

74 Including the operating surplus ratio, net financial liabilities ratio and asset renewals/replacement ratio.

75 Access Economics, 2006, *Local Government Finances in NSW – An Assessment*, for the Independent Review Panel, pp 17 and 19.

76 Excluding capital.

Table 6.1 Access Economics' assessment of financial sustainability by council category

	Councils whose long-term finances are assessed as unsustainable		
Council category	**Number**	**% of group**	**% of total**
Metropolitan	7	18	17
Regional	13	31	33
Country	20	27	50
Above average growth	19	31	48
Declining population	4	17	10
Largest 25%	6	17	15
Smallest 25%	13	35	33
All NSW Councils	40	26	100

Note: Metropolitan councils include DLG groups 1, 2, 3 & 7. Regional councils comprise DLG groups 4, 5, 6 & 7. Country councils comprise DLG groups 8, 9, 10 & 11.

Source: Access Economics, 2006, *Local Government Finances in NSW – An Assessment*, for the Independent Review Panel p 52.

In relation to the infrastructure backlog, Access Economics' estimated the annual capital expenditure ratio on the renewal or replacement of existing assets. It found a shortfall of annual depreciation of those assets by $400 million, or 40% of council's capital expenditure in 2004/05.[77] Based on this, it concluded that an infrastructure spending backlog has emerged for NSW councils, although it did not estimate the total size of this backlog.[78]

6.2.2 Western Australia (2006)

Access Economics applied a similar methodology to analyse the financial sustainability of local government in other states.[79] In Western Australia, it found that councils had operating deficits representing 4.5% of their own source revenue in 2004/05.[80] This is comparable to that found for NSW councils in the same year. Like NSW councils, WA councils had strong balance sheets with no evidence of over reliance on borrowing.

[77] Access Economics, 2006, Local Government Finances in NSW – An Assessment, for the Independent Review Panel, p 27.

[78] Access Economics, 2006, Local Government Finances in NSW – An Assessment, for the Independent Review Panel, p 30.

[79] See for example, Access Economics, 2007, *A Review of the Financial Sustainability of Local Government in Tasmania*; Access Economics, 2006, *Local Government Finances in Western Australia for the Systemic Sustainability Study*.

[80] Access Economics, 2006, *Local Government Finances in Western Australia for the Systemic Sustainability Study*.

In relation to the infrastructure backlog, Access Economics estimated that the infrastructure backlog represented 14% of the total value of councils' non financial assets in Western Australia.[81] This compares to the estimate of around 10% for NSW councils made by the Allan Inquiry for NSW in 2006.[82] Further, using forward projections (and accounting for the infrastructure backlog), Access Economics found that 58% of WA councils (serving 21% of the state's population) were financially unsustainable.[83]

6.2.3 Tasmania (2007)

Access Economics completed a similar study of the financial sustainability of Tasmanian local government in 2007. It found that Tasmanian councils had an average operating deficit of 2.1% in 2005/06[84], which is of the same order as the recurrent performance of NSW (3%) and WA councils (4.5%). It also found that Tasmanian councils had strong balance sheets with minimal levels of debt.

In relation to the infrastructure backlog, Access Economics' estimated the annual renewals gap ratio[85] to be around 28.4% of the desired level of renewals capital expenditure.[86] It estimated the infrastructure backlog as a proportion of the value of infrastructure assets to be 1.2% in 2005/06.[87] Overall, 21% of Tasmanian councils (serving 8% of the state's population) had long-term finances which were unsustainable.[88]

6.3 Financial Sustainability Review Board (South Australia) (2005)

In 2005, the Financial Sustainability Review Board[89] examined the financial sustainability of local government in South Australia. It found that in 2003/04, SA councils' average operating deficit was 12.5% of their annual rates revenues.[90] Their balance sheets were strong with low levels of debt. The infrastructure backlog was

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81 Access Economics, 2006, *Local Government Finances in Western Australia for the Systemic Sustainability Study*, p 34.

82 Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government - Final Report*, May 2006, p 117.

83 Access Economics, 2006, *Local Government Finances in Western Australia for the Systemic Sustainability Study*, p 61.

84 Access Economics, 2007, *A Review of the Financial Sustainability of Local Government in Tasmania*, p 14.

85 Based on actual renewals capital expenditure divided by desired renewals capital expenditure.

86 Access Economics, 2007, *A Review of the Financial Sustainability of Local Government in Tasmania*, p 20.

87 Access Economics, 2007, *A Review of the Financial Sustainability of Local Government in Tasmania*, p 9.

88 Access Economics, 2007, *A Review of the Financial Sustainability of Local Government in Tasmania*, p 27.

89 Financial Sustainability Review Board, 2005, *Rising to the Challenge, Towards Financially Sustainable Local Government in South Australia*, Volume 1 and 2

90 Financial Sustainability Review Board, 2005, *Rising to the Challenge, Towards Financially Sustainable Local Government in South Australia*, Volume 1, p 9.

estimated to be around 5% of their non-financial assets.[91] Overall, this study found that 38% of SA councils were financially sustainable in the long term.[92]

6.4 Municipal Association of Victoria (MAV)

MAV[93] assessed the financial strength of Victorian councils over a number of years to identify those facing financial risks, and assess whether through internal reform, they can improve their financial performance. It considered a council to be at risk if its combined (accumulated) capital underspend and long-term debt exceeds 100% of its rate revenue over the period 1997/98 to 2006/07, or 50% of its revenue between 2001/02 to 2006/07. This rating is known as the MAV Viability Index.[94]

In 2008, it found that 28% of councils were financially at risk, and more than half of these were at high or very high risk. The MAV considers that these councils require external funding support to improve their situation.[95]

In relation to the infrastructure backlog, the Auditor General identified an infrastructure backlog of $1.5 to $2.7 billion in 2002. The MAV calculated the annual infrastructure spending shortfall to be $280 million for Victorian Councils between 2007 and 2011.[96]

6.5 PricewaterhouseCoopers (PwC)

In 2006, PwC undertook a national study on the financial sustainability and infrastructure backlogs of councils in that year, extrapolating from other researchers' results on 441 councils in NSW, SA, WA and Victoria. PwC used the following definition of financial sustainability:

> The financial sustainability of a council is determined by its ability to manage expected financial requirements and financial risks and shocks over the long term without the use of disruptive revenue or expenditure measures; which is determined by:
>
> - healthy finances in the current period and long term outlook based on continuation of the council's present spending and funding policies and given likely economic and demographic developments, and

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91 Financial Sustainability Review Board, 2005, *Rising to the Challenge, Towards Financially Sustainable Local Government in South Australia*, Volume 1, p 9.

92 Financial Sustainability Review Board, 2005, *Rising to the Challenge, Towards Financially Sustainable Local Government in South Australia*, Volume 2, p 1.

93 Municipal Association of Victoria (MAV), *Trends in Local Government Finance 2006-07: Summary*, May 2009.

94 Municipal Association of Victoria (MAV), *Trends in Local Government Finance 2006-07: Summary*, May 2009, p 5.

95 Municipal Association of Victoria (MAV), *Trends in Local Government Finance 2006-07: Summary*, May 2009, p 4.

96 MAV, Members Brief, Financial Strength of Local Government, p 2.

- ensuring infrastructure renewals/replacement expenditure matches forward looking asset management plan expenditure needs. [97]

PwC also used a number of key performance indicators (KPIs) as proxy measures of financial sustainability (eg, interest coverage, capital expenditure ratio).

It found that although the majority of councils have indicator results at an acceptable level, some councils within each council category are operating at unsustainable levels. In particular, a higher proportion of the rural agricultural, rural remote and (to a lesser extent) urban fringe categories are at greater risk of becoming financially unsustainable. These findings are broadly consistent with Access Economics findings, discussed above.

In relation to the infrastructure backlog, PwC reported that it applied the average infrastructure backlog result calculated by Access Economics and the MAV across a sample of 700 councils in Australia to calculate an aggregate national renewals backlog of approximately $14.5 billion.[98] It estimated that the funding gap to clear this backlog and cover the annual underspend on renewals was $3.1 million per council per annum or $2.2 billion nationally[99]. It found that NSW had the highest per council backlog of all Australian councils, with an estimated funding gap of $5.9 million per council per annum.[100]

While PwC's findings for NSW regarding the expected annual underspend on asset renewals and replacements of $500 million are roughly in line with the $400 million estimated by Access Economics, the $6.3 billion backlog estimate appears to be sourced from Roorda and Associates (2006)[101] assessment of the backlog, based on councils' estimate of what spending is required to bring their assets to a 'satisfactory standard' (see section 8.2.1).

Table 6.2 summarises PwC's results.

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97 PricewaterhouseCoopers, 2006, *National Financial Sustainability Study of Local Government, commissioned by the Australian Local Government Association,* p 96.

98 The PwC results are slightly more positive than the Access results as data constraints meant that PwC analysis included all grants whereas the Access results excluded capital grants. Whilst capital grants fluctuate and they are arguably not a certain revenue stream, PwC asserted that many councils have come to depend on capital grants and government usage of them is growing. Hence retaining them within the analysis potentially provides a more realistic picture of sustainability (PwC Report, p 10).

99 PricewaterhouseCoopers, 2006, *National Financial Sustainability Study of Local Government, commissioned by the Australian Local Government Association,* p 11.

100 A mean, high and low estimation was determined for each of these backlog estimates by PwC, due to the large variation in each state's average council backlog as estimated by Access. The "low case" estimate applied the average of WA, Victoria and SA average result per local government to 259 councils in QLD, Tasmania and NT. The "mid case" estimate applied the average of WA, Victoria, SA and NSW average result per council to 259 councils in QLD, Tasmania and the NT. The "high case" estimate applied the NSW, Victoria and WA average result per council to 259 councils in QLD, Tasmania and the NT, p 11.

101 Roorda, J., 'The Present Condition and Management of Infrastructure in Local Government', *Allan Inquiry Research Report,* January 2006.

Table 6.2 PricewaterhouseCoopers – Reported local government infrastructure underspend and backlogs (as at 2006)

	NSW	SA	WA	VIC	Total[a] NSW/WA/ SA/VIC	Mid Case National Estimate[b]
Study source	Access	Access	Access	MAV	PwC	PwC
No. of LGBs in study	152	68	142	79	441	700
Estimated backlog in infrastructure renewals ($m)	$6,300[c]	$300[d]	$1,750	$806[e]	$9,156	$14,533
Estimated underspend on existing infrastructure renewals per annum ($m)	$500	$20	$110	$81	$711	$1,129
Estimated funding gap per council per annum[f] ($m)	$5.9	$0.6	$1.5	$2.6	$3.1	$3.1

Notes:

a Total includes 441 LGBs: 63 per cent of LGBs, 76% of population and 73% of local road km.

b Mid Case National Estimate (700 LGBs) (apply WA, Victoria, SA and NSW average result per council to 259 councils in Queensland, Tasmania and NT).

c This estimate appears to be sourced from Roorda and Associates (2006), rather than Access Economics.

d Access estimate for SA based only the backlog developed over last 10 years and full backlog will be higher.

e MAV estimate of infrastructure backlog is in 2003/04 dollars, for the period between 1997/98 – 2003/04, hence is understated.

f Estimated funding gap covers backlog and annual underspend to be generated via savings or extra revenue/grants.

Source: PwC Report, 2006, p 11.

6.6 FiscalStar Services Pty Ltd (FiscalStar)

FiscalStar[102] conducted various reviews of local government financial sustainability across Australia by examining financial policy sustainability and infrastructure policy sustainability. It defined councils' existing financial and infrastructure policies as financially sustainable if:

> Any operating deficit, infrastructure backlog or excessive debt that presently exists could be corrected without the council having to resort in future to substantial adjustments to its existing revenue raising or expenditure.[103]

[102] FiscalStar Services Pty Ltd, another group of consultants, is sponsored by Dexia Credit Local Asia Pacific, who specialises in local government public finance, to develop financial sustainability ratings from a ratepayers perspective.

[103] FiscalStar Services Pty Ltd, 2009, *NSW Local Government Financial Sustainability Review, How sustainable are the existing financial and infrastructure policies of NSW Councils?*, compiled by Review Today Pty Ltd, p ii.

In 2009, FiscalStar classified the 100 largest councils in NSW into 3 categories, based on its assessments of their financial and infrastructure policies and positions. It found that:

- 46 councils were 'sustainable' (ie, their present financial and infrastructure balances could be eliminated by 10 years worth of annual increases in rates, fees and charges less than one and two-thirds times annual inflation on average)
- 37 councils were 'unsustainable' (ie, their present financial and infrastructure balances could be eliminated by 10 years worth of annual increases in rates in excess of two times annual inflation on average)
- 16 councils were 'vulnerable' (ie, their existing policies were somewhere between financially 'sustainable' and financially 'unsustainable').[104]

(One council was not assessed because it had not published its statutory reports in full on its website.)

In relation to the infrastructure backlog, FiscalStar estimated the infrastructure backlog as a percentage of the gross carrying value of councils' infrastructure assets. Table 6.3 shows the backlog estimates for 5 council categories for 2007/08. The benchmark for this indicator is zero, and the results show that there is a considerable backlog across the council categories in NSW.

Table 6.3 FiscalStar's infrastructure backlog ratio estimates, 2007/08

Council category	Infrastructure backlog ratio (%)
Metropolitan – inner	6
Metropolitan – outer	6
Regional – inland urban	6
Regional – coastal urban	8
Regional – rural councils	4

Note: Infrastructure backlog is the estimated cost to bring assets to satisfactory standard (Special Schedule 7) divided by the gross carrying value of council's infrastructure assets.
Source: FiscalStar Services Pty Ltd, NSW Local Government Financial Sustainability Review, *How sustainable are the existing financial and infrastructure policies of NSW Councils?*, compiled by Review Today Pty Ltd, 2009, pp 16-20.

[104] FiscalStar Services Pty Ltd, 2009, *NSW Local Government Financial Sustainability Review, How sustainable are the existing financial and infrastructure policies of NSW Councils?*, compiled by Review Today Pty Ltd, p ii. For definitions of sustainable, vulnerable and unsustainable, see FiscalStar Services Pty Ltd, *Financial Sustainability Assessment Methodology*, Attachment B, p 4.

6.7 Queensland Treasury Corporation (QTC)

QTC reviewed the financial sustainability of Queensland councils over the period March 2006 to July 2007. It assessed financial sustainability in terms of a council's ability to:

- meet commitments in the short, medium and long term
- manage unforseen financial shocks and adverse changes in local government business and general economic conditions
- manage core business risks.

It used the SA Government's definition of financial sustainability which states that a council is sustainable if it is:

> …able to manage likely developments and unexpected financial shocks in future periods without having at some stage to introduce substantial and economically or socially destabilising expenditure or revenue adjustments.[105]

QTC found that most Queensland councils have strong balance sheets with low debt levels and sound liquidity. However, it identified a number of external[106] and internal factors[107] that are likely to negatively affect the financial performance of councils in the future. It concluded that if these negative factors are not addressed, they will continue to weaken the capacity of Queensland local government to provide infrastructure and services to their community.

In relation to infrastructure backlogs, QTC examined the capital expenditure ratios for Queensland councils. It did not estimate the total size of the infrastructure backlog, but found that of the councils included in the analysis, 67% maintained capital expenditure ratios above the minimum benchmark.

IPART findings

12 The results of previous studies of local government's financial sustainability indicate that the position of councils in NSW is broadly similar to that of councils in states not subject to rate pegging. In particular, they indicate:

- Most councils in all the states report small operating deficits.
- Most councils in all states have strong balance sheets, with low reliance on debt.
- Most councils in each state (between 80% and 60%) are financially sustainable (at least on a recurrent basis).

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105 Queensland Treasury Corporation, *Financial Sustainability in Queensland Local Government – Findings and Recommendations, 2008*, p 16.

106 External factors include national and regional demographics ie, economic growth and environmental issues, as well as local government industry and market drivers such as legislative requirements and government policy.

107 Internal factors include council's forecast needs and wants such as community expectations and financial capacity.

13 These results suggest that rate pegging is not a driving factor in NSW councils' financial sustainability.

14 In relation to the infrastructure backlog:

- previous studies provide evidence of a significant backlog in most states, and one study (by PwC) suggests the backlog may be worse in NSW than in other states
- most studies indicate that a range of factors contribute to the infrastructure backlog
- all studies suffered from the lack of reliable, consistent data on the infrastructure backlog.

15 This means the evidence on the infrastructure backlog provided by previous studies is inconclusive. It may suggest that rate pegging is a contributing factor to the infrastructure backlog in NSW but more clearly indicates it is not the only contributing factor.

7 What did our own assessment of the financial sustainability of NSW councils find?

As Chapter 6 discussed, previous studies of local government's financial sustainability provided sufficient evidence for us to conclude that the current rate pegging approach is not the key factor influencing NSW councils' financial sustainability. However, there is still a need to explore whether reform or replacement of this approach or some alternative action is required to help improve councils' long-term financial positions. Therefore, we undertook our own investigation of NSW councils' financial sustainability. This involved the following steps:

- defining financial sustainability to take account of both recurrent and capital sustainability, and establishing our approach
- assessing NSW councils' recurrent sustainability and capital sustainability over the past 6 years by comparing indicators of each type of sustainability against appropriate benchmarks
- examining the scope for councils' financial sustainability to change over time, using data from our 11 case study councils
- exploring the special case of small rural councils, and the implications for the framework for regulating council revenue in NSW and other government action to improve these councils' financial sustainability.

The section below provides an overview of our findings. The subsequent sections discuss each of the steps in our assessment in detail.

7.1 Overview of findings of our assessment of NSW councils' financial sustainability

On a recurrent basis, we found that more than two-thirds of all NSW councils are sustainable, but those in the rural and fringe categories are less likely to be sustainable. On a capital basis, the evidence is less reliable and more difficult to interpret. However, based on the available information, we found that more than half of NSW councils are managing to maintain capital expenditure at levels considered sustainable, even though many appear to significantly underutilise debt to fund long lived assets. Like previous studies, we found that there are infrastructure backlogs which may mean council's capital sustainability is at risk. However, the lack of reliable information made it impossible to measure the extent of the backlogs and the risk they pose.

In addition, we found that the financial sustainability of NSW councils can change significantly in a relatively short period, notwithstanding the limits placed on rates revenue by rate pegging. The financial performance of some case study councils improved over the review period, while that of others deteriorated. This provides further support for our finding that rate pegging is not the key factor influencing NSW councils' financial sustainability.

Finally, we found that small rural councils are a special case. Because the populations in the areas they serve are low compared to the size of these areas, their capacity to raise revenue from rates or charges and fees is limited. This means that although some of the changes to the framework (eg, to encourage longer term financial planning and sound asset management plans) will help to improve the financial sustainability of these councils, it is unlikely to solve all of the financial challenges they face.

7.2 Our definition and approach

To assess councils' financial sustainability, it is important to clearly define this term and how it will be measured. For our assessment, we took the view that a council's future financial sustainability is based on a combination of its operating (or recurrent) performance and its capital performance. Therefore, we measured both recurrent sustainability and capital sustainability.

7.2.1 How did we define recurrent sustainability?

Recurrent sustainability means that councils are able to fund their recurrent expenditures from recurrent revenues, and so avoid using capital revenues for this purpose or running recurring operating deficits. Recurrent revenues do not necessarily have to align with recurrent expenditures in any one year, but should do so over the medium term.

This implies that to maintain recurrent sustainability, councils need to match cost increases or growth in the services they provide with similar increases in revenue over the medium term. Therefore, they need fiscal flexibility: they need to be able to adjust their own revenues in response to the local environment and demands they face from their community. Like private businesses, local councils must maintain sufficient liquidity to cover their operating expenses.

Under our definition, if the costs of a council's recurrent operations are met from its recurrent revenues over the medium term (eg, 5 years), and not partly funded from its capital revenues (eg, proceeds from asset sales, developer contributions and capital grants), it is considered to be financially sustainable on a recurrent basis. But if it reports operating deficits greater than 10% of its operating revenues in any one year, it is considered financially unsustainable.

Table 7.1 Financial performance indicators and benchmarks

	Definition	Benchmark	What the indicator means and common problems with interpretation
Recurrent sustainability			
Operating balance ratio	Net operating result (excluding capital items) as a percentage of operating revenue (excluding capital items)	Operating deficit < 10% of revenue	This measures whether the council is sustainable in terms of its operating result. Councils should not be recording recurring operating deficits or funding operating results from capital revenues. This is an indicator of the intergenerational equity of council's financial performance.
Rates coverage ratio	Rate and annual charges divided by operating expenses	>40%	This is an indicator of a council's financial self sufficiency. It indicates how a council covers its operating costs through its taxation revenue. Councils that have a low ratio, tend to be more reliant on grants and generally have lower flexibility to vary these charges.
Current ratio (unrestricted)[a]	Unrestricted current assets divided by unrestricted current liabilities	1.5 times	This is an indicator of council liquidity, ie, a council's ability to meet short term liabilities with its short term assets.
Capital Sustainability			
Capital expenditure ratio	Net change in asset value (infrastructure, property, plant and equipment) from previous year, divided by depreciation expense	>1.0	Indicates whether, in a particular year, changes in total asset values are matched by depreciation. Its accuracy as an indicator in any one year depends on the reasonableness of the assumptions on asset values and asset lives. It is also affected by changes in valuations.
Debt service ratio	Net debt service cost divided by revenue from continuing operations	Greater than zero but less than 20%[b]	An indicator of whether the council has excessive debt servicing costs, relative to operating revenue.
Broad liabilities ratio	Total debt plus cost to clear infrastructure backlog (Special Schedule 7) divided by operating revenue.	Greater than zero but less than 60%[c]	An indicator of financial liabilities and infrastructure backlogs (total implied liabilities), relative to operating revenue. Backlog estimates are not audited and are reported subjectively in Special Schedule 7.

[a] Unrestricted current assets are those where there is no form of restriction imposed by regulations or some other externally imposed requirement. Restricted current assets have restrictions on their use eg, developer contributions, RTA contributions, water and sewerage rates, charges and grants, and domestic waste management charges.

[b] Debt Service indicative measure taken from the NSW Department of Local Government.

[c] Broad liabilities indicative measure from FiscalStar Services Pty Ltd, 2008, *The Financial Sustainability of the Existing Financial and Infrastructure Policies of NSW councils*, compiled by Review Today Pty Ltd, p 8.

Source: PricewaterhouseCoopers, 2006, *National Financial Sustainability Study of Local Government*, commissioned by the Australian Local Government Association.

In our analysis of recurrent performance we have used the operating balance, which is calculated as operating revenues minus operating expenditures, where operating expenditures includes depreciation.

7.2.2 How did we define capital sustainability?

Capital sustainability means that councils are able to fund infrastructure (both new and renewals) and asset maintenance to a level sufficient to ensure they can provide affordable services that meet reasonable standards over a 10-year period. This usually requires an appropriate use of debt. Thus, to achieve capital sustainability a council must be able to maintain and renew its existing assets as well as provide new infrastructure and make appropriate use of debt.

Under our definition, a council is considered to be financially sustainable when its service and infrastructure levels and standards are met over a 10-year period,[108] according to a long-term plan and consistent with key financial benchmarks – that is, where the council's long-term financial requirements are matched by its long-term financial capacity. A council is considered to be financially unsustainable on a capital basis if it is not able to meet its asset renewal requirements over a 10-year period.

Maintaining and renewing infrastructure

Councils need to ensure that capital infrastructure is adequately maintained and regular maintenance programs are in place, since reactive maintenance tends to be significantly more expensive in the long term and can severely impact on councils' ability to meet their costs with appropriate levels of revenue. This implies that there should be no backlogs of infrastructure maintenance or renewal projects. The existence of such backlogs is an important indicator that a council is not meeting its maintenance and renewal requirements, which is not sustainable in the long term.

One of the issues we encountered in our assessment of capital sustainability is that councils currently use the term 'infrastructure backlog' quite loosely, and do not report on backlogs using a consistent definition or measurement approach.[109] This made it difficult for us to form conclusions on the extent of NSW councils' infrastructure backlogs, and thus their capital sustainability.

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108 IPART considers this 10-year period to be an appropriate benchmark as it allows councils the flexibility to address any infrastructure backlog over the medium term, but is not considered too far in the future that the issue will not be addressed.

109 The problem of defining and measuring infrastructure backlogs is discussed further in Chapter 8.

Making appropriate use of debt

The financial position, or balance sheet, of a council reflects the level and composition of its assets and liabilities. The financial position of a council is considered healthy when financial liabilities and debt are at levels where council activities and net interest expense can be comfortably met from its existing annual operating revenue. Ideally, a council should:

- be a modest net debtor, with borrowings (debt) comprising a minority of the total capital invested in its infrastructure and other assets, and
- have an interest expense burden that is not a substantial proportion of its annual operating revenues.

The level of debt that is acceptable is not the same for all councils – this level depends on how much debt an individual council's revenue and cash flows can support.

However, the appropriateness of a council's use of debt depends largely on whether it is being used to fund recurrent or capital costs. If a council is using debt to partly fund new infrastructure assets or upgrade existing infrastructure assets, this is likely to be prudent and sustainable, provided the level of debt matches the council's financial capacity to service it. But if a council is using debt to fund its recurring operating deficits, this is unlikely to be sustainable. It also transfers the burden of its current operations onto future ratepayers, which is inconsistent with intergenerational equity.[110]

7.2.3 What was our approach?

We identified 3 important financial performance indicators for recurrent sustainability, and 3 for capital sustainability. For each indicator, we identified a benchmark that a council would need to meet (or exceed) for its performance against that indicator to be considered sustainable. (These indicators and benchmarks are summarised in Table 7.1, and discussed in sections 7.3 and 7.4 below.)

We then compared each NSW council's reported performance against the benchmarks for the period 2002/03 to 2007/08. We considered the results for NSW councils as a whole and for 4 council categories: metropolitan, fringe, regional and rural. We also undertook more detailed analysis of the financial performance of our 11 case study councils.

This approach allowed us to consider the financial performance of a range of council types and take into account diversity between councils with different geographic, demographic or economic characteristics. The benchmarking has helped to highlight the strengths and weaknesses of NSW councils and identify areas that may require investigation or corrective action. The case study analysis has allowed us to better

[110] Intergenerational equity means that the costs of long lived assets (like infrastructure) is shared between current and future users, based on their share of the use of the asset over its life.

understand the differences between different council categories, and the scope for a council's financial sustainability to change over time.

7.3 Findings on recurrent sustainability

To assess councils' recurrent sustainability, we focused on the following indicators:

- the operating balance ratio, which is a measure of the operating result (excluding capital), relative to operating revenue
- the rates coverage ratio, which is an indicator of a council's reliance on rates and other charges, relative to other revenues (such as grants) to cover its operating costs, and
- the current ratio, which is an indicator of a council's liquidity.

The benchmarks we selected for the operating balance ratio and the rates coverage ratio are based on PwC's analysis for its 2006 national financial sustainability study of local government (see section 6.5). The benchmark for the current ratio is based on the benchmark the NSW Division of Local Government uses in monitoring councils' financial performance (see Table 7.1).

Table 7.2 summarises the results of our assessment of NSW councils against the benchmark for each indicator for recurrent sustainability. The sections below discuss the results for each indicator, and our conclusions on recurrent sustainability.

Table 7.2 Recurrent sustainability – average performance against each indicator and percentage of councils meeting the minimum benchmark, 2002/03 to 2007/08

	Operating balance ratio[a] (%)		Rates coverage ratio (%)		Current ratio	
Council category	**Average**	**% of councils meeting benchmark**	**Average**	**% of councils meeting benchmark**	**Average**	**% of councils meeting benchmark**
Metropolitan	-3.5	87.5	63.6	100	2.9	90.2
Fringe	-11.0	63.6	65.5	100	2.3	72.7
Regional	-13.7	42.1	61.2	94.7	2.5	83.7
Rural	-14.1	45.7	39.8	45.0	4.1	93.2
All NSW councils	-11.5	55.0	51.7	72.2	3.3	88.8

[a] Operating Balance Ratio is calculated for 2007/08 only.

Notes

Operating balance ratio: net operating result (excluding grants and contributions for capital purposes and net gain/loss from the disposal of assets) as a percentage of own source operating revenue (excluding capital items). The minimum benchmark is above negative 10%.

Current Ratio: current assets (less all external restrictions) divided by current liabilities (less specific purpose liabilities). The benchmark is less than 1.5 times.

Rates Coverage Ratio: rates and annual charges divided by operating expenditure. The benchmark is greater than 40%.

Source: IPART Analysis.

7.3.1 Operating balance ratio

The operating balance ratio measures the operating result relative to operating revenue, **excluding** capital items.[111] If this ratio is zero, it indicates the council's recurrent revenue and expenditures are in balance. If it is positive, the council has an operating surplus, and if it is negative it has an operating deficit.

The sustainability benchmark for this indicator is -10%. This is consistent with PwC's view that operating deficits greater than 10% of operating revenues are financially unsustainable. It is also consistent with our view that a council with an operating result within 10% below and 10% above a balanced result should be able to achieve a balanced budget over the medium term.

We note that under the current reporting requirements, not all assets are reported at fair value (see Box 7.1). As a result, some caution is required in interpreting a council's reported operating balance ratio, as it may be driven by understated depreciation costs, due to conservatively low valuations of assets or infrequent updates to such valuations. The LGSA noted that our operating balance ratios in the draft report were understated because we didn't adjust depreciation to reflect the fact that councils are not reporting all their assets at fair value. In response, as a broad estimate, we have followed Access Economics' findings and increased the reported annual depreciation by 20% when calculating the operating balance ratio to reflect true depreciation costs.[112] Our assessment of NSW councils' performance against this indicator suggests that most are generally financially sustainable on recurrent basis. We found that 55.0% of NSW councils met or exceeded the benchmark of -10% in 2007/08.

The average operating balance ratio for all councils was -11.5%.[113] Metropolitan councils recorded the strongest recurrent performance with an average ratio of -3.5%, followed by fringe and regional councils with an average ratio of –11.0% and -13.7% respectively. Rural councils were found to have the largest operating deficits, with an average ratio of -14.1%.

Figure 7.1 shows the operating balance ratio (excluding capital revenues) for all NSW councils in 2007/08. It shows, that on this basis, most councils (55.0%) were not in financial stress, that is, they had an operating balance ratio above the benchmark (-10.0%). It also shows that there is a significant variation in the operating result of NSW councils. The majority (55.0%) of councils had operating deficits averaging 11.5%, which is below the benchmark. The councils with operating surpluses (21.2%) had operating surpluses averaging 9.9%.

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111 This ratio is calculated as operating revenues (excluding net gain/loss on disposal of assets and grants and contributions provided for capital purposes) minus operating expenditures (this includes depreciation and amortisation) as a percentage of operating revenues.

112 Access Economics, 2006, *Local Government Finances in NSW – An Assessment, for the Independent Review Panel* p 16.

113 This indicates that the majority of councils do not have excessive deficits, indicating they are matching recurrent expenditures against recurrent revenues, while allowing for some investment in capital infrastructure.

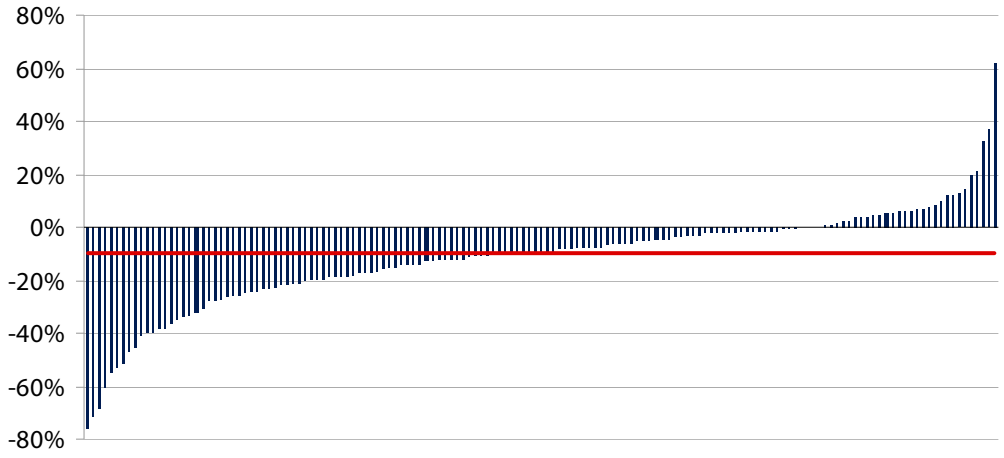
Box 7.1 Not all council assets are reported at fair value

The Department of Local Government has required all NSW councils to revaluate their infrastructure assets to recognise the 'fair value' of these assets. The Department has allowed councils to do this in stages; however, all revaluations are to have occurred by the end of 2009/10.[a]

These accounting changes are likely to affect councils' operating results. For example, our analyses of our case study councils indicate that they are resulting in sharp increases in the value of some councils' assets. For instance, one council recorded a doubling of asset value in 2007/08, from levels recorded in 2006/07. Over time, large rises in asset values will be reflected in higher depreciation expenses which, assuming other factors constant, will contribute to higher operating deficits.

a DLG, Circular to Councils, *Recognition of Certain Assets at Fair Value*, Circular No 09-09, 17 March 2009.

Figure 7.1 Operating Balance Ratio, All NSW Councils, 2007/08, %



Note Operating balance ratio excludes capital revenues. The value for depreciation has been increased by 20% to reflect the fair value of those assets. The red line represents the benchmark of -10%.

Data source: Division of Local Government.

We note that under current reporting requirements, councils report their operating result using two measures:

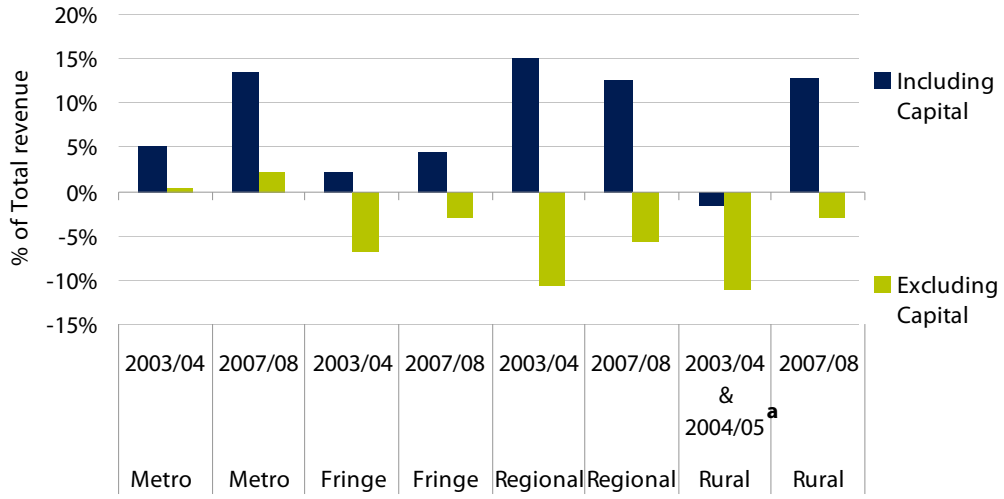
- the operating result, excluding capital revenues[114], and
- the operating result, including capital revenues.

114 This is not the same as the measure we have used in our analysis of operating results excluding capital revenues. We have also excluded net gain/losses from the disposal of assets from the operating result.

Most councils give prominence to the second of these measures – the operating result **including** capital revenues. However, we consider that the operating result excluding capital revenues is the more accurate measure. This is because the inclusion of capital revenues can mask the true operating position of councils, since these revenue sources tend to be one-off in nature (eg, asset sales) and intended for (or tied to) capital expenditure purposes (eg, capital grants and contributions).

To illustrate this point, we assessed our case study councils' operating balance ratios both including and excluding capital revenues from the operating result (Figure 7.2). We found that when capital revenues were **included**, all these councils recorded operating surpluses in 2007/08 (ie, a positive ratio). However, this situation changed markedly when capital revenues were **excluded,** with only the metropolitan case study councils continuing to record average surpluses (albeit, much reduced). The results for the fringe, regional and rural case study councils underwent a wholesale transformation – from generally being in surplus (when capital revenues were included) to having consistent deficits (when capital revenues were excluded).

Figure 7.2 Operating balance ratio for case study councils – including and excluding capital revenues



a Due to council amalgamations analysis started from 2004/05 for some councils.

Data source: Individual Council's Financial Statements for each of the 11 Case Study Councils.

In our view, these case study results suggest that NSW councils' current tendency to focus on the operating results **including** capital revenues can minimise or offset the reporting of operating losses on recurrent services. This is potentially confusing to stakeholders and council management, creating a risk that the operating results will be misinterpreted. The results will not clearly indicate whether a council's recurrent services are financially sustainable without drawing on capital revenues.

In addition, the results for the fringe, rural and regional case study councils shown on Figure 7.2 suggest that these councils may be using capital revenues to finance revenue shortfalls on recurrent operations. If so, continuing to focus on operating

results including capital revenues will mask the fact that they are not meeting their infrastructure renewal requirements.

7.3.2 Rates coverage ratio

The rates coverage ratio provides an indicator of the flexibility councils have to adjust their rates in order to respond to adverse financial conditions. Local government revenues are derived from 2 main sources:

- own-source revenue, where a local government has the ability to influence revenue growth (subject to the rate peg)
- externally sourced revenue, such as grants and contributions, to which local government generally has little control.

Generally, the greater the percentage of own-source revenue used to cover operating expenses, the greater the level of revenue independence and flexibility available to local government to influence future revenue generation and its recurrent sustainability. That is, the higher the rates coverage ratio, the greater flexibility councils have to respond to financial conditions. In NSW, rate pegging may limit this flexibility.

One indicator that can be used to measure the fiscal flexibility of local government is the rates coverage ratio. The rates coverage ratio is defined as rates and annual charges[115] as a percentage of operating expenses and indicates how a council covers its operating costs through its taxation revenue.

The sustainability benchmark for this indicator is 40%.[116] That is, to be considered sustainable, a council needs to cover at least 40% of its operating expenditures from rates and annual charges. Councils with ratios below this level tend to source a high percentage of their operating revenue from grants. As the size of these grants is largely outside their control, they have less flexibility to increase their revenues in response to changes in financial conditions.

Figure 7.3 compares the average rates coverage ratio for all NSW councils and the 4 categories of councils with the accepted benchmark of 40%. It shows that the average rates coverage ratio for all NSW councils was above the minimum benchmark. Of the 4 council categories, metropolitan, regional and fringe were well above the benchmark while rural councils on average were close to the acceptable benchmark.

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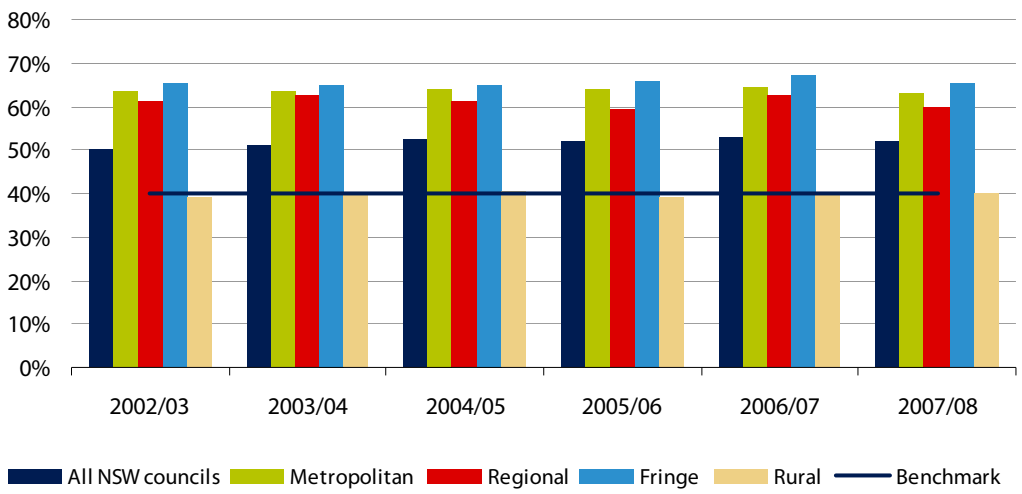
115 Annual charges include charges other than water, sewer and stormwater, waste management services and charges under 611 of the *Local Government Act 1993*. The main other sources of operating revenue are user charges and fees, grants, interest and other revenue (fines, external works and business activities).

116 PricewaterhouseCoopers, 2006, *National Financial Sustainability Study of Local Government*, commissioned by the Australian Local Government Association, p 99.

Figure 7.3 Average rates coverage ratio, NSW Councils 2002/03 to 2007/08



Data source: DLG, *Comparative Information on NSW Local Government Councils*, 2002/03 to 2007/08.

A closer examination of the rates coverage ratio over the period shows that on average, 72.2% of all NSW councils were above the benchmark. All metropolitan and fringe councils were above the benchmark, while 94.7% of regional councils were above the benchmark. This compares with rural councils where only 45.0% of the rural councils were above the acceptable benchmark for rates coverage (See Table 7.3). This indicates that most councils' rates revenue sufficiently cover operating expenses, but rural councils are at greater risk of becoming financial unsustainable due to their inability to cover operating expenses with their rates revenue.

Table 7.3 Average rates coverage ratio by council category, 2002/03 to 2007/08 (%)

Category	Average rates coverage ratio	% councils with rates coverage >40%
Metropolitan	63.6	100
Regional	61.2	94.7
Fringe	65.5	100
Rural	39.8	45.0
All NSW councils	51.7	72.2

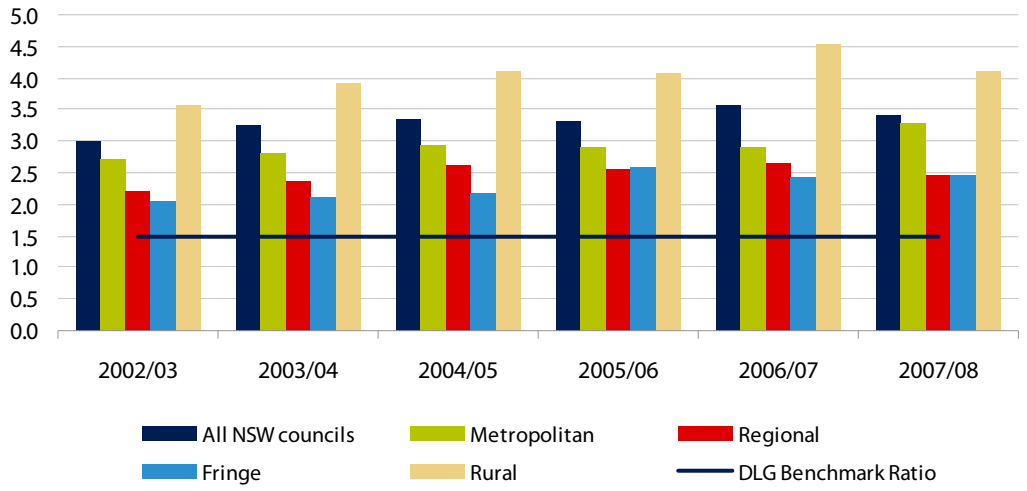
Source: DLG, *Comparative Information on NSW Local Government Councils*, 2002/03 to 2007/08.

7.3.3 Current ratio

The financial performance and position of a local government depends on its ability to provide services to the community in the short, medium and long term. This requires local government to maintain adequate liquid funds to meet day-to-day operations. Liquidity considerations are short term in nature and have the potential to affect financial performance.

The current ratio (current assets divided by current liabilities) measures a council's level of liquidity, or its ability to meet its short-term liabilities from short-term assets. The restriction on funding sources (eg, developer contributions, RTA contributions, charges and grants) complicates the measure of their relative liquidity. The Division of Local Government measures the performance of NSW councils using the unrestricted current ratio (ie, current assets less all current external restrictions divided by current liabilities less current specific purpose liabilities). This is shown in Figure 7.4.

Figure 7.4 Unrestricted current ratio for all NSW councils from 2002/03 to 2007/08, by council category



Note: These ratios may potentially overstate the availability of liquidity to meet their short term obligations due to the definition and funding sources included in the calculation of this ratio.

Data source: DLG, *Comparative Information on NSW Local Government Councils*, 2002/03 to 2007/08.

PwC considers the benchmark current ratio to be 1.0, while the Division of Local Government considers an acceptable benchmark to be 1.5. This reflects the differences in the structure of how the ratio is calculated.[117] A ratio between 1.5 and 2 is considered satisfactory, while a ratio greater than 2.0 may be indicative of either the impact of growing reserves or excess liquidity.

