IPART
New South Wales

Independent Pricing and Regulatory Tribunal

2013/14 Rate Peg

Local Government — Information Paper
November 2012

ISBN 978-1-922127-42-6

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1 Executive summary

The Independent Pricing and Regulatory Tribunal (IPART) is responsible for setting the rate peg each year. For 2013/14, we have set the rate peg at 3.4%.

The rate peg determines the maximum allowable percentage increase in general income for most local councils in NSW.[1] General income mainly includes income from council rates. It excludes council income from water, sewerage and waste charges.

1.1 The components of the 2013/14 rate peg

The rate peg of 3.4% for 2013/14 was calculated by:

- taking the increase in the Local Government Cost Index (LGCI) for the year to September 2012 of 3.7%
- deducting a productivity factor of 0.2%
- deducting 0.1% to remove part of the carbon price advance of 0.4% that was included in the rate peg last year.

Table 1.1 shows how we have calculated the rate peg.

Table 1.1 The 2013/14 rate peg and its components

Component	Percentage change
Local Government Cost Index	3.68
Less Productivity factor	-0.20
LGCI less productivity factor	3.48
Less withdrawal of carbon price advance	-0.10
Total increase	**3.38**
Rate peg (rounded to one decimal place)	**3.4**

Last year, we included a 0.4% advance in the rate peg of 3.6% for 2012/13. The advance was included in the rate peg to allow councils to increase their rates to reflect the higher prices resulting from the introduction of the carbon price from July 2012.

[1] Under the *Local Government Act 1993*, councils may seek approval to increase their general income by more than the rate peg by applying to IPART for a 'special rate variation'.

At the time we set last year's rate peg, we announced that we would withdraw the carbon price advance over the next 2 years, with 0.1% to be deducted from the rate peg for 2013/14 and 0.3% to be deducted from the rate peg for 2014/15. The withdrawal of the advance is necessary to avoid double counting the impact of the carbon price.

In the remainder of this paper we explain the 3 main components of the rate peg in more detail. In section 2 we explain the principal features of the LGCI and its increase in the year to September 2012. Then we explain how we determined the productivity factor (section 3). In section 4 we discuss the first withdrawal of the carbon price advance.

2 Local government costs

2.1 What is the rate peg?

Rate pegging is a policy in NSW which limits the allowable increase in councils' 'general income'. General income mainly comprises rates revenue, but also includes certain annual user charges. It excludes stormwater and waste charges, and water and sewerage charges.

The rate peg determines the maximum percentage by which a council may increase its general income in a particular financial year, unless the council has obtained approval for a special variation.[2]

IPART sets the rate peg and approves special variations under a delegation from the Minister for Local Government. In setting the rate peg, we use a local government cost index and deduct a productivity factor to ensure that councils share efficiency gains with ratepayers.

2.2 What is the LGCI?

The largest component of the rate peg is the Local Government Cost Index or LGCI. This is a measure of the annual average change in the prices paid for inputs for ordinary council activities that are funded from general rate revenue.

The LGCI measures the average change in the prices of a fixed 'basket' of goods and services purchased by councils. The basket of goods and services that we use is based on a survey of councils' expenditure which we undertook in 2010.[3]

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2 Councils with a need for rate increases that exceed the rate peg may apply to IPART for a special variation. For details, see our website at http://www.ipart.nsw.gov.au.

3 The survey collected information on actual council expenditure in 2008/09 and 2009/10. For more information, see *Local Government Cost Index - Information Paper*, December 2010, p 24.

We calculate the LGCI using price data from the ABS for the year to the September quarter, compared with the previous year's September quarter. This is the latest available published ABS data when we set the rate peg.

Table 2.1 shows the components of the LGCI, their weights, their change in prices for the year to September 2012 and their overall contribution to the rate peg.

The overall change in the LGCI over the year to September quarter 2012 was an increase of 3.68%. The most important contributors to this increase were:

- A 3.3% increase in Employee benefits and on-costs, measured by the ABS wage price index for the NSW public sector. This increase was lower than last year's result of 3.5%.
- A 5.6% increase in Construction works, measured by the ABS producer price series for Road and Bridge Construction in NSW.
- A 15.9% rise in Electricity prices. Electricity costs were affected by the introduction of the carbon price from 1 July 2012 as well as the continued flow-through of higher regulated network charges, and the cost of renewable energy and green schemes that have been mandated by Federal and State Governments.[4]

The only significant price fall (9.7%) was for 'Information technology & software'. The price of this cost item has been falling consistently for a decade. It has little effect on the index, because of its small weight.

