

Freezing existing rate paths for newly merged councils

Local Government — Interim Report
June 2016

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1 | Introduction and executive summary

The Independent Pricing and Regulatory Tribunal of NSW (IPART) is conducting a review of the local government ratings system in NSW. The Terms of Reference (ToR) require us to provide an Interim Report to Government recommending a legislative or regulatory approach to achieve the Government's policy of freezing existing rate paths for four years for newly **merged councils** ('new councils').¹

The purpose of this Interim Report is to make recommendations on implementing the rate path freeze policy. As set out in Box 1.1, this policy aims to:

- ▼ provide ratepayers with certainty about their rates
- ▼ protect ratepayers against future rate increases, and
- ▼ allow merger savings to place downward pressure on rates.

The policy also recognises the reduced need for new special variations during the four years of the rate path freeze period.

¹ See Appendix A for our Terms of Reference. The ToR also require us to review the current rating system, and recommend reforms that aim to enhance councils' ability to implement sustainable and equitable fiscal policy. We will address these requirements in our Draft Report, which is due for release in August 2016.

Box 1.1 NSW Government's rate path freeze policy

In its public announcements on the rate path freeze policy, the NSW Government stated that:

- ▼ there would be no change to existing rate paths for newly merged councils. This provides ratepayers with certainty about their rates, and
- ▼ ratepayers in new councils would have their rates protected against future increases during the rate path freeze period, meaning they will pay no more for their rates than they would have in their pre-merger council area for four years.

The rate path freeze policy also facilitates the NSW Government's objective for merger efficiencies to put downward pressure on rates over the long term.

Sources: NSW Government, *Media Release – Stronger Councils for Sydney and Regional NSW*, at <https://www.nsw.gov.au/media-releases-premier/stronger-councils-sydney-and-regional-nsw>, 18 December 2015), NSW Government, *Stronger Councils, Stronger Communities* (<https://www.strongercouncils.nsw.gov.au/>), NSW Government, *Media Release – 19 New Councils Created in NSW Today*, at [http://www.fitforthefuture.nsw.gov.au/sites/default/files/19 NEW COUNCILS CREATED IN NSW TODAY.pdf](http://www.fitforthefuture.nsw.gov.au/sites/default/files/19%20NEW%20COUNCILS%20CREATED%20IN%20NSW%20TODAY.pdf), 12-May 2016.

1.1 Overview of our recommendations

In this Interim Report we recommend an approach for:

- ▼ determining the general income for a pre-merger council area within a new council, and
- ▼ setting rates for that pre-merger council area (given this general income).

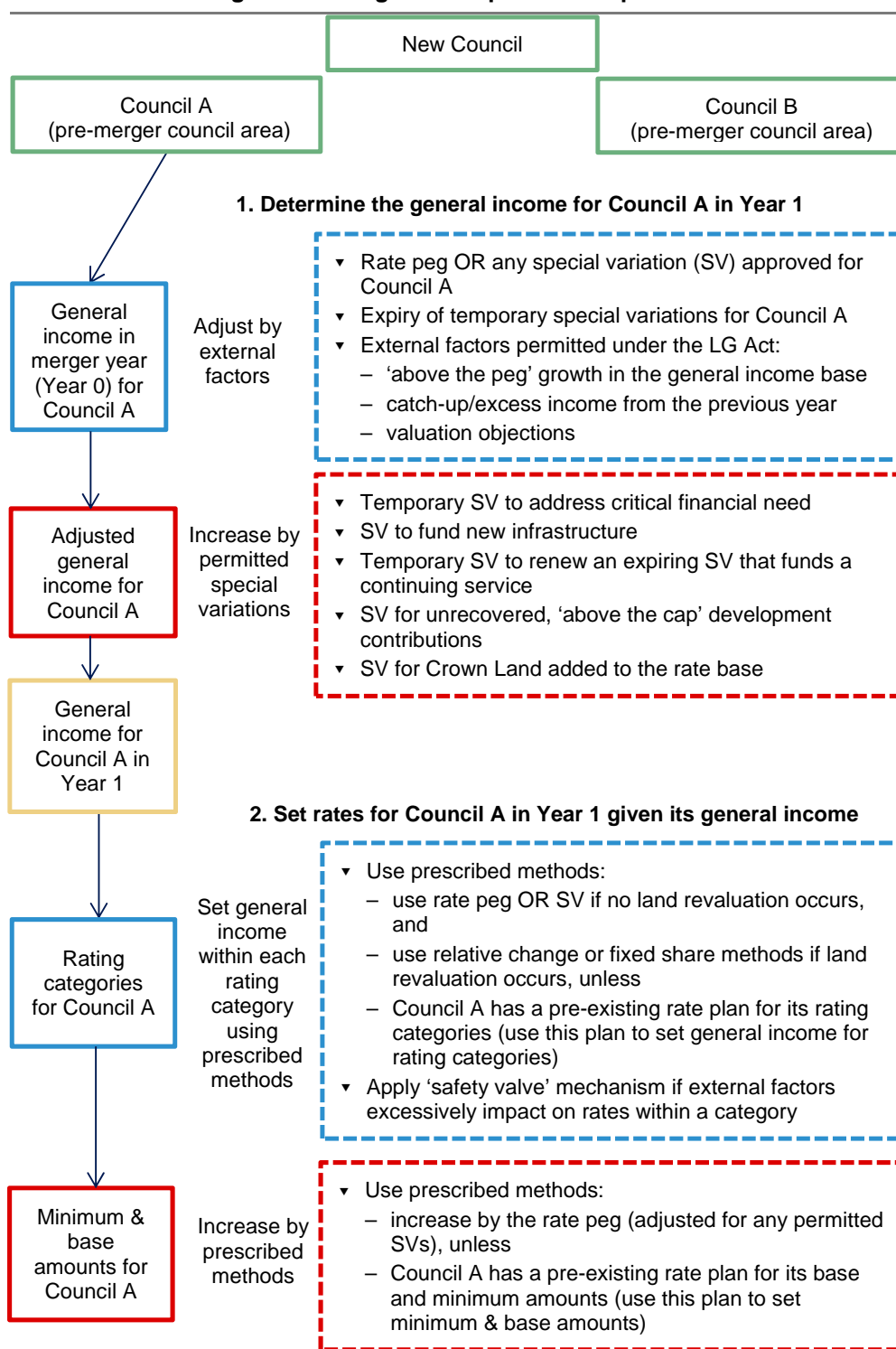
Our approach balances providing a sufficient degree of rate certainty to ratepayers (as required by the rate path freeze policy), with providing appropriate flexibility to councils to address unexpected or external factors.