It can be seen that only a few councils in NSW actually maintained liquidity levels below the benchmark of 1.5. In all council categories, more than 70% recorded a current ratio of at least 1.5. The average current ratio for all councils was 3.3, which is more than double the minimum benchmark for sustainability and above the maximum of 2.0. This contrasts with the findings by PwC that a substantial proportion of councils across Australia had insufficient liquidity levels and hence were financially unsustainable. Fringe councils, which face the greatest growth

[117] PwC uses a more refined current ratio, that is, it excludes all restricted sources of funding, whereas the DLG indicator still includes some forms of restricted assets within its unrestricted ratio.

pressures, tended to have the lowest current ratios but their average was still above 2.0 each year.[118]

These results indicate that most councils have sufficient levels of liquidity. They also suggest that some councils may be holding excess liquidity. High levels of liquidity may indicate that a council is building growing reserves (eg, for employee leave entitlement liabilities). However, they might also indicate that it is holding excess liquidity, which would suggest they are not efficiently converting ratepayers' funds into works and services.

IPART findings

16 Analysis of NSW councils' financial performance from 2002/03 to 2007/08 indicates most councils are financially sustainable on a recurrent basis. In particular:

- most councils' operating results are sustainable; however, a higher percentage of rural councils and fringe councils have unsustainable operating results than metropolitan councils
- most councils' rates coverage gives them sufficient capacity to adjust to adverse financial conditions; however, rural councils have a higher reliance on grants revenue and thus less flexibility to generate increased revenues from rates and annual charges
- most councils have very high levels of liquidity.

Recommendation

3 To facilitate more accurate measurement and interpretation of councils' operating results, that the Division of Local Government require councils to disclose their Net Operating Result (surplus/deficit), **excluding** capital revenues, as the principal measure of operating result. Capital revenues to be excluded from the result include:

- proceeds from asset sales
- developer contributions, and
- capital grants.

[118] On average, 72.7% of fringe councils had a current ratio above the benchmark of 1.5. Regional councils averaged 83.7% of councils above the benchmark, while metropolitan and rural councils averaged 90.2% and 93.2% above the benchmark respectively.

7.4 Findings on capital sustainability

To assess NSW councils' capital sustainability, we focussed on the following indicators:

- the capital expenditure ratio
- the debt service ratio, and
- the broad liabilities ratio.

Table 7.4 summarises the results of our assessment of councils' reported performance against the benchmark for each indicator. The table shows that most councils in all categories met the benchmark for the capital expenditure ratio, even though there is an under use of debt in all council categories. This suggests that councils' funding of long lived assets is not consistent with the principle of intergenerational equity, which says that the cost of such assets should be met by those who receive the benefits, including future ratepayers. However, only 37.4% of all councils met the benchmark for the broad liabilities ratio. Given the low reliance on debt by most councils, the broad liabilities ratio is largely driven by councils' estimates of the funding required to bring assets to a 'satisfactory standard' (as reported in Special Schedule 7). As there is no common definition of the standard, these estimates are largely subjective.

We note that 45% of rural councils met the broad liabilities ratio benchmark, and consider that this is quite high. The broad liabilities ratio excludes water and sewer, which is likely to increase the broad liabilities of rural councils, relative to the other council categories. Also, rural councils are less likely to have access to adequate resources and skills to estimate the size of the infrastructure backlog, relative to the other council categories. This may mean that their estimates of the value of the infrastructure backlog may be understated, and therefore the number of rural councils meeting the benchmark may be overstated. The results also point to the unreliability of data for measuring infrastructure backlogs. This issue is discussed in more detail in Chapter 8.

The sections below discuss the results of our assessment of capital sustainability in more detail, and set out our conclusions on capital sustainability. More detailed analysis on the issue of infrastructure backlogs is presented in Chapter 8.

Table 7.4 Capital sustainability – average performance against each indicator and percentage of councils meeting the minimum benchmark, 2002/03 to 2007/08

Council category	Capital expenditure ratio		Debt service ratio		Broad liabilities ratio[a]	
	Average	% of councils meeting benchmark	Average	% of councils meeting benchmark	Average	% of councils meeting benchmark
Metropolitan	2.2	60.1	2.8	100	64.1	54.7
Fringe	2.2	74.2	5.6	100	138.6	18.2
Regional	2.5	74.3	6.0	100	163.9	14.5
Rural	2.6	65.0	3.7	100	117.2	45.0
All NSW councils	2.5	66.4	4.2	100	119.2	37.4

a Broad Liabilities Ratio calculated for the 2006/07 and 2007/08 year only.

Notes:

Capital Expenditure Ratio: net change from year to year in infrastructure, property, plant and equipment divided by depreciation expense of those assets. The capital expenditure ratio benchmark is greater than 1.0

Debt Service Ratio: net debt service cost divided by revenue from continuing operations. The benchmark is greater than zero but less than 20%.

Broad Liabilities Ratio: total debt plus cost to clear infrastructure backlog (Special Schedule 7) divided by operating revenue. The benchmark is greater than zero but less than 60%.

Source: IPART Analysis.

7.4.1 Capital expenditure ratio

As noted in Chapter 5, a council's capital expenditure ratio is an indicator of whether it is at least maintaining its existing asset stock. We note that the results of our analysis on this indicator should be treated with caution due to a number of limitations with the available data.

In particular, gross fixed capital formation includes more than just expenditure on renewals and replacements, and so the ratios do not depict the actual 'asset replacement' performance of all states' councils. Also, the impact of fair valuation of assets is likely to understate depreciation in NSW relative to the other states.[119] From 2006/07, NSW councils were required to start revaluing all assets using fair value methodology. This would bring NSW into line with the practice in other states. Therefore the estimated capital expenditure ratios for NSW will be overstated. Nonetheless, the analysis is useful for comparative purposes because it demonstrates how local government's capital expenditure overall compares with its depreciation levels in all states.

[119] Access Economics, 2006, *Local Government Finances in NSW – An Assessment*, for the Independent Review Panel, p 3 estimated an average 15% increase in the depreciated value of council non-financial assets in 2004/05 to reflect the fair value of councils non-financial assets in NSW.

Individual council financial statement information provided by the Division of Local Government for 1999/2000 to 2006/07 indicates further improvement in NSW councils' capital expenditure ratios over these years. The capital expenditure ratio in this case measures the net change from year-to-year in the value of a council's assets (infrastructure, property, plant and equipment) divided by the depreciation of those assets. [120] It is an indicator of whether councils are at least maintaining their existing asset stock.[121]

Our assessment found that more than 66% of all councils met the minimum benchmark for the capital expenditure ratio, and the average ratio was 2.5. This means that around one-third of councils did not meet the benchmark. Although a council's capital expenditure does not always need to match depreciation exactly, the fact that such a sizable proportion of councils are spending below the minimum requirement on a sustained basis is of concern. It suggests that these councils are not adequately renewing their existing asset stock, and therefore that their capital sustainability is at risk.

Figure 7.5 shows the average and median capital expenditure ratios and estimated annual asset funding shortfalls per NSW council over the period from 1999/2000. The columns indicate that on average over the earlier years to about 2001/02 councils' capital expenditure was below their annual depreciation expense. This is shown by the average capital expenditure ratio being less than 1.0.

The red line shows the estimated average dollar difference between councils' reported capital expenditure and their depreciation.[122] The negative values mean that their capital expenditure was less than their depreciation, which indicates a shortfall in capital expenditure. This shortfall has occurred for some years, which suggests that councils in NSW do have some infrastructure backlogs. Based on these data, we estimate that the backlog over these years was $1.8 billion for all councils, or an average of $231 million per annum. This translates into an average estimated backlog of $1.5 million per council per year.

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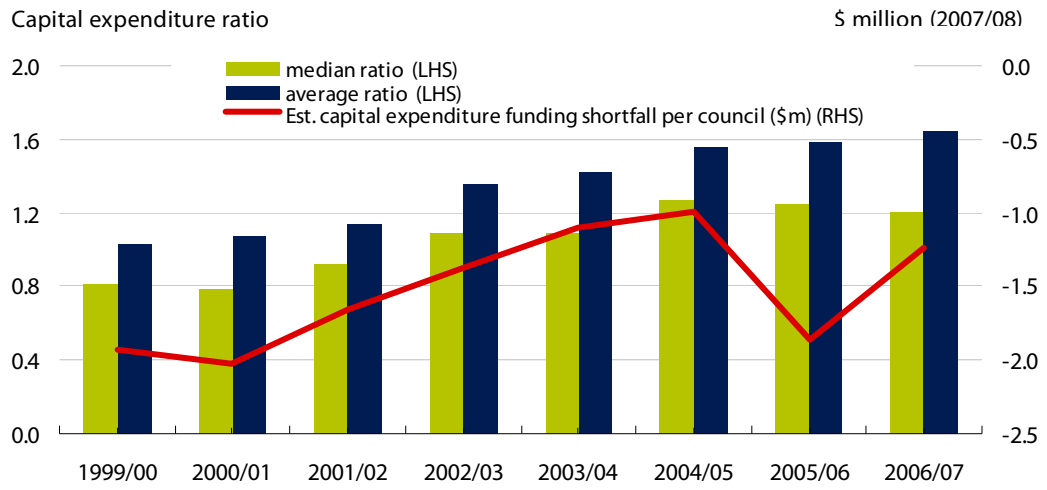
[120] In this case it is calculated as capital expenditure divided by depreciation, where change in infrastructure, property, plant and equipment is used as a proxy for capital expenditure. The change in infrastructure, property, plant and equipment as disclosed on councils balance sheet reflects a combination of changes in new capital expenditure as well as asset revaluations, and thus is an **indicator** of the true level of capital expenditure. This is a significant issue currently as councils are moving from valuation based on historic cost to the fair value approach. Moreover, any decrease in property, plant and equipment had to be excluded from the sample as capital expenditure cannot be negative. Also, the approaches to the estimation of asset lives and valuation also vary considerably from council to council.

[121] It should be noted that it is still possible for councils to be increasing their infrastructure backlog, even when their capital expenditure matches depreciation. Eg, councils that are growing would require capital expenditure to be greater than 1.0.

[122] The asset funding shortfall is based on the sum of the differences between capital expenditure and depreciation where capital expenditure is less than depreciation over the study period.

However, we note that these estimates are limited by the fact that a change in the value of infrastructure assets (including the fact that NSW councils have not fully implemented fair value) affects the values reported for depreciation.[123] Also, the reported capital expenditure does not effectively separate capital expenditure for renewal (which is counted as a backlog) and capital expenditure for expansion and enhancements (which is not counted as a backlog). Therefore, our estimates indicate that NSW councils had an infrastructure backlog over the years of study, but does not tell us what the magnitudes of the backlog was overall.

Figure 7.5 NSW local government capital expenditure ratios and estimated annual asset funding shortfalls per council, 1999/2000 - 2006/07



Note: The ratio is based on total capital expenditure divided by depreciation expenses.

Data source: DLG, *Comparative Information on NSW Local Government Councils, 1999/00* to 2006/07.

7.4.2 Debt service ratio

The debt service ratio is an indicator of the degree to which revenues from continuing operations are committed to the repayment of debt[124]. It indicates the council's capacity to fund additional debt through operating revenues. The benchmark for the debt service ratio is greater than zero but less than 20%.[125]

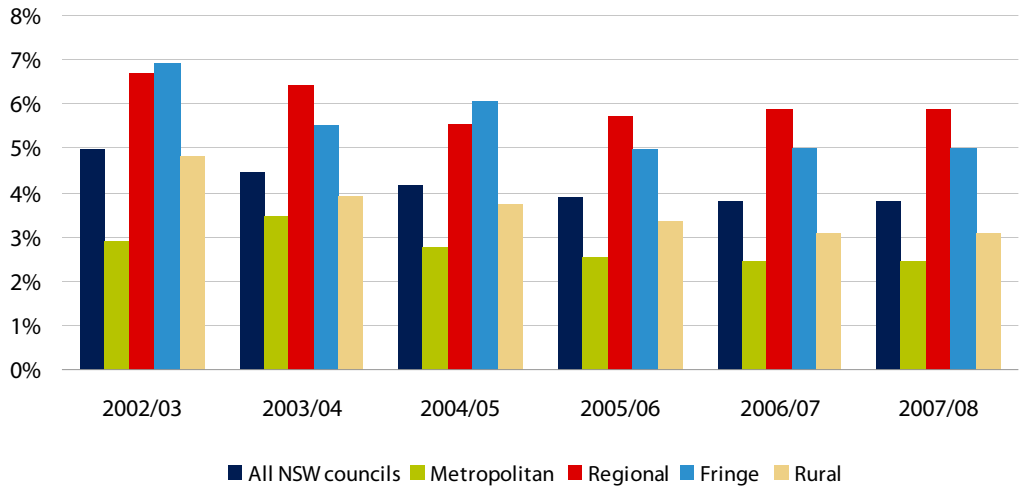
[123] As councils move to fair value reporting of its assets, there will be a step change in the value of its assets that will affect the reported capital expenditure (measured by the change in value of infrastructure, property, plant and equipment).

[124] Debt service costs include debt redemption from revenue, transfers to sinking funds and bank overdraft interest.

[125] DLG does not set a benchmark for the debt service but it monitors councils when they reach a range of between 10% to 20% of operating revenues.

Figure 7.6 shows the average debt service ratios for all NSW councils as well as the averages by council category over the period 2002/03 to 2007/08. Our assessment found that most councils in NSW meets the debt servicing ratio. On average, councils' debt service costs as a percentage of their operating revenues over the study period were 4.2%, compared with the upper limit of the benchmark of 20%. Our results are consistent with the findings of previous studies,[126] which found that there was an under-utilisation of debt by councils, resulting in current generations of ratepayers bearing the bulk of the cost of infrastructure. This means that NSW councils have considerable capacity to fund additional debt from their operating revenues.

Figure 7.6 Average Debt service ratio from 2002/03 to 2007/08



Data source: DLG, *Comparative Information on NSW Local Government Councils, 2002/03* to 2007/08.

The average debt service ratio for the four categories of councils shows that regional and fringe councils have a higher reliance on debt, relative to the rural and metropolitan councils. Further, the trends for the debt service ratio show that across all categories of councils (and consistent with the findings of PwC and Access Economics) that they generally have the financial capacity to take on further debt as appropriate for addressing infrastructure requirements that will benefit future generations of ratepayers.

While excessive debt can create risks for councils, under-use of debt is also a concern. For example, it can:

- limit investment in assets for community use
- place an additional burden on current ratepayers to fund capital assets with long lives.

126 Access Economics, 2006, *Local Government Finances in NSW – An Assessment*, for the Independent Review Panel, p 11.

In general, we consider it is more appropriate for councils to fund assets with long lives through borrowings. This approach means the burden of paying for the assets can be spread over several generations of ratepayers (all of whom will benefit from the assets). In contrast, funding long lived assets from current day operating revenues means this burden is shouldered by current ratepayers only, which is inconsistent with intergenerational equity.

Under-use of debt for long life infrastructure assets – evidence from our case study councils

Over the study period, the case study councils tended to fund new capital expenditure[127] from operating revenue rather than use debt funding for long life infrastructure assets, which is inconsistent with the principles of intergenerational equity. This was the case even though the councils had low levels of debt. The metropolitan and fringe councils in the case study funded new capital expenditure over the 2003-08 period largely through operating revenue.

In comparison, if these councils had funded new capital expenditure through an equal mix of revenue and debt, they could have lifted annual capital expenditure[128] from an estimated average of $9m to $13.6m annually for the metropolitan case study councils and from $17.5m to $26.2m annually for the fringe councils. This seems to be indicative of the position of councils more generally.

Rural case study councils were in a similar position, funding an average of 95% of capital expenditure over the period 2003-08 through operating revenue. Funding these works through a more balanced mix of revenue and debt could have allowed a 45% increase in capital expenditure from $2.4m to $3.5m annually. In contrast, regional case study councils seemed to have made active use of debt funding for financing capital expenditure over the study period.

Overall, the case studies indicate that many councils avoid debt funding for long life infrastructure assets and as a result infrastructure backlogs have remained higher than what would have been the case with more balanced funding strategies. The case study councils tended to fund new capital expenditure with operating revenues which is not always consistent with inter generational equity. As a general guideline, councils should have a combination of debt and revenue funding for capital purposes. We consider that the NSW local government revenue framework could be improved by encouraging councils to fund new capital expenditure through a more balanced mix of revenue and debt funding.

[127] Excluding those funded by developer contributions or capital grants.
[128] Not funded by developer contributions or grants.

7.4.3 Broad liabilities ratio

The broad liabilities ratio[129] combines information on actual liabilities (such as debt) with estimates of implied liabilities (infrastructure backlogs) and compares these with operating revenues. It indicates the size of councils long term debt and the cost of clearing its infrastructure backlog (all liabilities) relative to its operating revenue.

The benchmark for this indicator is a ratio of greater than zero but less than 60% -- that is, a council's liabilities must be equal to less than 60% of its operating revenues for it to be considered sustainable on a capital basis. A broad liability ratio of higher than 60% suggests its liabilities are too high for it to be able to meet its obligations, including addressing infrastructure backlogs.

Our assessment of NSW councils' reported broad liabilities ratios found that less than 40% of all councils met the minimum benchmark, meaning more than 60% have liabilities that are considered too high relative to their operating revenue. The proportion of councils that met the benchmark was low for all council categories, and was lowest for fringe and regional councils (less than 20% of which met the benchmark).

Table 7.5 provides information on the broad liabilities ratio for groups of NSW councils for 2003/04 and 2007/08. The data suggest that on average NSW councils have liabilities (debt plus infrastructure backlog) that exceed 60% of their operating revenues. This data tends to suggest that an infrastructure backlog exists.

Table 7.5 Average Broad Liabilities Ratio for All NSW Councils (%)

	2003/04	2007/08
Metropolitan	104.2	56.9
Regional	151.7	166.0
Fringe	111.0	139.2
Rural	138.8	118.2
All NSW Councils	133.0	118.8
Benchmark (less than 60%)	60.0	60.0

Note: Broad Liabilities Ratio: total debt plus cost to clear infrastructure backlog (Special Schedule 7) divided by operating revenue. The benchmark is greater than zero but less than 60%.

Source: IPART Analysis.

[129] The Broad Liabilities ratio is calculated as the sum of infrastructure backlogs and total debt divided by ordinary revenue. The estimate for infrastructure backlogs is taken from Special Schedule 7. Special Schedule 7 records council's estimate of the cost to bring their infrastructure assets to a satisfactory standard and is used as a proxy for the infrastructure backlog.

However, these results need to be treated with extreme caution as available data on infrastructure backlogs comes from councils' own estimates of these backlogs, and we consider that these estimates are not sufficiently well quantified to enable consistent comparisons to be made across councils and/or over time.[130] The results suggest many councils may be at risk in terms of capital sustainability. But we cannot reach a firm conclusion due to the lack of reliable consistent data.

Nevertheless, we accept that infrastructure backlogs are an important problem affecting the capital sustainability of NSW councils. Thus, the key question for our review is how can reform of the regulatory framework for rates revenue help to address this problem?

As Chapter 6 discussed, previous studies have shown that infrastructure backlogs exist in other states not subject to rate pegging, and this suggests that rate pegging is not the main cause of this problem. Therefore, the abolition of rate pegging is unlikely to solve the backlog problem for councils in NSW. Rather, we consider that the regulatory framework needs to give councils flexibility to achieve a level of financial performance that enables councils to meet their financial obligations (including backlogs).

This includes a rate peg amount that more closely aligns with councils increasing costs reflected by a local government cost index. Councils can also apply for special variations to improve their operating balances. Further, the framework needs to create incentives for councils to improve their asset management planning and reporting, and this includes the need to implement appropriate funding policies (a combination of debt and revenue funding) to address their backlogs and improve their capital sustainability. For example, this could be done by requiring councils to meet minimum benchmarks in terms of its asset management plans and levels of debt to gain greater flexibility in setting their own rates.

One of the key steps councils need to take to address their infrastructure backlogs is to accurately estimate these backlogs. The fact that they cannot currently do so clearly indicates a need for improvements in councils' asset management planning and reporting. As Access Economics has previously noted,[131] improved asset management planning and reporting is critical to enable councils to gain a better understanding of their infrastructure challenge and thus prompt them to do more to ensure their financial sustainability. (The issue of infrastructure backlogs and the role of improved asset management planning and reporting in addressing them are discussed in more detail in Chapter 8.)

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130 The available estimates on infrastructure backlogs are reported in Special Schedule 7 (of council's financial statements). However, the information reported is very subjective, is not audited and not all councils agree on a 'satisfactory standard'. Further details on this issue are discussed in Chapter 8.

131 Access Economics, 2006, *Local Government Finances in Western Australia*, for the Systemic Sustainability Study, p 71.

7.5 Findings on the scope for councils' financial sustainability to change over time

We undertook additional analysis of our 11 case study councils to explore the scope for councils' financial position to change over time. In selecting the sample for these case studies, we chose councils in 4 categories: metropolitan, regional, fringe and rural. We also ensured that the councils chosen for each category included at least 2 that had broadly comparable population size and growth, but varied in relation to their financial position at the start of the 5-year period we studied (2003/04 to 2007/08, inclusive).

We found that, even with the current regulation of rates revenue, some of these councils were able to improve their financial sustainability over the study period – both in terms of relative and absolute performance. Other case study councils retained strong financial performance over the study period, while others deteriorated or maintained low levels of financial sustainability.

In our view, these findings clearly indicate that most councils have flexibility to vary their revenue and expenditure policies, and most have flexibility to adapt their funding and liquidity policies to make better use of their available financial capacity. However, we note that small rural councils may be an exception to this.

Box 7.2 provides more detail on the findings of our case study analysis of councils' scope to change their financial performance, while the next section outlines our additional findings on small rural councils.

7.6 Additional findings on small rural councils

Like previous research on councils' financial sustainability, our case study analysis suggests that rural councils with small populations (less than 10,000 people) are at greatest risk of having unsustainable long-term positions. We found that this is largely because they have less capacity than other councils to increase their own-source revenue, especially their rates revenues, due to the characteristics of the areas and populations they serve.

Rural councils with small populations and large local government areas (approximately 50 in number or 33% of NSW councils) often have a fundamental mismatch between their expenditure responsibilities and their narrow revenue base. In addition, these councils tend to have less capacity to increase their total revenues because:

- Rates make up a relatively small proportion of their total revenues (approximately 30% as compared to about 50% for metropolitan councils). This means that they rely heavily on grants from higher levels of government, which they have little ability to influence.
- The areas they serve have a much smaller (and often declining) number of ratepayers compared to more financially sustainable rural councils.

Box 7.2 What influences councils' ability to change their financial performance over time?

In addition to the broad findings discussed in Section 7.5, our case study analysis identified some similarities between the councils that had maintained or achieved strong financial sustainability over the period of our study. These councils tended to:

- use special rate variations to progressively lift or maintain their own-source revenue and fiscal flexibility relative to total revenue
- have a rate base equivalent to 50% or more of their total revenue
- generally record operating surpluses, excluding capital revenues, over the study period
- have relatively low infrastructure backlogs relative to operating revenue (or recorded reductions in this ratio)
- retain or reduce their spending on traditional services as a percentage of total expenditure (traditional services relate to governance, administration, public order and safety, transport, communication/amenities).

In contrast, councils that maintained low levels of financial sustainability or whose financial position deteriorated over the study period:

- tended not to utilise special rate variations
- tended to have falling rates and annual charges relative to total revenue
- had rates and charges revenue equivalent to less than 33% of their total revenue
- tended to have sustained spending growth, resulting in deteriorating operating losses.

Case study councils that were volatile in terms of their financial sustainability tended to:

- record declining trends in their rates and annual charges revenue relative to total revenue
- have user charges and fees revenue equivalent to less than 9% of total revenue
- be becoming less reliant on rates and more reliant on user charges and fees revenue, or visa versa
- record spending growth
- record operating losses that only gradually improved over the study period.

- These ratepayers often do not have the financial capacity to pay higher rates and/or user fees and charges. For example, this may be because the population includes a large proportion of retired ratepayers (due to the ageing of rural communities), or a large proportion of impoverished ratepayers (due to the harsh drought conditions that have afflicted outback NSW for many years).

These characteristics suggest that small rural councils simply cannot raise sufficient own-source revenue to achieve and maintain long-term financial sustainability. While we note that the ability to set higher rates is unlikely to improve the long-term financial sustainability of these councils, other proposed changes to the revenue framework, such as those intended to encourage councils to adopt longer planning horizons, improve asset management and increase community involvement will help

councils to improve their financial sustainability. We also consider that to further improve the financial sustainability of these councils the NSW Government could:

- reduce the expenditure responsibilities of small rural councils
- advocate that the Federal Government redistribute needs-based general purpose grants to this group of councils.

We note that currently, all councils receive a minimum grant from the Federal Government, regardless of need. These minimum grants account for at least 30% of the total amount of general purpose grants NSW is entitled to under Section 9 of the Act. In our view, these minimum grants provisions may act to prevent full horizontal equalisation being achieved. Our analysis suggests that if these provisions were removed, the additional funding available for distribution to councils based on need would go along way towards assisting small rural councils to achieve financial sustainability. However, this issue is outside the scope of this review. Therefore, it is a matter for the Local Government Grants Commission and the Commonwealth to resolve.

Box 7.3 summarises our financial analysis of Wentworth Council and highlights the significant financial pressures faced by small rural councils in NSW.

IPART findings

17 NSW councils' performance in terms of capital sustainability is difficult to measure and interpret due to limitations in the available data:

- Councils' asset valuations have varied over the study period because of the change from valuation based on historic cost valuation to valuation based on fair values.
- Councils' estimates of infrastructure backlogs were derived using inconsistent estimation approaches and many were based on subjective interpretations of the 'satisfactory standard' for council assets.

18 Analysis of the available information indicates that:

- NSW councils have backlogs in infrastructure, but the extent of any backlog cannot be accurately estimated due to the unreliability of the data.
- More than half of NSW councils are managing to maintain capital expenditure at a rate at least equivalent to depreciation, despite significant underutilisation of debt to fund long lived assets.
- To the extent that councils presently underutilise debt, they have the scope to make greater progress towards reducing infrastructure backlogs through a more appropriate combination of revenue with debt funding of capital expenditure.
- Despite rate pegging, some of the case study councils were able to improve their financial sustainability over the study period through the use of special variations.

19 In relation to rural councils with small populations (less than 10,000 people), analysis indicates that:

- These councils are at greatest risk of having unsustainable long-term positions, largely because they have less capacity than other councils to increase own-source revenue, especially rates revenues, due to the characteristics of the areas and populations they serve
- These councils' low capacity to increase rates revenue means that changes to the framework for regulating council revenues are unlikely to be sufficient to reduce this risk, and alternative government action is likely to be necessary.

Box 7.3 Wentworth – A small rural council

Wentworth Shire Council was one of the small rural councils we examined as part of our case study analysis. Wentworth Shire covers an area of 26,000 sq km, and has a population of approximately 7,200 people. It is situated 1,075 km from Sydney, 585 km from Melbourne and 420 km from Adelaide and is located adjacent to the NSW border with Victoria. It includes the townships of Wentworth, Dareton, Buroga and Gol Gol, which are located on its southern boundary (along the Murray River).

Wentworth Shire Council recorded a small annual operating surplus over the study period (2003/04 to 2007/08).[a] This surplus averaged $0.6 million or 4% of total revenue, and was achieved through a combination of significant reductions in spending and modest gains in revenue. In real terms, spending was reduced by an average of 1.2% per annum between 2003 and 2008, while total ordinary revenue grew by 2.5% per annum.

As is typical for small rural councils, the bulk of Wentworth's expenditure was on traditional local government services (governance, administration, public order & safety, transport, communication and amenities). These services accounted for 78% of expenditure in 2007/08 (even though expenditure on these services was reduced over the study period). In contrast, metropolitan, fringe and regional councils selected as case studies by IPART spent only 65 per cent of their expenditure on these services.

The remaining 22% of expenditure was on health services, community and education, recreation/culture, economic affairs and mining/construction. Expenditure on these services remained generally stable over the study period.

Like many rural councils with relatively small populations (less than 10,000 people), Wentworth's rates and annual charges accounted for only 26% of its total revenue in 2007/08. In comparison, rates for metropolitan, fringe and regional case study councils amounted to 51% of total revenue, on average, in 2007/08.

As a result, Wentworth Shire relied heavily on grants revenue, which account for 43% of total revenue in 2007/08. This was much higher than the average of 14% for metropolitan, fringe and regional case study councils. This reliance on external funding provides small rural councils like Wentworth – which are large in geographical area and have considerable road lengths but small in terms of population and rate base – with minimal capacity to fund new capital expenditures and renew infrastructure assets (eg, roads, kerbing, footpaths, street lighting, stormwater drains, buildings, retaining walls, playgrounds, sports ovals, parks and gardens, etc).

Wentworth Shire Council's estimated infrastructure backlogs were $28m in 2007/08. This compares with average capital expenditure – excluding water and sewerage and works funded through developer contributions and capital grants – of only $2m per annum over the study period, and very low levels of debt ($2.4m in 2007/08).

Local Government commentators, such as Review Today[b], have in the past estimated that combined, debt and infrastructure backlogs should not exceed 0.6 of annual operating revenue for councils to be able to meet capital requirements on a sustainable basis. In 2007/08, Wentworth's ratio was 2.9, which indicates an unsustainable position in relation to capital requirements.

Overall, it would seem that even additional continued expenditure reduction will not be sufficient to rectify this situation, without substantial revenue growth to address capital sustainability over time. However, given an inability of rates to inject the required funds, it is uncertain how councils like Wentworth will be able to assure their long term sustainability.

a Excluding water and sewerage activities and capital revenues.

b Review Today is responsible for the publication of the results on sustainability ratings by FiscalStar Services Pty Ltd (see Chapter 6).

8 What is the problem in measuring infrastructure backlogs?

As Chapter 7 discussed, in assessing NSW councils' capital sustainability we examined each council's reported broad liabilities ratio, which is a measure of its actual liabilities (debts) plus its implied future liabilities (infrastructure backlogs) relative to its operating revenues for a particular year. We found that more than 60% of councils did not meet the sustainability benchmark for this indicator, which suggests they may be at risk in terms of capital sustainability. However, we noted that this finding should be treated with caution because available data for estimating the size of infrastructure backlogs are not consistent or reliable. (See section 7.4.3.)

The purpose of this chapter is to explore the problems associated with estimating the size of infrastructure backlogs in more detail, and present our findings on what needs to be done to address these backlogs. The sections below discuss:

- What is meant by infrastructure backlogs?
- The approaches used to measure infrastructure backlogs in previous studies, and what these studies have found.
- What our analysis of our 11 case study councils' infrastructure backlogs and asset management plans found?
- What other analysis of individual councils' infrastructure backlogs and asset management plans has found?
- Our conclusions on infrastructure backlogs and the need for improved asset management planning in NSW.

8.1 What is meant by infrastructure backlogs?

Councils can be responsible for a variety of infrastructure assets, such as the local road network in their areas, and public buildings and facilities like libraries, parks, sporting grounds and swimming pools. They need to spend money on infrastructure for 2 reasons: to renew or replace existing infrastructure, and to provide new infrastructure.

The term 'infrastructure backlog' refers to the cumulative value of a council's past annual expenditure requirements for renewing/replacing existing infrastructure that were not met from its annual capital expenditure, measured at a particular point in time. Thus, a sizable backlog is a strong indicator that the council has not been regularly and adequately maintaining its infrastructure asset base. This suggests it

has significant future liabilities in terms of infrastructure renewal and replacement, which may place pressure on its finances and therefore place its capital sustainability at risk.

8.2 What approaches have been used to measure infrastructure backlogs in previous studies, and what have these studies found?

Previous studies have used 2 broad approaches to measure infrastructure backlogs in NSW. These include:

- **The Special Schedule 7 method.** This approach uses the data councils have included in Special Schedule 7 of their annual financial statements. This data reflects councils' estimates of how much expenditure on renewing or replacing existing infrastructure assets is required to bring these assets to a 'satisfactory' standard. This magnitude of the infrastructure backlog is equivalent to the value of the required expenditure.
- **The capital expenditure/depreciation method.** This approach uses a council's capital expenditure ratio – that is, its annual capital expenditure on renewal/replacement of assets divided by its annual depreciation expense (ie, the indicator discussed in section 7.4). It assumes that the annual depreciation expense reflects the rate at which the council's infrastructure assets are being 'consumed', and therefore the need to renew those assets. If a council's capital expenditure ratio is 1.0 – ie, its annual capital expenditure and depreciation expense are equal – its existing asset base is just being renewed at the rate the assets are being consumed, so the backlog should be unaffected.[132] However, when this ratio is less than 1.0 – the council's annual capital expenditure is lower than its annual deprecation – the asset base is not being renewed at the rate of consumption, and an infrastructure backlog is accumulating. The magnitude of this backlog is equivalent to the shortfall between the annual capital expenditure on renewal/replacement and the annual depreciation.[133]

The findings of previous studies using each of these approaches are summarised below. It's important to note that both approaches have shortcomings, due to the quality of available data. For example, councils' estimates of the capital expenditure on asset renewal required to bring their infrastructure assets to a satisfactory standard are not audited. And as Chapter 7 discussed, they tend to be very subjective because there is no common definition of what satisfactory standard means. In addition, councils' data on capital expenditure doesn't distinguish

[132] However, it should be noted that even when capital expenditure is greater than depreciation, there is still the possibility that the infrastructure backlog is growing or not being reduced.

[133] Although this ratio provides an indicator of whether local government's asset base is growing or contracting, it should not be considered in isolation. It needs to be considered along with other factors such as regional demographics including population growth, age structure and incomes. Such information will assist in understanding whether capital expenditure is in line with community need. Eg, if population growth is high, ratio should be greater than 1.0, while local government with stable or no population growth the ratio would be closer to 1.0.

between expenditure on asset renewal/replacement and expenditure on new assets and services.

8.2.1 Findings of previous research using the Special Schedule 7 approach

Roorda and Associates (Roorda) reviewed the condition and management of infrastructure in local government for the 2006 Allan Inquiry. They did this by examining:

- All councils' Annual Reports (including financial statements) for 2003/04 of the cost to bring assets to satisfactory standard (Special Schedule 7).
- Results of a survey of 103 councils submitted to the Local Government Inquiry that collected information on the state and quality of asset management practices that are used to understand the cumulative impact of past and current decisions on infrastructure provision.[134]

As part of this review, Roorda estimated councils' infrastructure backlogs using councils' estimates of the amount of spending required to bring their assets to a satisfactory standard, as reported in Special Schedule 7. It found that collectively, NSW councils had reported a backlog in infrastructure renewals of $5.3 billion (excluding $1 billion which related to water and sewerage assets). It noted that if this estimate were accurate, councils' reported capital expenditure levels would have needed to increase **eightfold** to bring assets to a satisfactory level.[135] It pointed out that such an increase was clearly unrealistic, and that this exposed a flaw in the Special Schedule 7 approach to estimating backlogs.

Roorda found for 84% of asset categories, councils had estimated the cost of bringing their assets to a satisfactory standard based on the professional judgement of council engineers.[136] As a result, their estimates tended to reflect an "engineering/technical view of what the ideal [asset] condition should be", and often incorporated the costs of achieving substantial service improvements.[137] Thus, these costs may be much higher than those required to bring the assets to a satisfactory standard from their local community's point of view (ie, a standard that provides acceptable levels of risk, safety, quality and function). For example, a rural council may include the cost of sealing a gravel road in its estimated backlog, whereas its local community may consider the current road surface to be satisfactory, given the low use of the road.

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134 Roorda, J., 'The Present Condition and Management of Infrastructure in Local Government', *Allan Inquiry Research Report,* January 2006, p 15.

135 Roorda, J., 'The Present Condition and Management of Infrastructure in Local Government', *Allan Inquiry Research Report,* January 2006, p 23.

136 Roorda, J., 'The Present Condition and Management of Infrastructure in Local Government', *Allan Inquiry Research Report,* January 2006, p 4.

137 Roorda, J., 'The Present Condition and Management of Infrastructure in Local Government', *Allan Inquiry Research Report,* January 2006, p 23.

In addition, we note that the Division of Local Government makes the comment that data contained in Special Schedule 7 should be used with caution as it is very subjective and has not been audited.[138] We also note that the findings of the Allan Inquiry (for which Roorda undertook its research) also suggested that the infrastructure accounting and reporting requirements for NSW local government (including those for Special Schedule 7) are open to interpretation by councils and thus may not be consistently applied across the sector. For instance, the Allan Inquiry noted that the Special Schedule 7 data requirements:

> …does not split up future infrastructure renewals by time frame, nor does it define what is a 'satisfactory' condition for an asset. Also, it does not distinguish between capital expenditure on infrastructure renewal and capital expenditure on the expansion of existing assets or the acquisition of new assets. Most councils do not have the asset management systems and skills to ensure that assets are properly registered, valued, planned, acquired, operated, maintained, disposed of and renewed, let alone costed on a whole of life basis.[139]

In its submission to our draft report, the LGSA argued that we had not tested the assertion that Special Schedule 7 data tends to over estimate the size of the infrastructure backlog. We consider that Roorda's previous extensive analysis on this matter and other issues associated with council's asset management approaches provides sufficient evidence.

Given the above, while we accept that Special Schedule 7 data indicate that infrastructure backlogs are a significant problem for NSW councils' capital sustainability, they do not provide an accurate estimate of the size of these backlogs.

8.2.2 Findings of previous research using the capital expenditure/depreciation method

Two recent previous estimates of infrastructure backlogs have used the capital expenditure/depreciation method – one by Roorda and one by Access Economics. These studies were also undertaken for the 2006 Allan Inquiry.

Roorda applied the capital expenditure/depreciation approach as part of its review of condition and management of infrastructure in local government (discussed in the section above). It found that in 2003/04, the capital expenditure ratio for NSW councils ranged from 0.5 to 0.6, which suggested that the renewal needs of their infrastructure assets were being under funded by around 40% to 50%. It calculated that this represented under funding of $500 to $600 million each year by all NSW councils,[140] or an annual average of $3.6 million per council.

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138 Division of Local Government, Special Schedule 7 data.

139 Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government* - Final Report, May 2006, p 14.

140 Roorda, J., 'The Present Condition and Management of Infrastructure in Local Government', *Allan Inquiry Research Report,* January 2006, p 10.

Access Economics applied the capital expenditure/depreciation approach as part of its assessment of the financial sustainability of NSW councils (discussed in Chapter 6). It found that in 2004/05, the annual capital expenditure of NSW councils on renewing/replacing existing assets fell short of the annual depreciation of those assets by $400 million, or 40% of that capital expenditure.[141] This is equivalent to an annual average shortfall $2.6 million per council. Access Economics' findings are relatively consistent with Roorda's.

In our view, the accuracy of this approach to estimating the size of the infrastructure backlog depends on the validity of the councils' estimates of the renewal and replacement capital expenditure that they have undertaken (as distinct from expenditure on new assets or services). However, estimating renewal and replacement expenditure is not a simple task for 2 reasons:

- First, current accounting management systems may not record this expenditure separately. If this is the case, it is necessary to make assumptions about the proportion of total capital expenditure that was for the renewal/replacement of assets.
- Second, even if capital expenditure was reported separately, it is often difficult to distinguish whether capital expenditure is for renewal of existing assets or the provision of new assets to enhanced services or increase capacity. For example, an old outdoor pool may be replaced by a new recreation facility that includes a pool. Or population growth may mean an existing facility is replaced and expanded before the end of its life.

For these reasons, we consider that while the findings of the 2 studies discussed above suggest that infrastructure backlogs are a significant problem for NSW councils' capital sustainability, they don't provide an accurate estimate of the size of these backlogs.

8.2.3 Additional findings based on the above research

Findings of Allan Inquiry based on the above research

As noted above, each of the studies discussed above were undertaken as part of the 2006 Allan Inquiry into the financial sustainability of NSW councils. In its final report, this inquiry recommended that NSW councils would need an extra $900 million a year to overcome the 'infrastructure crisis', including $400 million to service $5.3 billion debt (excluding water and sewerage assets) and $500 million to close the gap between use of assets (depreciation) and current expenditure on asset renewal (based on Roorda's estimate).[142]

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141 Access Economics, 2006, *Local Government Finances in NSW – An Assessment*, for the Independent Review Panel, p 27-28.

142 Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government* - Final Report, May 2006, p 7.

However, our consideration of the research undertaken for the Allan Inquiry has led us to reach a different conclusion because we have placed a greater weight on the uncertainty attached to the data. As explained in the sections above, we consider that while this research indicates that infrastructure backlogs are a significant issue for NSW councils, they may not provide an accurate indication of the size of these backlogs.

Findings of PwC based on the above research

Similarly, as Section 6.5 discussed, PwC undertook a national study on the infrastructure backlogs of councils in 2006. This research extrapolated results from the state-based financial sustainability studies to estimate the total size of councils' infrastructure backlogs across Australia. This research showed that NSW councils had a significantly larger backlog than those reported in the other states. We note that the size of the NSW backlogs was estimated directly from Special Schedule 7, while the other states' backlogs were estimated based on capital expenditure/depreciation ratios or similar ratios because those councils don't report Special Schedule 7 type data. Therefore, the estimates are not directly comparable. On this basis, we take the view that the interstate comparisons regarding the magnitude of backlogs are inconclusive.

8.3 What did our analysis of case study councils' infrastructure backlogs and asset management plans find?

As Chapter 7 discussed, in our assessment of councils' financial sustainability we examined councils' reported performance against 3 indicators of their capital sustainability, and compared them to minimum benchmarks for sustainability. Two of these indicators provide insight into councils' infrastructure backlogs: the capital expenditure ratio and the broad liabilities ratio.[143]

As part of our additional analysis of 11 case study councils, we examined these councils' performance against these 2 indicators over a 5-year period, to see how this performance changed over the period. We also met with each council to discuss their asset management approach, and explored whether there was any link between this approach and a council's performance against the indicators and their ability to improve this performance over time.

[143] The capital expenditure ratio was also discussed in section 8.2 above, and represents a council's annual capital expenditure on renewal/replacement of assets divided by its annual depreciation expense. However, councils don't accurately separate renewal capital expenditure from expansion or new capital expenditure, so annual capital expenditure may be overstated as it includes both renewals and new capital expenditure. The broad liabilities ratio measures a council's actual liabilities (debts) and implied future liabilities (infrastructure backlog as reported in Special Schedule 7) relative to its operating revenue.

Table 8.1 shows our findings on each case study council's performance against these indicators in the first and last year of the study period. It indicates that individual council performance varied significantly over this period, ranging from well above the minimum benchmark for sustainability to well below this benchmark.

Table 8.1 Performance against broad liabilities and capital expenditure ratios, IPART's case study councils

	Broad liabilities ratio (%) (sustainability benchmark = less than 60% of ordinary revenue		Capital expenditure ratio (sustainability benchmark = greater than 1.0)	
Council Category	**2003/04**	**2007/08**	**2003/04**	**2007/08**
Metropolitan (1)	224.3	190.0	1.4	2.9
Metropolitan (2)	162.0	48.7	1.6	1.5
Fringe (3)	95.7	74.3	1.1	1.3
Fringe (4)	118.1	181.7	1.6	1.3
Regional (5)	51.2	62.2	1.9	1.4
Regional (6)	265.6	491.4	0.8	1.1
Regional (7)	N/A	86.2	1.7	2.1
Rural (8)	43.8	374.0	1.3	2.7
Rural (9)	182.9[a]	122.7	2.2[b]	1.3
Rural (10)	201.2	45.6	1.3[b]	1.6
Rural (11)	207.0	287.9	2.5	1.8

[a] This was calculated based on the sum of backlogs for the two councils which merged in 2004/05.

[b] This is calculated for the 2004/05 financial year.

Note:

Broad Liabilities Ratio: total debt plus special schedule 7 (cost to bring to satisfactory excluding water and sewer) divided by operating revenue.

Capital Expenditure Ratio: total Capital expenditure divided by depreciation.

Source: Individual council's financial statements.

The table shows that most of the 11 councils did not meet the broad liabilities ratio benchmark, as their broad liabilities were too high relative to their operating revenue. However, most exceeded the capital expenditure ratio benchmark. Given the known limitations of each of these indicators, these results are somewhat contradictory, and underscore our view that the data available to estimate the size of the infrastructure backlog is not reliable. In addition, there was substantial change in many councils' broad liabilities ratio over the study period. Some were able to significantly reduce their liabilities over 5 years, while others showed substantial increases in their liabilities.[144]

[144] It is likely that these councils' broad liabilities largely represent their infrastructure backlogs (as reported in their Special Schedule 7) given our finding on NSW councils' under-utilisation of debt (see section 7.4.2).

Looking at the performance of individual categories of council, we found the metropolitan case study councils were best placed to stabilise and reduce their infrastructure backlogs, and achieve annual growth in capital expenditure relative to depreciation. Their high capital expenditure ratios and declining broad liability ratios indicate that these councils were able to focus a greater proportion of their annual capital expenditure on renewing existing assets rather than expanding their infrastructure networks. We note that these councils typically source a larger proportion of their revenue from rates than other council types. Therefore, this finding supports our view that rate pegging is not a major driver of infrastructure backlogs and does not prohibit the reduction of backlogs.

In addition, our discussions with the metropolitan councils identified that the councils that had improved their broad liabilities ratios by reducing their infrastructure backlogs used computerised asset management systems. These councils commented that they were better able to understand the situation of their assets and this enabled them to rationalise their backlogs, by reclassifying them according to the council's priorities. That is, these systems enabled the consumption of infrastructure and requirements for new works and maintenance of assets to be better planned, forecast and managed – resulting in lower budgeted expenses and improving financial sustainability than otherwise would have been the case.