The Emergency Services Levy - for which we construct our own price index (as explained in Appendix B) – increased by 0.4% which had no measurable effect on the rise in the LGCI this year.

[4] The ABS was not able to separate out the effect of the carbon price on electricity prices from other influences. See ABS, *Consumer Price Index, Australia,* September 2012, p 3.

Table 2.1 Calculating the rise in LGCI for the year ended September 2012

Cost items	Effective weights as at end-Sep 2011 (%)	Price change to end-Sep 2012 (% annual average)	Contribution to index change (percentage points)
Operating costs			
Employee benefits and on-costs	42.0	3.3	1.39
Plant & equipment leasing	0.4	0.8	0.00
Operating contracts	1.3	2.9	0.04
Legal & accounting services	1.1	3.2	0.03
Office & building cleaning services	0.2	4.9	0.01
Other business services	6.0	2.8	0.17
Insurance	1.8	6.8	0.12
Telecommunications, telephone & internet services	0.5	1.3	0.01
Printing publishing & advertising	0.5	5.3	0.03
Motor vehicle parts	0.5	-0.5	0.00
Motor vehicle repairs & servicing	0.7	4.0	0.03
Automotive fuel	1.2	4.5	0.05
Electricity	3.0	15.9	0.48
Gas	0.1	8.6	0.00
Water & sewerage	0.5	4.4	0.02
Road, footpath, kerbing, bridge & drain building materials	3.0	5.6	0.17
Other building & construction materials	0.8	1.2	0.01
Office supplies	0.4	-0.6	0.00
Emergency services levies	1.4	0.4	0.01
Other expenses[a]	8.7	2.1	0.19
Capital costs			
Buildings – non-dwelling	6.4	1.2	0.08
Construction works - road, drains, footpaths, kerbing, bridges	13.6	5.6	0.76
Construction works - other	1.4	5.6	0.08
Plant & equipment – machinery	3.9	1.0	0.04
Plant & equipment – furniture etc.	0.2	-0.2	0.00
Information technology & software	0.3	-9.7	-0.03
Total change in LGCI	**100.0**		**3.68**

a Includes miscellaneous expenses with low weights in the Index, eg, councillor and mayoral fees.

Notes: Figures may not add due to rounding. Percentage changes are calculated from unrounded numbers.

2.3 Comparing the rise in the LGCI with inflation and other councils' costs

The design of the LGCI is similar to the design of the Consumer Price Index (CPI) and the South Australian Local Government Price Index. All 3 measure the average change in prices over time of a specific basket of items.

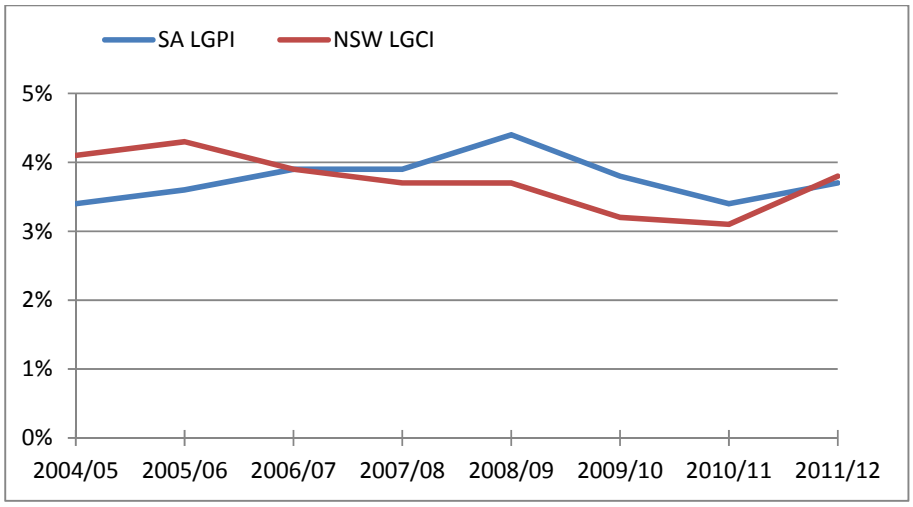
The CPI measures the weighted average change in the prices of a representative basket of goods and services purchased by households in Australia's capital cities. It does not measure the change in the prices faced by any individual household or particular groups of households.