Figure 1.1 provides an overview of our recommended approach, and how it applies to each pre-merger council area within a new council.

- ▼ It uses the example of moving from Year 0 (ie, the financial year in which the merger takes place) to Year 1 (ie, the first full financial year post-merger)² when determining general income and setting rates for pre-merger Council A.
- ▼ This process should apply annually for each pre-merger council area during the rate path freeze period (eg, to move from Year 1 to Year 2, which is the second full financial year post-merger), until the rate path freeze period expires on 30 June 2020.

² For example, if the merger takes place in May 2016, Year 0 is 2015-16 and Year 1 is 2016-17.

Figure 1.1 Recommended approach for determining general income and setting rates during the rate path freeze period



In making our recommendations, we have taken into account stakeholder submissions, as well as comments made at the public hearing and provided in targeted consultation with stakeholders.³ Our recommendations are generally consistent with our preliminary views in our Issues Paper.⁴

1.1.1 Freezing rate paths for new councils

Our interpretation of the rate path freeze policy is that the general income for each pre-merger council area should follow the trajectory as if the merger had not occurred. In general, stakeholders supported our interpretation of the rate path freeze policy, and we have decided to adopt this interpretation. Under our recommendations, the general income in a pre-merger council area would only increase by external factors.

We consider that our interpretation of the rate path freeze policy is consistent with the policy's aim of providing ratepayers with certainty. It also recognises that there is a reduced need for new special variations during this period. However, we identify some specific circumstances where councils should be allowed to apply for new special variations.

1.1.2 Permitting special variations during the rate path freeze period

We are recommending five circumstances where a new council could apply for a special variation. We consider these recommendations provide scope for new councils to:

- ▼ address critical or unexpected financial sustainability issues (eg, the aftermath of a natural disaster)
- ▼ encourage the development of new infrastructure and urban renewal, and
- ▼ ensure that current service delivery is not disrupted.

1.1.3 Setting rates in the pre-merger council area during the rate path freeze period

In implementing the rate path freeze within each pre-merger council area, we recommend applying the rate path freeze policy only at the rating category level, and not at the subcategory level. We consider applying the rate path freeze policy at the rating subcategory level may lead to excessive rates volatility.

³ We received over 150 submissions to the review and about a third provided comment on the rate path freeze.

⁴ IPART, *Review of the Local Government Rating System – Issues Paper*, April 2016.