We found that the fringe case study councils both had capital expenditure ratios above the benchmark over the study period, but only one managed to reduce its broad liabilities ratio. Again, in our discussions we found that the council with a computerised asset management system achieved a relatively low and falling broad liabilities ratio, while the council without this kind of system had a higher broad liabilities ratio which increased over the period. The fringe council with increasing backlogs had purchased an asset management system but had not yet completed data entry. This council expressed the view that once its asset management system was fully activated, it would be in a better position to more accurately estimate the value of infrastructure backlogs.

The regional case study councils' performance was very variable. Regional council (5) recorded a low broad liabilities ratio and a high capital expenditure ratio, both of which deteriorated slightly over the study period but still remained close to or above the minimum benchmark. This council currently uses engineer-based assessments of renewals plus regular community satisfaction surveys to review levels of service and identify service priorities. It noted that it has a computerised asset management system, but due to the substantial staff resources required, it will take 3 to 5 years before the system is fully operational.

Regional council (7) also recorded a low broad liabilities ratio and high capital expenditure ratios. It uses a computer-based asset management system to identify work and service priorities and to determine when intervention is required to renew, replace or dispose of assets. This system is assisting it to move to fair value in asset valuation and plan responses to infrastructure damage caused by major storm events. In contrast, regional council (6) recorded a high broad liabilities ratio that got

significantly higher over the study period, and a low capital expenditure ratio that increased over the period to a level above the benchmark. It estimates its backlogs based on its City Engineer's estimates, and notes that a future special variation will be sought to complete its asset management plan and other strategies.

The rural case study councils also recorded very variable performance. For example, 1 recorded a dramatic increase in its broad liabilities ratio, but also a significant increase in its capital expenditure ratio. Another dramatically reduced its broad liabilities ratio as well as increasing its capital expenditure ratio. None of the rural councils had established computerised asset management systems.

In addition, we reviewed our case study councils' infrastructure backlog estimates (as reported in Special Schedule 7) over a 5-year period (Table 8.2). The table shows that there was a high level of variability in these estimates from year to year. Our discussions with the case study councils showed that there was no consistent methodology applied for estimating the infrastructure backlog. This creates difficulties in comparing the councils' results, both over time and between councils. It also suggests that the robustness and reliability of data underlying these estimates is questionable. Overall, we concluded that the data on infrastructure backlogs included in Special Schedule 7 of councils' annual financial statements was not reliable, and tended to overestimate the size of these backlogs.[145]

Table 8.2 Special Schedule 7 estimate of infrastructure backlog, IPART's case study councils ($'000)

	2003/04	2004/05	2005/06	2006/07	2007/08
Metropolitan (1)	126,333	123,270	156,576	119,800	137,089
Metropolitan (2)	123,249	80,039	78,144	71,649	46,500
Fringe (3)	62,801	51,962	48,707	45,157	58,101
Fringe (4)	93,220	89,840	81,901	158,146	158,250
Regional (5)	11,953	14,195	24,238	27,258	30,225
Regional (6)	70,226	108,656	135,552	171,863	182,659
Regional (7)	0	0	0	0	80,275
Rural (8)	3,250	2,700	1,900	53,020	51,900
Rural (9)	na[a]	14,400	15,627	20,135	19,528
Rural (10)	30,090	19,880	17,907	20,277	2,600
Rural (11)	21,730	21,695	23,262	39,155	42,100

[a] Due to council merger in 2004/05.

Source: DLG Special Schedule 7.

[145] This is because a number of the case study councils were using engineer estimates for their backlogs, and Roorda has shown that engineer estimates tend to overstate the size of the backlog.

These case study findings suggest there is a link between councils' ability to address their infrastructure backlogs and the quality of their asset management systems. We are not suggesting that a council's asset management system is responsible for its performance in relation to backlogs. However, our findings do indicate that those councils with sophisticated asset management systems and the skills and resources to operate them effectively have a better understanding of their infrastructure requirements and thus are able to make informed decisions to address the problem.

Therefore, based on our case study analysis, we consider that many councils' do not have sufficient understanding and/or asset management resources to accurately manage their infrastructure assets, including whole-of-life costing models for critical infrastructure assets. Central NSW Councils (CENTROC) submission to our draft report supports this view, noting that:

> Very few of our members have a sound grasp of their asset backlogs.[146]

This poor understanding has contributed to the development of infrastructure backlogs, because it means these councils are unable to grasp the size of the problem they face. Together with the shortcomings in the current reporting requirements related to asset management,[147] this also makes it difficult for external parties like IPART to accurately measure the size of the infrastructure backlog problem in NSW.

8.4 What has other analysis of individual councils' infrastructure backlogs and asset management plans found?

We reviewed other recent research on individual NSW councils' infrastructure backlogs and asset management systems to compare with our case study findings. This research was undertaken by GHD, as part of a detailed analysis of 6 regional councils' financial sustainability (conducted by Review Today Pty Ltd at the request of the councils concerned).[148]

GHD was commissioned to examine the state of each council's infrastructure and estimate its infrastructure backlog. As part of this work, it undertook detailed analysis of the councils' asset management capabilities.

This analysis indicated that:

1. The quality of the key data required to measure the state of the councils' existing infrastructure and the size of any infrastructure backlog depended on their asset management systems.
2. There were gaps in the councils' current asset management systems that limited their ability to make quality decisions regarding their assets.

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146 Central NSW Councils (CENTROC) submission to IPART's draft report, 17 September 2009, p 3.

147 That is, the lack of a common definition of asset condition and satisfactory standard, discussed in Section 8.5.

148 The purpose of this research was to develop various policy alternatives for the councils to become financially sustainable over the longer term.

We consider these findings are consistent with our own findings on infrastructure backlogs and the need for improved asset management planning. In particular, they suggest that shortcomings in the currently available data mean that estimates of councils' infrastructure backlogs are subjective and unreliable as a basis for councils' budgeting policies. They also highlight the importance of more sophisticated asset management systems and processes to enable councils to address the demands on their infrastructure assets.

Table 8.3 compares GHD's estimate of each council's infrastructure backlog in different years over the period 2006 to 2009 with the council's own estimates for 2003/04 to 2007/08, as reported in Special Schedule 7. Note that in calculating its estimate, GHD took account of each council's knowledge and experience of its infrastructure condition, but reach a different estimate based on its own assessment of the current condition of the council's assets. This assessment reflected GHD's industry experience, factual data from previous studies on similar assets, and information provided by the council on its particular assets, its local environment, and the level of demand for the services it provides.

Table 8.3 GHD and council estimates of infrastructure backlog (including water and sewer) ($'000)

	GHD Estimates	Council estimates (Special Schedule 7)				
Study[a]	**GHD estimate**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Albury (2007)	102,000	67,743	43,222	52,765	71,742	75,217
Armidale (2009)	8,700	49,414	49,344	49,875	32,866	31,094
Great Lakes (2008)	26,100	148,350	149,258	156,584	117,058	58,116
Greater Taree (2009)	148,200	70,226	108,656	135,552	171,863	182,659
Newcastle (2006)	134,100	101,287	99,584	104,466	124,841	124,841
Wollongong (2007)	192,000	270,274	306,651	353,072	202,158	202,150

[a] Shows the year that GHD completed their estimates of the infrastructure backlog.

Note: The table compares GHD's estimate of the infrastructure backlog for the year in which they conducted study (first two columns) with councils reported infrastructure backlogs over the period 2003/04 to 2007/08 (remaining 5 columns).

Source: DLG Special Schedule 7, Review Today Pty Ltd (www.reviewtoday.com.au)

The table shows that there is considerable variability between each council's estimate of its backlog and GHD's estimate. There is also substantial variability in councils' estimates over time. This is consistent with the findings of our case study analysis, which found substantial variability in councils' estimates from year to year. It also supports our view that the robustness and reliability of backlog estimates based on currently available data is questionable.

8.5 The role of improved asset management reporting and planning in addressing the infrastructure backlog

The findings of the research and analysis discussed in this chapter clearly indicate that infrastructure backlogs are a concern, and may place the capital financial sustainability of NSW councils at risk. However, these findings also clearly indicate that currently available data are not sufficiently reliable – in terms of objectivity and consistency across councils and over time – to enable the size of the current backlog to be accurately measured.

We note that in its response to our draft report, Review Today Pty Ltd[149] questioned our conclusion that there was no evidence to suggest that the size the infrastructure backlog in NSW is no worse than the other states.[150] We note that in reaching a conclusion that the infrastructure backlog is comparatively worse in NSW, Review Today Pty Ltd compared an estimate of the NSW backlog based on Special Schedule 7 method with PwC's estimates for the other states based on the capital expenditure/depreciation method. These estimates are not directly comparable; therefore the size of the backlog in NSW relative to other states is not clear.

But in any case, as Chapter 7 noted, the exact size of the infrastructure backlog in NSW, and whether this is larger or smaller than the backlog in other states is not a key question for this review. We are more concerned with the question of what can be done (via changes to the broad regulatory framework) to improve councils' capacity to address improve their financial position, including addressing any infrastructure backlogs. The lack of reliable information to measure councils' infrastructure backlogs indicates that it is important to improve asset management reporting requirements for NSW councils and to provide more effective incentives for councils incentives to improve their asset management planning.

We note that while some NSW councils have well-developed asset management systems (see Box 8.1), previous research found that 80% don't even have an asset management plan.[151] We consider that widespread improved asset management planning and reporting are necessary to ensure all councils have a robust understanding of their infrastructure requirements and challenges, and so are able to develop effective approaches for dealing with any infrastructure backlog. For example, all councils need access to:

- Accurate data on the condition of their existing assets, based on common definitions of asset condition.
- Accurate data on actual capital expenditure on asset renewals and replacement.

149 Review Today Pty Ltd submission to IPART, 2 September 2009, p 4.
150 IPART, 2009, *Revenue Framework for Local Government*, Draft Report, p 4.
151 Allan P., Darlison, L., and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government – Final Report*, May 2006, p 119.

- Information on their local community's expectations in relation to council infrastructure, and their priorities and willingness to pay for improvements in infrastructure/services.
- Understanding of the risks and consequences of service level decisions on asset life.
- Asset management systems and skilled staff to ensure that assets are properly registered, valued and maintained, and to ensure assets are costed on a whole of life basis.

We note that the Integrated Planning and Reporting Framework includes improved requirements in relation to asset management planning and reporting. Once councils implement this framework, they should develop a better understanding of their infrastructure situation. This will both assist them to address any backlog problem, and generate improved data to enable future analysis of the size of this problem in NSW.

However, we consider further improvements to these planning and reporting requirements are needed to ensure that councils have access to the data they need to understand and address any infrastructure backlog, and that the size of the state-wide backlog problem can be measured and monitored.

Further, we consider the finding that infrastructure backlogs exist and may be significant in size indicates that the framework for regulating council revenues needs to provide councils with flexibility to address these backlogs over an appropriate time frame.

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20 Further analysis of the available evidence on infrastructure backlogs indicates that these backlogs are a concern for NSW councils, and confirms the previous finding that that currently available data are not sufficiently reliable to enable the size of the current backlog to be accurately measured.

21 This analysis also indicates that further improvements to councils' asset management planning and reporting requirements are needed to ensure they have the data they need to understand and address any infrastructure backlog, and that enable the size of the state-wide backlog problem to be measured and monitored.

Recommendations

4 To enable accurate measurement and monitoring of the state-wide infrastructure backlog, and assist councils to address their individual backlogs, that the Division of Local Government require councils to:

- report maintenance costs relating to public works in their operating statements
- report actual annual expenditure on renewal of capital works within Special Schedule No. 7 of the published financial statements

– have asset management systems based on a common definition of asset condition.

5 That the Division of Local Government and local councils should develop consistent definitions of asset condition for use by all councils in asset management planning and asset management systems.

Box 8.1 Example of well-developed asset management systems – Campbelltown City Council

Campbelltown City Council's Asset Management Strategy is based on a set of comprehensive tools, information flow and processes that are used to determine the long-term physical and financial asset management requirements of infrastructure assets. The council's asset management practices include, but are not limited, to the following elements:

1. Corporate Asset management systems (Conquest)
2. Pavement Management System
3. Bridge Management System
4. Moloney Network Modelling Software.

These systems are supported by a Geographic Information System and the financial management system which link the financial commitment to maintain assets and the amount needed to sustain programmed capital works programs.

Corporate Asset management system (Conquest)

The Conquest system includes the information support systems used to store and analyse asset management data. This system facilitates for the best use of resources in the maintenance, renewal, replacement, acquisition and disposal of assets. All assets are managed within a single corporate framework which is implemented at many levels of detail. It aims to ensure asset decisions are made on the basis of relevant information, rather than anecdotal experiences.

The system allows full auditing of asset financial information and ensures procedural consistency supported by reporting functions and sharing of information. This approach enables the council to manage risk exposure through definition of the level of risk and assessment of the consequence of asset failure. This is supported by asset maintenance histories including the recording and analysis of risk events (ie, accidents) relating to assets and asset classes. The system enables priorities to be set on the basis of ranking assets and/or actions based on user definable criteria.

Pavement Management System (PMS)

The PMS is a detailed data storage, manipulation and prediction system. It enables identification of appropriate funding levels to meet specified standards, plan network improvements according to budget restraints, realise cost effectiveness through prioritisation based on comparison of the costs and benefits of alternatives and determine the effects of deferring maintenance on upkeep and road user costs.

Box 8.1 continued

Bridge Management System

This system uses "BridgeAsyst" software that manages inventory and condition rating data for all types of bridges and culverts. It has the facility to record all maintenance activities and to produce all reports including annual maintenance programs and budgets. The system includes the following information:

- All critical bridge inventory information including bridge rating, specific access requirement and digital photographs of structure.
- Bridge inspection-data collected in accordance with the inspection methodology, including condition rating for each component, noting of specific defects or recommendations for maintenance work or further investigation.
- Generation of maintenance of special inspection order forms which include cost estimates and prioritisation to assist with the scheduling of the maintenance and special inspection work.
- Provision for recording historical maintenance records with costs.
- Collection of data in the field which has a local inspection database including general inventory, and inspection data for bridges scheduled to be inspected.

Moloney Modelling Tool

This tool was developed to enable the financial modelling of up to 20 different asset data sets and to provide the means of presenting a consolidated single report for all assets. The system has been set up to retrieve data from Conquest. However, it can be used with any other system to produce financial forecast outcomes. Currently the tool is being used to model the forecast expenditure and replacement needs for the following assets – footpaths, kerb and gutter, bridges and culverts and pipes and channels.

9 Has cost shifting adversely affected NSW councils' financial sustainability?

In addition to analysing the impact of rate pegging on NSW councils' financial sustainability, we considered whether other factors had adversely affected this sustainability. One of these factors was cost shifting. In submissions to this review, many councils put the view that cost shifting from higher levels of government had significantly expanded their role and responsibilities, and this had created cost pressures which have reduced their sustainability.

We note that cost shifting is a fairly general term, and views on its impact and significance for councils will depend strongly on how it is defined. Therefore, our first step in assessing the impact of cost shifting on NSW councils' financial sustainability was to define what cost shifting means in the context of this review. We then examined the examples of cost shifting provided in submissions, and considered the findings of previous research on this issue.

The section below provides an overview of our findings. The following sections discuss our assessment and findings in more detail.

9.1 Overview of our findings on cost shifting

Given the purpose of our review, we defined cost shifting as when a higher level of government **requires** local government to provide a function or service that is not traditionally associated with local government, **and** does not adequately provide for local government to recover the additional costs that this involves. We found that few of the examples of possible cost shifting provided by stakeholders meet this definition, which is more specific and objective than definitions used in previous research. We concluded that, based on our definition, the cost to councils is much less than councils currently estimate.[152]

Nevertheless, given the potential for cost shifting to occur in the future, we consider that the framework for regulating council revenues should specifically allow for councils' regulated revenues to be adjusted to enable them to recover the associated costs. (The way in which our recommended framework allows for this is described in section 13.1.)

[152] The LGSA's recent survey estimated that, in 2007/08, cost shifting imposed costs of $431m on NSW councils. This represents 5.92% of total income from operations before capital amounts for all NSW councils. See LGSA, *The Impact of Cost Shifting on Local Government in NSW: A survey of Councils – financial year 2007/08*, p 1.

In addition, we recognise the councils do face real cost pressures that arise from changes in the costs of services provided by higher levels of government, changes in their regulatory requirements, gaps in service delivery by other levels of government, and increasing community expectations. While these cost pressures are not cost shifting, they still need to be addressed. In our view, this should also be done through improvements to the framework for regulating council revenues. (The way in which our recommended framework allows for this is described in section 15.2.)

9.2 What is meant by cost shifting?

In general, cost shifting is said to occur when responsibility for providing a function or service is transferred from one level of government to a lower level of government without the associated funding.[153] However, we consider this definition to be too subjective and impractical for this review.

The general definition assumes that the roles and responsibilities of each level of government are clearly defined and matched with appropriate funding. But this is not the case in Australia. While the constitution sets out the general roles of the federal and state governments, their roles and responsibilities are not clearly defined. Local government is established under state legislation (not the constitution), so its functions and revenue raising powers are those delegated by state governments. As Chapter 2 discussed, the relevant NSW legislation sets out the general functions but provides local government with flexibility to provide services in response to community needs. This means that views on whether or not something is cost shifting is largely subjective, as they depend on assumptions about which level of government is responsible for it. (See Box 9.1 for more information.)

In addition, in practice it is not always possible to separate different governments' roles and responsibilities. For example, some functional responsibilities (such as roads and tourism) are often shared, as it would be less effective to assign them to one level of government. It can also be difficult to determine where one functional responsibility begins and another ends, especially because of the inter-relationships between different functional responsibilities of government.

Further, even it were possible to clearly define the functions for which each level of government is responsible for, it is not possible to match specific functions with a specific level or source of funding. For example, councils currently have the power to raise their own revenue from rates, charges and fees, but there is nothing in the legislation that specifies what functions this revenue is to be used for, or how much should go towards any specific function.

[153] See for example Hawker, D. and Burke, A., 'Rates and Taxes: A Fair Share for Responsible Local Government', *Final Report on the Inquiry by the House of Representatives Standing Committee on Economics, Finance and Public Administration*, October 2003.

Box 9.1 Defining the roles and responsibilities of the 3 levels of government

As noted in section 9.2, it difficult to make a strong case that councils face significant cost pressures due to cost shifting because the roles and responsibilities of the 3 levels of government are not clearly defined. In our view, the only way to overcome this difficulty is by clearly specifying the roles and responsibilities of each tier of government. This is a political issue which needs to be resolved within government itself.

We note that in April 2006 the Commonwealth and State Governments and local government (represented by the ALGA) signed an Inter-governmental agreement (IGA) that establishes principles to guide inter-governmental relations on local government matters.[a] In particular, the IGA set out principles that are to be reflected in future arrangements between the 3 spheres of government for the delivery of services and functions by local government. For example, these principles recognised that, where the Commonwealth or a state seeks local government to provide a service or function, local government should have the opportunity to decide whether it will accept responsibility for the delivery of the service or function on behalf of another sphere of government. The Commonwealth, or state, shall negotiate with local government on the service delivery standards, financial arrangements and implementation.[b]

We consider that this agreement should reduce the likelihood that true cost shifting will occur.

a Australian Government, *Inter-Governmental Agreement Establishing Principles to guide Inter-governmental relations on local government matters*, April 2006. (See for example, www.localgovt.sa.gov.au/__data/assets/pdf_file/0006/4875/IGA_Booklet_with_Signatures.pdf)

b Australian Government, *Inter-Governmental Agreement Establishing Principles to guide Inter-governmental relations on local government matters*, April 2006, p 5.

Given the above, we have defined cost shifting as where a higher level of government **requires** local government to undertake a function that is not traditionally associated with local government, **and** does not adequately fund local government for the additional cost of undertaking the function. In our view, this definition is:

- clearer than the more general definition outlined above (and clearer than many of definitions used in previous research, discussed below)
- better suited to the context of this review, which requires us to examine the revenue framework for local government and, in particular, the controls on rates revenues and the impact this has on council finances and ratepayers
- more consistent with the direction that many councils have indicated they want to move – that is, towards autonomy in decision-making and full accountability to their local community.

In particular, 3 key features of this definition help make it clearer and easier to apply in practice. First, to be considered cost shifting, the transfer of responsibilities must be mandatory; that is, local government cannot choose to not provide the service or

function. This excludes circumstances where local government is encouraged to provide a service.

Second, the function transferred must be one not traditionally associated with local government. For example, the provision of pensioner rebates on rates bills would meet this test, as such concessions are an equity/distribution issue normally addressed by higher levels of government. However, the costs of meeting stricter regulatory requirements would not, as compliance with relevant regulation is a normal part of council business. Thus, an increase in costs due to changes in regulation is seen as an increase in the cost of doing business, not cost shifting.

Third, the function transferred must be unfunded. That is, not only does local government not have a choice in providing the service or function, but to do so it must either cut other services or increase rates or other charges.

These 3 features also make our definition better suited to the context of this review, as they are directly relevant to the question of the framework for regulating council revenues and the impact of rate pegging. We consider that in principle, there is a stronger case for transferred functions that meet these requirements to be funded through a specific, transparent adjustment in rates, or other revenues, or through government transfers.

We recognise that there are circumstances where local government's freedom of choice may be severely constrained. For example, it may be difficult for a local council to withdraw a well-established service that is important to the local community. However, we still consider that the distinction between situations where the higher levels of government require local governments to provide a service that local government does not normally undertake, and those where this is essentially voluntary, is one that is worth making.

9.3 What examples of possible cost shifting did stakeholders provide?

In their submissions to this review, several councils provided examples of cost pressures arising from changing responsibilities which may represent cost shifting (see Table 9.1). As well, an LGSA survey of councils identified 23 functional areas that councils consider to be examples of cost shifting.[154] We considered these examples, as well as other potential sources of cost pressure on councils. We found that they can be grouped into the following categories:

- **Asset transfers:** assets are transferred to local government without an adequate funding base.
- **Legislative mandates:** local government is required by legislation to undertake a task that is outside of its ordinary functions and an additional source of revenue is not provided.

[154] LGSA, *The Impact of Cost Shifting on Local Government in NSW: A survey of Councils – financial year 2007/08*, Appendix A.

- **Discretionary expenditure:** local government chooses to provide additional services, which higher levels of government may encourage them to provide (eg, through the provision of subsidies).
- **Functional costs:** local government incurs additional costs as a result of a stricter regulatory requirement by a higher level of government, and meeting this requirement is a condition of doing business.
- **User pays:** a business owned by a higher level of government increases charges to local government.

In our view, only the first 2 of these categories – asset transfers and legislative mandates – meet our definition cost shifting, as local government has no choice but to take on the responsibility and incur the associated costs. We consider that none of the examples provided by stakeholders fit into the asset transfers category, and only 1 example (pensioner rebates) fits into the legislative mandates category.

The remaining 3 categories do not represent genuine cost shifting. In relation to discretionary expenditure, councils have choices about whether or not they provide these services, thus can choose whether or not they incur additional costs. In our view, community service programs fall into this category. In the case of functional costs and user charges, local government is in the same position as private sector businesses and individuals. Many of the examples provided by stakeholders fit into these last categories – including electricity and water, tipping fees, and election costs.

Some of the other examples provided by stakeholders are not cost shifting because they are associated with functions that have long been associated with local government – such as street lighting, administration of the Companion Animals Act and administration of food safety regulation.

Overall, after considering stakeholders comments, we consider there are likely to be few instances that meet our definition of cost shifting. We have identified only 2 instances: requirements to provide pensioner concessions without associated compensation; and the transfer of responsibility for regional roads to rural councils without associated funding. We note that the LGSA has done work on both these areas, and would be well placed to offer an appraisal of their impact on council finances.

Table 9.1 Stakeholder provided examples of cost pressures that may represent cost shifting

Submitter	Function/responsibility	Annual impact on council costs
Sutherland Shire Council	Valuation of all operating land, community land, roads and improvement in community land	$2m by 2010
SSROC	Street lighting	Potential 18% increase in forthcoming years
	Electricity and water	16% increase for 08/09
	Tipping Fees	29% increase
	Election costs	Increased by 120 %
Blacktown City Council	Pensioner Rebate	$1,361,578 in 07/08
	State exemptions from storm water charges	$198,650
	Public Libraries	$2.3m per annum
	Companion Animals Act	$506,103 per annum
	Noxious weed control	$125,000 p.a.
	Flood mitigation	$200,000 p.a.
	Community service programs	$120,000 p.a.
	Waste levy	$1,850,000 p.a.
	Elections	$500,000 greater than last election
	Street Lighting	$254,000 in 08/09
	Fire Brigade	$120,000 in 08/09

Source: Blacktown City Council submission to IPART, pp 7-9; SSROC submission to IPART, pp 14-18; Sutherland Council submission to IPART, p 4.

As noted above, we recognise that local governments do face real cost pressures, due to changes in the costs of services provided by other governments, increasing statutory requirements, gaps in service delivery, and rising community expectations. The first 2 of these are not unique to local government – for example, private service providers and individuals also face changes in the costs of electricity, water and other services. We consider that these 2 cost pressures can be addressed by reforms to the framework for regulating council revenues. For example, as Chapter 12 will discuss, we consider that changes to the basis for setting rate peg to ensure it accurately reflects the change in local-government-specific costs will go a long way towards addressing this issue.

In relation to the second 2 cost pressures – gaps in service delivery and rising community expectations – we note that local government has discretion in how it responds to these pressures. In principle, it can choose to not provide a new service or increase the quality of a service. If it chooses to do so, it needs to consider whether to reduce other services or seek increases in rates or other revenues. These are the same choices that it faces in other budget decisions, and so there is not a strong

argument for differentiating these cost pressures from the other cost pressures that local governments face.

9.4 What did previous research on cost shifting find?

We review several previous studies of cost shifting in Australia undertaken by the Commonwealth Grants Commission,[155] Hawker,[156] Allan[157] and the LGSA[158] (see Appendix I for additional information). In general, the findings of these previous studies suggest that cost shifting has substantially increased local government's role and responsibilities. The researchers have argued that local government's existing revenue base is insufficient to meet the growing demands placed on it, and further cost shifting is adding to this problem.

However, in our view, the definitions employed in these reviews and the conclusions derived from them bear re-examination. As noted above, we have defined cost shifting more narrowly than previous studies. In particular, we included only circumstances where a higher level of government has mandated that local government assume a function that is not traditionally associated with local government and has not provided for a commensurate increase in its revenues. We consider that the use of a broader definition is not appropriate for the purpose of our review, which is not to determine whether councils' role, responsibilities and costs have increased, but to determine how the framework for regulating council can better facilitate the effective and efficient provision of local government services.

9.5 Our conclusions on cost shifting and other cost pressures

In relation to cost pressures due to gaps in service delivery and rising community expectations, we note that local government has discretion in how it responds to these pressures. It can choose not to fill gaps or enhance services to meet expectation. Or it can consult with the local community to determine its willingness to pay for new or enhanced services through higher rates or charges.

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155 Commonwealth Grants Commission, *Review of the Operation of the Local Government (Financial Assistance) Act 1995*, 2001.

156 Hawker, D. and Burke, A., 'Rates and Taxes: A Fair Share for Responsible Local Government', *Final Report on the Inquiry by the House of Representatives Standing Committee on Economics, Finance and Public Administration*, October 2003.

157 Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government - Final Report*, May 2006.

158 Local Government and Shires Associations of NSW, *The Impact of Cost Shifting on Local Government in NSW: A Survey of Councils,* Prepared for the Independent Inquiry into the Financial Sustainability of Local Government in NSW, April 2006.

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22 When cost shifting is defined in a way appropriate to the focus of this review – ie, as the mandatory transfer of functions not traditionally associated with local government by a higher level of government without appropriate changes in funding -- only a few sources of councils' cost pressures are considered to be cost shifting.

23 Where an instance of cost shifting that meets this definition is found to have occurred, the framework for regulating council revenues should specifically allow for councils' regulated revenues to be adjusted to recover the associated costs.

24 Cost pressures that do not meet this definition are best addressed by improving the framework for regulating council revenues so that regulated revenue increases more closely reflect the change in councils' actual costs.

25 Councils can respond to cost pressures due to gaps in service delivery and rising community expectations by either choosing not to fill gaps or enhance services , by consulting their community to determine its willingness to pay for new or enhanced services through higher rates or charges.

10 Has NSW councils' efficiency and effectiveness affected their financial sustainability?

In addition to cost shifting, stakeholders and commentators identified councils' own levels of efficiency and effectiveness as a potential factor impacting on their long-term financial sustainability. More specifically, they suggested that improvements in these levels could enhance councils' sustainability.

To investigate this suggestion and consider how the framework for regulating council revenues might be used to facilitate improvements in councils' levels of efficiency and effectiveness, we considered how these levels are currently measured and reviewed available data to assess the potential for improvement. The sections below provide an overview of our findings, and discuss the findings in more detail.

10.1 Overview of findings on councils' potential to improve efficiency and effectiveness

We found that data on measures of councils' efficiency and effectiveness are not widely available, making it difficult to make aggregate comparisons. However, existing evidence tends to suggest that councils can improve their efficiency and effectiveness in some areas. We consider that conducting regular community satisfaction surveys would provide councils with an important tool to measure and improve their efficiency and effectiveness in the future.

10.2 How is councils' efficiency and effectiveness measured?

Typically, efficiency is defined by how well an organisation uses resources in producing goods or services. Effectiveness is defined by the extent to which an organisation accomplishes a given task in terms of the objectives it has set for itself, the standards set by regulators and/or the expectations of its customers. In local government, efficiency generally means providing services using the least cost or best available resources, while effectiveness means providing the right mix and standard of services and infrastructure to meet council policy and public needs and respond to changes in community demands.

To measure councils' efficiency and effectiveness, both quantitative and qualitative data need to be collected and examined. Various performance measurement approaches and indicators can be used, including:

- councils' internal performance measurement and evaluation systems
- productivity analysis
- comparative performance indicators
- community satisfaction surveys
- infrastructure and asset management.

Ideally, these approaches should be used in conjunction with each other to provide an accurate appraisal of councils' performance.

10.3 Our review of available data on NSW councils' efficiency and effectiveness

We examined the available data for each of the measures and approaches listed above. We found that the current reporting requirements for councils tend to focus on measures of financial or technical efficiency. These measures can be useful in helping councils reduce the costs of service provision. However, the reporting requirements don't include standard measures of service effectiveness. These measures usually involve qualitative information, and are important for assessing the effectiveness of councils' service and infrastructure provision.

Some councils do collect qualitative information; however, they tend to use the data primarily to inform their planning processes, rather than to evaluate their service effectiveness and test whether it matches community expectations. Little qualitative data are publicly available.

We consider that the collection and evaluation of qualitative data is important to ensure that improvements in councils' cost efficiency are not achieved through reductions in service quality, and that service standards align with community expectations.

10.3.1 Internal performance measurement

As part of our case study analysis, we investigated the kind of internal performance measurement councils currently undertake. We found that these include:

- comparing their performance with external industry standards and neighbouring councils for particular services, such as kerbing and guttering
- analysing potential productivity savings in areas such as administration, energy and water use

- assessing their performance against efficiency measures established by the Global Reporting Initiative (GRI), and
- commissioning consultancy reviews on their financial sustainability.

Councils often undertake internal assessments of their efficiency and effectiveness in service delivery to assist them in monitoring, controlling and improving productivity and service quality. However, there are no standard measures across all councils to enable NSW councils' performance to be measured at an aggregate level.

10.3.2 Productivity analysis

In the past, various economists have used a range of techniques to evaluate local government's performance in the delivery of specific services nationally and internationally. These studies enabled the measurement of councils' relative performance in specific service areas and quantification of their capacity for productivity improvements. In particular, Worthington's study of NSW local government using 1993 data concluded that while many councils were reasonably efficient, there was scope for productivity improvements approximately equivalent to cost reduction of up to 13% across most local government areas.[159]

However, there have been no recent studies that draw together multiple factors of local government services in NSW to quantify realised or potential improvements in local government service efficiency.[160] We note that the greater diversity in councils' roles means it is more difficult than in the past to estimate a single figure for the potential for productivity gains that is applicable to all local government areas.

In addition, there are currently no standard measures for councils' productivity in NSW. In the long term, we consider a standard measure of total factor productivity should be developed, to help both councils and their communities understand councils' relative productivity performance, and encourage councils to improve their performance. However, in the immediate term, wider use of standard measures of partial productivity and other benchmarks should be the priority.

We consider there would be benefits in expanding the reporting requirements for NSW councils to include a productivity report that highlights a council's expected and realised productivity improvements in specific service areas. This information would help inform local communities about the kind of efficiency and effectiveness gains they can expect their council to make over time. Potentially, it could also be used to inform a periodic review of the productivity performance across local government areas.

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159 Worthington, A., 'Cost Efficiency in Australian Local Government: A Comparative Analysis of Mathematical Programming and Econometric Approaches, *Financial Accountability and Management*, p 14.

160 IPART notes that two studies (Worthington, 2000; Dollery, 2005) found that there may be value in commissioning a wider review of the efficiency of local government in order to examine more accurately how efficient local government service delivery is.

10.3.3 Comparative performance indicators

The Division of Local Government currently provides a set of key performance indicators (KPIs) that councils can use to provide some indication of their efficiency in service delivery. However, it does not provide benchmarks against which councils can assess how their performance compares to that of other councils or best practice.

We note that setting such benchmarks is likely to be difficult, as previous analysis of councils KPI data has found significant difference between councils within the same council categories,[161] as well as across these categories, and across the whole sample of councils.[162] Nevertheless, some comparative performance indicators and benchmarks would be useful, provided this is combined with qualitative analysis.

10.3.4 Community satisfaction surveys

Research into ratepayer satisfaction is an effective way to measure the effectiveness of councils' service delivery. Some NSW councils undertake regular community surveys to measure levels of satisfaction and prioritise community concerns. However, there is no regular state-wide survey to aid in determining effectiveness and comparisons between councils (as there is in Victoria).[163]

In its submission to this review, the LGSA claimed "there is generally a high satisfaction of ratepayers with the services provided by councils" on the basis of community satisfaction research completed for the Allan Report in 2005.[164] This research surveyed 900 households in NSW to understand the importance they placed on different council roles and services, and their levels of satisfaction with council performance.[165] Table 10.1 provides a broad summary of the results of this research.

We note that construction and maintenance of local roads and environmental management – which constitute most of councils' infrastructure provision – were areas of high importance to ratepayers, but received low satisfaction ratings.

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161 As noted in Chapter 2, the Division of Local Government currently publishes statistics grouping councils into 11 categories, based upon population size and whether councils are urban (metropolitan, regional, fringe) or rural (agricultural, remote).

162 Dollery, 2005.

163 The results of the 2009 Local Government Community Satisfaction Survey are available at www.localgovernment.vic.gov.au

164 LGSA submission, p 9.

165 Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government - Final Report*, May 2006, p 74.

Table 10.1 Ratepayers' importance and satisfaction ratings for local government services and infrastructure, 2005 survey results

	Low importance	High importance
High satisfaction	Cultural and education facilities (eg, libraries, art centres, festivals) Recreation services and facilities (eg, pools, sporting fields, parks)	Waste collection Provision of commercial services and facilities (eg, water and sewerage, caravan parks) Appearance/upkeep of public areas
Low satisfaction	Economic development (eg, promotion of business and tourism) Town planning and processing of development applications Traffic management and parking facilities Health and human support services (eg, child, youth and aged care services)	Construction and maintenance of local roads, footpaths, kerbing Environmental management (eg, stormwater, bush care, noxious weed control)

Source: Allan Report, p 74.

In our 1998 report *Benchmarking Local Government Performance in NSW* we recommended that councils undertake an annual survey of community satisfaction with their performance, and that the then Department of Local Government and the LGSA should develop this survey for use by all councils.[166]

We still consider that such a survey should be implemented as a primary measure of the effectiveness of local government service delivery and infrastructure provision. Appropriate analysis of and response to the findings of these surveys will do much to improve and maintain the effectiveness of local government.

10.3.5 Infrastructure and asset management

There are several potential indicators of councils' efficiency and effectiveness in infrastructure and asset management. As noted above, ratepayer satisfaction surveys can be used to assess the community's satisfaction with the provision of key infrastructure such as local roads, public areas, and cultural and recreational facilities. The findings of the 2005 survey discussed above indicate low levels of satisfaction with local roads, which suggests councils may be under-investing in the maintenance and renewal of this infrastructure.

In submissions to this review, several stakeholders noted that NSW councils' perceived infrastructure backlogs were an indication of under-performance in this area. However, we note that a council's infrastructure backlog may be a product of inefficient behaviour, external financial pressure or a combination of both. (Chapter 8 discusses infrastructure backlogs in detail.)

[166] IPART, *Benchmarking Local Government Performance in NSW*, 1998, p vi.

The Urban Development Institute of Australia submitted there are structural and procedural inefficiencies that diminish the efficiency of councils' use of rate revenue for infrastructure. It pointed out "there are no third party review processes to confirm that councils are making prudent assessments of infrastructure demands and ensuring efficient procedures and structures for delivering the infrastructure in a timely fashion."[167] We note that the Division of Local Government has developed measures to improve the asset management reporting system of local government (see Chapter 4).

IPART findings

26 There are no standard measures for the productivity of local government service delivery. Requiring councils to report on both expected and realised productivity improvements for individual services would inform a potentially wider review of the productivity of local government.

27 There are no standard measures for the effectiveness of local government service delivery and infrastructure provision. Requiring councils to undertake a regular, common community satisfaction survey would provide an important tool for measuring this effectiveness and helping councils to improve in areas where satisfaction is found to be low.

Recommendations

6 That the Division of Local Government require councils to report on both expected and realised productivity improvements.

7 To facilitate improvement in councils' efficiency and effectiveness, that the Division of Local Government:

- Require all councils to conduct a community satisfaction survey every 4 years to measure satisfaction with service delivery and infrastructure provision in key areas, and publish the results in their annual report.
- Together with the LGSA develop this survey for use by all councils.

[167] Urban Development Institute of Australia submission to IPART, 20 September 2008 p 5.

11 How can the current arrangements for regulating council revenues be improved?

As Chapters 5 to 8 have discussed, our review did not find strong evidence that rate pegging has adversely affected the average financial position or long-term financial sustainability of councils in NSW. However, this does not mean that the current arrangements for regulating council revenues are without shortcomings. Based on our analysis and stakeholder consultations, we have identified a range of ways in which these arrangements can be improved to better facilitate the efficient and effective provision of local government services and infrastructure, and better comply with the principles of good regulatory practice. The sections below provide an overview of our findings, and explain these findings in more detail.

11.1 Overview of findings on how the current regulatory arrangements can be improved

We considered the fundamental question of whether or not it is necessary to continue regulating councils' revenue at all. We do not recommend the abolition of rate pegging at this stage for the following reasons.

- The primary objective of regulating rates revenue in NSW appears to be protecting ratepayers from excessive increases in rates.
- Many local governments have expressed a strong desire to be free of rate pegging but we have also noted the concerns of ratepayers which compete with those of the councils. While councils (eg, Junee)[168] have cited surveys that indicate community support for the abolition of rate pegging, other surveys (eg, IRIS quoted in Dollery's submission)[169] provide evidence that there is support for retaining rate pegging.
- We consider that the current arrangements are not currently strong enough to rely solely on the accountability of local councils to their electorate to protect ratepayers and other members of the community.
- Some councils wish to continue rate pegging.[170]

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168 Junee Council submission to IPART, September 2009, pp 3-4.

169 Dollery, B submission to IPART, September 2009, p 20. IRIS Research (2005) Opinion poll of local government in NSW, in Inquiry into the Financial Sustainability of NSW Local Government (Allan Report) (2006), *Are Councils Sustainable: Final Report and Recommendations, Volume Two* (Sydney: NSW Local Government and Shires Association).

170 For example, Dungog Council expressed this view at the Lake Macquarie Public Workshop.

- Finally, we note that for many councils, particularly those councils with very small populations (ie, less than 10,000 people) providing them with the flexibility to increase rates beyond the rate peg amount may not help to improve their financial position.
- In the longer term the abolition of rate pegging may be possible if Option B is successfully implemented by a significant number of councils.

In addition, we consider that it continues to be appropriate for this regulation to apply to rates revenue only. This approach protects ratepayers, while still allowing councils some autonomy in setting user fees and charges. Protection for ratepayers is justified because ratepayers cannot choose not to pay rates if they consider them to be too high. The only discretion they have is to move, or to vote the council out at the next council election. In contrast, the users of council services that attract a charge or fee can decide not to do so if they are not willing to pay the applicable charge or fee.

On the assumption that the regulation of rate revenue is to continue, we found that the current framework for regulating council revenues should be improved to:

- increase the transparency of the method for setting the rate peg and the criteria and process for approving special variations
- improve the method for setting the rate peg so it more accurately reflects the change in councils' costs
- encourage councils to take a longer term approach to planning and budgeting and improve their financial sustainability
- encourage councils to increase their accountability to their community by improving community engagement and community involvement in their planning and decision making
- more effectively encourage councils to improve the efficiency and effectiveness of their service provision, and
- take better account of the diversity among councils.

11.2 Improve transparency

Several stakeholders expressed concern that the current approaches for setting the rate peg and approving an application for a special variation to this amount are not transparent. We share this concern. As Chapter 4 noted, in the 30 or so years since rate pegging was introduced there has not been a clear explanation of the methodology used to set the rate peg.[171] In addition, the basis on which councils' applications for special variations are assessed is not sufficiently clear. While the Division of Local Government provides guidance on the special variation application

[171] Abelson, P. (2006) *Local Government taxes and Charges, Applied Economics*, pp 1-9 http://www.appliedeconomics.com.au/pubs/pdf/06_LG_taxes_and_charges.pdf

process, content and format, it does not clearly explain the criteria that will be used to decide whether or not applications will be approved.

We also note that the Division does not make information on the special variation applications it receives readily available until after the approval decisions are made. While ratepayers (and the community) within each local government area can obtain details from their own council, there is no mechanism in place for a review by the community of all applications. We acknowledge that the Division's Annual Report discloses the Minister's decisions on each application for a special variation, including the reason for the application, the increase approved, and the period for which the increase is to apply. However, this report is not released until after some months after the decisions have been announced.

We consider that the transparency of the framework for regulating council revenues should be improved by publishing clear explanations of the methodology for setting the rate peg and the criteria for assessing applications for special variations. The transparency of the process for assessing special variation should also be improved by making applications for special variations publicly available on the Division's website before the decisions are made, and publishing a summary of the Minister's decisions and reasons for those decisions on this website after the decisions are made.

In addition, stakeholders expressed other concerns about the special variations process that suggest it can also be improved to better reflect other principles of good regulatory practice. Some submitted that the process is unpredictable, unnecessarily complicated, and expensive to administer. Others argued that it creates uncertainty for councils in relation to their future planning and budgeting. For example, in its submission, the City of Sydney noted that:

> … removing the potential for political considerations and streamlining the process [for special variations] could increase the certainty of the outcome and facilitate improved financial and program planning for the coming year.[172]

REROC submitted that while the Minister can and does approve requests for special variations, its members:

> … would agree with comments made in the UTS Paper stating that the response to requests is inconsistent [and] "there have been marked differences in receptiveness from year to year" and noting that for some the approval comes only "after the council concerned has had to devote substantial resources to making its case and has been subjected to intense scrutiny".[173]

Our analysis of special variations applications over time provides some support for these concerns. This analysis indicates that on average over the last 7 years 21% of all NSW councils have applied for a special variation each year (Table 11.1). Over a longer period (from 1994/95 to 2008/09), nearly 80% of councils have applied for a

[172] City of Sydney submission to IPART, p 20.
[173] REROC submission to IPART, p 4.

special variation at least once, while 45 applied 5 times or more.[174] This shows that councils are using the special variations process fairly extensively, which may not be efficient.

Table 11.1 Applications for special variations under Section 508(2) and 508(A), 2003/04 to 2009/10

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Rate peg (%)	3.6	3.5	3.5	3.6	3.4	3.2	3.5
Number of applications for special variation received	23	25	42	46	34	26[a]	30
Number of applications for special variations approved	23	22	30	39	30	24[a]	18

a Includes 2 applications from 2007 under section 508A that were approved for 2008/09 under section 508(2).

Source: NSW Department of Local Government *Annual Report 2007/08* and Division of Local Government.

Recommendations

8 That the framework for regulating council revenues should clearly explain the methodology used to determine the rate peg and the criteria used to assess applications for special variations.

9 That all applications for special variations should be publicly available on the Division of Local Government's website, along with a summary of the Minister's decisions and reasons for those decisions.