The LGCI measures the weighted average change in the prices of a representative basket of goods and services purchased by NSW councils on average, and not the change in prices faced by individual councils or groups of councils.

Similarly, the SA Local Government Price Index (LGPI) reflects the costs incurred across all SA councils.

Figure 2.1 shows the NSW and SA council cost indices. These indices are not identical, but are broadly similar over time. Over the 7 years to 2011/12, the average annual rise in both indices has been around 3.7%.[5]

Figure 2.1 Annual average changes in local government cost indices in NSW and SA, years to end-June



Note: For the purpose of calculating the rate peg, we measures changes in the LGCI in the year to September. In this figure, for comparability with the SA LGPI, data are in financial years.

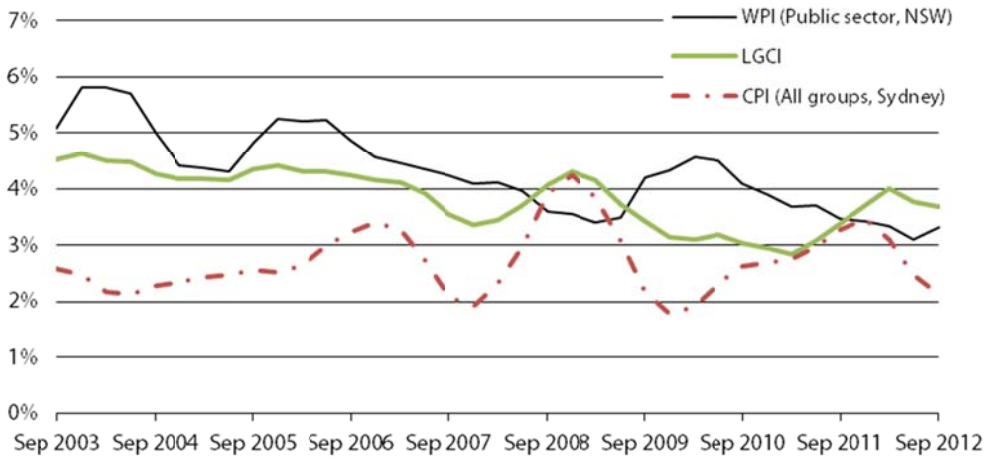
Sources: IPART and http://www.lga.sa.gov.au.

5 Indices that use weights that are based on a full range of council costs across a state or territory can be expected to move more consistently over time than indices that rely on only 1 or 2 price series. The latter types of indices are used by local council peak bodies in Victoria and Queensland.

Figure 2.2 shows the annual increases in the LGCI, CPI and the NSW public sector Wage Price Index (WPI).

The annual average increase in the Sydney CPI in the year to September 2012 was 2.13% compared to the 3.7% rise in the LGCI over the same period. Annual rises in the LGCI are usually higher than the rises in the Sydney CPI because the LGCI includes labour costs, and these generally rise faster than inflation.

Figure 2.2 Annual average rises in the LGCI, WPI and CPI



Source: ABS, various data release for consumer, producer and labour prices; and IPART.

Figure 2.2 also shows the annual increases in the NSW public sector WPI. We include this series for comparison.

The rise in public sector labour costs usually exceeds the rise in the LGCI. For example, over the past 5 years, the average annual increase in the LGCI has been 3.5% compared to 3.0% for the Sydney CPI and 3.7% for the WPI.

2.4 Re-examining the price series used in the LGCI

During 2012, we re-examined the ABS price indices we used last year to ensure that they remain the most relevant in relation to movements in council cost items. We did not find any published price series to be more suitable than the ones we used last year, so we have retained the same series. They are listed in Appendix A.

The ABS rebased its CPI and PPI series in September 2012. This did not affect the change in LGCI.

2.5 What the LGCI does not do

The LGCI measures the average change in prices for a basket of inputs that councils purchase. There are several important things that the LGCI does not do. It does not measure:

- an individual council's expenditure pattern, because it is weighted by the average spending pattern across all councils
- local price impacts eg, competition with local mining companies may cause higher wages for certain staff, or natural disasters may lift local building material prices
- increases in expenditures of councils resulting from supplying more goods and services.

The change in the LGCI also does not address:

- the effects of population growth
- any council or community desires to provide new services or increase in the quality of existing services
- any council or community desires to increase their expenditure on infrastructure renewal eg, to improve the standard of infrastructure for roads or drainage.

The Local Government Act allows councils to increase their general income by more than the rate peg through the special variation process. This allows for specific financial needs of individual councils and their communities to be funded through rate increases that are larger than those permitted under the rate peg.

3 The productivity factor

The rate peg includes a productivity factor to allow ratepayers to share the efficiency gains made by councils.

We have determined a productivity factor of 0.2% for 2013/14. As explained in section 3.2 below, the productivity factor has been informed by the long-term average of multifactor productivity in the market sector and a consideration of specific factors affecting local government.

The following sections outline the rationale for including a productivity factor in the rate peg and explain how we set the productivity factor for 2013/14.

3.1 Rationale for a productivity factor

IPART's terms of reference from the Government require us to have regard to the LGCI and a productivity factor when setting the rate peg. This follows from a recommendation we made in our 2009 review of the *Revenue Framework for Local Government* that the rate peg should allow ratepayers to share in the efficiency gains made by their councils, since this is what happens in competitive markets.

In market-oriented sectors of the economy, the pressures of competition usually provide sufficient incentive for a business to share any potential productivity (or efficiency) improvements with consumers through lower prices.

As local councils have suggested, they seek to make, and do make, efficiency and productivity gains over time, as do other sectors of the economy. Such gains may come from various sources, such as higher educational and skills levels of council staff and contractors, or from improved technology that is built into the latest capital equipment.

Evidence from other sectors of the economy shows that productivity improvements tend to occur repeatedly over time. However, a rise in the LGCI makes no allowance for higher productivity. We therefore take account of both economy-wide productivity trends as well as specific factors affecting local government when we determine an appropriate productivity factor for local government.

3.2 How is the size of the productivity factor determined?

This year we have determined that the productivity factor for local government should be 0.20%. This is almost identical to the productivity factor of 0.22% applied to the 2012/13 rate peg, although it has been derived by a different methodology from the one we used last year.

The methodology used this year is a two-step procedure that focuses on *multifactor* rather than *labour* productivity and takes industry-specific factors into account.

The first step is to use official estimates of the long-term growth in multifactor productivity to inform us of an appropriate benchmark productivity factor.

We have taken the latest measure available of the long-term annual average increase in the ABS measure of market-sector multifactor productivity. The latest year for which data are published is 2009/10 and the 15-year annual average rise is 0.3%.[6]

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6 Source: ABS Cat no. 5260.0.55.002 *Experimental Estimates of Industry Multifactor Productivity, Australia: Detailed Productivity Estimates*, 7 December 2011, Table 15.

We apply this benchmark across all the industry sectors that we regulate using a cost index of inputs.[7]

In the second step, we consider factors that are specific to the industry under review and make an adjustment to the benchmark productivity factor in light of them.

As a matter of judgment, we have discounted the productivity factor that we apply to local government in determining the 2013/14 rate peg. The discounting is based on similar grounds to those previously noted.[8] These are that:

- Local governments pursue multiple objectives, including social objectives, and efficiency gains may be more difficult to achieve than in market-oriented sectors of the economy.
- Local government productivity improvement may be limited by the geography and demographics of the local community. For example, facilities may need to be duplicated in dispersed townships. Private enterprise may choose where to operate and what to produce; local government cannot.

We have balanced these considerations in deciding to discount the benchmark productivity growth to 0.2%. Therefore, the productivity factors that we have used in the 2 most recent rate pegs are almost identical, despite the different methodologies.