11.3 Improving the method for setting the rate peg

Some stakeholders criticised the current rate pegging approach on the grounds that the regulated annual rate increases do not reflect the actual increase in local government's costs. For example, the LGSA submitted that its research has found that over the period 1997 to 2002, the maximum increase in rates allowed under rate pegging (ignoring special variations) was 16.4% while based on its estimates local government costs had risen by 24.3%.[175]

Our analysis supports this view. As Chapter 3 noted, since its introduction the rate peg has closely corresponded to the change in the CPI (see Figure 3.1, p 27). However, our analysis of our 11 case study councils indicated that local government costs have increased by significantly more than this change over the past 10 years. In particular, we estimated that on average, the case study councils' costs increased by

174 Department of Local Government, unpublished data.

175 LGSA, *NSW Local Government Rate Determination Model*, prepared by the National Institute of Economic and Industry Research, 2003.

6.2% more than the maximum increase allowed by the rate peg (and 7.7% more than the change in the CPI) over this period.[176]

In addition, our analysis of the case study councils' costs suggests that general economic indicators (such as the CPI and Average Weekly Earnings) are not a suitable basis for estimating changes in local government costs, and can significantly over or under estimate increases in these costs.[177] In particular, broad economic indexes do not accurately capture changes in council costs due to changes in the composition of their services or service levels.

We consider it important that the rate peg is based on cost change estimates that are as accurate as possible. Under estimates can expose councils to cost pressures (such as those discussed in Chapter 9) and make it difficult for councils to meet community demand for services without reducing the effectiveness of service delivery. Over estimates can undermine the incentives for councils to improve their efficiency.

Therefore, we consider that the rate peg should be set with reference to a local-government-specific cost index. The index would better reflect the composition of councils' costs and the relative importance of individual costs, and so would provide a more accurate estimate of the change in council costs.

In addition, we consider that the cost index should be developed, maintained and published by an independent party, using audited local government data. It should also be reweighted periodically, to ensure that it captures changes in the composition and relative importance of councils' costs over time. This approach is similar to the one we use in maintaining the cost indexes used in regulating other industries, such as taxis and ferries. It would provide for greater transparency, rigour and independence in estimating cost changes.

IPART findings

28 The framework for regulating council revenues should provide for regulated rate increases to be set with reference to a local-government-specific cost index.

29 This cost index should be developed, maintained and published by an independent party using audited local government data, and should be periodically reweighted.

11.4 Encourage councils to take a longer term approach to planning and budgeting and improve financial sustainability

As Chapter 4 discussed, the Division of Local Government recently introduced an Integrated Planning and Reporting Framework for NSW councils. This framework requires all councils to develop longer term strategic, delivery and resourcing plans. We strongly support this requirement, as we consider longer term planning horizons

[176] Appendix J, Table J.2.
[177] See Appendix J.

will improve councils' financial management and better enable them to improve their long-term sustainability.

In addition, we consider that the framework for regulating council revenues should reinforce this requirement. We note that the current rate pegging arrangements allow councils to seek a special variation for a period of up to 7 years. However, most councils appear to take a short-term approach. For example, over recent years, most of applications have been for a single year only. Only a few councils have applied for a much longer special variation.

The framework for regulating council revenues could more effectively encourage councils to take a longer term approach to planning revenues and expenditures, and strengthen the links between this planning and strategic planning by:

- incorporating a multi-year approach to determining special variations and rate paths
- linking rate pegging and special variations to the planning and budgeting processes required under the Integrated Planning and Reporting Framework (which establish efficient levels of capital and operating expenditure for a number of years into the future).

We note that for some councils, achieving long-term financial sustainability is likely to require major financial restructuring that will need to be implemented over time, to protect ratepayers from price shocks. Therefore, it is also important that the framework provides scope for councils to use medium-term revenue paths to improve their financial sustainability.

In addition, as Chapter 9 noted, where genuine cost shifting is found to have occurred, the framework should specifically allow for councils' regulated revenues to be adjusted to recover the associated costs.[178]

By having a medium term focus for its revenue requirements, a long term strategic plan and adopting a responsible approach to the use of debt for capital works, councils would be in a much better position to address their infrastructure backlogs.

IPART finding

30 The framework for regulating council revenues should:

- Encourage councils to take a longer term approach to planning expenditures and revenues, and strengthen the links between rate setting and the Integrated Planning and Reporting Framework.
- Provide scope for councils to develop medium-term revenue paths that enable them to improve their financial sustainability.

[178] See our definition cost shifting in Section 9.2.

11.5 Creating additional incentives for councils to increase community engagement and involvement in decision making

As Chapter 4 discussed, the new Integrated Planning and Reporting Framework will help to increase councils' accountability to their community by providing a stronger focus on community engagement and involvement in decision making. However, for this framework to succeed, councils need further encouragement and assistance to better engage their community and make it easier for community members to access information and provide input on council decisions.

We recommended some specific measures for this in Chapter 4. In addition, we consider that the framework for regulating council revenues should build on these measures by providing additional incentives for councils to improve their accountability to the community.

IPART finding

31 The framework for regulating council revenues should create additional incentives for councils to improve their accountability to their community.

11.6 More effectively encouraging councils to improve their efficiency and effectiveness

In competitive businesses, the threat from competitors and the drive to increase profits provide a strong incentive to reduce costs by improving efficiency. In monopoly service providers like councils, this incentive is not as strong. One of the aims of regulation should be to strengthen this incentive, while also ensuring that cost savings are not achieved at the expense of effective service delivery.

In principle, we consider the current rate pegging approach can create an incentive for councils to pursue efficiency gains. By limiting councils' scope to increase their rates revenue, this approach can create an incentive for them to seek out ways to reduce the costs of service delivery in order to meet their community's often increasing service needs or demands.

However, as Chapter 10 discussed, NSW councils are not currently required to report against comprehensive measures of efficiency and effectiveness. In particular, there are no standard measures of service effectiveness or productivity. This makes it difficult to assess councils' performance in this area, or draw inferences about how well the current regulatory arrangements encourage councils to improve their efficiency and effectiveness.

Nevertheless, we consider the current rate pegging approach is unlikely to be effective for several reasons. First, as discussed in the section above, the rate peg does not appear to be based on accurate estimates of the change in councils' costs. This can make it difficult for councils to meet community demand for services

without reducing the effectiveness of service delivery, or undermine the incentives for them to improve efficiency.

Second, to effectively encourage improved efficiency **and** improved effectiveness, this approach would need to have regard to:

- The change in councils' expenditure requirements, taking into account changes in both the costs of service delivery and the demand for services or service quality.
- The potential for councils to make productivity gains.

Otherwise, regulation could result in a mismatch between councils' allowed and required revenues, which could result in **reduced** levels of efficiency and effectiveness.

The current framework for regulating council revenues does not appear to meet these requirements. The special variations process provides some scope for changes in demand for services and service quality to be taken into account. However, as the process is not transparent, the extent to which this occurs is not clear. In addition, as there is no requirement for councils to measure and report on their service effectiveness, there is no way to assess whether councils are increasing their efficiency or reducing their effectiveness to constrain their expenditure in line with the rate peg. Further, as there is no requirement for councils to measure and report on their productivity, the potential for productivity gains cannot be assessed or taken into account.

We have already identified the need to require councils to measure and report on indicators of service effectiveness and productivity (see Chapter 10) and to improve the transparency of the special variations process (see section 11.2). In addition, we consider that the framework for regulating council revenue could more effectively encourage councils to improve their efficiency by explicitly indicating the productivity gains they are expected to meet. This can be done by making a separate, transparent, productivity adjustment to the measured change in the cost index on which the rate peg is based.

We also note that there is a third reason why the current regulatory framework may not be effective in encouraging councils to improve their efficiency – that is, for this framework to provide a strong economic incentive for councils to improve their efficiency, it would need to constrain their total revenues. In general, the findings of our comparative analysis (discussed in Chapter 5) show that although rate pegging has constrained NSW councils' taxation revenues, substitution with revenue from other sources, particularly user charges and fees, has enabled their total average revenues to grow at a rate relatively consistent with that of other Australian councils. This suggests that the current approach has not provided a stronger constraint on councils' total expenditure than normal political or community pressures.

However, we don't consider the regulatory framework should be changed to address this issue. As Chapter 4 discussed, we consider it appropriate for the framework to continue to focus largely on rates revenue and allow councils some autonomy in setting user charges, given ratepayers' greater need for consumer protection. In addition, as Chapter 5 noted, the recent slowing of growth in NSW councils' revenue from user fees and charges suggest that councils may have taken up available opportunities to increase their revenue from this source, and that political and community pressures may be sufficient to keep future increases in check.

IPART finding

32 The framework for regulating council revenues should include an explicit, transparent productivity adjustment.

11.7 Taking better account of the diversity among councils

As Chapter 2 discussed, NSW councils differ significantly in terms of the size and populations of the area they serve, which leads to very different expenditure needs and scope to raise rates revenue. This diversity is reflected in their different attitudes towards the current approach to rate pegging:

- Some councils object strongly to the current approach on the grounds that it denies them the autonomy to set revenue policies in a way that allows them to provide the range and quality of services their community demands. These councils tend to be those that are in a relatively strong financial position and rely on rates for a large proportion of their revenue.
- Other councils support rate pegging as they find it politically difficult to increase rates, and regulated rate increases help them to justify increases in their local government area. These councils tend to be small rural councils.
- For a relatively small number of councils, rate pegging is largely irrelevant because rates contribute only a small proportion of their total revenue. These councils tend to be rural councils that serve large geographic areas with relatively small populations (less than 10,000 persons). The ratepayers in their areas tend to be declining in number and on limited incomes, so may not be able to afford significant rate increases. These councils usually receive a large portion of their total revenue from grants and subsidies. In submissions and at the public workshops, a number of these councils strongly put the view that a move away from traditional rate pegging would not help them to increase their revenues sufficiently to match their expenditure requirements.

It is important that the framework for regulating council revenues is flexible enough to take account of councils' different needs and circumstances. However, we note that it may not be possible for the framework to address **all** councils' needs.

IPART finding

33 The framework for regulating council revenues should be more flexible in order to take better account of the diversity among NSW councils.

12 Overview of our recommended framework for regulating council revenues

The findings of our analysis and consultations on the framework for regulating council revenues (discussed in the previous chapters) have led us to conclude that:

- Ideally, NSW councils should have more autonomy in determining their own-source revenue policies. However, the current arrangements are not strong enough to rely solely on the accountability of councils to their electorates to protect consumers from unreasonable increases in local government rates and charges. Therefore, some form of regulation continues to be required.
- This regulation should continue to apply to councils' general income only (which consists primarily of rates revenue), as there is a greater need to protect ratepayers than users of council services. This is because ratepayers have no choice but to pay rates, while users have some discretion over whether or not they use council services (see Chapter 4).
- There is no clear evidence that rate pegging has had a significant negative effect on NSW councils' financial position, or has been the only contributing factor in determining their financial sustainability or causing their infrastructure backlogs (see Chapters 5 to 8). Therefore, there is no reason why rate pegging should not continue to be a key element of the framework for regulating council revenues.
- The current framework requires important reforms to better facilitate efficient and effective provision of local government services and infrastructure in NSW. In particular, reforms are needed to:
  - Improve the transparency of the regulatory framework, and provide for greater rigour and independence in calculating the basis of regulated rate increases.
  - Encourage councils to take a longer term approach to planning their revenue and expenditure, and link these budgeting processes to the Integrated Planning and Reporting framework.
  - Provide incentives for councils to improve their engagement with and accountability to their community.
  - Encourage councils to improve their efficiency and effectiveness.
  - Encourage councils to improve their financial management and provide greater scope for them to improve their long-term financial sustainability.
  - Take better account of the diversity among NSW councils (see Chapter 11).

Given these conclusions, we have developed a new framework for regulating council revenue that retains rate pegging, but builds on and improves this approach. Our recommended framework incorporates all the improvements outlined above. It also links to and builds on other elements of the broader framework for regulating councils, particularly the Integrated Planning and Reporting Framework. In addition, it incorporates some of the features of the pricing frameworks developed for regulated utilities in recent years.

The sections below provide an overview of our recommended framework, and explain how it differs from the framework outlined in our draft report. The subsequent sections explain how the framework incorporates the improvements outlined above. Chapters 13 to 16 discuss key aspects of the framework in detail.

12.1 Overview of IPART's recommended framework

Our recommended framework provides 2 alternative options for regulating the increase in councils' rates revenue - Option A and Option B.

Option A is the default regulatory mechanism for all councils under the framework. It maintains the general rate pegging approach, but provides for greater transparency, rigour, and independence in the process for setting regulated rate increases and assessing applications for special variations. It also creates incentives for councils to adopt longer planning horizons and improves the links between rate setting and strategic planning. In addition, it encourages councils to improve their accountability to the community and their efficiency and effectiveness, and should make it easier for many of the councils currently in poor financial shape to improve their sustainability over time.

Option B is the alternative regulatory mechanism that is available only to councils that meet specified eligibility requirements. This option provides councils with the opportunity to gain greater autonomy over rate setting by meeting a set of minimum financial performance standards, developing a 4-year revenue plan, and obtaining a mandate from the community to implement the plan. Thus it creates further incentives for councils to develop effective systems for engaging and consulting with their community, and to achieve high standards of financial management, planning and reporting. Councils would need to apply to operate under Option B and the Minister would confirm their eligibility.

The outcomes for ratepayers are more assured under Option A than under Option B. However, in some cases the outcomes may be better and more consistent with community preferences under Option B, given the diversity of councils. In addition, by providing the scope for councils to progressively move towards Option B, the framework is more consistent with the principles of subsidiary and democracy (especially participation and accountability), and with the position of local government as a genuine third tier of government.

Once a council achieves Option B status, it would retain that status at the end of the 4-year life of its revenue plan, provided it continued to meet the specified financial performance requirements and comply with the requirements of the Integrated Planning and Reporting Framework. It would not need to re-apply to the Minister for eligibility to operate under Option B. However, it would need to review its revenue plan and confirm that its community continues to support the (existing or revised) plan. If community support cannot be demonstrated, the council would revert to Option A.

Recommendations

10 That the NSW Government continue to regulate councils' general income (as defined for the purpose of regulating council revenue), and introduce a new regulatory framework that:

- provides 2 options for regulating council revenues (Option A and Option B) as outlined in Recommendations 11 and 12
- introduces 4-year rate setting horizons
- establishes a closer relationship between rate setting and councils' strategic planning.

11 That Option A be adopted as the new default arrangement for all councils, and that this option retains rate pegging and:

- provides for the Minister to determine annual regulated rate increases with reference to the change in a Local Government Cost Index (LGCI), which would be independently calculated and published, and a productivity adjustment factor
- retains the option for councils to apply for a special variation and establishes transparent criteria for assessing these applications
- provides that councils applying for multi-year special variations must develop medium-term revenue paths and meet other minimum eligibility requirements.

12 That Option B be adopted as an alternative form of regulation that operates in conjunction with Option A, and that this option:

- provide eligible councils with greater autonomy over rate setting that is balanced with greater accountability to their community to ensure that rate setting is consistent with a community mandate
- be available only to councils that have sought and received Ministerial approval to operate under Option B on the basis that they meet specified minimum eligibility criteria.

12.2 Changes to the framework since the draft report

The recommended framework for regulating council revenues is broadly the same as the one proposed in our draft report. In finalising this framework, we considered stakeholders' comments on the proposed framework expressed in submissions and public workshops. These comments generally supported the direction of the framework, and suggested some specific changes to it.

For example, Maitland council noted that although it considers that rate pegging has run its course in NSW, it supported the options presented as an important step in improving the current regulatory framework. It also noted that Option B aligns with the Integrated Planning and Reporting Framework, including 4-year Delivery Programs.[179] WSROC indicated that the proposals for both Options A and B "don't seem unreasonable subject to some refinements." In particular, Option A would need to provide revenue for unfunded works that have accumulated over the years in some local government areas.[180]

Wagga Wagga City Council considered that Option B was an appropriate regulatory mechanism for increasing local government's autonomy in determining the required level and mix of rates, annual charges and fees to fund services and renew infrastructure. However, it argued that the proposed eligibility criteria were too strict.[181] In relation to Option A, it suggested that IPART (rather than the Minister) should determine the annual regulated rate increase, and that this should be provided for in the Local Government Act.[182]

Other councils put the view that the proposed framework did not go far enough in terms of providing for and encouraging greater autonomy. For example, Newcastle City Council stated:

> Whilst there is a rate pegging default consideration attached to Option A, Council believes that this should be a short term default option with the ultimate goal that all councils will satisfy the criteria and be eligible for the rate setting autonomy afforded by Option B. This option provides Council with greater flexibility, however comes with higher standards of accountability. It is considered that it should be the goal of all LGAs to attain this level of autonomy and perhaps the government consider mandating a period of expectation for all councils compliance.[183]

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179 Maitland Council in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 16 September 2009 at Lake Macquarie City Council, Speers Point.

180 WSROC in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 2 September 2009 at Grace Hotel, Sydney, p 18.

181 Wagga Wagga City Council in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 8 September 2009 at Country Comfort Motel, Wagga Wagga.

182 Wagga Wagga City Council in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 8 September 2009 at Country Comfort Motel, Wagga Wagga.

183 Newcastle Council submission, p 3.

Coffs Harbour Council[184] proposed an Option C which would allow a council to set its own rate base for a 10-year period in line with its long-term planning and financial modelling. Other councils proposed the complete abolition of rate-pegging.

After considering stakeholders' views, and reviewing the proposed framework, we made some changes to the specific details of the framework. These included changes to:

- allow greater flexibility in applying for a rate variation under Option A
- bring forward the timing of the release of the Local Government Cost Index to November
- relax the criteria for eligibility to be regulated under Option B
- introduce an option of a sample survey to engage the community under Option B
- separately identify the productivity adjustment.

We also considered the complete abolition of rate pegging but have not proposed this as an option at this stage. While we have noted the strong desire of local government to be free of rate pegging, we have also noted the concerns of ratepayers. In the longer term, the abolition of rate pegging may be possible if our recommended framework is successfully implemented by a significant number of councils. However, we do not recommend the abolition of rate pegging at this stage.

12.3 Providing for greater transparency, rigour and independence

The recommended framework makes the regulation of council revenue under Option A more transparent by:

- providing for the Minister to determine the regulated rate increase (or rate peg) with reference to the change in a Local Government Cost Index and a productivity adjustment factor, both of which will be calculated and published each year
- providing for the Minister to explain the reasons for any difference between the rate peg and the change in the Local Government Cost Index minus the productivity factor
- establishing criteria for assessing applications for medium-term revenue paths (which incorporate special variations), and providing for the Minister to summarise the reasons for his/her decisions to approve/disapprove individual applications
- providing for all applications for medium-term revenue paths to be published on the Local Government Division's website prior to decisions being made, and for the decisions and a summary of the reasons for these decisions to be published after the decisions are made

[184] Coffs Harbour City Council submission to IPART, 18 September 2009.

- encouraging councils to improve their community engagement to ensure more widespread understanding of their revenue and expenditure plans.

The recommended framework provides for greater rigour in setting regulated rate increases by providing for regulated rate increases to be set with reference to the change in a Local Government Cost Index. In addition, it specifies that this index will be developed and maintained by a third party (eg, not the Division of Local Government or the LGSA), which provides for independence in calculating the change in the index.

The recommended framework provides for greater transparency and independence under Option B by providing for councils to determine their own medium-term revenue path provided that they demonstrate they have consulted their community and have a mandate for their proposed path.

12.4 Encouraging councils to take a longer term approach to revenue and expenditure planning and link this to their strategic planning

Under the recommended framework, both Option A and Option B are designed to encourage councils to develop medium-term revenue paths and improve the links between rate setting and their strategic planning under the Integrated Planning and Reporting Framework. For example:

- Under Option A councils applying for medium-term revenue paths must demonstrate that they have met the requirements under the Integrated Planning and Reporting Framework, including developing a 4-year Delivery Program. They must also show that their application for a special variation is consistent with a 4-year revenue plan that aligns with this Delivery Program. This approach contrasts with the current arrangements under which councils have tended to take a short-term view by seeking 1-year special variations.
- Under Option B, councils set rates for 4-year periods that align with the electoral cycle. They are required to develop 4-year revenue and expenditure plans that are consistent with their strategic planning under the Integrated Planning and Reporting Framework.

12.5 Providing incentives for councils to improve their engagement with and accountability to their community

The recommended framework provides strong incentives for councils to improve their engagement with and accountability to their community. These incentives build on the requirement under the Integrated Planning and Reporting Framework for councils to have community engagement strategies, and our recommendations for strengthening this requirement and providing additional guidance set out in Chapter 4 (see Recommendation 2).

Under Option A, councils applying for a special variation must show that they have involved their community in developing their strategic projects, their expenditure on these projects and their rate revenue requirements. They are also required to publish delivery and resourcing plans and revenue requirements, hold public meetings and seek feedback from the community.

To be eligible for regulation under Option B, councils are required to meet a set of financial criteria and then to obtain a mandate from the community for their 4-year expenditure plans, and the rate increases required to fund the projects in these plans. This will necessarily involve considerable community engagement and involvement in the planning and decision making process. In return, councils will be given a high level of autonomy in rate setting. Given the strong desire for such autonomy expressed by many stakeholders, we consider that Option B will provide a strong incentive for councils to improve their community engagement and accountability.

12.6 Encouraging councils to improve the efficiency and effectiveness of service provision

As Chapter 10 discussed, councils are not currently required to report against standard measures of their productivity or service effectiveness, which makes it difficult for them to understand how their efficiency and effectiveness compares to other councils' and identify where and how they need to improve. Therefore, we have recommended changes to the current reporting requirements to address this (see Recommendations 6 and 7).

The recommended framework for regulating council revenues provides further encouragement for councils to improve efficiency and effectiveness by:

- Providing for regulated rate increases to be set with reference to the change in a Local Government Cost Index. This approach will mean that regulated rate increases more accurately reflect the actual change in councils' costs, and thus help ensure that cost pressures (such as rising electricity and water costs) do not result in reductions in service effectiveness.
- Providing for a transparent productivity adjustment. This approach will set a local-government-wide goal for productivity gains, and allow councils that can achieve greater productivity gains to keep the benefits.
- Providing that councils applying for medium-term revenue paths under Option A must demonstrate the need for rate increases above the regulated increase, and show they have community support for their proposed revenue plan. When combined with provisions for regulated increases to be based on changes in the Local Government Cost Index, this is likely to place councils under greater pressure to demonstrate that they currently provide services for the lowest possible cost, and any proposed service expansion or enhancement is in line with community demand.

- Providing that councils seeking to operate under Option B must demonstrate sound financial performance and asset management strategies, both of which are associated with high levels of efficiency. In addition, these councils must obtain a community mandate for their revenue and expenditure plans. We consider that a council could be unlikely to succeed in this unless it can show the community it provides services that are cost-efficient and in line with community demand.

12.7 Encouraging councils to improve their financial management and providing greater scope for them to improve their long-term sustainability

In Chapters 7 and 8, we made recommendations for improving reporting on financial performance and asset management (see Recommendations 3, 4 and 5). These improvements should facilitate better financial management and encourage councils to improve their long-term financial sustainability.

The recommended framework for regulating council revenues builds on these improvements. To meet the minimum eligibility criteria for a medium-term revenue path under Option A, or to operate under Option B, councils need to have sound asset management and practices and financial performance. In addition, to operate under Option B, councils have to demonstrate that they can achieve **recurrent** financial sustainability over the coming 4-year revenue path. We accept that capital sustainability is best achieved by focussing on policies and practices to improve asset management and reduce the infrastructure backlog.

The recommended framework also provides greater scope for councils regulated under Option A which are not in a position to achieve recurrent financial sustainability in the medium term to work towards this over the longer term – by using medium-term revenue paths that incorporate special variations for the specific purpose of improving their financial position. At the same time, the criteria for assessing councils' applications for medium-term revenue paths ensure that progress towards financial sustainability, and the major financial restructuring this is likely to involve, does not result in unacceptable impacts for ratepayers.

Our analysis, plus stakeholder comments in submissions on the draft report and in public workshops, indicates that NSW councils fall into 4 groups in regards to recurrent financial sustainability:

1. **Councils that are presently financially sustainable**. These are councils that have been able to retain recurrent financial sustainability while often also lifting spending over time without incurring large or recurring operating losses. This group consists of many metropolitan and some urban fringe, regional and rural councils. In past years, these councils have tended to have obtained approval for special variations and generally have a relatively high (in the order of 50%) contribution of rates revenue to total revenue.

2. **Councils that may become financial sustainable in the medium term (4 years or less)**. These councils share many of the attributes of financially sustainable councils (above). However, they generally either have a combination of lower average rates, user charges and/or higher spending levels. Through modest improvements in revenues and/or lower expenditures these councils can be reasonably expected to achieve recurrent financial sustainability over the medium term.
3. **Councils that may become financial sustainable in the longer term (10 or more years)**. This group of councils requires significant financial restructuring to achieve recurrent financial sustainability. This includes major changes to budgeted revenues and expenditures which are not immediately affordable by local communities but may be realisable over a longer period of time.
4. **Chronically financially unsustainable councils**. These councils tend to be geographically large rural councils with relatively small and often declining populations (less than 10,000 persons). This group of councils are typified by trends of recurring budget deficits, stable or falling levels of expenditure over time, relatively low contribution of rates to total revenue and a low incidence of special variations (as local communities subjected to droughts or economic decline have falling capacity to pay). Not surprisingly, given these difficulties these local government areas are heavily reliant upon grants for a substantial (40% or more) proportion of total revenue. Councils in this situation are unlikely ever to be able to raise sufficient rates revenue to achieve recurrent sustainability. Therefore, some form of intervention by higher levels of government (either in the form of additional grants revenue or reduced responsibilities) will be needed for them to be financially sustainable.

In addition, we consider that councils must achieve and maintain recurrent financially sustainability first, or they will not have the fiscal capacity to achieve capital sustainability (ie, to roll back their infrastructure backlog within a decade).

Table 12.1 sets out how we see the recommended framework applying to each group of councils in relation to recurrent financial sustainability.

Under the recommended framework for regulating council revenues, councils are encouraged to improve their **capital** financial sustainability by focussing on policies and practices to improve it. In particular:

- The Integrated Planning and Reporting Framework requires councils to develop asset management plans. Councils wishing to be eligible for Option B must have these plans audited.
- Using these asset management plans councils will be better able to develop programs to address their infrastructure backlogs and to seek either approval from the Minister for a medium term price path under Option A, or endorsement from the community for their program of works under Option B.
- By having a responsible approach to the use of debt councils will be better able to fund their infrastructure requirements.

Table 12.1-How the recommended framework applies to councils with different levels of financial sustainability

Council type	Which option is most appropriate?	Related scope and benefits
1. Currently Financially Sustainable	Option A or B	Councils are able to elect to remain within improved rate pegging (Option A) or move to independent rate setting (Option B) over 4 year term subject to the Minister's consent that a community mandate exists for changes in rates revenue and related expenditures.
2. Sustainable in the medium term (4 years or less)	Option A or B	Councils are able to introduce changes in rates revenue and expenditures to achieve recurrent sustainability within 4 years by either remaining within improved rate pegging – including a broader use of medium-term rate variations (Option A) or adopt independent rate setting (Option B) over the 4-year term subject to Minister's approval of a community mandate for changes in rates revenue and related expenditures.
3. Sustainability achieved over the long term (10 or more years)	Option A	Councils are able to introduce changes in rates revenue and expenditures to achieve recurrent sustainability by remaining within improved rate pegging – including a broader use of medium-term rate variations (Option A). Option A balances the need for financial restructuring with the need to maintain essential ratepayer protection against uncontrolled rate increases.
4. Chronically financially unsustainable	Option A	Low capacity for increasing rates revenue. Councils should increase rates to the extent reasonable (Option A). Consideration should be given to case for greater grants funding.

Source: IPART.

12.8 Taking better account of the diversity among NSW councils

The recommended framework takes better account of the diversity among councils by providing them with several options – either to apply the annual regulated rate increases, or to seek more autonomy in rate setting through medium-term revenue paths under Option A, or to seek even more autonomy through Option B. Councils' choice of option will depend partly on their situation (in terms of the size, population and community needs of the area they serve), and on their current financial performance and goals.

However, we recognise the framework does not fully address the needs of small rural councils. As Chapter 7 discussed, there is a fundamental mismatch between these councils' expenditure responsibilities and their narrow revenue base, which means they cannot raise sufficient own-source revenue to achieve and maintain long-term financial sustainability, regardless of the framework for regulating revenue. Therefore, addressing the long-term sustainability of these councils will require some other mechanism. For example, we note that the Allan Inquiry found that this is likely to require major financial restructuring of revenues and expenditures. In addition, redistributing grant income to councils most in need could assist these councils to achieve financial sustainability.

13 How Option A would work

As Chapter 12 indicated, Option A is the default regulatory mechanism for all councils under the recommended framework. This option provides essential ratepayer protection by maintaining the general rate pegging approach. However, it improves on the current arrangements by improving the transparency and rigour of key processes, and providing more scope and stronger incentives for councils to lift their performance in a range of areas to facilitate more efficient and effective provision of local government services. It also provides greater flexibility to better reflect the diversity among councils.

Under Option A, councils' general income is regulated in 2 ways: the Minister determines an annual rate peg, and eligible councils can propose and gain approval to implement a medium-term revenue path. These forms of regulation operate together. Those councils that cannot, or do not want to, move beyond regulated annual rate increases will adjust their rates in line with the annual rate peg. Councils that seek but do not gain approval to implement their proposed medium-term revenue path will also adjust their rates in line with the annual rate peg. However, they have the option to seek approval for a medium-term revenue path again in a subsequent year. Councils that are successful in gaining approval for their medium-term revenue path will adjust their rates in line with the approved path for the approved period.

The sections below explain key elements of the arrangements under Option A in more detail, including:

- how the annual rate peg will be determined
- what happens when a council increases rates by less than the annual rate peg
- how the medium-term revenue path will work, including the application process, the eligibility requirements, and the criteria for assessing applications
- what happens to a council's revenue base at the end of an approved medium-term revenue path.

13.1 How will the annual rate peg be determined?

Under the recommended framework, the Minister will continue to determine the annual rate peg. However, this decision will be made with reference to advice on:

- **The annual change in a Local Government Cost Index.** This cost index will be developed, maintained and published by IPART (as an independent body). It will provide a means to more accurately measure the average change in NSW councils' specific costs. Each year, we will calculate the annual change in the index, and advise the Minister of this change.
- **The annual productivity adjustment factor.** This factor will reflect the estimated annual potential for NSW local government to achieve productivity gains over the medium term. IPART will calculate this in the first year of every 4-year local government electoral cycle, and advise the Minister of the annual productivity factor that is to apply for each year of the cycle.

The implication of the above advice is that the annual rate peg should be set so it is equivalent to the annual change in Local Government Cost Index **minus** the annual productivity factor. This approach is consistent with the approach we use in other industries we regulate with a cost index (such as the taxi industry). It is intended to ensure that regulated rate increases accurately reflect the change in councils' costs, and encourage councils to reduce the costs of service provision by increasing their efficiency.

The Minister will have the discretion and flexibility to set the rate peg at a higher or lower level than implied by IPART's advice. However, he or she will be obliged to publish a statement of the reasons for this decision. IPART will also publish its advice and calculations in relation to the change in the cost index and the productivity factor to provide for greater transparency.

We note that one reason why the Minister might set the annual rate peg at a level greater than implied by our advice is where there has been a genuine cost shift to local government that would affect all councils to roughly the same degree. (See Chapter 9 for our definition of a genuine cost shift.) In this case, the Minister could provide for councils to recover the additional costs associated with the cost shift through the rates by adjusting the annual rate peg. In our view, a single adjustment made in this way is likely to be more efficient than requiring councils to apply for special variations to cover the associated costs.

We recognise that **not** adjusting the annual rate peg to reflect the potential for productivity gains would allow those councils that improve their efficiency to use the resulting cost savings to expand their services or help address infrastructure backlogs. But in our view, council decisions to use productivity gains for purposes other than reducing rate increases should be made in consultation with the community. Therefore, under the regulated framework, a council that wants to use productivity gains for such purposes would need to seek approval for a medium-term revenue path. To gain approval, it would need (among other things) to explain

the productivity improvements it plans to make over the duration of the revenue path, and show it has community support for its planned expenditure (see section 13.3). However, a council that achieves productivity gains higher than the adjustment factor applied to the annual rate peg would be free to choose how it uses the cost savings from the additional gains.

We also consider it important to ensure that productivity adjustments to the annual rate peg do not result in reductions in the standards of service councils provide. In our view, the annual rate peg (including any productivity adjustment) should be set in the expectation that current service levels will be maintained and that cost reductions and efficiency savings will not be obtained at the expense of service standards, unless approved by the community.

We note that our recommendation to require councils to conduct regular community satisfaction surveys is important for ensuring that this expectation is met. We also note that incentives for improved financial performance within the recommended framework for regulating council revenues, combined with our recommendations for improved setting and monitoring of key performance indicators, should drive efficiency improvements. This may mean that a productivity adjustment is not always necessary (ie, the productivity adjustment factor may be zero).

In the Draft Report, we proposed to calculate and advise the Minister of the change in productivity-adjusted Local Government Cost Index (ie, this change **after** applying the productivity adjustment factor). However, in finalising our recommendations, we decided it was preferable to calculate and advise the Minister of the change in the cost index and the productivity adjustment factor separately. The main reason for this change is to improve the transparency of both components.

In calculating the productivity adjustment factor, we will estimate NSW councils' potential to achieve productivity gains over a 4-year period, to give councils an indication of overall productivity gain they may be expected to achieve over the medium-term. However, we will convert this into an annual productivity adjustment factor to facilitate its potential application to the annual rate peg. We note that this approach will also assist councils applying for medium-term revenue paths to understand what level of planned productivity improvements might be appropriate for them.

The approaches for constructing and maintaining the Local Government Cost Index and estimating the productivity adjustment factors are discussed in Chapter 15.

Recommendations

13 That IPART:

- develop, maintain and publish the LGCI, and calculate the change in this index on an annual basis
- estimate the productivity adjustment factor in 2010/11 for 2011/12, and then in the first year of every 4-year local government electoral cycle
- provide advice to the Minister on the annual change in the Local Government Cost Index and the annual productivity adjustment factor, and publish this advice and calculations.

14 That the Minister retain the discretion and flexibility to set the regulated annual rate increase at a higher or lower level than implied in IPART's advice and, when this occurs, be obliged to publish a statement of reasons for this decision.

13.2 What happens when a council increases rates by less than the annual regulated rate peg?

The recommended framework provides those councils regulated via regulated annual rate increases with the flexibility to adjust rates by less than the regulated increase in some years, without necessarily foregoing the associated rate revenue. That is, if such a council decides to increase rates by less that the regulated amount in 1-year – for example, to address concerns about ratepayers' ability to pay – it will automatically be able to 'catch up' by increasing rates by more than the regulated increase over the next 3 years.

However, its rates must move by no more than the cumulative rate peg for the 4-year period. In addition, any foregone rate increases not caught up by the end of this period will be forfeited, and any rate peg increases for the next 4-year term would be applied to council's actual regulated revenue at the end of the period.

Recommendation

15 That a council applying the annual rate peg automatically be entitled to 'catch up' rates income foregone when it adjusts rates by less than the annual rate peg in a particular year, provided it does so over the remaining years of the 4-year period.

13.3 How will medium-term revenue paths work?

Under the recommended framework, councils regulated under Option A are able to seek approval to set rates in line with a proposed medium-term revenue path. This process replaces the 1-year and multi-year special variation application process under the current arrangements, and is intended to encourage councils to adopt longer planning horizons. It provides similar flexibility for councils to seek and obtain special variations to regulated rate increases, but incorporates some important changes:

- Only councils that meet minimum eligibility requirements are entitled to apply for a medium-term revenue path.
- As part of the application process, councils must propose a detailed medium-term revenue path (ie, rating proposal) that aligns with their 4-year Delivery Plan. They must also demonstrate that they have sought and obtained community support for the proposed revenue path, and that they meet the minimum eligibility requirements.
- Applications will be approved, varied or rejected by the Minster based on the extent to which they satisfy a transparent set of assessment criteria.
- At the end of an approved medium-term revenue path, a council's revenue base would be reset usually to the end point of the revenue path (see Section 13.4).

Note that the focus on medium-term revenue paths does not preclude councils from seeking to increase rates above the annual regulated increase for just 1, 2 or 3 years to fund non-recurrent cost items.

However, we envisage that the length of a medium-term revenue path would be 4-years. This is intended to encourage councils to align their revenue planning with their medium- to long-term strategic planning under the Integrated Planning and Reporting Framework.

13.3.1 What are the eligibility requirements?

To be eligible to seek a medium-term revenue path, a council must meet minimum requirements for planning and community consultation. These requirements build on those under the Integrated Planning and Reporting Framework, and include having developed:

- a 10-year Community Strategic Plan
- a detailed, sound asset management plan
- a 4-year Delivery Plan
- annual resourcing plans.

These eligibility requirements are intended to strengthen the incentive for councils to comply with the requirements under the Integrated Planning and Reporting Framework and thus improve their strategic and financial planning.

Councils that do not meet these requirements may not apply for a medium-term revenue path and will be subject to annual regulated rate increases until the next council election, or until they are able to meet these requirements.

13.3.2 What do the application and approval processes involve?

To seek a medium-term revenue path, a council will need to develop a medium-term revenue plan that aligns with its 10-year Community Strategic Plan and 4-year Delivery Plan. This plan will need to set out its detailed revenue requirements (in real terms) for the period of the revenue path, and indicate the implications for rate increases.

In addition, in preparing this revenue plan, the council will need to engage and consult with its community and obtain support for the plan. In our view, this will involve developing and implementing a strategy similar to the Community Engagement Strategy the Integrated Planning and Reporting Framework requires councils to use in developing or reviewing their Community Strategic Plan. In addition, the strategy will need to enable the council to **demonstrate** that it has obtained community support for the revenue plan – for example, through the results of a community survey.

In preparing its application for approval to set rates in line with the medium-term revenue plan, the council will need to:

- Provide its proposed revenue plan and 4-year Delivery Program.
- Provide adequate evidence and supporting information to demonstrate that it:
  - meets the minimum eligibility requirements (see section 13.3.1)
  - has consulted the community and received community support for the proposed revenue plan, and
  - satisfies the other criteria for assessing and approving applications (see section 13.3).

The council will need to lodge its application with the Division of Local Government by September of the year following a council election. The application will be assessed by the Division of Local Government and the Minister within 3 months of it being lodged. This assessment, and the decision to approve or reject the application, will be based on a clear set of criteria. The Division of Local Government will publish these criteria and guidelines for preparing applications annually.

The Minister will have the final authority to approve or reject applications for a medium-term path. Where the Minister approves an application, the council will be entitled to set rates in line with the approved revenue path for the length of that path. After the first year of that path, the approved rate increases will be inflated in line with the change in the Local Government Cost Index (as calculated and published by IPART).

Where the Minister rejects an application, he or she will need to provide a statement of reasons and publish the statement on the Division of Local Government's website. The council will automatically be subject to the regulated annual rate increase for that year. However, it will have the option of applying to increase rates above the

annual regulated increase in subsequent years of the 4-year cycle. However, they will need to apply for such increases in the context of a medium-term revenue plan.

13.3.3 What are the assessment and approval criteria?

Under the recommended framework, applications for medium-term revenue paths will be assessed against transparent criteria. We consider that these criteria should include:

- **A demonstrated need for the rate increases implied by the proposed revenue path.** This need may stem from:
  - **Community service requirements**. For example, to demonstrate this need a council might provide evidence of unmet demand for services, or community support for enhanced service standards.
  - **A special or unique cost pressure** faced by the council. For example, this may arise from the need to prepare audited asset management plans. It may also include the need for financial restructuring as part of a longer term plan for achieving financial sustainability.
  - **Infrastructure backlogs** that have adverse implications for the amenity, safety and health of community.
- **Demonstrated community support for the proposed revenue path.** As noted above, this may include an explanation of the community engagement and consultation strategy, and evidence of community support (such as the results of a community survey).
- **Demonstrated adequate use of debt to address capital expenditure requirements.** To meet this criterion, a council will need to develop and clearly state its strategy for funding new capital works, whether this is from rates revenue, debt, user charges or a combination of these. In developing this strategy, it should consider the extent to which it is appropriate to use debt for funding for new capital works, taking into account the Division of Local Government's benchmark ranges for the debt service ratio and the principles of intergenerational equity. As Chapter 7 discussed, our analysis of NSW councils' performance against the debt service ratio found most have the capacity to make greater use of debt.
- **Reasonable impact on ratepayers.** This criterion is important, given the primary purpose of regulating council revenues is to protect ratepayers from unreasonable increases in rates. One of the factors considered in relation to this criterion will be the evidence of community support for the proposed revenue path.
- **Adequate evidence of compliance with minimum eligibility requirements.**
- **An explanation of the productivity improvements** the council has realised in past years, and plans to realise over the proposed revenue path.

These criteria will be used to decide whether or not an application for a medium-term revenue path is approved or rejected. A decision to reject an application will be accompanied by a Statement of Reasons which will also be published on the Local Government Division's website.

As indicated above, the criteria will also be helpful in guiding councils applying for a medium-term revenue path. Such councils can increase the certainty of the outcome by ensuring that their application adequately addresses all the criteria.

13.4 What happens to the revenue base at the end of an approved medium-term revenue path?

Under the current regulatory arrangements, at the end of the period for which a special variation was granted, the council's regulated revenue base can either remain at the new level (incorporating the special variation to the regulated rate increases) or return to the previous level (so it is in line with the increases allowed under the rate peg over the period). Which occurs essentially depends on the basis on which the special variation has been granted. For example, if the variation was granted to address a one-off additional cost, the revenue base would return to the previous level.

In response to the draft report, a number of stakeholders questioned what will happen to a council's base revenue at the end of an approved medium-term revenue path. Under the recommended framework, after a council has implemented an approved medium-term revenue path, its revenue base will be reset to reflect the end point of this path. However, where a council applies for a special variation to the rate cap (for 1, 2 or 3 years), base revenue would be return to the rate peg adjusted base rate after the expiry of the special variation.

Recommendations

16 That to be eligible to apply for a medium-term (4-year) revenue path (which incorporates special variations to regulated rate increases) under Option A, councils be required to meet minimum eligibility requirements. These requirements should reflect those under the Integrated Planning and Reporting Framework, and should include councils having developed:

- a 10-year Community Strategic Plan
- a detailed asset management plan
- a 4-year Delivery Plan
- annual resourcing plans.

17 That before applying for a medium-term revenue path under Option A, a council must:

- develop a medium-term revenue plan that aligns with its 4-year Delivery Program, sets out its detailed revenue requirements and expenditure plans for the period of the revenue path (in real terms), and indicates the implications for rate increases
- engage and consult with its community in developing this plan and obtain community support for the plan.

18 That applications for medium-term revenue paths under Option A include:

- The council's proposed revenue plan and 4-year Delivery Program.
- Adequate evidence and supporting material to demonstrate that the council meets the minimum eligibility requirements, and has consulted the community and received community support for the proposed revenue plan.
- Adequate evidence and supporting material to demonstrate that the application satisfies the assessment criteria.

19 That councils be required to lodge applications for medium-term revenue paths with the Division of Local Government by September 30 of the year following a council election.

20 That the Division of Local Government and the Minister be required to assess and decide upon such applications within 3 months of lodgement.

21 That applications for medium-term revenue paths under Option A be assessed against transparent criteria that include:

- A demonstrated need for the rate increases implied by the proposed revenue path due to 1 or more of the following:
    - Service provision requirements (eg, unmet demand for services, or community support for enhanced service standards).
    - A special or unique cost pressure faced by the council (eg, due to need to prepare audited asset management plans, or undertake financial restructuring as part of a longer term plan for achieving financial sustainability).
    - Infrastructure backlogs that have adverse implications for the amenity, safety and health of community.
- Demonstrated community support for the proposed revenue path.
- Demonstrated sustainable use of debt to address capital expenditure requirements.
- Reasonable impact on ratepayers.
- Adequate evidence of compliance with minimum eligibility requirements.
- An explanation of the productivity improvements the council has realised in past years, and plans to realise over the proposed revenue path.

22 That the Minister retain the flexibility to approve, vary or reject a council's application for a medium-term revenue path under Option A based on the extent to which the application satisfies the assessment criteria. Where a council's application is rejected, a statement of reasons must be provided and published on the Division of Local Government's website.

23 That where a council's application for a medium-term rate path under Option A is rejected, the council be subject to the regulated annual rate increase for the year, and may apply again for a one-off variation in subsequent years of the 4-year cycle.

24 That at the end of an approved medium-term revenue path under Option A, a council's revenue base be reset to reflect the endpoint of that path, except where the revenue path was granted to enable the council to meet a non-recurrent cost. In this latter case, the revenue base would be adjusted to reflect the cumulative regulated rate increase for the period of the path.