Table 3.1 Productivity factors in 2012/13 and 2013/14

	2012/13	2013/14
Market sector labour productivity (5-year average)	1.03	
Benchmark market-sector multifactor productivity (15-year average)		0.30
After applying to the labour component	0.43	
Discount for industry-specific factors	–50%	0.10
Productivity factor	**0.22**	**0.20**
LGCI	3.41	3.68
LGCI minus productivity factor	**3.19**	**3.48**

Table 3.1 shows the derivation of the productivity-adjusted LGCI for both years using the different methodologies. The differences in the methodologies are that multifactor productivity replaces labour productivity, the productivity factor is applied to all input costs and not just labour costs, and we replace a 5-year average with a long-term (15-year) average.

7 A detailed explanation of the methodology may be found in IPART, *Adjusting Industry Cost Indices to Share Productivity Gains with Customers*, October 2012, available on the IPART website.

8 IPART *Information Paper - Rate Peg 2012/13*, December 2011, p 14.

4 First withdrawal of the carbon price advance

The introduction of a carbon price from 1 July 2012 has affected the prices that local councils pay for some of their inputs.

Because the LGCI is a lagged index, the version of it used to inform the 2012/13 rate peg did not reflect the introduction of the carbon price. Therefore, we included a carbon price advance (CPA) in the 2012/13 rate peg of 0.4% to assist councils to meet higher prices arising from its introduction.

Once the effect of the carbon price has flowed through to electricity and other prices that are used in the LGCI, we would be double-counting the effect of the carbon price if we did not withdraw the advance given in the 2012/13 rate peg.

Because the effect of the carbon price upon local government input prices is now flowing through to the LGCI, beginning with the September quarter 2012, the CPA is now being withdrawn, in 2 steps, starting with a 0.1% withdrawal in the 2013/14 rate peg.[9]

Our decision to include a CPA in the 2012/13 rate peg was an exception to our practice of basing the LGCI on past, known increases in prices. We decided to do this because councils would face higher prices flowing from the carbon price but the rate peg would not provide the extra income needed to meet the additional expenditure.

5 Councils with special variations approved before 2011/12

Last year we noted that some councils with special variations that had been approved prior to December 2011 might be disadvantaged by the withdrawal of the carbon price advance. These councils may have received a reduced rate peg without benefiting from the initial advance.

Therefore, during 2012, we invited these councils to apply to us to adjust their special variations. Of the 16 councils that applied, all were approved. We added 0.4% to the previously approved variations for 2012/13 and reduced approved variations by 0.1% in 2013/14 and by 0.3% in 2014/15.[10] These adjustments ensured that councils with approved variations were not disadvantaged by the withdrawal of the carbon price advance.

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9 For more detail, see IPART, *Rate Peg 2012/13 – Information Paper*, December 2011. The LGCI does not capture the effect on council costs of the rise in prices for fuel used in non-transport and off-road transport. But this effect was too small to alter the size of the first withdrawal of the CPA.

10 For further detail, see IPART *Fact Sheet - Changes to existing special rate variations of councils for the carbon price advance - May 2012*.

Appendices

A Component Price Indexes

Table A.1 LGCI cost items and the price indexes that measure their changes

Recurrent cost items	Component price indexes[a]
Employee benefits and on-costs	WPI - Public sector, NSW
Plant & equipment leasing (excluding waste management)	PPI - 663 Other goods & equipment rental and hiring
Operating contracts (excluding waste management)	PPI – 729 Other administrative services
Legal & accounting services	PPI - 693 Legal & accounting services
Office & building cleaning services	PPI - 7311 Building & other industrial cleaning services
Other business services	PPI - 7299 Other administrative services n.e.c
Insurance	CPI – Insurance Services, Sydney
Telecommunications, telephone & internet services	CPI – Telecommunications, Sydney
Printing publishing & advertising	PPI - 16 Printing (including reproduction of recorded media)
Motor vehicle parts	CPI - Spare parts and accessories for motor vehicles, Sydney
Motor vehicle repairs & servicing	CPI – Maintenance and repair of motor vehicles, Sydney
Automotive fuel	CPI - Automotive fuel, Sydney
Electricity	CPI – Electricity, Sydney
Gas	CPI - Gas & other household fuels, Sydney
Water & Sewerage	CPI - Water & sewerage - Sydney
Road, footpath, kerbing, bridge & drain building materials	PPI - 3101 Road & bridge construction, NSW
Other building & construction mats	PPI - 3020 Non-residential building construction, NSW
Office supplies	CPI - Audio, visual & computer media & services, Sydney
Emergency services levies	IPART index of council ESL per rateable property
Other expenses	CPI – All groups, Sydney
Capital cost items	
Buildings – non-dwelling	PPI - 3020 Non-residential building construction, NSW
Construction works - road, drains, footpaths, kerbing, bridges	PPI - 3101 Road & bridge construction, NSW
Construction works - other	PPI - 3101 Road and bridge construction, NSW
Plant & equipment – machinery	PPI - 231 Motor vehicle & motor vehicle part manufacturing
Plant & equipment – furniture etc.	PPI – 24 Machinery & equipment manufacturing
Information technology & software	CPI - Audio, visual & computer equipment & services, Sydney