14 How Option B would work

Option B provides an opportunity for councils that meet high standards of planning, reporting and financial performance to gain greater independence in setting rates and be primarily accountable to their local community rather than the State Government, as several councils indicated they would strongly prefer. Option B is an adjunct to Option A, not a standalone option. Only councils that meet specified minimum performance requirements will be eligible to apply to operate under Option B. Of those, only councils clearly able to demonstrate a community mandate for their proposed revenue and expenditure plans will be granted approval by the Minister. Once they have this approval, these councils will be able to set rates in line with their medium-term revenue paths indefinitely, provided they continue to meet the minimum performance requirements and obtain community support for their proposed revenue and expenditure plans. If they don't continue to meet these requirements or obtain community support, they will revert to regulation under Option A.

The main difference between Option A and Option B is the stringency of the eligibility requirements and approval criteria, and the level of autonomy afforded to councils. Compared to a council applying for a medium-term revenue path under Option A, one applying to operate under Option B must meet higher performance standards. To gain approval to operate under Option B, it needs to demonstrate stronger community engagement and accountability processes and provide stronger evidence of community support. However, once it gains this approval, it is entitled to set rates in accordance with its 4-year revenue and expenditure plans indefinitely, as long as it is able to demonstrate to the Minister's satisfaction that it has a community mandate for these plans and continues to meet the necessary performance standards. In contrast, a council operating under Option A must either apply an annual regulated rate increase or seek and obtain Ministerial approval to increase rates in line with a proposed medium-term revenue path every 4 years (or longer if it gains approval for a longer path). Another key differences between the options is that under Option B it is the community and not the Minister that assesses the reasonableness of the councils revenue plan.

The advantages of councils operating under Option B and thus being directly accountable to their community for rate increases include enhanced participation and democracy at the local government level, and greater ability for council decisions to reflect community preferences. While this sort of approach is unusual in Australia, it

is common in many European countries (for example Switzerland) and in many states of the United States (eg, Washington State).[185]

However, we have not recommended that councils be required to put their proposed rates or budgets to a direct vote, as is the case in some of these jurisdictions. We consider that this can undermine the principles of representative democracy and result in budgeting stalemates (as demonstrated by the budgeting problems experienced in the state of California).

The sections below explain key elements of the arrangements under Option B in more detail, including:

- The process for applying to operate under Option B.
- The requirements councils must meet to be eligible to apply, and gain approval to operate under Option B.
- What happens once a council gains this approval.

14.1 What is the process for applying to operate under Option B?

The process for applying to operate under Option B starts after a council election, and involves 2 stages.

14.1.1 Stage 1

Immediately after an election, a council would undertake the planning required under the Integrated Planning and Reporting Framework. At the same time, it would develop a 4-year revenue and expenditure plan including proposed rates and rates revenue.

If it wishes to operate under Option B, the council must apply in writing to the Minister. This application would need to demonstrate that the council meets the minimum performance standards required for eligibility to apply for Option B.

The Minister would assess this initial application. If satisfied that the council meets the eligibility requirements, he or she would inform the council that it is eligible to proceed to the second stage of the application process. If not, the council would continue to be regulated under Option A for that 4-year term.

[185] In these countries, voters have the opportunity to either elect their council members based on their stated position or to vote on specific projects. See KÜBLER D and LADNER A, *Local Government Reform in Switzerland, More 'for' than 'by' – but what about 'of'?* (http://www.uni-stuttgart.de/soz/avps/rlg/papers/Switzerland-Kuebler.pdf) and Office of the Secretary of State and King County Elections, *State of Washington Voter's Pamphlet Edition 15D*.

14.1.2 Stage 2

If the council is informed that it is eligible, the council would then implement its Community Engagement Strategy to seek and obtain evidence of community support for its 4-year revenue and expenditure plan. If it is confident it has gained sufficient support, it must make a second application in writing to the Minister, seeking approval to implement this plan (and thus operate under Option B). This application would need to demonstrate that the council has a mandate from its community to implement its revenue and expenditure plan.

The Minister would assess this second application. If satisfied that the council has adequately demonstrated that it has a community mandate, he or she would inform the council that it has approval to operate under Option B and thus is permitted to implement its proposed revenue and expenditure plan over the 4-year term. If the Minister is not satisfied, the council would continue to be regulated under Option A for that term.

14.2 What minimum performance requirements must councils meet to be eligible to apply to operate under Option B?

To be eligible for the first stage of the process for applying to operate under Option B, councils will be required to meet relatively high performance standards. If our recommended framework is adopted, we consider it unlikely that many councils will be immediately eligible to apply for this option. In most cases, a council that aspires to greater autonomy will first need to make sustained, progressive improvements in its financial management, planning and reporting and community engagement performance.

We consider that the minimum requirements for eligibility to proceed to Stage 1 of the application process should include:

- financial performance criteria
- planning and reporting criteria, and
- community engagement and consultation criteria.

Table 14.1 provides overview of these criteria. The sections below discuss the criteria in more detail.

Table 14.1 Minimum performance requirements to be eligible to apply to operate under Option B

Financial performance criteria	Planning and reporting criteria	Community consultation and engagement criteria
Meet benchmarks for key financial performance indicators	Meet all requirements under Integrated Planning and Reporting Framework, and report on the key financial performance indicators	Have a Community Engagement Strategy that outlines planned approach for seeking mandate for revenue and expenditure plan
Have a responsible funding policy for capital works	Develop detailed 4-year revenue and expenditure plan, including fully costed list of infrastructure works and services	
Have a track record of sound asset management, and all assets valued at fair value	Have an audited asset management plan that defines service levels	

Source: IPART analysis.

14.2.1 Financial performance criteria

In general, the financial performance criteria are designed to establish that the council has robust financial and asset management systems and practices in place, and generally sound financial performance. More specifically, these criteria include that a council:

1. Complies with the Local Government Code of Accounting Practice and Financial Reporting.
2. Has a responsible funding policy for capital works that uses a combination of sustainable debt levels and revenue funding.[186]
3. Has a track record of sound asset management practices, including having all assets valued at fair value.
4. Has a track record of sound financial management that indicates the council at least has the capacity to achieve recurrent financial sustainability over the current 4-year term, including:

[186] Each council should have a responsible funding policy. This means that council should fund its activities in a manner that is consistent with its particular circumstances. For example, council could fund new capital works from rates revenue, debt, user charges or a combination of these. Whether a council chooses to increase its debt position would depend on the circumstances of the individual council, eg, its current level of debt, its capacity to service the debt, its population and capacity to increase rates. In determining whether it should take on debt council should consider whether it is in their best interests and in the interests of intergenerational equity for them to use debt to fund capital works.

- a track record of generally balanced operating results over the economic cycle (eg, the previous 5 years)
- a reasonable liquidity ratio
- a sustainable level of debt
- a reasonable program of asset renewal to address infrastructure backlogs.

We consider that the Division of Local Government should establish a set of performance indicators and minimum performance benchmarks to guide councils on what is required to demonstrate sound financial performance. We have suggested some potential indicators and benchmarks (Table 14.2), based on the indicators recommended by the Allan Inquiry and our consideration of councils' financial sustainability (discussed in Chapters 5 to 8). We note that the Division of Local Government already requires councils to measure their performance against 2 of our suggested indicators. Thus, we are suggesting only 2 additions to the KPIs councils are currently required to measure and report on: net financial liabilities ratio and capital renewals expenditure divided by depreciation.

Our recommendations on the minimum financial performance requirements for eligibility to make a Stage 1 application for Option B are less stringent than those we proposed in our draft report. In particular, we proposed that councils be required to meet criteria that indicate that they are already financially sustainable on both a recurrent and capital basis. After considering stakeholder comments in submissions and public workshops we have revised this view. We now consider such councils should be required to show that they at least have the capacity to achieve financial sustainability on a **recurrent basis** over the 4-year term.

In addition, we proposed that councils be required to have achieved an average 5% operating surplus over the previous economic cycle (5 years). We now consider that they should be required only to have achieved a balanced operating result over that period, with no operating deficit greater than 10% of operating revenues in any one year.

We consider that **capital sustainability** can best be ensured through mandating policies and practices as a pre-condition for Option B (eg, fair value, asset management, identify backlogs and develop a plan to address it). This plus community endorsement provide better outcomes.

Table 14.2 IPART's suggested indicators and minimum benchmarks to demonstrate sound financial performance

	Indicator/definition	Benchmark
Recurrent sustainability		
Operating results	Operating result excluding capital amounts (ie, operating balance excluding capital amounts divided by total operating revenue excluding capital amounts expressed as a percentage)[a]	Balanced operating result on average over economic cycle (5 years) and no operating deficit greater than 10% of operating revenues in any one year
Liquidity	Unrestricted current ratio (ie, unrestricted current assets divided by unrestricted current liabilities)[b]	Not greater than 2.0
Capital sustainability		
Debt	Net financial liabilities ratio (i.e. net financial liabilities divided by total operating revenue expressed as a percentage)	100%
Asset management	Capital renewal expenditure divided by depreciation[b]	>1.0

[a] Councils currently report on operating results measures (both including and excluding capital amounts) in their Financial Statements. However, the Operating Result excluding capital amounts is defined differently to how we have defined it (see Footnote 106 in section 7.3.1).

[b] Councils currently report on unrestricted current ratio and the capital renewal expenditure divided by depreciation (Building and Infrastructure Renewals Ratio) in their Financial Statements.

14.2.2 Planning and reporting criteria

The minimum planning and reporting requirements for a council to be eligible to make a Stage 1 application to operating under Option B include meeting all requirements under the Integrated Planning and Reporting Framework. Among other things, this includes having developed a 10-year Community Strategic Plan and a 4-year Delivery Program.

In addition, minimum planning and reporting requirements include reporting its performance against the financial performance indicators (discussed above). They also include developing a detailed revenue and expenditure plan for the current 4-year. This involves:

- developing a fully costed list of major capital projects to be funded via rates revenue (either directly or indirectly) in consultation with the community
- developing an audited asset management plan that defines the service levels provided by each asset, and
- estimating the revenue requirements for the 4-year period (in line with the Delivery Program and list of major projects), and the implications for rates revenue.

As under Option A, councils are to estimate the revenue requirements in real terms. If a council is granted approval to implement its revenue and expenditure plan, these requirements be inflated each year in line with the change in the Local Government Cost Index as calculated and published by IPART.

14.2.3 Community engagement and consultation criteria

In addition to meeting the financial performance and planning and reporting criteria discussed above, to be eligible to apply to operate under Option B councils will need to develop and submit a Community Engagement Strategy. This strategy should outline the approaches the council proposes to use to engage and consult its community on the proposed revenue and expenditure plan, including the list of major projects. It should also outline how the council proposes to measure the level of community support for the plan in order to demonstrate that it has a community mandate.

14.3 What requirements must councils meet to gain approval to operate under Option B

As indicated above, once a council is granted approval to apply to operate under Option B, it can move to Stage 2 of the application process. This involves the council demonstrating to the Minister's satisfaction that it has sufficient community support to constitute a mandate for its proposed revenue and expenditure plan.

However, defining the level of support that constitutes a mandate is not a simple, cut-and-dried matter. Neither is demonstrating that this level of support exists. We have not attempted to recommend a specific definition, or prescribe a specific approach councils should use to demonstrate their mandate. Rather we have outlined several options that may be appropriate. These include:

1. A survey option, which involves surveying a reasonable sample of the community to gauge the level of community support for this plan.
2. A comprehensive survey option, which is similar to the sample survey approach but involves surveying the whole community and ratepayers.
3. A voting option, which involves the council having contested and won the most recent election based on its stated position on the revenue and expenditure plan.

In our draft report, we proposed only the second and third options. In submissions and public workshops, stakeholders raised a number of practical concerns about both these options. They also voiced strong support for a less onerous survey option that involved surveying a reasonable sample of the community only. After considering stakeholders' views, we have included a sample survey option. We consider that surveying a statistically significant proportion of the community (which includes all residents in the local government area and any non-resident ratepayers) is a practical method for demonstrating a council mandate.

We do not consider it necessary for the framework for regulating council revenues to prescribe a particular approach. Rather, the exact means by which a council might convince the Minister that it has a mandate for its plan should be left open. Hence, the framework should specify that a council must satisfy the Minister first that it has a robust approach for engaging and consulting the community on its proposed plan (in Stage 1 of the application process), and second that it has achieved this community mandate for this plan (in Stage 2).

The sections below discuss each of the 3 options outlined above in more detail.

14.3.1 Sample survey option

One option for a council to demonstrate the level of community support for its proposed revenue and expenditure plan is to survey a sample of the community. The majority of submissions argued in favour of this approach and that the survey should be designed and conducted by an independent consultant. The sample should be large enough for the results to be statistically reliable (95% confidence), and should be representative of the community (including ratepayers and other residents who live in the local government area and ratepayers who live outside the area). In addition, those surveyed should have ready access to a summary of the proposed plan, including the costed list of proposed major projects and the implications for rates.

We have not formed a firm view on the size of the sample needed to demonstrate the level of support required to constitute a mandate. Ultimately, the Minister will decide this on the basis of a council's application. However, in our view it would be helpful if the Division of Local Government (perhaps in consultation with the LGSA) developed guidelines on these matters to increase the transparency and certainty of the approval process.

14.3.2 More comprehensive survey option

Another option for demonstrating the level of community support is to conduct a survey as outlined above, but to send the survey to all members of the community. In our draft report, we proposed there should be rigorous guidelines about what percentage of ratepayers should respond to the survey, and what level of support constitutes a mandate. We suggested that it may be appropriate that:

- at least 25% to 30% of ratepayers should respond to the survey
- at least 50% to 60% of those ratepayers should indicate support for the proposal to constitute a mandate.

Stakeholders raised some concerns about this suggestion. Some councils[187] and the NSW Treasury pointed out that the participation requirements were unnecessarily onerous and a smaller survey sample would still be statistically reliable. In addition, they pointed out that it would be more equitable to include both ratepayers and residents who were not ratepayers in the survey. As indicated above, we accept their point about the sample size, and agree that it is equitable to survey all members of the community. However, we consider it is important to ensure that all ratepayers are represented in the survey, given the regulatory objective of protecting ratepayers from excessive rate increases. Thus if councils are to conduct a full survey it should be of all ratepayers and members of the community. Similarly, the proportions listed above should be with reference to all ratepayers and the community.

14.3.3 Voting option

A further alternative option is for a council to set out their proposed revenue and expenditure plan as part of its platform for re-election. If it won the election, it would still need to complete Stage 1 of the process for applying to operate under Option B. If it was successful in this, it could use information on its election platform and campaign to demonstrate that it obtained a mandate to implement the plan through the council election process.

Under this option, an outgoing council would produce information for the community detailing its proposed plan for the coming 4-year term, including the proposed program of works and implications of rates revenue, prior to council elections. The majority of the council would need to support this plan, and it would need to form the basis of debate at the council election.

Once elected, the incoming council may need to reconsider the plan and ensure there continued to be majority support for it. If this were the case, the council would endorse the plan and proceed to Stage 1 application process for approval to operate under Option B. If it gained approval to proceed to Stage 2 of this process, it would then need to demonstrate that the election provided it with a mandate from the community to implement its proposed plan (and that the plan has not been significantly amended since then).

In response to the draft report, some councils noted that there were a number of practical difficulties with this approach, as many councils comprise independents who would not necessarily be able to put forward a uniform council position to the community at an election, or to the Minister. In addition, they noted that it would be extremely difficult and expensive to run a formal vote on a propose revenue and

[187] Lake Macquarie City Council, Dungog Shire Council and Maitland Council in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 16 September 2009 at Lake Macquarie City Council Chambers, Speers Point. Mr Abelson, Treasury representative, in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 2 September 2009 at Grace Hotel Sydney.

expenditure plan in conjunction with an election.[188] Treasury expressed similar concerns.[189]

Although it would provide the clearest mandate, we didn't intend to imply that a formal vote specifically on a revenue and expenditure plan was part of the voting option. We consider this would be a move away from representative democracy and towards a direct democratic system, which is inconsistent with the concept of local councils as a third tier of government in Australia. We note that if the Government decided that a formal voting system was to be implemented for Option B, then a formal vote would be required every 4 years in order to maintain consistency of this approach and this may be costly for councils to maintain.

14.4 What happens once a council has gained approval to operate under Option B?

Once a council has Ministerial approval to operate under Option B, it will not require further approval from the Minister to remain in the Option B framework, provided that it:

- continues to meet the minimum financial performance and planning and reporting requirements discussed above
- continues to be able to satisfy the Minister (at the start of every 4-year term) that it has obtained a community mandate for its proposed revenue and expenditure plan.

Councils operating under Option B would be subject to annual monitoring by the Division of Local Government to ensure they have been performing consistent with the minimum performance criteria. They would be advised if they have not met these criteria in any given year and it would be at the Minister's discretion to return the council to the Option A framework should their performance not be satisfactory.

After an election, these councils would remain eligible to operate under Option B, but they would need to undertake a new process of developing a proposed 4-year revenue and expenditure plan, and seeking a community mandate to implement this plan. They would then need to satisfy the Minister that they have obtained such a mandate.

If a council was not successful in satisfying the Minister, it would revert to being regulated under Option A. Where this occurs, the council's base revenue for regulated increases would be the rate revenue at the time of reverting to Option A.

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188 Lake Macquarie City Council, Dungog Shire Council and Maitland Council in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 16 September 2009 at Lake Macquarie City Council Chambers, Speers Point. Coffs Harbour City Council in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 18 august 2009 at Novotel Pacific Resort Coffs Harbour.

189 Mr Abelson, Treasury representative, in Transcript of Public Hearing by Independent Pricing and Regulatory Tribunal on 2 September 2009 at Grace Hotel Sydney, pp 31-32.

Recommendations

25 That to be entitled to apply to operate under Option B, a council be required to meet a specified set of minimum eligibiity requirements including:

- financial performance requirements, as outlined in Recommendation 26
- planning and reporting requirements, as outlined in Recommendation 27
- community engagement and consultation requirements, as outlined in Recommendation 28.

26 That the financial performance requirements under Option B include:

- Compliance with the Local Government Code of Accounting Practice and Financial Reporting.
- A responsible funding policy for capital works that uses a combination of sustainable debt levels and revenue funding.
- A track record of sound asset management practices, including having all assets valued at fair value.
- A track record of sound financial performance that indicates the council at least has the capacity to achieve recurrent financial sustainability over the current 4-year term and policies and practices in place to achieve capital sustainability, including:
    - a track record of generally balanced operating results over the economic cycle (eg, previous 5 years)
    - a reasonable liquidity ratio
    - demonstrated sustainable use of debt to address capital expenditure requirements
    - a reasonable program of asset renewal to address infrastructure backlogs.

27 That the planning and reporting requirements under Option B include:

- meeting all requirements under the Integrated Planning and Reporting Framework
- reporting performance against the financial performance requirements outlined in Recommendation 26 to the Division of Local Government
- developing a detailed revenue and expenditure plan for the current 4-year term that aligns with the council's 4-year Delivery Program and includes:
    - a fully costed list of major capital projects to be funded via rates revenue (either directly or indirectly)
    - an audited asset management plan that defines the service levels, and
    - the estimated revenue requirements for implementing the revenue and expenditure.

28 That the community engagement and consultation requirements under Option B include developing a Community Engagement Strategy that outlines the approaches the council proposes to use to:

- engage and consult its community on the proposed revenue and expenditure plan
- measure the level of community support for the plan and demonstrate that it has a community mandate.

29 That to gain approval to operate under Option B, a council must:

- First apply in writing to the Minister, demonstrating to the Minister's satisfaction that it meets the minimum eligibility requirements
- Second, after being notified that approval to apply has been granted, apply in writing to the Minister, demonstrating to the Minister's satisfaction that it has implemented its Community Engagement Stategy and obtained a community mandate to implement its proposed revenue and expenditure plan.

30 That the specific approaches councils may use to demonstrate their community mandate under Option B not be prescribed, and that the Division of Local Government develop guidelines to assist councils in deciding on an appropriate approach. For example, the guidelines might outline:

- Options for this approach, such as a sample survey option, a more comprehensive survey option and a voting option.
- Guidelines for designing and conducting survey options.
- Guidelines for determining what percentage of ratepayers should respond to the survey, and what level of support constitutes a mandate.

31 That councils that fail to gain Ministerial approval to apply to operate under Option B, or subsequently fail to gain Ministerial approval to operate under Option B be subject to the regulatory arrangements under Option A until the start of the next council term.

32 That councils that succeed in gaining Ministerial approval to operate under Option B not be required to gain further approval from the Minister to operate under Option B, provided that:

- the Division of Local Government's annual monitoring of its performance shows that it continues to meet the minimum eligibility requirements
- it continues to satisfy the Minister (at the start of every 4-year term) that it has obtained a community mandate for its proposed revenue and expenditure plan.

33 Where annual monitoring shows that a council's performance has slipped below the minimum eligibility requirements in a given year, that the council be advised, and that it may revert to being regulated under Option A at the Minister's discretion.

34 Where a council does not continue to satisfy the Minister that it has obtained a community mandate, that the council revert to being regulated under Option A, and that its base revenue for regulated rate increases be the rate revenue at the time of reverting to Option A.

15 How the local government cost index would work

As Chapter 12 discussed, we have recommended that the annual regulated rate increases under Option A be set with reference to the annual change in a Local Government Cost Index and an annual productivity adjustment factor. We have also recommended that IPART be responsible for developing and publishing the cost index, and for calculating and publishing the change in this index and the productivity adjustment factor. The sections below discuss the cost index and productivity adjustment factor in more detail, and outline the approaches we would use in calculating them.

15.1 The Local Government Cost Index

This index is intended to measure, in percentage terms, how much the overall cost of providing local government services changes each year. The index consists of a basket of local government cost items – such as fuel, labour and insurance costs – that are weighted according to the proportion of overall local government costs they represent. In addition, each cost item has a relevant 'inflator' that will be used to calculate how much it changes each year. The inflators have been selected on the basis that they provide the best available indication of how the cost item changes over time and, if possible, rely on publicly available data.

In responses to our draft report, most stakeholders supported the use of a transparent cost index calculated by an independent agency (like IPART) as the basis for setting the rate peg. Councils also noted that while the data used to inflate the cost items should be the most recent available, publishing a preliminary index based on data for the year to the September quarter in December would be helpful for their budgeting purposes.[190]

The sections below explain what cost items the cost index will include, how these cost items will be weighted and inflated, and how and when we will calculate and publish the change in the cost index each year.

[190] Newcastle City Council submission to IPART, 2009.

15.2 What cost items will the index include?

A cost index typically consists of a basket of cost items, each of which is weighted according to its importance to the industry being regulated. The change in these indicators is monitored over a period of time and the overall change in the index calculated.

Based on information provided by the South Australian Local Government Managers' Association, the LGSA, submissions from NSW councils and our analysis of our case study councils, we have identified a range of cost items that we consider should be included in the index (see Table 15.1). In our view, these items provide the best indicators of NSW councils' expenditure possible, given currently available data.

In submissions in response to the draft report, some councils noted that the proposed list of cost items were not necessarily the best indicators of council costs. In particular, they pointed out that waste management costs are currently recovered through a separate charge and therefore should not be considered in calculating a basis for setting rates. We agree, and have been removed that cost item from the index.

In addition, many submissions argued that additional cost items should be included – such as statutory charges and fees (eg, the fire services levy and emergency services levy) weed control, and play and recreation areas. For example, Camden City Council submitted that:

> The selection of cost items (expenses) included in the proposed local government index is far from exhaustive and does not truly reflect the types of expenses local government typically incurs in providing services to the community. Expenses such as fire service levies, street lighting charges and other cost-shifting expenses do not appear to be taken into account in the index. If this is the case, the index will always represent an underestimation of the cost of running local government services to the community.[191]

In response to these comments, we consider that the inclusion of any given item in the cost index only has an impact insofar as its weighting relative to other cost items is significant, and its inflator is either different, or moves significantly differently to other items in the index. Since the index is a measure of how councils' costs change over time, not of their total expenditure, including additional items in the cost index will not automatically result in greater annual changes in the index.

If certain fees and charges vary across council areas, they may form the basis of a special variation application to address any unforeseen increase. In addition, any increases in fees such as election costs that are common to all councils, may be addressed by the Minister increasing the rate peg amount by more than the movement in the cost index.

[191] Camden City Council submission to IPART, 2 September 2009, p 3.

Recommendation

35 That the cost items listed in Table15.1 form the basket of cost items included in the Local Government Cost Index.

Table 15.1 Cost items included in the Local Government Cost Index

Expense categories
Employee costs - TOTAL
Plant and equipment leasing (excluding waste management)
Other operating contracts (excluding waste management)
Legal and accounting services
Office and building cleaning services
Other business services
Insurance
Telecommunications and internet services
Printing, publishing and advertising
Statutory charges (eg Fire Services Levy, State Emergency Services levy)
Motor vehicle parts
Motor vehicle repairs and servicing
Automotive fuel
Electricity
Gas
Water and sewerage
Road, footpath, kerbing, bridge and drain building materials
Other building and construction materials
Office supplies
Other expenses
Buildings - non-dwelling
Construction works - road, drains, footpaths, kerbing, bridges
Construction works - other
Plant and equipment - machinery etc
Plant and equipment - furniture etc
Information Technology (hardware and software)

Source: IPART analysis, South Australian Local Government Manager's Association.

15.3 How will we weight the cost items?

For the cost index to accurately measure changes in the cost of providing local government services, the individual cost items need to be weighted in a way that reflects their relative contribution to the total cost. The weightings also need to be periodically reviewed to ensure that the relativities of the items remain accurate.

We intend to conduct an initial survey of local government to identify the most appropriate way to weight the major cost items in the Local Government Cost Index. We have considered 3 options for this. In our view, the first option – using aggregate weights is the most appropriate. Each option is discussed below.

Aggregate weights

As with other industries we regulate, it may be possible for us to use aggregate weightings, and so use a single index for all councils in the state. With this approach, the relativities between different items will be set based on the results of an initial council survey and fixed for a 4-year period. However, each item's relative contribution to the index may increase or decrease over this period depending on the movement in their respective inflators.

Given the problems associated with regional and council weights (discussed below), we consider that using aggregate weights is the best option for a transparent, independent cost index.

Regional/group weights

Another option is to create separate cost indices for groups of councils based on their characteristics in terms of location, size and growth factors, to account for their different cost structures. For this to be justified, a significant difference between the relativities between the cost items for different council groups must exist. For example, we currently produce different cost indexes for different categories of ferries based on their speed, because we identified that the difference in relativities between their cost items was more than 10%.

Our case study analysis showed that although some diversity occurred between individual councils, there appeared to be no significant differences between the cost item relativities of different council categories. We note that some councils may have nominally larger expenditure on items of both current and capital nature. However, it is the proportion of expenditure that matters in relation to the cost index, and this did not vary significantly between councils.

We also note that in other industries where several separate cost indexes are used, the impetus for this has come from stakeholders within the industry drawing attention to differences that justify separate cost indexes. Stakeholders in this review expressed mixed support for separate regional or council-size based cost indices.

In addition, if individual councils were experiencing exceptional circumstances or cost changes, they would be able to apply for medium-term revenue paths that incorporate rate increases beyond the rate peg under Option A.

Council weights

The third alternative for weighting the index is a model that allows each individual council to set its own weights into a prescribed cost index model and therefore calculate the annual change in its costs itself. There has been some support for this option from stakeholders. For example at a public workshop, one council representative commented:

> One thing that I think would be more sensible is to develop those indicators of what our real costs are going up by and then you put it out to the council and say, for example to Bombala Council, "Here are the indicators, you apply it to your percentages, and that will come up with a number for your council that indicates what is a reasonable level to keep up your real terms of revenue." I don't think we need this obsession with trying to group us together into classes or categories. I think we should be able to use more flexible and dynamic models to suit the individual councils.[192]

However, if each council was permitted to use their own weightings to calculate the change in its costs and therefore its annual regulated rate increase, this would require individual approval by IPART or the Minister for all 152 councils. The regulatory cost involved in this would not be justified.

We note that as we will publish the methodology for calculating the cost index and the annual change in it, individual councils may use the model to calculate their own cost index. This will allow them to compare their results with those produced by IPART's index with aggregate weightings, and perhaps support their applications for medium-term revenue paths or a different approach to weighting the index.

Recommendations

36 That a single set of weights based on aggregate state-wide costs be used in constructing the Local Government Cost Index unless systematic differences in expenditure weights for specific council groupings are demonstrated.

37 That the Local Government Cost Index be re-weighted every 4 years based on an analysis of actual council expenditures.

15.4 How will the index be updated each year for price changes?

In other industries we regulate via a cost index, we regularly review many of the inflators used to calculate the annual change in the cost items. We aim to use data that is independent, verifiable and transparent for inflating each cost item, rather than relying on data provided by stakeholders.

[192] Bombala Council, Queanbeyan Public Hearing, Transcript, p 39.

Usually, the most appropriate inflators to use are determined through a combination of public consultation and our own analysis. In developing the recommended inflators for the Local Government Cost Index, we have been guided by the inflators used by the South Australian Local Government Association, all of which are based on ABS data. Our recommended inflator for each cost item is listed in Table 15.2.

Although different local government areas face different price levels for costs of inputs, it is the changes in price that are relevant for the cost index model, and these tend to be common across most areas. Councils with different levels of costs may experience the same trends in cost changes over time, which result in similar movements in rates under a cost index approach.

Recommendation

38 That the inflators listed in Table 15.2 be used to inflate the cost items in the Local Government Cost Index on an annual basis.

Table 15.2 Recommended inflator for each cost item in the Local Government Cost Index

Cost items included in index	Recommended inflator
Recurrent	
Employee costs - total	LPI - Public sector, NSW
Contracts and equipment leasing (excl. waste management)	PPI 7743 Plant hiring or lease
Operating contracts (excl. waste management)	PPI - 786 Other business services
Insurance	CPI - Insurance
Legal and accounting services	PPI - 784 Legal & accounting services
Office and building cleaning services	PPI - 7866 Cleaning services
Other business services	PPI - 7869 Business services not elsewhere classified
Printing publishing and advertising	PPI - 24 Printing, publishing & recorded media
Road, footpath, kerbing, bridge and drain building materials	PPI - Construction material mining
Other building and construction materials	PPI - 4112 Residential building construction n.e.c. - NSW
Telecommunications and internet services	CPI - Telecommunication - NSW
Statutory Charges (eg FSL, SES)	Composite index developed by IPART
Motor vehicle parts	CPI - Motor vehicle parts & accessories - NSW
Motor vehicle repairs and servicing	CPI - Motor vehicle repair & servicing - NSW
Automotive fuel	CPI - Automotive fuel - NSW
Electricity	CPI - Electricity - NSW
Gas	CPI - Gas & other household fuels - NSW
Water and Sewerage	CPI - Water & sewerage - NSW
Office supplies	CPI - Audio, visual and computing media and services - NSW
Other expenses	CPI – all groups - Sydney
Capital	
Buildings – non-dwelling	PPI - 4113 Non-residential building construction - NSW
Construction works - road, drains, footpaths, kerbing, bridges	PPI - 4121 Road and bridge construction - NSW
Construction works - other	PPI - 412 Non-building construction - NSW
Plant and equipment – machinery	PPI - 281 Motor vehicles & parts
Plant and equipment – furniture etc.	PPI - 283-286 Electronic equipment & other machinery
Information technology and software	CPI - Audio, visual and computing equipment - NSW

Note: ABS Cat No 6345.0, 6427.0 and 6401.0.

15.5 How will we calculate the annual change in the cost index?

To calculate the annual change in the cost index, we will take the current weighting of each cost item and multiply it by the relevant cost inflator (expressed as a percentage). This gives the contribution of each cost item to the annual change in the index. We will then sum the contributions of the cost items to give the overall percentage change in the index. Both the weighting of the cost item and value of the inflator will affect its contribution to this overall change. Table 15.3 shows the change in a hypothetical cost index as an example.

Table 15.3 Hypothetical cost index calculation

	Weighting %	Change in relevant inflator %	Calculated contribution to change in the LGCI %
Cost item A	36.0	0.2	0.07
Cost item B	23.0	7.3	1.68
Cost item C	17.8	23.4	4.17
Cost item D	12.4	2.6	0.32
Cost item E	10.8	3.3	0.36
Total	100	n/a	6.60

Note: Items may not add up due to rounding.
Source: IPART.

15.6 When will we calculate and publish the change in the cost index?

Currently, the rate peg in NSW is announced in late March or early April each year, to be implemented for the financial year commencing July 1. Many councils submitted that this timing is too late for their budgeting process, largely because the method of determining the rate cap is not transparent, which makes it difficult for them to forecast rate increases. Some councils also indicated that if the current method continued they would prefer this figure to be published as early as November of the previous year, in order to have sufficient time to prepare their budget.

As discussed above, we are recommending that the cost items be inflated based on published ABS data. These data are currently published quarterly within 6-8 weeks of the end of the quarter. As calculating the change in the Local Government Cost Index is relatively straightforward, we consider it should be possible for us to do this within 2-3 weeks of the ABS data being made available.

In determining the recommended timing for calculating and publishing the change in the cost index, we tried to balance the need for councils to have sufficient time to prepare budgets for the following financial year and the need for the calculation to use data that is as recent as possible (relative to when the rate peg will apply). We

note that the data we recommend be used to inflate the Local Government Cost Index is in fact lagged. Therefore, it is less of a concern if inflators from the preceding calendar year are used to estimate cost increases for the following financial year.

On balance, we consider it appropriate to provide a final calculation of the change in the cost index in November each year, using September quarter data. This will provide greater certainty to councils in terms of their planning requirements. Councils who consider that the likely regulated rate increase based on the change in the cost index will not meet their revenue requirements for the coming would then have more time to apply for a medium-term revenue path under Option A or apply to be regulated under Option B. Councils content to apply the regulated annual increase would also have more time with which to develop their revenue and delivery plans for the coming financial year.

Recommendation

39 That the Local Government Cost Index should be constructed and the calculation of the annual change in this index should be based on September quarter data from the Australian Bureau of Statistics (where available) and should be published in November each year.

15.6.1 Will the cost index be prospective or retrospective?

A cost index may either reflect actual movement in costs over the previous period (retrospective index) or forecast movements over the coming period (prospective index). In our view, each of these approaches has flaws. Most submissions to this review favoured a prospective index.

However, there is no consistent method for projecting increases in an accurate manner. In cases of inaccurate prospective indices, allowances for a correctional mechanism must be addressed and this increases the cost of regulation.

Therefore, in the interests of accuracy, consistency, transparency and simplicity, we consider it more appropriate to use a retrospective or lagged index, consistent with the approach we use in other industries we regulate via a cost index.

15.7 The productivity adjustment factor

In addition to calculating the annual change in the LGCI, we have recommended that we also calculate and publish a separate annual productivity adjustment factor. As Chapter 12 discussed, this factor will be based on our estimate of NSW councils' estimated potential to achieve productivity gains over the medium-term. If the Minister decides to take account of the productivity adjustment factor in setting the regulated annual rate increase, this factor would be subtracted from the change in the

cost index to provide the annual rate peg (provided no other factors need to be taken into account).

Calculating a single productivity adjustment factor for all NSW councils will be a difficult task, as there is no established methodology for productivity measurement of all factors of local government services. It is also likely to be time-consuming, and it may be difficult to take account of efficiency improvements that may have been achieved, or should be achieved, within local government, as opposed to those that may have been achieved by suppliers of council services.

At this stage, the precise method we will use to calculate a productivity adjustment for local government has not been decided as it would be a matter for a future Tribunal. There are some notable sources from which productivity information can be gained, in addition to the local government sector itself. For example:

- The ABS publishes labour market productivity based on movements in market wages and salaries for private sector labour in NSW, and provides an estimate of the opportunity cost of public sector labour.
- The NSW Government also produces its own efficiency dividend to apply across State Government departmental budgets. However, since local government regularly contracts out services via competitive tender, it would only be appropriate to apply this efficiency dividend to councils' own service provision. The most effective way to implement this would be to apply an efficiency adjustment to the labour component of the cost index.
- The ABS currently produces economy-wide estimates for market productivity, which may be used to inform labour productivity for local government.

16 Roles under the new framework

The following sections outline the role of IPART, the Division of Local Government and the Minister for Local Government under the proposed revenue framework.

16.1 Role for the Minister

Under the current framework, the Minister for Local Government's regulatory role is to determine the annual rate peg amount each year and approve or disallow council applications for variations beyond this amount.

Under Option A of the proposed framework, IPART would develop and maintain the Local Government Cost Index and productivity adjustment and would provide advice to the Minister so that the Minister can determine the annual regulated rate increase. The Minister may vary the rate cap from IPART's recommendation but must provide a Statement of Reasons for doing so. For example, the Minister may determine an increase in rates that is either over or under the cost index after giving a statement of reasons.

Under Option A, the Minister retains the ability to approve, vary or reject with a Statement of Reasons, applications by councils, in the form of detailed revenue requirements, for rate increases above the regulated annual rate.

The Minister could disapprove an application if it fails to meet the application criteria (see Section 13.3.3). For example:

- The need for increases in rates was not adequately demonstrated.
- The correct processes, planning or performance requirements were not met.
- There was no demonstrated community support.
- The impacts on ratepayers were judged to be excessive.

Many councils argued in submissions and workshops that the Minister should have no role in setting the regulated annual rate increase for local government and that rate pegging, if retained, should continue directly on the basis of the cost index provided by IPART.

IPART notes that the role of the Minister is important to allow flexibility in the rate setting process, in particular to allow real increase in rates beyond cost movements.

It is envisaged that the Minister may choose to vary the regulated annual rate increase beyond the cost index in circumstances where there are identifiable cost pressures that apply to all councils, such as increases in State or federal Government charges or statutory requirements.

For Option B, the Minister would be primarily responsible for approving applications by councils who have met the requirements for eligibility to move into Option B of the framework. The Minister would also have to approve applications by councils demonstrating they have a mandate to implement their rate revenue plans under Option B. The Minister has no role in the rate setting process for councils who are successful in moving under Option B. For councils in Option B, the Minister is responsible for ensuring compliance with all required financial performance criteria, with the assistance of the Division of Local Government.

Recommendations

40 In relation to the rate peg, that the Minister for Local Government would:

- consider IPART's advice on the Local Government Cost Index and the productivity adjustment
- determine the increase in rate peg, and providing a statement of reasons for any increase over or under the increase in the productivity adjusted cost index.

41 In relation to variations under Option A, that the Minister for Local Government's role should involve approving, varying or rejecting, applications by councils for rate variations under Option A, whether for a multi-year or single year increase. The Minister's decision should be accompanied by a statement of reasons.

42 In relation to variations under Option B, that the Minister for Local Government would:

- approve, or reject with a statement of reasons, councils' satisfaction of eligibility criteria to move into Option B of the framework
- approve, or reject (with a statement of reasons), councils' satisfaction of community engagement criteria to implement rate revenue plans under Option B of the framework.

16.2 Role for the Division of Local Government of the Department of Premier and Cabinet

Under the proposed framework, in addition to its current administrative role, the Division of Local Government would maintain responsibility for reviewing council applications for rate increases beyond the recommended annual rate increase.

The Department would be responsible for implementing the proposed revenue framework through:

- monitoring council rate increases
- administering and monitoring revenue requirements proposed by councils in Option A and Option B
- monitoring compliance with performance and accountability criteria in Option A and Option B.

We believe that these roles are appropriate for the Division as:

- They relate closely to its roles under the Integrated Planning and Reporting Framework.
- It currently monitors councils' financial performance.
- It advises the Minister on applications for special variations under the existing framework.

The Division of Local Government would be responsible for advising the Minister for Local Government as to whether councils who have made applications under Option A and Option B have met all the relevant eligibility, performance and accountability requirements and for taking appropriate remedial action if they have not.

Recommendation

43 That the Division of Local Government' would:

- Monitor council rate increases.
- Advise the Minister on variation proposals under Option A.
- Administer and analyse revenue requirements proposed by councils in Option A and monitor revenue requirements proposed by councils in B.
- Monitor and advise the Minister on compliance with eligibility, performance and accountability criteria in Option A and B.

16.3 Role for IPART

There has been support amongst stakeholders through submissions and workshops for IPART to have a role in publishing a transparent cost index for local government. IPART currently publishes cost indices which assist in setting fare increases for taxis and ferries in NSW.

Under the proposed framework, IPART's role would involve developing, maintaining and publishing an annual cost index for local government that takes account of possible productivity adjustments. The index would be the basis for IPART's advice to the Minister under Option A. The index and related calculations, including the estimated productivity adjustments, would be published on IPART's website.

IPART would operate this cost index in line with the measures outlined in Section 17.5. IPART would have the role of periodically reviewing the weightings used in the cost index (every 4 years).

Whilst IPART's role is to ensure that the index it recommends is set at a level that reflects the costs of providing local government services to ratepayers, IPART has no role in setting the type or quality of those services. In calculating the index IPART may consider a productivity component for the index. This would be important in identifying productivity trends for councils and informing a wider review of the productivity of local government with regards to ensuring best practice regulation.

IPART would also conduct a periodic review of the criteria used to approve the requirements for councils achieving higher than regulated annual rate increases under Option A and autonomy under Option B.

Recommendation

44 That IPART would:

- Develop, maintain and publish the Local Government Cost Index.
- Estimate and publish a productivity adjustment factor.
- Recommend to the Minister the Local Government Cost Index to be used for the regulated annual rate increase.
- Recommend to the Minister the productivity adjustment factor to be used for the regulated annual rate increase.
- Review the criteria used to approve requirements for councils achieving higher rate increases under Option A and Option B.

17 Implementing the new revenue framework

This chapter outlines when the proposed framework would come into effect, the transition arrangements and the timeframes involved in implementing the framework.

17.1 When would the proposed framework come into effect?

We consider that there should be a staged approach to implementing the proposed framework. This would allow for:

- The development of the Local Government Cost Index (LGCI) and productivity factor.
- Implementation of the Integrated Planning and Reporting Framework (IPRF).

Prior to calculating an LGCI, we would need to collect cost information from councils and estimate weights. If we were able to do this by February 2010, we could calculate an index that could be used for regulated rate increases in 2010/11. However, this would require an early indication from Government that it wishes IPART to have this role and to give us the power to collect the data.

In the draft report we indicated that the medium term price path arrangements would not come into effect until after the next council elections (in 2012). At the time we considered that this was the best time for this part of the framework to commence as it was, in part, dependent on the Integrated Planning and Reporting Framework. This timing was reinforced during the public hearings where a number of councils suggested that, although the new IPRF is mandatory, councils would be slow to develop its plans, due to the increased demands on planning and reporting requirements.

We note that the Division of Local Government's (DLG's) transition plans for the new framework would mean that councils would be adopting it between 2010 and 2012.[193] With the DLG's transitional arrangements for the IPRF, most councils would have their Community Strategic Plan and Delivery Plan in place prior to 2011/12.

[193] Department of Premier and Cabinet (Division of Local Government), Circular 09-37, *Commencement Of The Local Government Amendment (Planning And Reporting) Act 2009*, 14 October 2009. Councils may choose which transitional group they wish to be in. Group 1 must have their Community Strategic Plan and Delivery Program in place by 30 June 2010, Group 2 by 30 June 2011 and Group 3 by 30 June 2012.

We consider that councils who wish to make applications sooner for medium term revenue paths under Options A and B of our proposed revenue framework should be allowed to do so.

Therefore, we propose that councils should be able to apply for medium term price paths under Option A or to be eligible for Option B during 2010/11 financial year, provided they have satisfactorily implemented the IPRF.

However, as not all councils will be able eligible for Option A or Option B, the existing arrangements should continue to apply in parallel with the new revenue framework until the end of 2012/13.

Recommendations

45 That the LGCI should be used for regulated annual rate increase from 2010/11.

46 That IPART should commence a survey of councils' costs during 2009/10 to determine the weightings for the cost index model to apply from 2010/11.

47 That councils may apply for the proposed medium term revenue plans under Options A and B from the 2010/11 financial year.

48 That IPART's proposed revenue framework and the existing rate-pegging arrangements operate in parallel until 2012/13 by which time all councils have implemented the IPRF. The new medium term (revenue plans) under Options A and B would fully replace the current framework by June 30, 2013.

17.2 What are the transition arrangements?

As we proposed in Section 17.1, our recommended revenue framework should be implemented fully by the end of the 2012/13 financial year. In the interim period, changes could be implemented to improve the cost reflectiveness and transparency of the rate capping methodology. We consider that this could be best achieved by using the Local Government Cost Index to inform the setting of the rate cap. This would have the advantage that both frameworks would be using the same cap for regulated rate increases.

As well, the staged introduction of the IPRF would permit councils to enter into our recommended framework. Table 17.1 illustrates the timing of these transitional arrangements.

Table 17.1 Combined transition arrangements for the IPRF and the revenue framework

	2010/11	2011/12	2012/13	2013/14
			Election	Review Development Plan
Group 1	Implement IPRF			Prepare new revenue plan
	Rate Peg Increases	Option A or B	Option A or B	Option A or B
Group 2		Implement IPRF		Prepare new revenue plan
	Rate Peg Increases	Rate Peg Increases	Option A or B	Option A or B
Group 3			Implement IPRF	Prepare new revenue plan
	Rate Peg Increases	Rate Peg Increases	Rate Peg Increases	Option A or B

Note: Councils may choose which transitional group they wish to be in. Group one 1 must have their Community Strategic Plan and Delivery Program in place by 30 June 2010, Group 2 by 30 June 2011 and Group 3 by 30 June 2012.