a Detailed data sources were provided in our *Local Government Cost Index – Information Paper*, December 2010. 'WPI' = ABS Wage Price Index, 'PPI' = Producer Price Index and 'CPI' = Consumer Price Index.

B Emergency Services Levies

The local government sector, the insurance industry and the state government make statutory contributions to the cost of maintaining the 3 emergency service agencies: Fire & Rescue NSW, the Rural Fire Service and the State Emergency Service. The statutory contributions are called 'emergency services levies' (ESL).

Of the total cost of running the emergency services, the insurance industry funds 73.7%, NSW local councils 11.7% and the state government funds the balance.

There is no ABS price series that estimates the cost movements in this sector, so we have used the change in the ESL rate paid by councils per rateable property to calculate a price series for use in the LGCI.

To estimate the ESL payable by councils per rateable property in NSW, we divide the total ESL payable by councils (data supplied by NSW Treasury) by the number of rateable properties (data supplied by DLG) to derive an 'effective rate of council ESL'. For the latest year, we use Treasury's budget estimates for the councils' share of the cost of providing emergency services and reasonable estimates about the growth in the number of rateable properties.

Table B.1 estimates the average council ESL per property over the past 5 years.

Table B.1 Calculating the effective rate of the council ESL

	2008/09	2009/10	2010/11	2011/12	2012/13[e]
NSW rateable properties	2,885,120	2,906,613	2,932,273	2,948,744	2,965,215
Council contributions to:					
Fire & Rescue NSW ($m)	63.2	64.0	69.6	69.9	68.9
Rural Fire Service ($m)	29.9	23.5	29.7	31.8	30.5
SES ($m)	0.0	5.5	7.0	7.5	9.5
Total contributions ($m)	**93.1**	**93.1**	**106.2**	**109.1**	**109.0**
Effective rate of council ESL (contribution per property) ($)	32.3	32.0	36.2	37.0	36.8
Change in effective rate of council ESL (%)		-0.7	13.2	2.1	-0.7

e = estimate. The latest year of councils' ESL contributions are based on Treasury budget estimates. The number of rateable properties is extrapolated by 0.5% using their actual growth rate in 2011/12.

Notes: Numbers may not add due to rounding.

Source: NSW Treasury, DLG and IPART calculations.

We have constructed a price index that reflects the effective rate of the levy. We increase the price index by the change in the effective rate in the September quarter of the year in which occurs. For consistency with the LGCI we then calculate an annual average. This is shown in Table B.2.

The change in the effective rate of the ESL is included in the LGCI. Due to the lagged index, these cost impacts are therefore partially reflected in the current rate peg year and partly in the year following.

Table B.2 Index of effective rate of levy and impact on the LGCI

	Change in ESL rate (%)	Price Index	Average for year to Sep	Annual avg change (%)	Contribution to LGCI (shown to 2 decimal places)
Dec 2009	0.0	171.4			
Mar 2010	0.0	171.4			
Jun 2010	0.0	171.4			
Sep 2010[r]	13.2	193.1	176.8	2.6	0.04
Dec 2010	0.0	193.1			
Mar 2011	0.0	193.1			
Jun 2011	0.0	193.1			
Sep 2011[r]	2.1	194.4	193.4	9.4	0.14
Dec 2011	0.0	194.4			
Mar 2012	0.0	194.4			
Jun 2012	0.0	194.4			
Sep 2012	-0.7	193.1	194.1	0.4	0.01

r= revised. We have taken into account any differences between estimated and actual outcomes from previous years. They have been too small to make any difference to the size of the latest rate peg.

Source: IPART, using data provided by NSW Treasury and DLG.