Source: DLG, *Commencement of the Local Government Amendment (Planning and Reporting) Act 2009*, Circular 09-37.

As we have noted, councils could operate under either the current or our recommended frameworks as they would operate simultaneously for three financial years (2010/11, 2011/12, 2012/13). Following the conclusion of the 2012/13 financial year, the current system would be fully replaced by our proposed framework. This is because councils who wish to apply for special variations may make applications under the new framework following the 2012 elections. These applications are not due until the second half of 2013 and would not take effect until 2014/15.

We note that several councils may have active special variations which may continue beyond the designated starting point for our recommended framework. We recommend that these councils be allowed to continue their approved special variation for rate increases until they expire.

Finally we consider that councils should be encouraged to move to the new framework as soon as practicable. Therefore, we propose that councils should only be permitted to apply for special variations during this transition period if they end by 30 June 2014. This is when all new medium term revenue paths would commence under the new revenue framework.

Recommendations

49 That councils with existing special variation applications may continue to implement these beyond the starting point for our recommended revenue framework.

50 That councils may continue to apply for special variations under the existing revenue framework until 2012/13 provided these special variations do not extend beyond 30 June 2014.

17.3 What are the proposed timeframes?

From 2010, we propose that the cost index for local government should be published in November each year, using the September quarter data available from the Australian Bureau of Statistics (where available) (see Recommendation 39).

The processes under Options A and B by which councils can apply for variations in rate increase above the regulated annual rate are linked to the election cycle through the IPRF. For example, if a council wishes to increase its rates above the regulated amount under Option A:

- Council must first complete its review of its delivery plan (under the IPRF) within 9 months of the election, that is, by June 2013 initially.
- Council must then submit its application to the Minister for a revenue path by September of the year following the election (ie, September 2013 initially)
- The Minister would then announce his, or her, approval, or disapproval, of councils' rate revenue requirements by no later than December, in order to allow councils sufficient time to prepare their budgets in time for the next financial year.
- Council would apply its new rates under the medium term revenue path from July of the following year (ie, July 2014 initially).

This timing would mean that councils' 4-year revenue paths would continue into the life of the next council. This is unavoidable as the framework needs to allow sufficient time for:

- councils to prepare their plans following each election in accordance with the requirements under the IPRF
- the Division of Local Government and Minister for Local Government to assess applications for medium term revenue paths.

Our draft report outlined the suggested time frames for each of the components of the new framework. We have sought to further clarify these time frames below.

Table 17.2 displays the timeframe applicable to each component of the framework.

Recommendation

51 That the time frames outline in Table 17.2 be adopted for the proposed framework.

Table 17.2 Time frame for proposed revenue framework

	Financial year of election				Financial year following election			Each subsequent financial year	
	November	**December**	**March**	**June**	**July 1st**	**September**	**December**	**July 1st**	**December**
IPRF				Community Strategic Plan & Delivery plan due				Councils to review their Delivery Plan by 30 June	
Option A Regulated rate increase	Index published on IPART website	Minister announces regulated annual rate increase for following year			New regulated rates take effect		Minister announces regulated annual rate increase for following year	New regulated rates take effect	Minister announces regulated annual rate increase for following year
Medium term revenue path	Index published on IPART website				Previous rate plan continues OR New regulated rates take effect	Applications for medium term revenue path due	Minister announces approval/ disapproval of medium term revenue path	New rates take effect under medium term price path	
Option B	Index published on IPART website		Councils to apply to the Minister for eligibility for Option B	Minister approves/ disapproves councils' eligibility for Option B	Previous rate plan continues OR New regulated rates take effect	Councils to apply to the Minister demonstrating community mandate for revenue plans	Minister confirms / disapproves councils' demonstration of community mandate and implementation of revenue path	New rates take effect under medium term price path	

18 Framework for the statutory authorities

This Chapter addresses our third term of reference. This requires us to recommend a framework for setting charges to enable certain public authorities to recover costs for the provision of services normally provided by local government. W e note that since the review commenced that authorities to which this framework apply have changed to include only SHFA and SOPA.

The two councils, Auburn and City of Sydney, adjoining the development areas managed by the authorities, receive rates from tenants (and in some instances from SHFA) within the special development areas. However, SHFA and SOPA claim they are providing and funding some local services which are normally provided by councils in other parts of the local government area adjacent to the special development areas and consider they should be reimbursed by councils.

This Chapter considers current service roles and revenue arrangements of agencies and councils, stakeholder views on a regulated revenue framework for local government types of services provided by agencies and options for a revenue framework.

We recommend that the agencies and councils should deal with this issue primarily by negotiation, supported by a dispute resolution process. This framework would be based on legislation with guidelines to assist in allocation of costs between the authorities and councils concerned. It would require agencies and councils to first negotiate in good faith and then if necessary to undertake mediation and finally binding arbitration. However prior to the implementation of any legislative scheme, SHFA and SOPA should consider whether some local government services would be better managed by councils and transferred where parties agree.

18.1 Current service roles and revenue arrangements

To assist in its analysis of options for a regulatory framework IPART has compared the roles and responsibilities of local government agencies and the Sydney Harbour Foreshore Authority and Sydney Olympic Park Authority to determine the extent of overlaps in services provided.

The scope of the review has been reduced to issues relating to SOPA and SHFA as it was noted that RWA does not provide typical local government services within its area of responsibility.[194] As well, the role of SHFA has been reduced with the establishment of the Barangaroo Delivery Authority to deal with future major development and the transfer of planning functions to Department of Planning.[195] A framework for assigning costs of local government services, could apply to the Barangaroo Delivery Authority.

On 29 October 2008, the Minister for Planning announced the GCC would be merged with the Department of Planning.[196] As we noted, this agency did not previously provide local government types of services and this would continue to be the case, the GCC was not included in our analysis.

18.1.1 Current service roles of authorities and local government

In developing our recommendations, we identified current service roles of each of the Authorities and the adjoining council. These roles are compared in Tables 18.1 and 18.2 below to enable service overlaps and duplication to be identified for each development area.

18.1.2 Current arrangements for service provision and for rates and charges revenue within Sydney Harbour Foreshore Authority and Sydney Olympic Park Authority

The Authorities provide a range of services: typical local government services, including planning and development, heritage, events management and promotional activities. The types of activities that are provided by Authorities vary including the services that would typically be provided by local government. In relation to City of Sydney Council and the SHFA there is some overlap, but no duplication, with regard to services traditionally provided by local government. There are no overlaps between Auburn Council and SOPA. However, waste management is proposed to be contracted out to the council.

SHFA

SHFA provides a wide range of municipal services to its precincts that normally would be provided by local government. These services include cleaning, waste management, security (ie, rangers and CCTV monitoring), parks and gardens maintenance, utilities and landscaping. Additionally, the City of Sydney Council and SHFA share costs related to the maintenance of roads, footpaths and parks within SHFA's legislative area, based on the respective ownership of these assets. SHFA has already transferred and is the process of transferring further ownership of

194 City of Sydney Council submission to IPART dated 11 September 2008, p 25.
195 The Hon Kristina Keneally, Minister for Planning, Media Release dated 7 November 2008.
196 The Hon Kristina Keneally, Minister for Planning, Media Release dated 29 October 2008.

roads and parks and related future maintenance costs, from its area to the City of Sydney Council.[197]

SHFA does not receive corresponding rates revenue for undertaking these services within its precincts. SHFA has responsibility for Government owned lands with tenants generally taking a 99 year lease. These tenants within SHFA's precincts are obliged to pay property rates to the City of Sydney. Further, SHFA is also liable to pay Council rates for shorter term leases, with the exception of those leases where tenants have agreed to take up the liability for payment of rates to the Council.[198]

SHFA partly funds these services and the rates it pays through rents, and cross-subsidises the remainder of the costs involved through its other commercial activities. In its submission, SHFA noted that it does not collect development levies or estate levies within its precincts. While a section 94 scheme (administered by City of Sydney Council) applied to developments within the former City West Development, SHFA is no longer expecting any further section 94 contributions.[199]

SHFA advises that the commercial returns generated from the various SHFA assets are injected back into the Authority's precincts with a $3 million yearly dividend being paid to the NSW Treasury. These arrangements will end with the implementation of the commercial asset divestment program and the Authority will become a budget dependent agency and will require recurrent funding from NSW Treasury in order to service the Rocks and Darling Harbour precincts.[200]

SHFA is no longer responsible for planning functions or for Barangaroo following the recent reforms announced by the Minister for Planning. In relation to the Barangaroo area, given the establishment of the new Barangaroo Delivery Authority, any proposed levies will be payable to the new Authority and not SHFA.

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[197] City of Sydney Council submission to IPART dated 11 September 2008, p 25.
[198] IPART, *Issues Paper - Revenue Framework for Local Government*, July 2008, p 67.
[199] Submission to IPART from RWA, SOPA and SFHA dated 4 September 2008, p 2.
[200] Email from SHFA to IPART dated 31 March 2009.

Table 18.1 Local government services provided by SHFA and City of Sydney Council within SHFA and similar services provided by Council in adjoining areas.

SHFA 's role and functions	Local government types of services provided by SHFA	Similar services provided by City of Sydney Council in adjoining area	Complementary SHFA and City of Sydney Council Services (within SHFA area)
SHFA is responsible for : ▾ protecting and enhancing the natural and cultural heritage of the area ▾ promoting, co-ordinating, managing, undertaking the orderly and economic development and use of the area, including the provision of infrastructure ▾ promoting, co-ordinating, organising, managing, undertaking, providing and conducting cultural, educational, commercial, tourist, recreational, entertainment and transport facilities	▾ cleaning/maintenance(contracted to Council in Rocks area only) ▾ waste management ▾ security ▾ parks, gardens landscaping ▾ utilities ▾ (planning & development revoked and transferred to Dept of Planning) ▾ natural and cultural heritage ▾ public domain ▾ promotional activities ▾ events ▾ tourism ▾ environmental management	▾ Infrastructure construction and maintenance eg,: -roads -footpaths -drainage -public domain -parks -pools -street cleaning -waste services ▾ recreational and social -services eg,: -libraries -child care -aged services -activity centres ▾ planning and regulatory services ▾ traffic management ▾ economic development ▾ environmental management ▾ events ▾ tourism ▾ promotion activities ▾ security	Council and SHFA share costs (based on respective ownership) for maintenance of: - roads - footpaths - parks ▾ promotion activities ▾ security

Source: IPART, *Revenue Framework for Local Government*, Issues Paper, July 2008 and submissions from SHFA, RWA, SOPA and City of Sydney Council.

SOPA

SOPA has legislative authority to carry out the functions of a council within Sydney Olympic Park. The Authority, like SHFA, is responsible for the delivery of municipal services within the park that usually would be provided by local government. This includes roads and footpath maintenance, street lighting and cleaning, state and regional sports facilities, open space and land use planning. SOPA, rather than Auburn Council, provides all of these services within its area.

Lessees within the Park pay property rates to Auburn Council rather than to SOPA. SOPA maintains that over the next 2-4 years, the revenue to the Council from these rates is expected to rise significantly as new commercial development and the first tranche of residential development are brought on-stream. However, Auburn Council argues that it has been significantly disadvantaged by the loss of rate revenue (arising from government ownership) in the past ($20 million) and costs imposed on it from major events at the Sydney Olympic Park.[201]

While it is expected, the council will provide waste management services (garbage removal) under contract for the new residents, SOPA maintains that it will continue to fund its other local government related services.

In its submission, SOPA notes that it charges an estate levy to tenants. However SOPA argues that these charges are not necessarily linked to services provided and are usually derived from historical 'commercial arrangements' and are in no way intended to fund the base-line services that would normally be the responsibility of a local council.

SOPA is funded by the NSW government for about $36 million per annum and generates about $34 million from car parking and commercial leases and licences. SOPA points out that there is an ongoing regime of revenue reduction of funding from Treasury and that this is planned to continue.[202] SOPA advises that it relies on its commercial activities to cover any gap between the costs of services to residents and tenants and revenue from the estate levy.

[201] Auburn Council submission to IPART, dated August 2008, sections 2, 3 and 4.

[202] IPART Public Workshop – Review of revenue framework for local government and certain Government agencies, 26 November 2008.

Table 18.2 Local government services provided by SOPA and Auburn Council within SOPA and similar services provided by Council in adjoining areas

SOPA 's role and functions	Local government types of services provided by SOPA	Similar services provided by Auburn Council in adjoining area	Complementary SOPA and Auburn Council Services (within SOPA area)
SOPA is responsible for managing the public assets of Sydney Olympic Park eg,: ▾ development including provision and management of infrastructure ▾ cultural, sporting, educational, commercial, tourist, recreational, entertainment and transport activities and facilities ▾ natural and cultural heritage with a focus on the Millennium Parklands ▾ public transport facilities within Sydney Olympic Park ▾ arrangements with Olympic organisation	▾ Infrastructure construction and maintenance of -roads -footpaths -public domain -parks -pool -street cleaning -street lighting ▾ waste management ▾ security ▾ parks, gardens landscaping ▾ utilities ▾ planning and development ▾ natural and cultural heritage ▾ promotions	▾ Infrastructure construction and maintenance eg, -roads -footpaths -drainage -public domain -parks -pools -street cleaning -waste services ▾ recreational and social services eg, -libraries -child care -aged services -activity centres ▾ planning and regulatory services ▾ traffic management ▾ economic development ▾ environmental management ▾ events ▾ tourism ▾ promotion activities ▾ security	Nil However council is to provide waste management services for future residents (under contract to SOPA)

Source: IPART, *Revenue Framework for Local Government*, Issues Paper, July 2008 and submissions from SHFA, RWA, SOPA, and Auburn Council.

18.2 Stakeholder views

18.2.1 Issues and options raised in submissions regarding a regulated revenue framework for local government services provided by government agencies

Neither the agencies (SHFA and SOPA) nor the local councils (City of Sydney Council and Auburn Council) support a common regulatory framework for local government and government agencies to enable general rates revenue to be obtained by agencies for local services provided.[203]

The Councils submitted that there should be no regulatory framework which allows a proportion of councils' rates revenue to be transferred to agencies such as SHFA or SOPA for local government types of services provided by agencies as:

- These agencies' services primarily contribute to the commercial value of the areas or fulfil core major facilities management objectives which have benefits to the State rather than the local community. By shifting State costs to councils ratepayers will be subsidizing expensive amenities that are not of direct benefit to residents in the local government area. Agencies do not provide a comprehensive range of local government services. They should not seek to recover recurrent revenue to cover such costs as it may be more efficient for local councils to deliver the services.
- To ensure accountability and prevent uncoordinated service delivery, local government should be involved in local service asset management plans. If ratepayers are to reimburse agencies for provision of local services, the agencies should be required to undertake associated public consultative processes for planning and delivery of services to the community as is required of councils.

In addition, Auburn council pointed out that it is one of the most disadvantaged local government areas in Metropolitan Sydney and has suffered significant rate losses as a result of the transfer of the Ford factory site to Strathfield Council in 1991 and the Abattoir site being proclaimed non rateable in 1993. Council advised that it has submitted a proposal to SOPA to assume responsibility for municipal services and ongoing maintenance of civic assets in the Sydney Olympic site as Council could deliver these services more cheaply due to economies of scale.

Western Sydney Regional Organisation of Councils (WSROC) has also advised that:

- current arrangements with Rouse Hill Town Centre and Norwest Business Park provide a more appropriate comparison with SOPA
- SOPA's claim for reimbursement should be dismissed because Auburn council has submitted a proposal to assume municipal services and ongoing maintenance of built civic assets without any loss in rate revenue by council.

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[203] Joint submission from SHFA, SOPA and RWA dated 4 September 2008, submission from City of Sydney Council dated 11 September 2008 and submission from Auburn Council dated August 2008.

The agencies submitted[204] that:

- A common framework for levying charges was not necessary as there is no duplication or overlap of services; it is usually clear which organisation performs certain services in their respective areas.
- SHFA and SOPA derive most of their income from commercial activities such as leasing and car park operations which is used to pay for local services. Other income is derived by SOPA from estate levies imposed.
- Developer contributions for capital works currently mirror the planning framework for local government[205] for SOPA (that is, as consent authority, SOPA would receive the contributions). However, the planning role has been transferred from SHFA to Department of Planning.[206] SHFA advised that it did not collect development levies within its precincts, but a section 94 scheme, administered by City of Sydney, is applicable to developments falling within the boundaries of the former City West Development Corporation.
- The Act should be amended to enable SOPA and SHFA to recover the costs of providing local government types of services from the City of Sydney Council's and Auburn Council's general rate income. This proposal would involve an independent expert to apportion rates revenue, based on a framework rather than a detailed costing regime and could be extended to other public authorities as approved by the Minister for Local Government.
- The level of service provided by state agencies may often exceed local council base line service levels, and it could be argued that local councils should not have to pay for this higher level of service. For example, SHFA has separately advised IPART[207] that as 41 million visitors per year visit Darling Harbour and the Rocks, it estimates that approximately $6,954 million out of a total of $12,056 million of SHFA's total public domain expenditure could be attributed to a minimum service level that should be paid for by council. Table 18.3 lists SHFA's public domain expenditure.
- SOPA outsources all of its maintenance functions and councils would need to be competitive on price and service level if they were to undertake this role.
- Additional rates revenue derived by councils from new development as a result of State owned land becoming rateable on sale and development, should exceed costs incurred from the impact of state authorities eg, from increased demand for services and infrastructure.
- SOPA has advised that it supports the process of negotiation and arbitration as proposed in our draft report (including the principles of determining the services costs avoided by councils) to resolve reimbursement of efficient costs to statutory authorities for local government services provided.

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204 Joint submission to IPART from SHFA, SOPA and RWA dated 4 September 2008.
205 Ibid.
206 Email from SHFA to IPART dated 31 March 2009.
207 Ibid.

Table 18.3 Total public domain expenditure by SHFA 2007 ($000)

Total public domain expenditure	The Rocks	Darling Harbour	Total
Cleaning	1,119	2,193	3,312
Security	890	2,253	3,143
Major events security and amenities (NYE, Australia Day, Anzac day, St Patrick's Day	506	0	506
Waste management	439	193	631
Public domain furniture and fittings	109	261	370
CCTV (contribution to City of Sydney)	52	0	52
Public domain hard surfaces	90	216	306
Turf management	52	165	218
Public domain utilities–Electricity	49	496	544
Public domain utilities–Water	26	79	105
Public domain electrical systems	56	159	215
Landscaping	95	138	233
Public domain plumbing	30	368	398
Public domain structural works	52	243	295
Public domain external applied finishes	57	90	147
Public domain lifts and escalators	29	109	138
Public domain lighting systems	86	198	284
Other	84	1,073	1,158
Total	**3,822**	**8,234**	**12,056**

Note: To estimate the minimum level of service SHFA has made the assumption that cleaning costs should include public domain, toilets and water features and the security costs should be based on one ranger and one control room operator monitoring CCTV for 24 hours in each precinct. Expenditure on grounds of buildings such as Unwin Stores and Campbell's Warehouse and the Authority's own buildings were excluded from the estimate. Expenditure on marine structures including Pyrmont Bridge and seawalls and the SHFA's own operations and service buildings, security and amenity costs for major events ie, New Years Eve, Australia Day and Saint Patrick's Day have been excluded. (Total amounts may differ from the sum of individual expenditures due to rounding.)

The cleaning services provided by the City of Sydney Council within the SHFA precincts are invoiced and paid for by the SHFA.

Source: Email from SHFA to IPART dated 31 March 2009.

The Local Government and Shires Associations[208] supported the following position:

- All land held by government businesses for commercial purposes should be fully rateable.
- It is questionable whether the government agencies should continue to administer and service these land holdings.
- Of the four special purpose agencies relevant to the review, one had already been abolished (Growth Centres Commission) and two may cease to exist in the next few years (Sydney Harbour Foreshore Authority and Redfern Waterloo Authority). A new regulatory framework in order to address cost recovery between SOPA and Auburn Council is not necessary.
- Cost recovery should be through a mutual agreement mechanism.

Local Government Managers Australia[209] also supported a mutual form of agreement, eg, using MOUs as a means of dealing with service overlaps in precincts.

18.3 IPART's considerations/analysis

Our analysis and consideration of the issues raised by agencies, councils and other interested parties are outlined below.

Although rates revenue is a core source of funding for services provided by councils, the authorities do not receive rates revenue for them but recover the costs of these services through commercial activities such as leasing and car park operations. Councils receive rates from tenants (and in some cases from SHFA) in the special development areas but do not provide some local government services within the areas. SHFA and SOPA claim that they should receive a share of the rates to compensate then for the services cost. On the other hand councils claim that the Authorities provide services as a result of demand from the major development areas and should not receive payments from rates for this.

As SOPA and SHFA are undertaking a narrow range of traditional local government areas of service namely roads, foot paths, street cleaning, street lighting, parks, security and waste disposal, councils are concerned that the agencies will not be able to deliver services as efficiently as councils. Waste disposal is not part of the general income revenue and for local councils should be provided on a fee for service basis. It is not clear whether waste fees for these special development areas are being charged by councils in addition to rates. If this is the case, then the waste management fees would need to be considered in any agency revenue framework.

[208] Local Government and Shires Associations submission dated September 2008 and letter dated 17 December 2008.
[209] Submission from Local Government Managers Association dated 29 August 2008.

As SHFA and SOPA provide services that are similar to those provided by adjoining councils, the main issue for consideration concerns compensation to agencies on the basis of avoided council costs. To address councils' concerns about efficient costs of services, a framework for reimbursement of service costs to statutory agencies would need to ensure that reimbursement was the lower of the costs that the agency incurs or the amount that councils would need to spend.

To deal with councils' claims that residents should not be subsidizing facilities that are not of direct benefit to them, any reimbursement determination would need to take into account the extent to which the service the agency provides is one the council would normally provide in other parts of the local government area.

Auburn Council also raised the argument that special events at the Sydney Olympic Park create extra costs on the council. Similarly, City of Sydney Council pointed out that it is already making key contributions for a range of services throughout the city on behalf of the State which are over and above local government expectations and should be compensated directly by the State.

In considering these views, IPART notes that SOPA did not provide costings or local community usage figures in support of its claim for a share of Auburn council's rates revenue. While SHFA provided costings on its public domain costs, it was not able to demonstrate the usage of the facilities by the local community. The Authorities additionally recognised that councils should not pay for the full cost of the public domain services as these services are provided at a much higher level of service in the special development area venues than normally provided by councils due to the state and regional nature of the facilities.

We considered the councils' claim that the SHFA and SOPA roles were no different from a commercial developer or owner of a large complex (eg, a shopping mall) and agree that there may be some common elements in the roles of SHFA and SOPA and those of a commercial developer. For the following reasons, IPART is of the view that the facilities provided by commercial developments and agencies such as SHFA and SOPA are able to be differentiated.

We consider that the size and nature of the facilities in the special development areas are broader and more extensive than services provided in a commercial facility. The special development areas cover significant areas of land with mixed land uses which could be compared to parts of a suburb or neighbourhood. WSROC has suggested that we consider the planning agreement arrangements in place in the Rouse Hill Town Centre and Norwest Business Park which provide a more appropriate comparison with SOPA. However, the framework that we proposed for statutory authorities is intended to deal with reimbursement of agencies' costs for services already in place rather than future provision of services through planning agreements between private developers and councils.

We have considered councils concerns that they should be involved in the planning and asset management of local services where they would be required to reimburse agencies and that agencies should be required to undertake public engagement in services planning as is required of councils. In relation to community engagement in services planning, the framework for resolving reimbursement costs is to be limited to services in existence rather than planning of future services in special development areas. Should both parties agree to transfer assets to council ownership, it would then appropriate for the facility to be included in councils asset management plan.

SOPA and SHFA considered that there should be a framework for deciding what maintenance costs should be paid by the councils. Whilst supporting a legislative framework, the agencies did not consider the overall costs associated with their proposal relative to the rates reimbursement that they would receive and as a result could not provide relevant information for IPART's consideration.

The legislative model proposed by SHFA and SOPA did not provide for a negotiation or mediation phase to precede arbitration by the independent expert to encourage matters to be dealt with without the expense of arbitrators. The inclusion of these steps in a framework could reduce costs and improve the efficiency of the process. The agency submissions did not deal with other considerations such as equity or transparency considerations, for example, pricing principles to ensure a fair allocation of costs or the public availability of reasons for decisions.

We consider that is not possible to assign costs and responsibilities for the services in question based on the material submitted to us by the agencies without a detailed investigation of the services in question.

Currently there are no incentives or mandatory requirements for councils to negotiate with agencies to resolve responsibility for costs of local government services provided by agencies in special development areas. To ensure that all parties, that is, both councils and special development area agencies are required to undertake negotiations, a legislative provision would be required to establish a mandatory dispute resolution process. If the parties fail to resolve the dispute by negotiation, a mediator could be involved to encourage a settlement. Failing agreement at mediation, an adjudication process akin to arbitration could be used to allocate the costs.

If the dispute reached the adjudicative stage, an independent arbitrator (with local government experience in for example, town planning or engineering) could be agreed on by the parties to minimise the need for higher level involvement. In the event that no agreement was reached as to the arbitrator, then the Minister for Local Government should appoint an appropriate arbitrator.

As the range of services in question is very narrow, we consider that the legislation should be designed to ensure parties' costs are kept to a minimum. To minimise costs, the scheme should contain a requirement that parties engage in negotiation in good faith, followed by mediation before proceeding to arbitration. As the issues

under consideration require an understanding of local government services and costs, the arbitrators to be used should have experience in this area.

As part of a framework for agencies such as SHFA and SOPA, it would be necessary to provide guidance to the arbitrator and the parties to the dispute (that is, the agencies and the councils) about principles which should underpin any negotiations or mediation or arbitration.

A set of principles that would guide the arbitrator in any arbitration is set out in Box 18.1 below. The underlying principle is that any reimbursement of the authorities' costs by councils should be limited to the costs that the councils avoid because the authorities are providing the relevant services. Rates revenue is required to fund in part the general operations of the council and the justification for reimbursing the authorities is that the council would need to spend more if the authorities were not providing the relevant services. As the councils already provide similar services to areas adjacent to the special areas it is possible that their avoided costs may be less that the cost of the agencies. If so, the agencies may not recover all they have spent on the relevant services.

Further councils should not be out of pocket for these services. Therefore, the amount they reimburse the agency should be no more than the revenue they receive from rates from tenants and the agency within the special development area.

Additionally the framework should provide for current year service costs only (rather than retrospective costs) to be reimbursed to agencies to provide councils with sufficient notice to budget for any additional costs.

Box 18.1 Principles to be applied by an arbitrator in assessing the extent to which local government avoids costs when services are provided by an agency

- The extent to which the service that the agency provides is one which the council provides in other parts of the relevant local government area.
- The amount to be reimbursed is the lower of the costs that the agency incurs in providing the service and the amount that the council would need to spend if it was providing the services efficiently. Costs include direct operating costs, capital costs for provision of the services and a share of common and joint costs. Only current (and not retrospective costs) are to be considered.
- In making these calculations, costs are to be calculated net of any associated revenues.
- The amount councils reimburse the agency should be no more than the revenue council receives from rates from tenants and the agency within the special development area.
- The amount of any estate levies paid by tenants for a relevant service should be deducted from the cost to the agency of providing the service.
- Any contribution received by the agency under section 94 of the *Environmental Planning and Assessment Act 1979* should be subtracted from the agency's asset base when calculating capital costs.
- Reasons for the arbitrator's decision are to be documented in the decision and made public.

In principle, we agree with councils that there are likely to be increased costs as a result of the use of their services outside of the development areas. However, we did not find that there was a case for councils being compensated for these maintenance service costs outside the special areas. We consider that there would be some benefits accruing to councils from an increased rates revenue base arising from the proposed new residential development in these areas and greater revenue from the existing commercial activities.

18.4 Proposed Framework

In addition to a set of principles to form the basis of any negotiations or mediations and be considered by the arbitrator (see Box 18.1, earlier), consideration would need to be given to procedural issues for an arbitration framework such as those discussed in Box 18.2. This box sets out a number of possible provisions, some of which have been based on the *Commercial Arbitration Act 1984*.

The scope of the dispute resolution scheme could be extended to other special development areas, by the Minister for Local Government if required, for example by making a Regulation.

We note that Auburn council has prepared a proposal to assume local municipal services and assets from SOPA and that SHFA is transferring local service assets across to City of Sydney Council for ongoing management. Both councils consider that this will assist in resolving responsibility for on going maintenance costs. If this approach was adopted for local service assets by agencies such as SHFA and the SOPA, in advance of a legislative scheme, then the dispute resolution process and related costs may be avoided in some cases. If agencies required a higher level of service than normally provided by the council, this could be achieved through contractual arrangements with the council.

Recommendations

52 That the NSW Government should put in place arrangements, and if necessary enact legislation, that provide for a dispute resolution framework to enable special development authorities and relevant councils to reach a binding agreement on payment for local services provided by authorities.

53 That the dispute resolution framework should initially require the parties to undertake negotiations. Should negotiations not result in an agreement, then the process could require the parties to submit to mediation. Finally, if no agreement can be reached, the framework should require the parties to submit to a binding adjudication process similar to arbitration.

54 That the amount that the authorities can receive from councils should be limited to the amount that councils save because the authorities, and not councils, are providing the service.

55 That prior to the implementation of any legislative scheme councils, SHFA and SOPA should consider whether some local services would be better managed by council and transferred, where parties agree.

Box 18.2 Options for establishing a legislative dispute resolution framework

Application of Legislation to Special Development Areas:: The dispute resolution scheme could apply to present or future disputes between special development agencies such as SHFA and SOPA and adjoining councils concerning the services eg, roads, footpaths, street cleaning, street lighting, security (eg, CCTV and rangers) and parks within the boundaries of special development areas. The Minister for Planning could require the scheme to be applied to other special development areas eg, by making a Regulation.

Procedural provisions: These should be kept to a minimum to minimise costs. The scheme would provide, firstly for negotiation, then mediation and as a final option, binding arbitration procedures to resolve a dispute between the agency and council. If both parties cannot agree on the appointment of the independent arbitrator, the Minister for Local Government could appoint an arbitrator with relevant experience of local government services and costs.

The provisions would deal with the manner in which evidence is to be given before an arbitrator and the powers of the arbitrator to request information.

Basis on which an arbitrator shall reach a decision: Box 18.1 set out the principles to be applied by an arbitrator in assessment of cost avoidance by local government when services are provided by an agency. The arbitrator would publish the reasons for the decision.

Enforcement of arbitration award: The award would be binding on both parties. Enforcement could be modelled on the *Commercial Arbitration Act 1984* which provides that arbitration can be enforced in the same way as a judgment or order of the Supreme Court. The arbitrator also has a wide discretion to order payment of costs of either party to the arbitration. These provisions may ensure a more certain outcome with maximum cooperation by both parties.

Duties of parties to assist arbitration: In order to prevent one party from delaying or postponing the resolution of a dispute, parties to the arbitration would be required to do all that the arbitrator requires to enable a just award to be made. Section 37 of the *Commercial Arbitration Act 1984* requires these provisions apply to the scheme to minimize costs and expedite proceedings.

Powers of the Court regarding the decision of the arbitrator: To minimise public expenditure, the decision of arbitrators should not be subject to an appeal to the courts.

19 IPART's consideration of comments in submissions and at workshops

Following release of its draft report we received 73 submissions as listed in Appendix C and conducted public workshops as set out in Appendix D. The following table sets out the key comments made during the public consultation that require some form of response together with how we have addressed those comments in the final report.

Issue	Tribunal Comments
IPART's report lacks independence as it does not recommend abolition of rate pegging despite the evidence and industry view	We considered the option of removing rate pegging all together and have decided not to propose such an option in the report. We note that while councils have been vocal in their opposition to rate pegging, they are not the only voice. Ratepayers in general are in favour of rate pegging. Option B may be considered as a transitional path for the future. However, some councils want to retain arrangements similar to Option A. (Section 11.1)
The proposed framework may be an improvement on existing arrangements but falls short of expectation of rate peg abolition as per Option 4 and 5 in issues paper	See above
Lack of recommendations addressing struggling rural councils	We agree that it has not got the answer to the problems of small rural councils. However, consideration could be given to increasing Commonwealth and State grants. (Section 7.6)
Lack of consideration of Section 94 contributions in the draft report	Although a significant source of revenue it is outside the terms of reference for the review. (Section 2.5)
There is no council support for Minister's role in setting rate cap (potentially below cost index)	We decided that there should be no change to the position set out in the draft report. (Section 16.1)
Questions over the transparency and appropriateness of the productivity adjustment	The final report notes that the actual amount of the productivity adjustment would be an issue for a future Tribunal. The final report makes it clear that we would report separately on the productivity adjustment factor. Where appropriate the productivity factor could be zero. (Section 15.7)
Weighting of the index every four years in conjunction with the productivity adjustment	We agree that the index would be reweighted every four years at the same time that the productivity adjustment is calculated. (Section 15.3)
Strong support for a preliminary index or for the release of the index earlier in the year	We agree that the index should be released as early as possible to provide councils time to use it in their budgeting. IPART proposes that the LGCI be estimated and published in November each year. (Section 15.6)
Waste management should not be in cost index and statutory charges should be in the index	We agree that waste management costs which are outside the rate pegging arrangements should be excluded from the LGCI and that Statutory charges should be included in the index where they are not already included in costs. (Section 15.2)
Councils to explain why they chose not to utilise the full rate cap	We consider that this should not be an issue as the catch up mechanism should minimise this concern. (Section 13.2)
Submissions seek clarification for community consultation under Option A special variations	We have provided greater clarification in the final report. (Section 13.3)

Issue	Tribunal Comments
Seeking clarification over whether special variations are temporary or change base rate	The final report is clearer on whether special variations are temporary or result in a change in the rate base. (Section 13.4)
Submissions seek clarification of one-off emergency increases	The final report is less prescriptive in setting out the arrangements for seeking increases if the councils were unsuccessful in having their above rate pegging increases approved by the Minister (under Option A) or by the community (under Option B) (Section 13.3 and 14.1)
New process for special variations is less flexible than current arrangements	We consider that the arrangements under Option A should not be any less flexible than under the current arrangements. A one or two year variation can be accommodated within a four year price path. (Section 13.3)
Clarification of criteria for applying for a special variation	We consider that councils should be able to apply to improve (or maintain) financial sustainability, for new services/works (including any cost shifts) or to address backlogs. (Section 13.3)
No difference between Option A and Option B	The report is clearer in distinguishing between Option A and Option B. (Section 12.4)
No support for IPART's whole population survey option - instead a sample survey with reliable statistical guidelines should be used, IPART must set guidelines for the survey (preferred 95% confidence, independent consultant	We have included the option of councils using a rigorous sample survey. (Section 14.3)
The requirement to hold community satisfaction surveys every 2 years may be too often	We have decided that the final report should require the satisfaction survey to be conducted every 4 years prior to the development of the 4-year revenue plan. This could be done in conjunction with any survey conducted as part of the council's forward revenue plan under Option A or Option B. (Section 10.3)
The role of the Minister in determining eligibility for entering into Option B and ticking off on the mandate	We have decided that the Minister's role should not be changed for the final report and have explained the reasoning for this more clearly in the final report. (Section 16.1)
Why is the revenue plan (and each term of revenue regulation) restricted to four years when under the IPRF councils are required to develop strategic plans for 10 years	We consider that councils should develop a 10 year plan in line with the IPRF and that it should be reviewed every four years. This does not preclude longer term planning. (Section 12.4)
Mixed views on whether surveys for option B should be of ratepayers or all resident	We have decided that the councils should engage with all residents and non-resident rate-payers. (Section 14.3)
A one size fits all index does not address the diversity amount councils	The index applies to those councils that do not wish to apply for a rate revenue path that is above the regulated amount. Council which have specific needs should be able to fund those through either Option A (Section 13.3) or Option B. (Section 14.3)

Issue	Tribunal Comments
The framework does not recognise the fact that when rate pegging was introduced, many councils were not recovering their costs	Options A and B allow councils to develop revenue paths that reflects that revenue requirements over the four year period that would address this issue. (Section 12.1)
IPART framework is encouraging councils to take on debt	We are encouraging councils to adopt a responsible funding policy to new capital expenditure. In developing this policy, and in particular the extent to which it takes on debt, council should consider its own particular circumstances consistent with intergenerational equity. (Section 7.4.2)
Timing within option B in relation to the elections, that is, it should be after the elections not before	Timing in the final report has been adjusted so that it aligns with the timelines under the IPRF. (Section 17.3)
The absence of an Option C (no regulation) in the draft report	We have considered the complete abolition of rate pegging and do not consider that this is an option at this point in time. While councils are vocal in their opposition they are not the only voice. Ratepayers in general are supportive of rate pegging. While councils (eg Junee) have cited surveys that indicate community support for the abolition of rate pegging, other surveys (eg IRIS quoted in Brian Dollery's submission) provide evidence that there is support for retaining rate pegging. Also as we noted at some of the workshops, Option B could be a transitional path for the future. (Section 11.1)
DLG is not funded to carry out role we are proposing	Should the government choose to adopt our recommendations it should adequately resource both the DLG and IPART to implement the reforms. (Section 16.2)
There is a cost of regulation that IPART is proposing and this will add to the costs to councils	We recognise that the cost of regulation is one cost of councils. The IPRF covers a large part of the work required to be done by councils. The revenue framework allows councils to determine their total revenue needs and seek to recover those costs either from rate payers or other sources. (Section 15.1)
Definition of cost shifting creates concerns as it is too narrow and has implications for the framework	We have defined cost shifting as when a higher level of government required local government to provide a function or service that is not traditionally associated with local government and does not adequately provide for local government to recover the additional costs that this involves. The framework will allow for councils regulated revenues to be adjusted to enable them to recover the associated costs. (Section 9.4)
Cost index does not address shortfall in funding or backlogs	While the cost index applies to all councils uniformly across NSW, the new framework provides 2 options for regulating council revenues (Option A and Option B) to help address these issues. Provided that councils satisfy transparent criteria applicable to one of these options , they may apply to introduce a four year rate setting horizon to address funding shortfalls including backlogs. (Section 13.3 and 14.2)

Issue	Tribunal Comments
Capital sustainability indicators should be included in assessing financial sustainability of councils. The threshold requirement for a council to be eligible to adopt option B should be based on adequate financial and asset management policies as opposed to adequate financial performance	In chapters 7 and 8 we made recommendations for improving financial performance and asset management to encourage councils to improve their financial management and their long term financial sustainability. To meet the minimum eligibility criteria to operate under Option B councils need to have sound asset management practices and a policies and practices that would allow them to achieve financial performance. (Section 12.1)
The backlog of councils in NSW is not overstated and may be understated	Our further analysis of the available evidence on infrastructure backlogs indicates that these are a concern for NSW councils and confirms the previous finding that currently available data are not sufficiently reliable to enable the size of the current backlog to be accurately measured. We consider that further improvements to councils' asset management planning and reporting are required to enable the backlog problem to be measured, monitored and addressed. We have made specific recommendations for the Division of local Government to implement to address this (Section 7.4 and 8.5)
National Seniors primary concern in relation the revenue framework for local government is that the position of pension concession card holding rate payers should not be comprised in respect of the rate rebates which currently apply	Our recommendations do not alter the position of pension concession card holding rate payers in respect of the NSW government rate rebates which currently apply. (Section 9.5)
Consideration must be given to increasing council efficiencies	To facilitate improvement of councils efficiency and effectiveness we have recommended that the Division of Local Government require all councils to conduct a community satisfaction survey every 4 years to measure satisfaction with service delivery and infrastructure provision in key areas and publish the result in their annual report. We recommend that the Division of Local Government and the LGSA jointly develop the survey Under Options A and B, councils are also required to demonstrate efficient use of funding and to outline both planned and realised productivity savings. (Section 13.7 and 14.2)
Rates revenue is the only type of local government revenue which should be regulated	We have recommended that the regulation of council revenues continue to apply to rates only as this protects rate payers while still allowing councils some autonomy in setting user fees and charges and fines. Protection for rate payers is justified because they cannot choose not to pay rates if they consider them to be too high. In contrast the users of council services that attract a fee or charge can decide not to do so if they are not willing to charge the applicable fee or charge. Section 10.3)

Appendices

A Terms of Reference

I, Morris Iemma, Premier of NSW, under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992* (the 'IPART Act'), approve of the Independent Pricing and Regulatory Tribunal ('IPART') entering into an arrangement with the Department of Local Government to provide assistance to the Department by conducting a review with the following terms of reference.

IPART is to investigate and make recommendations on the following matters:

1. An appropriate inter-governmental and regulatory framework for the setting of rates and charges that facilitates the effective and efficient provision of local government services in NSW.
2. A role for IPART in setting of local government rates and charges in future years.
3. A framework for setting of charges by certain public authorities such as the Sydney Harbour Foreshore Authority, Redfern Waterloo Authority, Sydney Olympic Park Authority and the Growth Centres Commission to enable these authorities to recover costs for the provision of services that are normally provided by local government.

In undertaking this review, the IPART is to have regard to:

- the particular role of local government in the delivery of infrastructure and services to the community
- the current financial position of local government
- the present roles and responsibilities of local government, and the extent to which these are self-determined or determined by statutory requirements
- the current and likely future level of expenditure required by local government to undertake its responsibilities
- the scope for greater efficiency in the provision of local government services, including the use of total asset management planning
- all of the revenue sources available to local government, the potential adequacy of these revenue sources, constraints on those revenue sources, and the financial capacity of local government to meet its statutory obligations and remain financially sustainable
- the extent to which local government provides infrastructure and services that overlap those provided by other levels of government

- the socio-economic impacts of rates and charges, including the ability of families and pensioners to meet their rate obligations, and local government hardship and concessions policies
- differences between metropolitan, regional and rural councils, and also between new development areas and established suburbs
- the current process by which increases in rates and charges are determined and whether this process adequately meets local government wage cost and other expenditure adjustments
- the roles and responsibilities of local government and State Government in determining local government revenues, and
- any relevant recent reviews of local government such as those conducted by the NSW Local Government and Shires Associations and the Productivity Commission.

In addition, IPART is to consider the matters listed under section 15 of the IPART Act to the extent that they are relevant to this review and they are not otherwise addressed by the matters set out above.

In undertaking this review, IPART is not required to consider, review or make recommendations on:

- issues relating to the valuation of individual property, and
- matters associated with the operation of councils' water and wastewater businesses.

IPART should provide a draft report to the Minister for Local Government within 12 months of commencement. IPART may also make an interim report to the Minister for purposes of setting rates revenues from 1 July 2009. The draft report should be made publicly available and comments invited from interested parties. A final report is to be provided to the Minister within a further 4 months of the draft report.

Background

The roles and responsibilities of local government have evolved over many years. The *Local Government Act 1993* sets out the means by which councils are financed. Councils have the power to set rates and charges on individual properties in line with local needs and the provisions of the *Local Government Act 1993*, which requires that rates that councils set must be fair and equitable. Local government revenue is also influenced by statutory requirements set out in other legislation, such as the developer contributions provisions of the *Environmental Planning and Assessment Act 1979* (currently under review). Local Government also derives revenue from the Commonwealth Government and other sources. A significant component of the revenue base of councils has been subject to 'rate pegging' since 1976, with provision for special variations.

B Section 15 of the IPART Act

15 Matters to be considered by Tribunal under this Act

(1) In making determinations and recommendations under this Act, the Tribunal is to have regard to the following matters (in addition to any other matters the Tribunal 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).

(2) In any report of a determination or recommendation made by the Tribunal under this Act, the Tribunal must indicate what regard it has had to the matters set out in subsection (1) in reaching that determination or recommendation.

(3) To remove any doubt, it is declared that this section does not apply to the Tribunal in the exercise of any of its functions under section 12A.

(4) This section does not apply to the Tribunal in the exercise of any of its functions under section 11 (3).

C Submissions

IPART received the following submissions on the Issues Paper which was released on July 2008.

Submitter
Auburn Council
Baulkham Hills Shire Council
Bega Valley Shire Council
Berrigan Shire Council
Blacktown City Council
Blue Mountains City Council
Burwood Council
Cabonne Council
Camden Council
Campbelltown City Council
Canterbury City Council
CENTROC
City of Sydney
Clarence Valley Council
CPSA NSW Inc
Dubbo City Council
Dungog Shire Council
Eurobodalla Shire Council
Glen Innes Severn council
Gosford City Council
Griffith City Council
Gwydir Shire Council
HIA Limited
Holroyd City Council
Hornsby Shire Council
IAG Limited
Individual – Gary Mills
Individual – Michael Sobb
Insurance Council of Australia Limited
Lachlan Shire Council

Submitter
Lake Macquarie City Council
LGMA NSW
LGSA
Lismore City Council
Local Government Association of NSW Shires Association of NSW
MACROC
Manly Council
Mid Western Regional Council
Muswellbrook Shire Council
Nambucca Shire Council
Narromine Shire Council
National Seniors Australia
Natural Allies Environmental Advocates and Consultants
Natural Allies Environmental Advocates and Consultants
North Sydney Council
NSW Department of Planning
NSW Treasury
Port Stephens Council
Property Council of Australia
Redfern Waterloo Authority
REROC
Richmond Valley Council
Riverina and Murray Regional Organisation of Councils
Shires Association of NSW
Shoalhaven City Council
Snowy River Shire Council
SSROC
Sutherland Shire Council
Tamworth Regional Council
The Vaucluse Progress Association
Tweed Shire Council
UDIA NSW
Upper Hunter Shire Council
Upper Lachlan Shire Council
Urban Taskforce Australia
Wagga Wagga City Council
Willoughby City Council
Wollondilly Shire Council
WSROC
Wyong Shire Council

IPART received the following submissions on the Draft Report which was released on 23 July 2009.

Submitter
Auburn Council
Australian Property Institute NSW
Ballina Shire Council
Banaroa Point and District Residents Assoc Inc
Bathurst Regional Council
Bellingen Shire Council
Berrigan Shire Council
Broken Hill City Council
Cabonne Council
Camden City Council
Central NSW Councils
City of Canterbury
City of Ryde
City of Sydney
Coffs Harbour City Council
Cowra Council
Department of Premier and Cabinet
Gloucester Shire Council
Gosford City Council
Great Lakes Council
Gundagai Shire Council
Gunnedah Shire Council
Gwydir Shire Council
Holroyd City Council
Hornsby Shire Council
Housing Industry Association
Individual - B.Gray
Individual - Bruce Berry
Individual - G A Crisp
Individual - Greg Moore
Individual - John Tauszik
Individual - Leigh Fitton
Individual - MR Forster
Individual - Reg T Fisk
Individual - Ron Hartley
Individual - Thomas Port
Individual - Vince Kelly
Junee Shire Council

Submitter
Kempsey Shire Council
Lake Macquarie City Council
Lithgow City Council
Local Government Association of NSW
Maitland City Council
Mosman Council
Muswellbrook Shire Council
Nambucca Shire Council
Narrabri Shire Council
Natural Allies
Natural Allies (Supplementary)
Newcastle City Council
Northern Sydney Regional Organisation of Councils (NSROC)
NSW Business Chamber
NSW Farmers Association
NSW State Policy Group
Penrith City Council
Port Macquarie-Hastings Council
Port Stephens Council
Randwick City Council
Review Today
Riverina Eastern Regional Organisation of Councils
Shoalhaven City Council
Sydney Olympic Park Authority
Tamworth Regional Council
Tumbarumba Shire Council
Tweed Shire Council
University of New England
Urban Taskforce
Wagga Wagga City Council
Weddin Shire Council
Wellington Council
Western Sydney Regional Organisation of Councils
Willoughby City Council
Wollahra Municipal Council

D Public Workshops

Issues paper

IPART held a Public Workshop at the Wesley Centre, Sydney on 29 September 2008 and in regional centres during October and November 2008. The venues were:

- Sydney (29 September 2008)
- Griffith (8 October 2008)
- Queanbeyan (14 October 2008)
- Dubbo (22 October 2008)
- Maitland (5 November 2008)
- Coffs Harbour (12 November 2008).

IPART held also a Public Workshop at its offices, Level 8, 1 Market Street Sydney, in relation to the State Government Authorities.

- Sydney (26 November 2008).

Draft report

IPART held a Public Workshop at the Grace Hotel, Sydney on 2 September 2009 and in regional centres during August and September 2009. The venues were:

- Coffs Harbour (18 August 2009).
- Sydney (2 September 2009)
- Wagga Wagga (8 September 2009)
- Dubbo (11 September 2009)
- Lake Macquarie (16 September 2009)

Transcripts of these public workshops may be found on IPART's website (www.ipart.nsw.gov.au).

E Local Government in NSW

Local government in NSW has been in existence for more than 160 years. However, local government is not recognised in the Australian Constitution. This means that the Commonwealth Government does not have legislative power with respect to local government. Rather, their authority and functions are established under individual State legislation.[210]

Section 51 of the *Constitution Act 1902* (NSW) ensures that a system of local government exists in NSW. The *Local Government Act 1993* (NSW) (the Act) provides the regulatory framework for councils, their function, responsibilities and governance. The Act is administered by the Minister for Local Government through the Division of Local Government.

The sections below provide an overview of local government in NSW, including the accountabilities under the legislative framework, the sources of revenue, the key characteristics of local councils, the role of local government and how councils are classified in this report.

E.1 Existing accountability arrangements in the Local Government Act

In NSW, the *Local Government Act 1993* (the Act) includes provisions that make councils accountable to the State Government and to their local community. Councils are accountable to the State Government – via the Minister and the Department of Local Government – because local government is established through state-based legislation. A similar situation exists in all Australian states and territories, with legislation in each state providing powers to the State Ministers or State Parliaments to monitor council performance and intervene in council decisions or operations if councils are not performing effectively.

In NSW, under normal circumstances, councils are required to hold elections every four years. This means they are ultimately accountable to their community. In addition, the Act requires them to inform their community on council activities and involve the community in council processes.

[210] In November 2008, the Prime Minister reaffirmed the government's commitment for constitutional recognition of local government.

In several states including NSW, steps are being taken to redirect the accountability of local government more towards the local community, rather than to the State Government. For example, recent or proposed amendments to local government legislation in Queensland, South Australia and Victoria include reference to improved accountability to the community.[211]

E.1.1 Accountabilities to Minister and Department

The Act provides the Minister for Local Government and the Department with direct and clearly defined powers that are key elements of the existing accountability arrangements for local government. In particular, the Act provides the Minister and/or Department with significant powers to take actions or impose sanctions to prevent or resolve non-compliance with legislation or poor performance by councils. Some of these actions or sanctions include:

- requiring councils to provide specified information in regular reports to the Department or respond to specific requests for information by the Minister or Director General of the Department
- conducting investigations[212]
- dismissing non-performing or corrupt councillors
- dissolving councils and appointing administrators, or
- removing service functions.[213]

These powers have been used from time to time – for example, in recent years, the Minister has appointed administrators in the Wollongong, Tweed Heads, Shellharbour and Port Macquarie council areas.

Each year, councils must prepare an Operational Plan (based on the 4 year Delivery Plan), audited financial statements and an annual report. They must also submit the financial statements and annual report to the Department. These provisions enable the Department to monitor councils' performance, so that the Minister or Director General can take action or impose sanctions when deemed necessary. (These provisions are also important elements of the arrangements for councils' accountability to the community, and are discussed in more detail in section I.1.2 below.)

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211 The Local Government Bill 2009 (Qld) is intended to increase the accountability and viability of local governments through the introduction of a principles-based, rather than prescriptive, framework for governance. Local Government (Accountability Framework) Amendment Bill 2009 (SA). For Victoria see Kluvers R and Tippet J, *The Anatomy of Accountability in Local Government*, paper presented at AFAANZ Conference 5-7 July 2009, Adelaide.

212 Sections 429 and 430, *Local Government Act 1993*.

213 See for example: Sections 66 and 255-259, *Local Government Act 1993*.

In addition, the Act sets out the current rate pegging system and provides for the Minister to approve special variations to the rate peg amount. Essentially, these rate pegging arrangements limit council flexibility to determine their revenue policies – (such as the balance between taxes and charges) and may also mean that the Minister can influence the range and quality of these services provided (since these are limited by the amount of revenue councils can raise and the nature of services funded through approved special variations).

E.1.2 Accountabilities to local community

The Act requires that a local government election be held every four years. This means that councils are ultimately accountable to their community, which can vote them out if they are not satisfied with their performance (including the level of rates they levy and the services and infrastructure they provide).

However, for this democratic process to be most effective, voters need to have a meaningful understanding of their council's activities and its (and individual councillors') effectiveness. To this end, councils are required to inform the public on council activities and involve them in council processes. For example, the Integrated Planning and Reporting requirements stipulate that each year councils must prepare:

- any updates to the four year delivery program
- a one year operational plan
- financial statements for each year, which must be audited, and
- an annual report.

Financial reports

The Act requires that each year, councils prepare financial reports for the previous financial year. Financial reports must be prepared in accordance with Australian Accounting Standards and the Local Government Code of Accounting Practice and Financial Reporting, and audited within four months of the end of the financial year.[214] The audited financial reports must be included in the council's annual report.

The Act also requires that the auditor provide an audit report to the council and the Director General of the Department,[215] and that the council arrange a public meeting to present the audited financial report and the auditor's report.[216] Members of the community are able to make submissions to council in relation to the audited financial reports or audit reports.

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[214] Councils may seek an extension of time from the Director General of the Department of Local Government.

[215] Section 417, *Local Government Act 1993*.

[216] Sections 418-419, *Local Government Act 1993*.

Financial reports and audit reports are important documents that can help to identify where there are problems over financial controls or issues with a council's financial management.

Annual reports

The Act requires councils to prepare an annual report outlining their achievements in implementing their delivery program over the past year. In the year of the ordinary election, the report must also include an outline of achievements on implementing the 10 year Community Strategic Plan. The report also includes information about the state of the environment and specific information that is important for community members to know about (as prescribed in the regulation). There is no standard format for the annual report.

The Act also requires that councils include in the annual report:

- a copy of the council's audited financial reports
- a report on the condition of the public works (including public buildings, public roads and water, sewerage and drainage works) under the control of the council as at the end of that year
- an estimate (at current values) of the amount of money required to bring the works up to a satisfactory standard
- an estimate (at current values) of the annual expense of maintaining the works at that standard
- the council's program of maintenance for that year in respect of the works.

In addition, the Act requires that councils make the annual report available to the public and submit a copy to the Department. Most councils publish the report in hard copy and their website.

Annual reports can be useful documents that improve council transparency by including a range of material on council activities, such as expenditure on capital works and maintenance. Since annual reports contain comparisons of actual performance against performance targets, they can help members of the community to assess council effectiveness and are therefore an important part of the accountability framework.

E.2 Revenue sources

Chapter 15 of the Act grants councils the power to impose rates and make charges for the provision of services. It also limits the amount by which councils can increase their revenue from rates and charges.[217] Under the Act, the Government may set a limit on the total amount of income that a council can raise from general income, that is, income from ordinary rates, special rates and annual charges.[218] The Minister may specify the percentage by which councils' general income for a specified year may be varied. This is called the rate peg percentage.[219]

The Act allows for:

- Ordinary rates – councils are required to make and levy an ordinary rate for each year on all rateable land in its area (Box E.1 lists land that is exempt from rates).
- Special rates – councils have the discretion to levy a special rate for works or services provided or proposed to be provided or for other special purposes. Special rates can be levied on subgroups of ratepayers.
- Charges – councils may make and levy charges in relation to specified services provided by council (eg, water and sewerage services or the collection of garbage). Charges may be annual or based upon usage. A charge, when made, has the same characteristics as a rate concerning payment, accrual of interest and recovery of the charge.
- Fees – councils may charge a fee for any service it provides. Unlike charges fees are not a debt on the land and are recoverable through civil proceedings.
- Other revenue including fines, interest and investment income.
- Developer charges.

Local councils in NSW have a number of other revenue sources, including:

- grants and subsidies from the NSW and Commonwealth Governments
- other (including fines, contributions and donations).[220]

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217 *Local Government Act 1993*, sections 505 to 513.

218 General income includes revenue from rates and certain annual charges. Most annual charges, eg, domestic waste charges are excluded from general revenue. The annual charges that are included in General Income are drainage levies (levied by Armidale Dumaresq, Bourke and Dubbo) and emergency services levies (levied by Blue Mountains).

219 *Local Government Act 1993*, sections 505 - 506. The peg is, in effect, based on the amount of general income per property.

220 This analysis is based on one of the financial statements, ie, the operating statement, which indicates the net result over a period of time (eg, a financial year) after all revenues and expenses have been accounted for. The operating statement does not ordinarily include items such as borrowings and asset disposals.

Box E.1 Land exempt from rating

All land in a local government area is 'rateable' unless it is 'exempt from rating'. The types of land exempt from all rates (under section 555) include:

- land held by the Crown, not being leased for private purposes
- land within a national park, historic site, nature reserve or state game reserve
- land subject to a conservation agreement
- land occupied by a church or another building used or occupied for public worship
- land occupied by a building used or occupied with religious teaching or training, or as a residence for a minister of religion
- land that belongs to and is occupied and used in connection with a school
- land that is within a special area for the Hunter Water Corporation or other water supply authority
- land that is vested in the NSW Aboriginal Land Council or a Local Aboriginal Land Council and is declared under Division 5 of Part 2 of the Aboriginal Land Rights Act 1983 (this may also exempt land from all charges in some circumstances)
- land owned by the Rail Infrastructure Corporation
- land below the high water mark and used for any aquaculture relating to the cultivation of oysters.

Some land is exempt from all rates, other than those relating to water supply and sewerage service (section 556). However this land is not exempt from annual charges made under section 501. The types of land exempt under section 556 include:

- land that is a public place, common or public reserve
- land used as a public cemetery, public library, public hospital, college, university or mining rescue company
- land that belongs to and is used by a public benevolent institution or charity
- land belonging to the Sydney Cricket and Sports Ground Trust or the Zoological Parks Board.

No land is exempt from user charges made under section 502 of the Act.

Source: Department of Local Government, Council Rating and Revenue Raising Manual, 2007.

E.3 Classifying councils

The Terms of Reference for this review require IPART to have regard to the differences between councils. We note that there are already two classification systems for local government (that is, the Australian Classification of Local Government[221] and the Division of Local Government Classification.[222] Appendix F describes these approaches to classifying councils.) However, we have decided to use a classification that includes a smaller number of categories based on location as shown in Table E.1. Appendix F lists the councils in each of these categories.

Table E.1 Classification for NSW local government councils by location

Classification	DLG Group Number
Sydney City	1
Metropolitan developed	2,3
Regional town/city	4,5
Fringe	6,7
Rural	8,9,10,11

Note: This classifications follows that used by Brooks, J, 2006, NSW *Local government revenue and expenditure analysis*, for the Independent Inquiry into the Financial Sustainability of NSW local government.

Source: Department of Local Government, *Comparative Statistics on New South Wales Local Government Councils*, 2006/07.

E.4 Classification of council functions

The Act contains a Charter to guide councils in carrying out their functions.[223] As part of this Charter, councils are required to:

- provide (either directly or on behalf of other levels of government) adequate, equitable and appropriate services and facilities for the community
- manage the assets for which they are responsible
- exercise regulatory functions, and
- raise funds for local purposes by the fair imposition of rates, charges and fees, and by income earned from investments.

The Act imposes few limitations on what services local government can provide.[224] Rather, its intention is to provide councils with the flexibility to provide services in response to the changing needs of their communities.

[221] The Australian Classification of Local Governments (ACLG) classifies councils into 22 categories according to their socioeconomic characteristics and their capacity to deliver a range of services to the community.

[222] The Department of Local Government puts NSW councils into 11 groups or categories instead of 22. This is because several of the ACLG categories contained either no NSW councils or only one or two councils.

[223] Section 8, *Local Government Act 1993*.

[224] Chapter 6, Section 24, *Local Government Act 1993*.

Given the preponderance of the view that the role of councils is largely determined by its policy response to community demands, IPART sought to examine ways in which these could usefully be classified.

Traditional and non-traditional functions of councils

Drawing on a PricewaterhouseCoopers report of 2006, we categorised the range of council functions into traditional and non-traditional service areas.[225] Traditional services are broadly defined as embracing governance, administration, public order and safety, transport and communication and housing and amenities. Non-traditional services include but are not limited to health services, community services and education, recreation and culture, economic affairs, mining, manufacturing and construction.

We have mapped its categorisation of services against the Department's expenditure categories (listed in Box E.2). This mapping demonstrates the difficulty of assigning clear classifications to services. For example, under the PwC library services and recreation areas were classed as traditional local government functions, whereas they are classified in the DLG's non-traditional category. Given data limitations, we decided to classify services such a recreation areas and library services under the broader non-traditional category.

While much of the traditional functions relate to property or the provision of infrastructure, the non-traditional services relate primarily to the provision of human services. The following sections examine council functions in terms this classification.

Infrastructure provision

Councils in NSW spend $1,546.8 million each year on providing infrastructure.[226] Infrastructure commonly provided by councils includes:

- roads, pavements, traffic lights, bridges and other transport facilities
- stormwater and drainage systems
- libraries, sporting fields, town and community halls, and car parks
- childcare and aged care facilities.

In addition, councils in rural areas may also be responsible for infrastructure such as livestock sales yards, airports and caravan parks.

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[225] The PwC report identified which functions are considered to be part of a narrow (traditional) or broad (non-traditional) role for local government. PwC stated that in general, the core, and perhaps most important, functions performed by local government are the delivery of essential services (waste, and sometimes water and sewerage) and maintaining corresponding infrastructure for local residents (eg, roads, footpaths, drainage).

[226] DLG time series data: Comparative Data Time Series to 0607.xls, available from www.dlg.nsw.gov.au. This has been calculated as the change in property, plant and equipment (excluding land, water and sewerage).

Box E.2

TRADITIONAL FUNCTIONS

Administration

Corporate Support, Engineering & Works

Housing and Community Amenities

Housing, Town Planning, Domestic Waste Management, Other Waste Management, Street Cleaning, Other Sanitation & Garbage, Urban Stormwater Drainage, Environmental Protection, Public Cemeteries, Public Conveniences, Other Community Amenities

Public Order and Safety

Contributions to Fire Service Levy, Fire Protection – Other, Animal Control, Beach Control, Enforcement of Local Govt Regs, Emergency Services

Transport and Communication

Urban and Rural Roads and Bridges, Footpaths, Aerodromes, Parking Areas, Bus Shelters & Services, Water Transport, RTA Works (State), Street Lighting, Other

NON-TRADITIONAL FUNCTIONS

Community Services and Education

Administration, Family Day Care, Child Care, Youth Services, Other Families & Children, Aged & Disabled, Migrant Services, Aboriginal Services, Education

Economic Affairs

Camping Areas, Caravan Parks, Tourism & Area Promotion, Industrial Development Promotion, Saleyards & Markets, Real Estate Development, Commercial Nurseries, Other Business Undertakings

Health

Administration & Inspection, Immunisations, Food Control, Insect/Vermin Control, Noxious Plants, Health Centres

Mining Manufacturing and Construction

Building Control, Abattoirs, Quarries & Pits, Other

Recreation and Culture

Public Libraries, Museums, Art Galleries, Community Centres, Public Halls, Other Cultural Services, Swimming Pools, Sporting Grounds, Parks & Gardens (Lakes), Other Sport & Recreation

Source: Department of Local Government, Local Government Code of Accounting Practice and Financial Reporting, Update No 17, June 2009. DLG has defined the services within each category; it has not distinguished between 'Traditional' and 'Non-traditional'. IPART has done this based on the earlier work of PwC.

Submissions indicated that there is a wide range of infrastructure demands placed upon councils and that each council undertakes its own reviews of infrastructure to determine capital requirements. Internal processes to calculate infrastructure needs vary significantly between councils and are discussed further in Chapter 8.

There are several external factors that affect efficiency of infrastructure delivery between councils, such as size, level of urbanisation, growth and regional price variations. Examples of these are as follows:

- Rural councils often serve a large geographic area with a low population density and substantial road networks. Many rural councils are also responsible for providing water and drainage services. This means they have a small rating base from which they must fund significant infrastructure maintenance and renewal costs. In contrast, most metropolitan councils serve smaller areas with high population densities, less substantial road networks and no responsibility for providing water and drainage services.
- In relation to the provision of social or cultural facilities, such as libraries and sporting fields, rural councils with small populations are likely to have less wear and tear on these facilities, which may lower the total costs of provision. However, they may also be required to provide multiple facilities across a large geographic area to serve scattered communities, and this may increase the total costs per capita. In contrast, metropolitan councils with large populations are able to provide larger, concentrated facilities at a lower cost per capita, but the higher level of usage may increase the total costs of provision.
- Rural councils can face difficulties in attracting skilled infrastructure managers. Rural councils are concerned that their capacity to provide infrastructure is further compromised by workforce shortages.
- Councils serving areas where the population is growing often have greater new capital expenditure needs but also a younger average age of infrastructure, with new infrastructure being funded to some extent through developer contributions. Councils serving areas with 'static' or declining populations have greater concentrations of existing, ageing infrastructure.
- Councils with diverse topography often face a wide range of costs for the same levels of service, for example, construction work costs vary due to engineering requirements differing between areas with unique terrain.[227]

[227] Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government - Final Report*, May 2006, p 114.

The Allan report found that to be most effective, a local council's provision of infrastructure should be confined to items that fall within the area it serves.[228] The Allan report proposed that when a council provides regional infrastructure, it should either be compensated by neighbouring councils, or by a higher tier of government representing a wider constituency.[229] For example, the report specifically suggested that the State government should be responsible for funding regional roads, rather than rural councils.[230]

228 Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government - Final Report*, May 2006, p 113.

229 Allan, P., Darlison, L. and Gibbs, D., *Independent Inquiry into the Financial Sustainability of NSW Local Government - Final Report*, May 2006, p 147.

230 Council are responsible for funding, determining of priorities and carrying out works with respect to local and regional roads (see p 23 of this report).

F Classification of councils

Under the Australian Classification of Local Governments Councils are first classified as either urban or rural. Urban councils are then divided into four categories– capital city, metropolitan developed, regional town/city or fringe. Rural councils are divided into three categories – significant growth, agricultural or remote. The final classification step for both urban and rural councils is based on population eg, small, medium, large and very large.

Each council is given a numerical category and a three letter based alpha code. For example 2(UDS) means the council is urban, metropolitan developed and small and in category two.

DLG created 11 groups (identified by group numbers 1 to 11) by merging a number of the groups because of the small number of councils in them.[231] As well, a few of the groups are not applicable to NSW as they have no members. For example, in the Urban category towns have been categorised in two population sub-categories (up to 70,000 and more than 70,000) instead of four. In the Rural category, the sub-categories of 'Significant Growth', 'Remote Extra Small' and 'Remote Small' are not applicable in NSW.

For its analysis in this report, IPART has aggregated a number of the Department of Local Government Classifications. The councils in each classification are listed below.

[231] The classification is explained in DLG, *Comparative Information 2006-07*, pp 11-12.

Council	DLG Classification
Sydney City	
Sydney, Council of the City of	1
Metropolitan developed	
Ashfield, The Council of the Municipality of	2
Auburn Council	2
Bankstown City Council	3
Blacktown City Council	3
Botany Bay, The Council of the City of	2
Burwood Council	2
Canada Bay City Council	2
Canterbury City Council	3
Fairfield City Council	3
Holroyd City Council	3
Hunters Hill, The Council of the Municipality of	2
Hurstville City Council	3
Kogarah Municipal Council	2
Ku-ring-gai Council	3
Lane Cove Municipal Council	2
Leichhardt Municipal Council	2
Manly Council	2
Marrickville Council	3
Mosman Municipal Council	2
North Sydney Council	2
Parramatta City Council	3
Pittwater Council	2
Randwick City Council	3
Rockdale City Council	3
Ryde City Council	3
Strathfield Municipal Council	2
Sutherland Shire Council	3
Warringah Council	3
Waverley Council	2
Willoughby City Council	2
Woollahra Municipal Council	2
Regional	
Albury City Council	4
Armidale Dumaresq Council	4
Ballina Shire Council	4
Bathurst Regional Council	4
Bega Valley Shire Council	4

Council	DLG Classification
Broken Hill City Council	4
Byron Shire Council	4
Cessnock City Council	4
Clarence Valley Council	4
Coffs Harbour City Council	4
Deniliquin Council	4
Dubbo City Council	4
Eurobodalla Shire Council	4
Goulburn Mulwaree Council	4
Great Lakes Council	4
Greater Taree City Council	4
Griffith City Council	4
Kempsey Shire Council	4
Kiama, The Council of the Municipality of	4
Lake Macquarie City Council	5
Lismore City Council	4
Lithgow Council, City of	4
Maitland City Council	4
Mid-Western Regional Council	4
Newcastle City Council	5
Orange City Council	4
Port Macquarie-Hastings Council	4
Port Stephens Council	4
Queanbeyan City Council	4
Richmond Valley Council	4
Shellharbour City Council	4
Shoalhaven City Council	5
Singleton Shire Council	4
Tamworth Regional Council	4
Tweed Shire Council	5
Wagga Wagga City Council	4
Wingecarribee Shire Council	4
Wollongong City Council	5
Fringe	
Baulkham Hills, The Council of the Shire of	7
Blue Mountains City Council	7
Camden Council	6
Campbelltown City Council	7
Gosford City Council	7
Hawkesbury City Council	6
Hornsby, The Council of the Shire of	7

Council	DLG Classification
Liverpool City Council	7
Penrith City Council	7
Wollondilly Shire Council	6
Wyong Shire Council	7
Rural	
Balranald Shire Council	9
Bellingen Shire Council	11
Berrigan Shire Council	10
Bland Shire Council	10
Blayney Shire Council	10
Bogan Shire Council	9
Bombala Council	9
Boorowa Council	9
Bourke Shire Council	9
Brewarrina Shire Council	9
Cabonne Shire Council	11
Carrathool Shire Council	9
Central Darling Shire Council	9
Cobar Shire Council	10
Conargo Shire Council	8
Coolamon Shire Council	9
Cooma-Monaro Shire Council	10
Coonamble Shire Council	9
Cootamundra Shire Council	10
Corowa Shire Council	11
Cowra Shire Council	11
Dungog Shire Council	10
Forbes Shire Council	11
Gilgandra Shire Council	9
Glen Innes Severn Shire Council	10
Gloucester Shire Council	9
Greater Hume Shire Council	11
Gundagai Shire Council	9
Gunnedah Shire Council	11
Guyra Shire Council	9
Gwydir Shire Council	10
Harden Shire Council	9
Hay Shire Council	9
Inverell Shire Council	11
Jerilderie Shire Council	8
Junee Shire Council	10

Council	DLG Classification
Kyogle Council	10
Lachlan Shire Council	10
Leeton Shire Council	11
Liverpool Plains Shire Council	10
Lockhart Shire Council	9
Moree Plains Shire Council	11
Murray Shire Council	10
Murrumbidgee Shire Council	9
Muswellbrook Shire Council	11
Nambucca Shire Council	11
Narrabri Shire Council	11
Narrandera Shire Council	10
Narromine Shire Council	10
Oberon Council	10
Palerang Council	11
Parkes Shire Council	11
Snowy River Shire Council	10
Temora Shire Council	10
Tenterfield Shire Council	10
Tumbarumba Shire Council	9
Tumut Shire Council	11
Upper Hunter Shire Council	11
Upper Lachlan Shire Council	10
Uralla Shire Council	10
Urana Shire Council	8
Wakool, The Council of the Shire of	9
Walcha Council	9
Walgett Shire Council	10
Warren Shire Council	9
Warrumbungle Shire Council	11
Weddin Shire Council	9
Wellington Council	10
Wentworth Shire Council	10
Yass Valley Council	11
Young Shire Council	11

Source: DLG, *Comparative Statistics*, 2006/07.

G Autonomy of local government in Australia and overseas

This Appendix contains a brief consideration of the autonomy of local government in Australia compared with other countries. It also contains a discussion on the principles underlying good governance and local democracy which has helped guide us in assessing the appropriate framework for local government revenues.

We have not explored in detail arguments for and against changes to Australia's federal structure that have been proposed at various times, but have examined the issue of state government control of local government versus local government autonomy. This has been considered in the context of the accountability framework for local government in NSW and rate pegging.

G.1 Degree of local government autonomy in Australia and overseas

A review of international literature in intergovernmental relations, shows a high degree of diversity for local government autonomy in different countries. The autonomy provided to local government by higher level government (either regional or central) and the intergovernmental arrangements that underpin this, differ from country to country and reflect a range of historical or constitutional factors. Box G.1 contains an outline of local government autonomy in a range of countries.

G.1.1 Why and how do higher level governments control local governments

Goldsmith argues that the establishment of local government systems is an important determinant of the extent of local government autonomy.[232] In some countries, original constitutions refer to local government as part of the structure of government (for example, Mexico and Austria) whilst in others they do not (Australia, United States, Canada). Some countries have subsequently amended their constitutions to refer to local government (such as Germany, South Africa and Switzerland).

[232] Goldsmith, M. 'Central Government Control over Local Government – A Western European Comparison,' *Local Government Studies*, 28:3, 91-112.

Box G.1 Degree of Autonomy and recognition in various countries

In **Australia**, Local Government is not recognised in the federal constitution. States were given all reserve powers not allocated to the Commonwealth and local governments were set up under legislation in individual states. Some States have amended their original constitutions to reflect the existence of Local Government (Victoria). State governments can and have placed restrictions on local governments (including, merging councils, controlling them directly, or abolishing them outright). The NSW and Northern Territory Governments directly limit council rates at present. Other States have limited rates in the past.

In the **United Kingdom**, there is no written constitution and there are two tiers of government (national and local). Over time there has developed a strong system on central guidance and monitoring of local councils by the national bureaucracy. This was further strengthened in the early 1980s with local councils being abolished and rate capping introduced.[a]

In **New Zealand**, the central government is not involved with local government as is the case in Australian states. The government passed new legislation in 2002 which conferred on local government a power to promote well being. Councils in making decisions are now subject to rules requiring them to give consideration to the views of the local community. Changes to rating legislation further reinforced the autonomy of councils. Importantly local authorities are now required to prepare a planning document – the Long term Council Community Plan (LTCCP) every six years in consultation with the local community. Accountability to the local community rather than government intervention is the means of protecting the ratepayer.

In the **United States**, states, rather than the federal government, are responsible for local government. Individual states are able to choose a wide variety of systems of government as long as it is consistent with their constitution. State governments can place restrictions on municipalities (including, merging municipalities, controlling them directly, or abolishing them outright), as long as this does not breach their constitution. Some States, for example, New Jersey, place limits on increases in rates. Several states (Connecticut, Florida, Minnesota, New Jersey, Rhode Island, and Texas) have recently considered imposing severe caps on property tax revenue.[b]

In **Germany**, local authorities have the right to govern themselves with regard to local issues of importance to communities and the ability to cooperate to jointly deliver services or perform administrative tasks. Local governments also have responsibility for their own finances and have a constitutional right to commercial and property taxes. Local Councils in Germany cannot, however, raise new taxes. As is the case in NSW, councils face a growing gap between revenue (as property and commercial taxes become relatively less important) and expenditure (as pressures for services grow).

Norway, essentially has a three tiered structure of government with a national government, 19 counties, divided into 435 municipalities. There are eighteen bureaucratic prefectoral districts that align with the counties.[c] Their chief responsibility is to supervise county decisions and budgets and they can review decisions of counties. There is no constitutional protection of local government and the federal government sets a ceiling for local government tax levels.

Box G.1 Degree of Autonomy and recognitions in various countries (continued)

In **South Africa** the new Constitution, adopted in 1996, establishes local government as a distinct sphere of government. Municipalities in South Africa have constitutionally guaranteed taxing power and are entitled to an "equitable share" of nationally collected tax revenue.

In **Sweden**, also has a three tiered system of government, national, regional (21 county councils) and local (289 municipalities). The constitution contains detailed guarantees of local self government. County administrations have responsibility for monitoring certain areas of national policy, but few options to apply sanctions. Municipalities are free to set their tax levels and local charges and there is constitutional protection of local government and local government has freedom to set local tax levels.

In **Switzerland**, the Constitution recognises major urban and metropolitan centres. Federal authorities have to consider the special interests of Swiss cities and metropolitan areas when making decisions. However, previously there was a moratorium on local taxation by the national government, which later became a ceiling.

Notes

[a] Iain Roxburgh Next Steps for Local Democracy: leadership, accountability and partnership, New Local Government Network, 2008, p 9.

[b] Iris J. Lav and Karen Lyons, *The Problems with Property Tax Revenue Caps*, June 21, 2007, p 1, http://www.cbpp.org/cms/?fa=view&id=414.

[c] There are 19 county councils and 18 prefectures because the county councils of Oslo and Akershus are combined into one district.

Source: Goldsmith, M 'Central Government Control over Local Government – A Western European Comparison', *Local Government Studies*, 28:3, pp 91-112. Iain Roxburgh, *Next Steps for Local Democracy: leadership, accountability and partnership*, New Local Government Network, 2008, p 9. *Guided Democracy to Multi level governance: Trends in Central-Local Relations in the Nordic Countries.* ALGA, *Fact Sheet 6 – International Examples,* http://www.alga.asn.au/constitutionalrecognition/pdf/Factsheet6_International.pdf. Peter McKinlay, *Autonomy versus Accountability :the New Zealand Experience*, Local Government Centre, Auckland University of Technology, 19 Jan2006 (www.lgsa-plus.net/resources/documents/mckinlay)

In addition to constitutional or legislative controls, there are a number of informal ways that federal or state governments across the world influence local government decisions – such as:

- control of local government income and expenditure
  - by determining which taxes local governments can levy
  - by setting local government tax rates
  - by determining the form of intergovernmental grants and the flexibility of their application
  - through control of borrowing
  - by setting limits on expenditure or prohibiting certain types of expenditure
  - by requiring local governments to meet a higher proportion of costs from their own expenditures

- administrative regulations or prescription about how services should be provided
- by controlling local government input into central decision making processes.

The Australian Constitution does not mention local government, but the NSW Constitution does. Generally, the legislative basis for local government in Australia is considered to be weaker than in many other countries, since:

- local governments are not recognised in the Australian constitution
- local governments are subject to State Government legislation and direction, and
- local governments have limited taxing powers.

In addition, local governments in Australia provide a narrower range of functions than in many other federations (such as the United States, New Zealand, the United Kingdom, Canada and Germany).[233] In these countries, local governments undertake many functions delivered by State governments in Australia (such as education, policing and health). Australia's federal structure and sharing of income and responsibilities between levels of governments partly reflect historical factors, such as our origin as a federation of states and the nature of the Constitution, as well as our population, which by world standards is relatively small and dispersed.

G.1.2 Limits on local government revenues in other countries

As indicated in Box G.1, in a number of countries, various state or federal governments have controls over local government revenues. Direct control of local government revenues has occurred in various States in the United States, Norway, Sweden and the United Kingdom. In some cases, the central (or state) government controls the amount by which rates can increase (eg, some states in the USA). Reflecting its concern to protect ratepayers from high increases, the UK government has the power to cap rate increases. However, it has used these powers for only a small number of councils since 2003. In Australia, NSW is the only state that retained rate pegging over an extended period (32 years). Other states have introduced rate pegging at various times (see section G.2.1).[234]

G.2 How are council rates and charges regulated in other jurisdictions?

Whilst a comparison with other countries is made difficult by virtue of differing roles and responsibilities, as a general observation, most local governments in Australia appear to have relatively more limited functions, lower expenditure shares, and lower tax sources available. Within Australia, local councils in most other Australian

[233] Brown, A.J. and Bellamy, J.A. (eds), *Federalism and regionalism in Australia New Approaches, New Institutions?*, Chapter 2, ANU E Press, 2007.

[234] The Northern Territory government is the only other state to currently limit or control local government revenues. Previously Victoria has limited local government rates.

states have greater autonomy in setting their rates and charges than do councils in NSW.

G.2.1 Other Australian States[235]

Victoria

Under the *Local Government Act 1989* (Vic), the Victorian Minister for Local Government has the power to control local government rate setting. The current government policy allows councils to determine rates. Under this policy, councils must prepare a Rates and Charges Impact Statement and undertake community consultation.

Queensland

The *Local Government Act 1993* (Qld) establishes procedures for rate setting. The Queensland Government does not limit rate increases. Ultimately, each local council is responsible to its own constituencies.

Tasmania

The *Local Government Act 1993* (Tas) places the onus on local government for setting rates and charges. The Act requires all councils to publish budgets and make all decisions about rates and charges at open meetings with well-publicised agendas. The Act also requires councils to prepare a five-year strategic plan, and an annual operational plan that relates to the strategic plan, and to undertake community consultation in preparing these plans.

South Australia

The *Local Government Act 1999* (SA) accepts that councils are responsible to their own constituencies for the taxes they set. The Act requires all councils to have and publish a rates policy. It also requires councils to undertake community consultation before making significant changes to this policy.

Western Australia

The *Local Government Act 1995* (WA) does not provide the Government with powers to directly set council rates. It is generally considered that local government elections are the best test of the financial management capacity of local government.

However, the Act requires that councils develop their budget within a community consultation/planning framework. It also imposes conditions related to the rates a councils set, including that the minimum rate cannot apply to more than 50% of

[235] LGSA, *NSW Local Government Rate Determination Model*, July 2003, pp 3-5.

properties. It also requires councils to seek Ministerial approval if the highest rate for an individual property is greater than twice the lowest rate within the LGA.

Northern Territory

Until recently, the Northern Territory *Local Government Act* has allowed councils to set rates. However, it stipulated that councils should not budget for a deficit, and requires councils to publish and publicise their budgeting process. Following a series of reforms for local government, the Minister may cap rates for the first three years of the NT Government's New Local Government Reform Program.[236]

Australian Capital Territory

ACT property owners pay rates and land tax to provide funding for municipal and other essential services. The imposition of rates and land tax are authorized and administered under the *Rates Act 2004* (ACT). The amount of rates payable has two components – a fixed charge and a valuation charge for each rateable property. In calculating rates payable different fixed charges and valuation charges are required to be applied to residential, commercial and rural properties.[237] The valuation charge is based on Unimproved Capital Value of the land.

G.2.2 Why do higher level governments control local government revenues

Controls over local government revenues are put in place for a range of reasons, including:

- to protect local government taxpayers from excessive increases in local taxes or revenues
- to improve uniformity of taxes
- to increase efficiency of local government (by aiming to limit expenditure, by limiting revenue)
- concerns over the administrative capacity of local government, or
- risks of duplication and expansion of Government as a whole.

While revenue controls by a higher level of government may achieve these objectives, control of local government revenues can limit the scope for councils to use local democratic processes to make local choices about the level and types of council revenues and council expenditures.

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236 Section 268 of the *Local Government Act 2008* (NT), permits the Minister to impose limits on rates for the 2008/09, 2009/10 and 2010/11 financial years. Rate limits were re-gazetted on 25 February 2009.

237 See www.revenue.act.gov.au/rates.

G.3 Principles of fiscal federalism and good governance

Fiscal federalism literature contains a number of principles that are useful in considering which level of government should make decisions about service delivery (or provide services to the community).[238] These include:

Subsidiarity – goods and services should generally be provided by the lowest level of government, closest to customers, since this helps to ensure that services are provided to match customer preferences.

Correspondence – goods and services should be provided by the level of government that best matches the distribution of customer preferences (where there are geographic differences in preferences).

Economies of scale – goods and services that can be provided more efficiently as volumes increase should be provided by a higher level of government (or across multiple jurisdictions through appropriate cost sharing arrangements).

Costs of inter-jurisdictional differences – goods and services should be provided by a higher level of government (or standardised across areas) where significant transaction costs are provided on labour or firms by different levels of service provision in different jurisdictions, for example, the cost of varying business regulations between jurisdictions.

Accountability – accountability is generally considered to be higher where a single level of government is responsible for delivery of a function or service.

For local government to effectively benefit from its service its local community it needs to have effective systems in place to ensure:

- democracy and community participation in decision making, and
- community scrutiny of performance.

Box G.2 contains a series of high level principles that generally underlie good governance and democracy in both Governments and public organisations.

[238] Brown, A.J. and Bellamy, J.A. (eds), *Federalism and Regionalism in Australia, New Approaches, New Institutions?* http://epress.anu.edu.au/anzsog/fra/mobile_devices/index.html

Box G.2 Principles of good governance and democracy

Some of the relevant principles underlying good governance include:

Participation – the community should have a voice in decision making and should have the opportunity for constructive participation.

Rule of law – legal frameworks should be fair and enforced impartially.

Transparency – meaningful and useable information should be available to the community.

Responsiveness – decision makers should respond to stakeholder preferences.

Consensus orientation – processes, policies and procedures are required to mediate differing preferences, in the best interests of the group.

Equity – there should be fairness and equality of treatment of members of the community and organisations.

Effectiveness and efficiency – delivering goods and services to maximise benefits to the community, while making the best use of resources.

Accountability – decision makers should be accountable to the community.

Strategic vision – leaders and the public should have a broad and long term vision.

Source: Based on principles from the United Nations Development Program, Governance for sustainable human development.

G.3.1 Subsidiarity

Of particular relevance to this discussion is the principle of subsidiarity which holds that a higher level of government should not exercise functions which can be carried out efficiently by a lower level of government. The State should support local government and help to coordinate its activity with the activities of the whole community.[239] However, if local government wants a higher level of government to also provide services, they could have a level of shared responsibility.

As Warren[240] points out subsidiarity is an important benchmark for the efficiency of Australia's intergovernmental fiscal arrangements. Sub-national governments should, subject to efficiency considerations, be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service.

[239] Democracia Participativa – 'Principles of Subsidiarity' at www. Democraciaparticipativa.net/documentos/principle_of_Subsidiarity.html.

[240] Warren, N, *Benchmarking Australia's Intergovernmental Fiscal Arrangements – Final Report*, May 2006, p 31.

In other words, the State should take action only in so far as the objectives of the proposed action cannot be sufficiently achieved by the local communities and can be better achieved at state level, for example:

- if the policy can be better implemented in a unified way, or
- if the policy/or failure to act will have a state-wide impact.

Policies should always be made at the lowest possible level of government unless there is unanimous agreement that uniform legislation is necessary. Given the diversity amongst councils, and the fact that they are democratic bodies, this principle is relevant to the review of local government revenue regulation.

H The Government's new Integrated Planning and Reporting Framework

The NSW Government has recently introduced changes to the planning and reporting arrangements for local government. The new Integrated Planning and Reporting Framework requires councils to compile a longer term strategic plan (10 years or more).

The framework is aimed at providing greater integration of strategic, service, asset and financial planning. The key elements of the Integrated Planning and Reporting Framework include:

- A 10-year strategic plan (to be known as a community strategic plan).
- A 4-year delivery plan.
- An annual operational plan.
- An annual report.

H.1 Community strategic plan

Under the new framework, each council would be required to develop and endorse a long-term community strategic plan on behalf of its community. In developing and reviewing this plan, each council would also be required to devise a community engagement strategy that identifies key stakeholders and plans methods for engaging them.

The Community Strategic Plan must include:

- a community vision statement
- a series of strategic objectives for the community
- strategies for achieving each objective
- assessment methods for determining whether the objectives are being achieved
- a Community engagement strategy.

The purpose of the Community Strategic Plan is to identify the community's main priorities and expectations for the future and to plan strategies for achieving these goals.

The Community Strategic Plan must be reviewed every four years by each new council following ordinary local government elections. While there are some transitional timeframes associated with the implementation of the proposed framework, ordinarily the review will be completed within nine months of the new council's election.

The Integrated Planning and Reporting Framework requires councils to prepare a longer term community strategic plan and resourcing strategy which would replace the management plan. The community strategic plan would have a time horizon of at least 10 years, which is consistent with that used for local government planning in many other jurisdictions, including South Australia[241] and New Zealand.[242] For example, in South Australia, councils are required to do longer term planning and prepare a series of integrated plans, including long-term strategic and financial plans (10 years or more), medium-term plans (3-4 years) and one-year operational plans and budgets.

The introduction of a longer term strategic plan, and a four-year financial plan linked to programs and budgets for councils in NSW are an integral part of increased financial autonomy.

H.1.1 Community Engagement Strategy

As part of the Community strategic plan, each council must develop and implement a Community Engagement Strategy. This strategy is the basis on which the council would engage the local community and other identified stakeholders, such as State agencies and community organisations, in the development and review of the Community Strategic Plan.

Improving community engagement would benefit from good examples of successful engagement. For example, the South Australian Government and the Local Government Association of South Australia have collected numerous examples of effective community engagement. Box H.1 provides two of these examples, which IPART considers represent either the 'involve' or 'collaborate' level in the spectrum outlined in the box above.

241 *Local Government Act* (South Australia) 1999, Chapter 8.
242 McKinlay, P, *Autonomy versus Accountability: The New Zealand Experience*, January 2006.

Box H.1 Examples of effective community engagement by South Australian councils

Adelaide Hills Council: "Lets work together on the budget"

The Adelaide Hills Council area is a diverse community situated in the Mt Lofty Ranges to the east of Adelaide, with a population of 39,048. In 2006, the Council adopted a creative approach to engaging its community. It used a broadsheet and questionnaire as a tool for consulting the community on its annual goals, rates, and budget priorities for the coming year. It delivered the broadsheet and questionnaire to every household and ratepayer in the Council area, and made them available in public places. It also convened four "Meet your Councillors" sessions in key locations across the Council area to facilitate discussions between community and council members.

The Council's key message was "We're working together with our community so pick up a pencil and make yourself heard on which services and facilities are the most important to you and your family".

The broadsheet introduced the major budget items, explained how the rating system works in easy to read language, and set out the key areas of Council's strategic management plan. It also summarised the status of current services and programs, and possible options for the future. The questionnaire was designed to be simple to complete and return. It included:

- clear instructions about what to do
- a simple requirement to circle a preferred response for each question, but also an option to include comments along the way
- a reply paid envelope to complete the task, or the option of delivery to a service centre or library, and
- the option of completing the questionnaire on line, via Council's website.

The broadsheet also extended an invitation to residents and ratepayers to continue their involvement in the further development of the budget plans, through participating in on-going reference groups.

The strategy very successfully mobilised residents and ratepayers prior to the 2006/07 budget period. The council received more than 2000 responses to the questionnaire, which helped shape the priorities in the council's final budget.

The Council rated the community input about priorities as extremely valuable in facilitating informed decisions in the Chamber. It hoped that listening and taking account of community views will result in greater community confidence in the Council's management of Adelaide Hills community resources.

Source: Government of South Australia and the Local Government Association of South Australia, *Community Engagement Showcase*, June 2007.

Box H.1 Continued

Barossa Council: "A new domestic waste collection service – vote for the option you prefer"

The Barossa Council is a rural council situated to the north of Adelaide with a population of 21,060. The council is committed to implementing strategies to minimise waste, increase recycling and reduce the amount of material going to landfill. It decided to implement a new waste collection service for residents as of July 2007. The new service had to be environmentally responsible, easy to use and cost effective. It was considering two options and wanted to know which service the community preferred.

It developed a community engagement strategy to announce the pending implementation of the new service, and to encourage residents to provide feedback about their preferred option. The strategy involved preparing an information sheet, posting the draft waste management strategy onto Council's website, providing media releases about the review of the domestic waste management scheme, and making community radio announcements.

It then followed up these public announcements with displays in service centres and libraries, roadside signs, and a mail out to households. The mail out included an A4 double sided information sheet outlining the two options. This clearly set out in simple table form the service offered through the two options, changes to the current service, the estimated annual cost of each option and the current service. It also included a tear off "voting slip".

The simplicity of the voting slip made it easy for residents to clearly indicate their preference, and more than one-third of households in the council returned the slip. The council welcomed the community's contribution and considered that it enabled them to make a well-informed decision about the community's preferred option for the new waste collection service.

Source: Government of South Australia and the Local Government Association of South Australia, *Community Engagement Showcase*, June 2007, pp 25 and 31.

H.1.2 Resourcing Strategy

Each council must have a long term Resourcing Strategy to achieve the objectives established by the Community Strategic Plan. The Resourcing Strategy informs the development of the Community Strategic Plan and will be informed by the adopted Community Strategic Plan. The Resourcing Strategy must include:

- long-term financial planning
- workforce management plan
- asset management planning.

H.2 Delivery plan

Each newly elected council would also develop a four-year delivery plan which sets out its commitment to the community. Through this plan, council accounts for its stewardship of the community's long term goals, outlining what it intends to do towards achieving these goals during its term of office and what its priorities will be.

The delivery plan is intended to be the single point of reference for all activities undertaken by council during each term of office (like the current management plan). All plans, projects, activities and funding allocations must be directly linked to it.

H.3 Operational plan

The delivery program must be supported by an annual operational plan. This plan would detail the individual projects and activities that will be undertaken each year to achieve the commitments made in the delivery program.

H.4 Annual report

The new framework includes a number of changes to the annual reporting requirements. The annual report will focus on council's implementation of the delivery plan and operational plan, as these are wholly the council's responsibility. Councils must prepare an annual report within five months of the end of the financial year. This report must:

- outline the council's achievements in implementing its delivery program
- contain the council's audited financial statements and any information required by the regulations or guidelines
- include a report as to the state of the environment
- include an outline of the council's achievements in implementing the community strategic plan (in the year of the ordinary election only).

An independent audit of financial statements helps to improve council transparency and accountability. Effective audits can help identify instances where there has been poor financial performance by a council or council staff. However, since financial and audit reports are backward looking, they are of limited value to members of the community as a tool to help shape future council policy.

The council representatives who attended IPART's public workshops generally put the view that currently, annual reports are not an effective accountability tool. This is because:

- They don't engage the local community. For example, some councils noted that although they held community meetings it was difficult to get community input.
- They are produced to satisfy regulatory requirements and do not seem to be relevant to the community.[243]

However, other councils considered that annual reports are useful in that that they report where the money is spent, whether or not anyone is actually reading them. In addition to complying the regulatory requirements, annual reports provide a good reference point to the trend in the council's activities. They are also useful for internal reporting and benchmarking processes.[244]

[243] IPART, Maitland Public Workshop, 5 November 2008, pp 12, 17.
[244] IPART, Coffs Harbour Public Workshop, 12 November 2008, pp 15, 17, 18, 22.

I Earlier studies on cost shifting

At its most simplistic level, cost shifting occurs when a government responsibility has been transferred to a lower level of government without an appropriate funding source.[245] IPART defines cost shifting to occur where a higher level of government *requires* local government to undertake a function that is not traditionally associated with local government but does not adequately fund local government for the additional cost of undertaking the function. This definition focuses on situations where local government is required to provide a particular service that is outside its normal functions.

This appendix provides background information on how others have considered the matter of cost shifting.

I.1 How has cost shifting evolved?

Cost shifting has its foundation in the separation of revenue and expenditure functions as specified in the Australian Constitution. In 2003, the Hawker Report concluded that cost shifting is ultimately a symptom of dysfunctional governance and funding arrangements. The constitution gives the Commonwealth substantial share of revenue powers, while the States have large expenditure powers. This creates a situation of substantial vertical fiscal imbalance (VFI) between the States and the Commonwealth. With local government being the third tier of government not recognised by the constitution, its revenue and expenditure capabilities are largely determined by the State.

Cost shifting is possible within the Federation because the roles and responsibilities of each sphere of government are not clearly defined. It is therefore difficult to allocate costs as a responsibility to a particular level of government.

[245] This definition limits cost shifting to the cost transfers between different spheres of government. This excludes increases in costs that may result from a receding private sector, particularly in remote communities.

I.2 Evidence of Cost Shifting

A substantial literature exists on the empirical dimension of cost shifting in the United States, but the estimates of the aggregate monetary impact of cost shifting on the American local government vary widely.[246] In a survey conducted by Beckett-Camarata,[247] it was found that 47% of respondents identified increasing expenditures for unfunded state mandated programs as a primary factor leading to Ohio local government fiscal emergency. This highlights the significance of the potential impact of cost shifting in the United States.

In contrast, the evidence of cost shifting in Australia is limited. The Hawker Inquiry was the first major study into cost shifting in Australia. This was followed by the Allan Inquiry (2006) into financial sustainability, which also addressed the issue of cost shifting. The LGSA has continued to utilise the cost shifting survey approach undertaken as part of the Allan Inquiry in order to develop and make readily available accurate data on the size and significance of cost shifting.

I.2.1 Commonwealth Grants Commission (CGC)

The Commonwealth Grants Commission (CGC) had previously considered a number of other factors that have caused changes in local governments' functions and responsibilities.[248] As part of its review, the CGC identified five key areas that have been responsible for expanding local government's functions and responsibilities. These are shown in Box I.1 below.

The CGC noted that its analysis supported local government claims that there had been increases in responsibilities as a result of the States and Commonwealth devolving responsibilities to local government. However, the CGC stated that where the new functions are:

- a result of the discretionary actions of local government, it would be appropriate for local government to funds these functions from their own revenue sources
- a result of changing policies or actions of other spheres of government, it would be appropriate for that sphere to acknowledge the effects of its actions on local government.[249]

Where these changing policies or actions impose extra functions on local government the CGC considered that greater financial assistance might be appropriate. The CGC noted, however, that the diversity of local government meant that, the ability of an

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[246] Dollery, B, 2005, *Government Obligations and Cost Shifting, Working Paper*, University of New England, Armidale.

[247] Beckett-Camarata, J, 2004, 'Identifying and Coping with Fiscal Emergencies in Ohio Local Governments,' *International Journal of Public Administration*, Vol 27, No 8 & 9, pp 615-630.

[248] Commonwealth Grants Commission, *Review of the Operation of the Local Government (Financial Assistance) Act 1995*, 2001.

[249] Commonwealth Grants Commission, *Review of the Operation of the Local Government (Financial Assistance) Act 1995*, 2001, p 55.

individual council to deal with increases in costs would depend on the circumstances of that council.

Box I.1 Commonwealth Grants Commission's Five Key factors causing changes in local government functions and responsibilities over time

1. Devolution: where another sphere of government gives local government responsibility for new functions (equivalent to (1) and (2) in Box 14.2).
2. 'Raising the bar': where another sphere of government, through legislative or other changes, increases the complexity of or standard which a local government service must be provided, and hence increases its costs.
3. Cost shifting (in narrow sense): where there were two types of behaviour. The first is where local government agrees to provide services on behalf of another sphere of government but funding is subsequently reduced or stopped, and local government is unable to withdraw because of community demand for the service. The second is where, for whatever reason, another sphere of government ceases to provide a service and local government steps in (equivalent to (3) and (4) in Box 14.2).
4. Increased community expectations: where community demands improvements in existing local government services.
5. Policy choice: where individual council's choose to expand their service provision.

Source: CGC, *Review of the Operation of Local Government (Financial Assistance) Act 1995*, 2001, p xx.

I.2.2 Hawker Report

The Hawker Inquiry was the first major study which attempted to document the true extent of cost shifting from other spheres of government. The Hawker Inquiry noted that cost shifting is broadly defined such that any attempt to measure it is likely to be met with controversy. With an exhaustive list of potential examples, this difficulty in measurement has tended to discourage organisations and other interested parties from estimating cost shifting. Consequently, the Hawker Inquiry did not independently estimate the economic impact of cost shifting, instead relying on the submissions of interested parties.

In relation to the CGC's five key areas of cost shifting, Hawker considered that

> …where adequate funding is not provided, (i), (ii) and (iii) could be considered types of cost shifting, while (iv) and (v) are a matter of local government choice. Another burden placed on the shoulders of local government is devolved administrative and regulatory responsibilities.[250]

[250] Hawker, D. and Burke, A., 'Rates and Taxes: A Fair Share for Responsible Local Government', *Final Report on the Inquiry by the House of Representatives Standing Committee on Economics, Finance and Public Administration*, October 2003, p 11.

On this view, the Committee identified four common scenarios to help in defining cost shifting. These scenarios are listed in Box I.2.

Box I.2 Hawker Inquiry: Cost Shifting Scenarios

1. The cost related to the imposition of responsibility for providing a certain service, asset or regulatory function upon Local Government by other levels of government (Commonwealth or State Government) without the provision of corresponding funding or compensation or the conferral of corresponding and adequate revenue raising capacity.
2. The cost related to the transfer of responsibility to local government for funding of a service/function (including concessions and rebates) responsibility from other levels of government.
3. The cost related to the situation where local government agrees to provide a service/function on behalf of another sphere of government but funding is subsequently reduced or stopped, and local government is unable to withdraw because of community demand for the service/function.
4. The cost related to the situation where, for whatever reason, another sphere of government ceases to provide, or provides insufficient levels of, a service/function and local government steps in because of community demand for the service/function.

Source: Hawker Report 2003.

Much of the uncertainty as to what is cost shifting revolves around the fourth category. For example, rural or remote communities may subsidise some costs to secure a doctor for a township or where the private sector withdraws from remote communities due to a lack of profitability and local government takes on this responsibility to continue providing the service. The need for councils to do this may be attributed to the impact of Commonwealth or State health policies and thus considered to be cost shifting. However, this link may be contentious and requires further examination.

As a nation-wide study, the Hawker Committee received estimates of cost shifting on a state-wide basis from Victoria and Queensland.

- MAV estimated cost shifting in Victoria to be $40 million per annum in the recurrent funding of three major specific purpose programs including Home and Community Care Services, Libraries and Maternal and Child Health. A further $20 million was estimated for a range of other specific programs.[251]

[251] Municipal Association of Victoria, Submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration Inquiry into Local Government and Cost Shifting, September 2002, p 22.

- The Local Government Association of Queensland (LGAQ) surveyed councils and estimated the overall financial impact of devolved, discretionary or compliance requirements from other levels of government to be around $80 million with $33 million being received in grants. The net impact of cost shifting was estimated to be $47 million.[252]

The MAV in making its submission stated that at approximately $40 million per annum that cost shifting is significant in Victoria. However, it is remarked that, within Victoria, cost shifting is a secondary problem to the much larger overall funding problem for local government. With an infrastructure backlog estimated at $358 million in 2000/01, it was found that only $60 million is directly accounted by cost shifting. This represents 15% to 20% of the greater funding shortfall for local government. Consequently, addressing cost shifting will only partly reduce the funding shortfall. The larger problem is the overall lack of funds required to fund daily operations in addition to the necessary infrastructure renewal and replacement. The MAV argues that this situation can only be resolved by giving local government access to a share of a Commonwealth growth tax such as GST.[253]

In addition, the data in Victoria shows that councils have increased rates, fees and charges at a relatively high rate in an attempt to reduce the funding shortfall. Given the significance of the estimates for cost shifting in Victoria and Queensland, and the fact that they have greater flexibility in setting their own revenue, this brings to question whether rate pegging in NSW exacerbates the impact of cost shifting. Although the evidence is unclear, the presumption is that because rate pegging reduces the flexibility of its revenue raising, then it may be difficult for NSW councils to recover costs inline with its growing responsibilities caused by cost shifting. This risk is greater where the increases in costs are significantly greater than the increases in general prices and wages that provide a reference.

In NSW, the available evidence of cost shifting relates to individual council estimates. Table I.1 shows the estimates for the NSW council's as provided to the Hawker Inquiry. The estimates include a component for annual running expense as well as the provision of capital for maintenance of the assets involved in the service provided. These indicative estimates suggest that cost shifting is substantial. Also, ALGA estimated cost shifting at a national level to be between $500 million and $1.1 billion per annum. These estimates are substantially higher than the estimates for Victoria and Queensland. This suggests that the estimates may be high.

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[252] Local Government Association of Queensland Inc, Supplementary Submission to the House of Representatives Inquiry into Local Government and Cost Shifting, November 2002, p 5.

[253] Municipal Association of Victoria, Submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration Inquiry into Local Government and Cost Shifting, September 2002, pp 1, 22.

Table I.1 Examples of Annual Cost Shifts 2003

Council	Classification	Estimated annual cost shift
Nambucca Shire Council	Rural, agricultural, very large	$1,591,800
Eurobodalla Shire Council	Urban, regional, medium	$732,500
Newcastle City Council	Urban, regional, very large	$4,481,000
City of Albury	Urban, regional, medium	$8,109,000
Manilla Shire Council	Rural, agricultural, medium	$381,479
Guyra Shire Council	Rural, agricultural, medium	$367,000

Source: Hawker Report, 2003, p 29.

In summary, the Hawker Committee identified a number of significant issues being faced by local government. The most significant being the fact that the local government revenue base was deficient relative to its increased roles and responsibilities, of which cost shifting has played a major part. The report also links the infrastructure backlog as a major affect of cost shifting and a significant cause of the increasing financial concerns of local government. The Hawker Committee made 18 recommendations aimed at clarifying the roles and responsibilities of the different levels of government and addressing cost shifting. In response, the Commonwealth Government has since agreed to introduce an intergovernmental agreement to guide allocation of responsibilities across levels of government into the future; recognise the significance of local government through a parliamentary motion and also commissioned the Productivity Commission review into the revenue raising capacity of local government.

I.2.3 Allan Report

The Allan Inquiry (2006) undertook a more detailed examination of the financial sustainability of NSW local government in the face of growing financial concerns of local government. This report was consistent with the conclusions reached by the Hawker Inquiry. The Allan Inquiry concluded that council finances are under significant financial pressure. Specifically, the inquiry estimated the infrastructure backlog to be $6.3 billion and is growing by about $500 million per annum, while local government revenue was inadequate to respond to the infrastructure backlog.

The inquiry made a number of recommendations in the areas of; clarifying local government's role, boosting revenues from rates and user charges, infrastructure backlog and long term strategic planning. As part of this review, the inquiry commissioned a study into quantifying the level of cost shifting in NSW. Moege (2006) surveyed 19 councils on specific areas of cost shifting. The estimated cost shifting values were based exclusively on ongoing annual costs and were expressed as a proportion of council's total revenue from ordinary activities excluding capital revenues. The survey found a cost shifting ratio of 6.9%. Extrapolating these results for all NSW councils, the total burden of cost shifting on NSW Local Government was found to be $430 million per annum. These indicative estimates suggest that cost shifting is significant and thus warrant further investigation.

However, it should be noted that the estimates are broadly 10 times those made by local government in Victoria and Queensland. This raises the question as to whether the differences between the states in cost shifting is that great or does the differences reflect the accuracy of the estimates.

I.2.4 Local Government and Shires Association

One of the earlier documentations into cost shifting was the LGSA's NSW Budget Submission 2001/02. The LGSA listed 10 Acts of the NSW parliament covering environmental and social issues that placed a financial and administrative burden on councils but did not provide commensurate funding.[254]

More recently, in response to the Allan Inquiry and the need to obtain more detailed observations of cost shifting, the LGSA continued the approach of the Hawker Inquiry by conducting cost shifting surveys on an annual basis.

In undertaking the surveys, the LGSA adopted the following definition of cost shifting:

> Where the responsibility for or merely the costs of providing a certain service, concession, asset or regulatory function itself are "shifted" from a higher level of government (Commonwealth or State Government) onto Local Government without the provision of corresponding funding or the conferral of corresponding and adequate revenue raising capacity.[255]

This definition is broad and is open to interpretation. Consequently, the list of examples which can be considered cost shifting is quite extensive.

Cost shifting surveys have been completed for the 2005/06 to 2008/09 financial years. The survey focused on establishing the total amount of cost shifting based on the estimates of net ongoing cost (excluding capital expenditure) for each of the 23 functional areas provided by council. If councils were unable to provide actual estimates, a cost value of zero was allocated. Moreover, the survey excluded any capital expenditure related to these areas. It was suggested by council's that this inclusion would significantly increase the amount of cost shifting. Therefore, the estimates of the cost shifting survey can be considered to be conservative.

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[254] This includes *Protection of the Environment Operations Act 1997*; *Local Government Amendment (ESD) Regulation 1997*; Stormwater Management Planning; *Local Government (Approvals) Amendment (Sewage Management) Regulation 1998*; *Waste Minimisation and Management Act 1995*; *Contaminated Land Management Act 1997*; Environmental Objectives for NSW Waters; *Marine Parks Act 1997*; *Companion Animals Act 1998*; *Local Government Amendment (Community and Social Plans) Regulation 1998*.

[255] LGSA, *The Impact of Cost Shifting on Local Government in NSW: A Survey of Councils (Financial Years 2005/06 and 2006/07)*, March 2008, p 4.

Table I.2 shows the estimates for cost shifting for the 2005/06 to 2007/08 financial years. The cost shifting ratio is calculated as the total amount of cost shifting as a proportion of total income from operations before capital amounts. The survey results were extrapolated to all local government in NSW by applying the established cost shifting ratios to total income from operations before capital amounts for all NSW councils. Estimates show that cost shifting amounts to around 6% of council's total income before capital amounts. This is a substantial impost on local councils.

Table I.2 Total amount of cost shifting onto NSW Local Government ($)

Year	Sample Size	Total amount of cost shifting	Total income from operations (exc. Capital)	Cost Shifting ratio (%)[a]
2005/06	84	379,744,949	6,502,482,000	5.84
2006/07	84	412,244,986	6,928,487,164	5.95
2007/08	65	431,284,746	7,280,361,566	5.92

Note: Total amount of cost shifting as a proportion on total income from operations before capital items.

Source: LGSA, *The Impact of Cost Shifting on Local Government in NSW: A Survey of Councils (Financial Years 2005/06, 2006/07 and 2007/08)*, March 2008. LGSA, *The Impact of Cost Shifting on Local Government in NSW: A Survey of Councils (Financial Year 2007/08.* 2009.

J Cost index

J.1 Background

Under the current approach, the Minister announces a rate peg amount. The rate peg amount is an index based on movement in wages and the CPI. This approach uses ABS data from the December quarter to project an estimate of cost movements to the end of the following June quarter. The announcement of the rate peg is made in March each year, with factors such as ratepayer capacity to pay taken into account. However, the extent to which these contribute to the rate peg amount is not transparent.

This method has been criticised by councils for not reflecting true cost pressures of local government. The NSW Local Government and Shires Associations (LGSA) have indicated that according to its research, rate peg amounts typically have not kept pace with cost increases. The LGSA's own analysis shows that over the period 1997-2002, rates had risen by 16.4% whilst local government costs had risen by 24.3%.[256]

Additionally, submissions to the review have indicated there is a perceived lack of transparency and accountability of the current rate peg model, as the method for estimating rate peg amounts is not disclosed publicly nor is local government consulted about changes to its cost requirements.

J.1.1 What do other states do?

NSW until recently has been the only state in Australia to set rate peg limits (the Northern Territory currently also limits rate increases), however other states (Victoria, Queensland and South Australia) produce local government cost indices for information purposes.[257]

The various forms of local government cost indices are shown in Table J.1.

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256 LGSA, *NSW Local Government Rate Determination Model*, prepared by the National Institute of Economic and Industry Research, 2003, p 1.

257 Victoria and South Australia had a policy of rate pegging for a short period in the 1990s and the Northern Territory has recently announced that residential rates will be capped to CPI.

Table J.1 Summary of cost indices in other states

	Indicators	Weights	Data/Publication	Use
VIC	Average Weekly Earnings (AWE), Roads Maintenance and Construction (BTR) Index	80% AWE 20% BTR	ABS data Quarterly 6-8 weeks after end of quarter	Information
QLD	General Construction Index, CPI – all groups	50% GCI 50% CPI	ABS data Quarterly 6-8 weeks after end of quarter	Information
SA	High detail	Reweighted yearly	Annual council data ABS data Quarterly 6-8 weeks after end of quarter	Information
NSWLGA	Moderate detail	Reweighted by councils	Annual council data ABS data Quarterly 6-8 weeks after end of quarter	Proposed rate setting

Source: NSW LGSA Rate Determination Model, MAV Local Government Research and Policy Unit, Local Government Association of Queensland, South Australian Financial Manager's Association.

J.1.2 Examples of where IPART uses Cost Indices

IPART currently publishes indices which assist in setting fare increases for taxis and ferries in NSW.

These price indices were initially developed by consultants (PricewaterhouseCoopers) who undertook an extensive survey of costs within each industry and developed appropriate indicators aimed at capturing the most relevant costs for each. Where reliable information is unavailable (for example, driver earnings), proxy items have been used to complete the index.

The weightings for each index are based upon what constitutes an efficient level of costs for the industry. Weightings are reviewed periodically (usually every five years) with some scope for earlier revision should particularly volatile price changes occur for significant items such as fuel.

Data is sourced from a survey undertaken of key industry stakeholders and a price index is published annually, with regards to a price increase on July 1 each year.

The price index for each industry is not a direct indication of how prices should move in a given year, often some scope for a productivity increase and other factors such as broader economic conditions, social impacts and timing of the price change may affect the final pricing recommendation made to the Ministry of Transport.

J.2 The Role of a Cost Index in the revenue framework

We have identified three main roles for a potential Cost Index for Local Government:

1. part of a replacement for the current rate pegging system, within a revised revenue framework, that is, used as an input to determine rate increases
2. a guide for councils
3. a benchmark for the community.

Regardless of how the cost index fits within the framework, we consider that it would be an important part of such a framework.

Responses to our review to date have indicated that:

- Whether or not a policy of rate pegging is retained the publication of a Local Government Cost Index that is reflective of local government costs should be published.
- A published index would be a useful tool in both setting rates and improving accountability and transparency of local government revenue collection.
- An industry based cost index provides the public with specific information on the movement of local government costs. The value of this approach is recognised within the local government sector.

Views vary on the use of an index for determining rate adjustments. For example:

- Many councils are in favour of removing regulation on rates revenue altogether.
- The Treasury submission to the review recommended an alternative approach, involving regulating the process of rate setting, rather than the outcome. It is considered that this method requires councils to set their rates according to a specified formula that is transparent and efficient, whilst accounting for the ultimate degree of diversity between councils. The Treasury submission proposed that any attempt to regulate the outcome of the rating process removes a degree of diversity.
- Some councils would prefer to retain rate pegging as a benchmark to measure their performance against.

J.2.1 Issues with the use of an index to determine rate adjustments

The South Australian Local Government Association considers that there are limitations of the cost index approach:

- ABS price indexes used in a cost index model are estimates, based on a sample of goods and services from a sample of retailers, wholesalers and employing organisations. Therefore any local government price indexes which are calculated using ABS price indexes are also estimates.
- Ultimately, Council budgets (and rates) must be set in the context of a Council's Strategic Management Plan, Community Consultation, and decisions about the level of services and revenue required each year.

We consider that if an index were to be adopted as part of the revenue framework of local government in NSW, it should form one of the key inputs to the rate cap. The Minister would be responsible for determining the final rate cap amount after consideration of IPART's cost index.

J.3 What type of cost index should be used for local government?

A cost index for local government could either be based on a broad economic indicator or it could be based on a wider range of indicators that reflect the cost pressure in councils.

Generally CPI is used in price regulation for escalating revenues or prices. However, submissions to the review have indicated that broad economic indicators such as CPI do not accurately represent the costs associated with local government.

A specific cost index approach is suitable for industries where there are not periodic zero-based resets and/or a CPI price path is not the best estimation of costs. IPART has previously been involved in developing cost indices in other industries it regulates, such as taxis, buses and ferries.

A key feature of the cost index approach is its simplicity to maintain. The actual items that constitute the cost index are unchanged from year-to-year, and potential rate adjustments may be estimated by considering the change in each of the cost items (usually weighted by their relative share of total costs).

The following sections detail the analysis behind our recommended position on a cost index for local government.

J.3.1 Should the cost index reflect local government costs or should it reflect general economic indicators?

To develop an appropriate cost index for local government in NSW, it is necessary to consider whether a cost index should include indicators that are directly related to local government costs, or whether general economic indicators such as CPI may be suitable for calculating estimates.

NSW Councils in general have expressed dissatisfaction with an index linked purely to CPI and other states that publish cost indices share similar concerns.

The Municipal Association of Victoria (MAV) explains that the basic premise behind its index is that the local government basket of goods is different to other indices available, such as, the CPI, the Labour Price Index, and Average Weekly Earnings.[258] It argues that local government expenditure is characterised by its relatively high level of direct employee costs, reflective of the service based nature of a significant proportion of its activities, such as aged care, childcare, public library provision, planning, parking and food enforcement; and material and contracting costs. In addition, councils have considerable capital programs which include the construction and maintenance of assets and infrastructure.

The Queensland Treasury Corporation's 2007/08 annual report also recommended that councils should increase their net rates, utility, fees and charges based on appropriate industry price movements, such as those revealed in the Local Government Association of Queensland's Council Cost Index, and not just the CPI.[259]

The South Australian Local Government Association notes that:

> The lack of relevance of CPI (which is a measure of household costs) as an indicator of changes of Council costs has previously been noted by many in the sector over a number of years. Despite the CPI not being relevant for the Local Government sector, many ratepayers and the media continue to use the CPI as a reference point when evaluating Council rate rises.[260]

SALGA considers that the Local Government Price Index it publishes quarterly is a reliable and independent measure of the inflationary effect on price changes in the South Australian Local Government sector.[261]

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[258] Municipal Association of Victoria, *Local Government Cost Index Report,* Economic Policy and Research Unit, May 2007, p 1.

[259] Queensland Treasury Corporation, *Financial Sustainability in Queensland Local Government, October 2008*, p 25.

[260] SALGA, *SA Local Government Price Index*, www.lga.sa.gov.au/goto/priceindex.

[261] SALGA, *SA Local Government Price Index*, www.lga.sa.gov.au/goto/priceindex.

J.3.2 Movement in costs over time

During its review, we conducted case study analysis of a sample of local councils. Part of this analysis involved collecting data from these councils including their cost movements over the recent past.

The aim of our analysis was to clarify two issues:

- Whether movements in rates and local government costs have differed in recent years?
- What kind of cost index model best reflects the movement in local government costs?

We considered various options for a cost index to examine which of the options would be most prudent to adopt for local government. The models included in the comparative analysis were as follows:

- rate peg
- CPI
- composite indicators: MAV model, QLD model
- local government specific indicators (a local government cost index (LGCI) which has been based on the SA model).

These models differ in terms of the cost items and inflators used and the weights applied to them. The example used by the LGSA in its 2003 research paper has not been included in this analysis, as data relating to its sub-categories is no longer available.

To undertake this comparison, we created a local government cost index using NSW data collected during the case studies. This index has been based on the South Australian model as it was considered to be the most complete measure for estimating local government cost movements over time. To construct this model, we set weights for each cost item based on the actual data provided to it by case study councils. We also selected the appropriate NSW equivalents for the inflators used in the South Australian model.[262]

Table J.2 and Figure J.1 show the movement in each of the indices over the period 1997/98 to 2007/08.

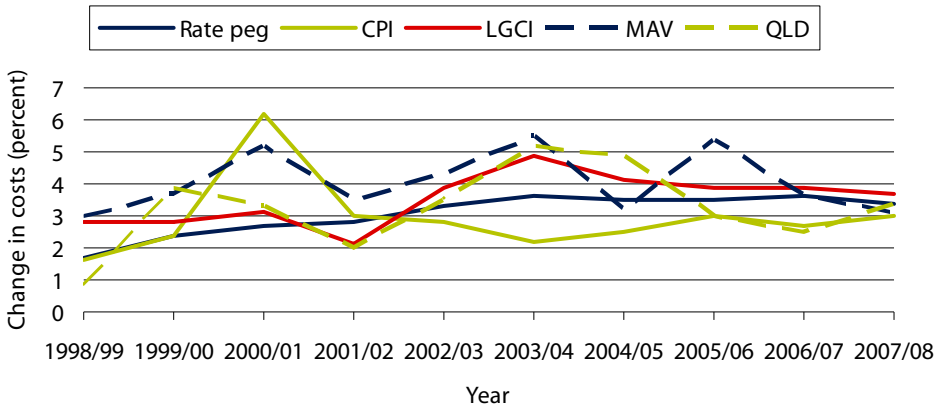
[262] Separate employee cost categories were omitted from the cost index due to a lack of data. As a result, employee costs were included as total employee costs, in a manner similar to that of that LGSA model. IPART consider this to have had made no material difference to the final outcomes presented above.

Table J.2 Comparison of local government rates and cost increases for case study councils 1997/98 to 2007/08 (%)

	Rate Peg	CPI	LGCI	MAV	QLD
Estimated cumulative increase 1997/98 to 2007/08	35	33.5	41.2	47.4	32.4

Source: IPART analysis.

Figure J.1 Comparison of local government rates and cost increases for case study councils 1997/98 to 2007/08



Note: The 2000/01 CPI increase reflects the introduction of the GST.
Data source: IPART analysis, Department of Local Government, ABS.

Whilst the current rate pegging formula appears to have kept pace with CPI, it appears that local government costs for case study councils have in fact moved consistently higher over the past ten years.

According to our analysis, over the last ten years, the costs of case study councils are estimated to have increased 6.2% more than the rate peg amount. That is, the difference between the LGCI and the rate peg amount over the period was 6.2%.

The analysis also showed that for the group of case study councils, neither the CPI nor the composite indexes (MAV, QLD) were able to provide close approximations of the detailed local government cost model.

The MAV model estimated an increase 12.4% more than the rate peg, whilst the QLD model and CPI moved slightly less than the rate peg over the same period.

J.3.3 Further comparison between models

To determine the most suitable index to publish for local government, we consider that each index must be assessed against some key principles of regulation: simplicity, transparency, efficiency, accountability, effectiveness and data source.

In addition, considerations should also be given to how each index may be administrated and published.

Table J.3 summarises the assessment of each option against the given criteria. A detailed discussion of each criterion follows.

Table J.3 Cost index options versus performance criteria

	Simplicity	Transparency	Efficiency	Accountability	Effectiveness	Data source
Broad economic indicators	High	High/Low	High/Low	Medium	Low	ABS
Local government specific cost items	Low	High/Low	High/Low	High	High	ABS, local government

Simplicity / administrative ease

A broad economic index is a simple system, administratively efficient and may be easy to communicate to the broader community on a regular basis. However, as demonstrated by our case study analysis, the simplicity of the index means it does not consistently capture accurate changes in local government costs. Using broad economic indices is also rather inflexible, as it is difficult to make adjustments to the index when the composition of local government services varies.

An industry specific model relying upon council data imposes costs on the time and resources of all councils and any potential regulator. The task of aggregating and auditing an industry specific cost model is more intensive than collating and publishing relatively fewer ABS statistics.

However, an industry specific index may be modified so that it is easier and less cumbersome to administer. Less in-depth data is required if only items that contribute significantly to the index, or that vary significantly different to CPI, are included. Using an industry specific cost index is also more flexible, in that smaller changes in the relative weightings between cost items may be included to produce a more accurate estimate.

Transparency

Either cost index approach may be transparent, as long as the economic indicators or indices used in determining the cost changes, the inflators and weighting of the model and the justification behind their use are made publicly available.

Efficiency

Efficiency measures how well the index promotes the allocation of goods and services by councils.

Generally, a cost index approach may or may not be efficient. An industry knowing all its costs increases will be matched by a price increase, may not seek out the most efficient cost structure. However, given the accuracy with which a cost index measures cost changes, it may be more effective to create incentives for improved efficiency by means such as productivity adjustments or key performance indicators.

Using local government specific cost items, productivity adjustments may be made to account for perceived efficiency gains and key areas of growth may be targeted and reweighted periodically to reflect changing local government operations.

Using general economic indicators, any adjustments that may be made are economy-wide and may not reflect the nature of local government.

Historical data shows that using broad economic indicators such as CPI has tended to significantly under or over estimate cost increases and can lead to inefficient service outcomes by restraining or relaxing estimates by too much.

Accountability

Publishing a cost index will in general, increase accountability for councils.

An industry specific cost model is arguably the most effective increase for accountability, as it promotes the best fit for local government costs, whereas using economy-wide indicators are only general guides to cost changes and councils may argue (as they do now) they do not capture the scope of local government operations.

Effectiveness

Effectiveness indicates how well the cost index measures local government cost movements.

Our case study analysis shows that general economic indicators do not closely estimate changes in local government costs.

An industry specific cost index provides a better estimate of local government costs and recognition of the tasks local government is involved in and promotes effective allocation of resources.

Using broad economic indicators such as CPI has tended to significantly under or over estimate cost increases. A broad economic index does not capture service changes or changes to the composition of local government roles as accurately and if estimating cost increases inaccurately, can reduce effectiveness of service delivery.

Data requirements/timing

A consistent cost index publication relies upon timely and accurate provision of data.

Using broad economic indicators relies only upon ABS data for publication, which is typically available 4-6 weeks after the end of each quarter and is reliable and easily accessible.

Publishing an industry specific cost index would also be a straightforward escalation of each of the cost items by the relevant inflator. However, reweighting the index would be a more complex task.

As part of its case study analysis, we asked councils to complete a questionnaire for developing a cost index, based upon the South Australian price index model, to ascertain the highest level of data collection currently possible. Other price index models rely upon information that is currently available from councils.

Although there were some issues with councils obtaining detailed information on employee costs, councils were able to supply sufficient data for a thorough estimation of a cost index to be calculated. In addition, the task of reweighting the index may not need to be conducted regularly, only once every five years or so.

We note there is a lack of readily available aggregated local government data and the disadvantages of such a system are that it relies upon timely and accurate data from local councils themselves, which may be difficult to maintain. It may also be more expensive and time-consuming to produce.

In order for a local government specific cost index to be effectively produced, it would need to be reweighted periodically and local government data audited before use, in a process similar to that of other industries we regulate with a cost index, such as taxis and ferries.

Glossary

ABS	Australian Bureau of Statistics
CCTV	Closed Circuit Television
CGC	Commonwealth Grants Commission
CPI	Consumer Price Index
DLG	Division of Local Government (Department of Premier and Cabinet) previously Department of Local Government
DPC	Department of Premier and Cabinet
GSP	Gross State Product
IPART	Independent Pricing and Regulatory Tribunal of NSW
LGCI	Local Government Cost Index
LGSA	Local Government and Shires Associations of NSW
LPI	Labour Price Index
NSW	New South Wales
PPI	Producer Price Index
PwC	PricewaterhouseCoopers
RWA	Redfern Waterloo Authority
SALGA	South Australian Local Government Association
SHFA	Sydney Harbour Foreshore Authority
SOPA	Sydney Olympic Park Authority
SPP	Specific Purpose Payment

List of Findings

1 NSW council revenues should continue to be regulated in some way, as councils' accountability to their local community is currently not strong enough to rely solely on the democratic process to protect ratepayers and other residents. 44

2 The framework for regulating council revenues should continue to focus on council's general income, as this approach protects ratepayers (who have no discretion over whether or not they pay rates) while providing councils with some autonomy in setting user fees and charges and fines. 44

3 There is scope to improve councils' accountability to their community by setting more explicit requirements and providing additional guidance and support tools to increase: 44

- The level of community engagement and involvement in council planning and decision making. 44
- The standard of information provided to the community in terms of accessibility and meaningfulness. 44
- The compliance with requirements of councils to develop asset management plans. 44

4 Analysis of the trends in council revenues in NSW compared to those in other states indicates that rate pegging has not had a significant impact on NSW councils' total revenue growth. While it may have constrained growth in rates revenue, councils have been able to substitute other sources of revenue, such as sales of goods and services. As a result, the growth in NSW councils' total revenues has been broadly in line with that in the other states for most of the time since rate pegging was introduced. 55

5 Over the last 10 years, growth in NSW councils' revenue from sales of goods and services has slowed, which may indicate that councils have taken up available opportunities to increase their revenue from this source. If this were the case, NSW councils may not be in a position to maintain growth in total revenues in line with other states in future. 55

6 There is a significant diversity across NSW councils in terms of the relative importance of different sources of revenue. Rural councils, in particular, are much more reliant on grants and subsidies than other councils, and less reliant on rates

revenue and user charges. This suggests that they are less able to raise their own revenue. 55

7 At the aggregate level, there has been relatively strong growth in local government operating expenditures over the period of rate pegging, and average growth has been stronger in NSW than in other states. This indicates that rate pegging has not constrained local government expenditures. 59

8 More detailed analysis of the expenditure trends in NSW indicates that the growth of expenditure varies by council type, as does the composition of expenditure. Rural councils tended to record lower growth in operating expenditure and spend more on traditional services than other types of council. The lower expenditure patterns of rural councils may reflect financial pressures on these councils. 59

9 Analysis of published material on aggregate trends in local government's capital investment indicates that on average, councils' infrastructure investment per person has been lower in NSW than in the other states over the period of rate pegging. However, infrastructure investment tends to be lumpy and there have been significant changes in rates of investment in both NSW and the rest of Australia over this period. Therefore, the link between inadequate spending on infrastructure by councils in NSW and the policy of rate pegging is not established by this analysis. 64

10 A number of other factors are likely to have contributed to a council's level of infrastructure investment – including economic growth, its policies (eg, choices to forgo maintenance to provide funding for new capital works), asset management approach, the level of grants, subsidies and developer contributions it receives and the demands on its revenue associated with asset maintenance. 64

11 On balance, despite rate pegging, the trends in NSW councils' revenues and expenditure have been largely similar to those in other states over the past 30 years. This indicates that other factors are driving council's financial performance, and this performance cannot be directly linked to rate pegging. 65

12 The results of previous studies of local government's financial sustainability indicate that the position of councils in NSW is broadly similar to that of councils in states not subject to rate pegging. In particular, they indicate: 75

- Most councils in all the states report small operating deficits. 75
- Most councils in all states have strong balance sheets, with low reliance on debt. 75
- Most councils in each state (between 80% and 60%) are financially sustainable (at least on a recurrent basis). 75

13 These results suggest that rate pegging is not a driving factor in NSW councils' financial sustainability. 76

14 In relation to the infrastructure backlog: 76

- previous studies provide evidence of a significant backlog in most states, and one study (by PwC) suggests the backlog may be worse in NSW than in other states 76
- most studies indicate that a range of factors contribute to the infrastructure backlog 76
- all studies suffered from the lack of reliable, consistent data on the infrastructure backlog. 76

15 This means the evidence on the infrastructure backlog provided by previous studies is inconclusive. It may suggest that rate pegging is a contributing factor to the infrastructure backlog in NSW but more clearly indicates it is not the only contributing factor. 76

16 Analysis of NSW councils' financial performance from 2002/03 to 2007/08 indicates most councils are financially sustainable on a recurrent basis. In particular: 89

- most councils' operating results are sustainable; however, a higher percentage of rural councils and fringe councils have unsustainable operating results than metropolitan councils 89
- most councils' rates coverage gives them sufficient capacity to adjust to adverse financial conditions; however, rural councils have a higher reliance on grants revenue and thus less flexibility to generate increased revenues from rates and annual charges 89
- most councils have very high levels of liquidity. 89

17 NSW councils' performance in terms of capital sustainability is difficult to measure and interpret due to limitations in the available data: 100

- Councils' asset valuations have varied over the study period because of the change from valuation based on historic cost valuation to valuation based on fair values. 100
- Councils' estimates of infrastructure backlogs were derived using inconsistent estimation approaches and many were based on subjective interpretations of the 'satisfactory standard' for council assets. 100

18 Analysis of the available information indicates that: 100

- NSW councils have backlogs in infrastructure, but the extent of any backlog cannot be accurately estimated due to the unreliability of the data. 100
- More than half of NSW councils are managing to maintain capital expenditure at a rate at least equivalent to depreciation, despite significant underutilisation of debt to fund long lived assets. 100
- To the extent that councils presently underutilise debt, they have the scope to make greater progress towards reducing infrastructure backlogs through a

more appropriate combination of revenue with debt funding of capital expenditure. 100

– Despite rate pegging, some of the case study councils were able to improve their financial sustainability over the study period through the use of special variations. 100

19 In relation to rural councils with small populations (less than 10,000 people), analysis indicates that: 101

– These councils are at greatest risk of having unsustainable long-term positions, largely because they have less capacity than other councils to increase own-source revenue, especially rates revenues, due to the characteristics of the areas and populations they serve 101

– These councils' low capacity to increase rates revenue means that changes to the framework for regulating council revenues are unlikely to be sufficient to reduce this risk, and alternative government action is likely to be necessary. 101

20 Further analysis of the available evidence on infrastructure backlogs indicates that these backlogs are a concern for NSW councils, and confirms the previous finding that that currently available data are not sufficiently reliable to enable the size of the current backlog to be accurately measured. 115

21 This analysis also indicates that further improvements to councils' asset management planning and reporting requirements are needed to ensure they have the data they need to understand and address any infrastructure backlog, and that enable the size of the state-wide backlog problem to be measured and monitored. 115

22 When cost shifting is defined in a way appropriate to the focus of this review – ie, as the mandatory transfer of functions not traditionally associated with local government by a higher level of government without appropriate changes in funding -- only a few sources of councils' cost pressures are considered to be cost shifting. 125

23 Where an instance of cost shifting that meets this definition is found to have occurred, the framework for regulating council revenues should specifically allow for councils' regulated revenues to be adjusted to recover the associated costs. 125

24 Cost pressures that do not meet this definition are best addressed by improving the framework for regulating council revenues so that regulated revenue increases more closely reflect the change in councils' actual costs. 125

25 Councils can respond to cost pressures due to gaps in service delivery and rising community expectations by either choosing not to fill gaps or enhance services , by consulting their community to determine its willingness to pay for new or enhanced services through higher rates or charges. 125

26 There are no standard measures for the productivity of local government service delivery. Requiring councils to report on both expected and realised productivity improvements for individual services would inform a potentially wider review of the productivity of local government. 131

27 There are no standard measures for the effectiveness of local government service delivery and infrastructure provision. Requiring councils to undertake a regular, common community satisfaction survey would provide an important tool for measuring this effectiveness and helping councils to improve in areas where satisfaction is found to be low. 131

28 The framework for regulating council revenues should provide for regulated rate increases to be set with reference to a local-government-specific cost index. 136

29 This cost index should be developed, maintained and published by an independent party using audited local government data, and should be periodically reweighted. 136

30 The framework for regulating council revenues should: 137

- Encourage councils to take a longer term approach to planning expenditures and revenues, and strengthen the links between rate setting and the Integrated Planning and Reporting Framework. 137
- Provide scope for councils to develop medium-term revenue paths that enable them to improve their financial sustainability. 137

31 The framework for regulating council revenues should create additional incentives for councils to improve their accountability to their community. 138

32 The framework for regulating council revenues should include an explicit, transparent productivity adjustment. 140

33 The framework for regulating council revenues should be more flexible in order to take better account of the diversity among NSW councils. 141