We recommend applying the rate path freeze policy to minimum and base amounts as well. Otherwise, a new council could rebalance the rates it sets for a pre-merger council area between fixed charges (ie, minimum and base amounts) and variable charges (ie, ad valorem amounts).⁵ This rebalancing would always result in rate increases for some ratepayers.⁶

Additionally, if a pre-merger council had an existing rate plan for rating categories and/or base and minimum amounts that was previously approved and is currently being implemented, we recommend the new council have the option to set rates in that pre-merger area over the rate path freeze period in accordance with this plan (subject to IPART approval).

We also recommend that:

- ▼ the 50% cap on base amounts under the *Local Government Act 1993* (NSW) (LG Act) should not apply to new councils over the rate path freeze period⁷
- ▼ new councils are able to use a ‘safety valve’ mechanism for rate rebalancing between categories in a pre-merger council area, if external factors would otherwise excessively impact on rates within a category, and
- ▼ changes in the rating burden from land revaluations are distributed within each pre-merger council area using a relative change or a fixed share method, unless the pre-existing rate plan applies.

1.1.4 Implementing the rate path freeze policy

We recommend that the LG Act is amended to give the Minister for Local Government the ability to implement the rate path freeze policy for new councils, subject to a 4-year sunset clause. Stakeholders generally supported this position in consultation.

⁵ Councils currently set rates using an **ad valorem amount** (ie, a variable charge calculated as a percentage of the unimproved land value of the rateable property), which may be subject to a **minimum amount** (ie, a fixed charge which applies instead of the ad valorem amount, where it is greater than the ad valorem amount). Alternatively, they may use an **ad valorem amount** plus a **base amount** (ie, a fixed charge levied equally on all properties within a given category).

⁶ For example, suppose a new council increases the minimum amount for a subcategory, and correspondingly decreases the ad valorem amount (to keep rates revenue unchanged in that subcategory). Ratepayers who are only liable to pay the minimum amount would experience a rate increase.

⁷ After the rate path freeze period expires, new councils would again be subject to any cap on base amounts set out in the LG Act. However, since the rate path freeze policy would no longer apply at this time, new councils would be able to implement their new rating structures, and accordingly adjust their base amounts to ensure compliance with the LG Act.

1.2 IPART's approach to the task

In accordance with our ToR, we consulted with relevant stakeholders and NSW Government agencies by releasing an Issues Paper on 13 April 2016, holding a public hearing on 26 April 2016 and having meetings with key stakeholders. The next step is to release a Draft Report in mid-August seeking submissions from stakeholders on our draft recommendations, followed by our Final Report in December 2016.

1.3 What the rest of the Interim Report covers

- ▼ Chapter 2 outlines our interpretation of the Government's policy of freezing the existing rate path for each pre-merger council area within a new council.
- ▼ Chapter 3 sets out the new special variations that new councils should be able to apply for during the rate path freeze period.
- ▼ Chapter 4 looks at how new councils should set rates in pre-merger council areas for rating categories, as well as base and minimum amounts, during the rate path freeze period.
- ▼ Chapter 5 discusses our preferred option for implementing the rate path freeze.

1.4 List of our recommendations

Freezing existing rate paths for new councils

- 1 That the general income for a pre-merger council area should be adjusted annually by the following external factors: 10
 - the rate peg OR any special variation approved for that pre-merger council area 10
 - the expiry of any temporary special variations during the rate path freeze period, that apply in the pre-merger council area and are not renewed using a permitted special variation (see Recommendation 6), and 10
 - other external factors permitted under the *Local Government Act 1993* (NSW) (ie, 'above the peg' growth in general income, catch-up or excess income from the previous year and valuation objections). 10
- 2 That new councils should not be permitted to equalise rates across their pre-merger council areas by: 12
 - applying for new special variations, or 12
 - rebalancing the allocation of rates between pre-merger council areas by increasing rates in any pre-merger council area. 12

- 3 That new councils should continue to be allowed discretion to set rates below the rate cap ceiling during the rate path freeze. 14

Special variations permitted during the rate path freeze period

- 4 That a new council be permitted to apply for a new temporary special variation where there is a critical financial need for the special variation, according to the criteria set out in Table 3.1. 18
- 5 That a new council be permitted to apply for a new special variation to fund new infrastructure in its area by levying a special rate under section 495 of the *Local Government Act 1993* (NSW). 21
- 6 That a new council be permitted to apply for a new temporary special variation: 22
- to renew an expiring special variation that currently funds a service in a pre-merger council area, and 22
 - the council demonstrates that the service would be discontinued if the special variation were not renewed. 22
- 7 That a new council be permitted to apply for a new special variation for unrecovered development contributions that are ‘above the cap’ under the *Environmental Planning and Assessment Act 1979* (NSW). 24
- 8 That a new council be permitted to apply for a new special variation where former Crown Land has been added to its rate base during the rate path freeze period. 25

Setting rates in the pre-merger council area during the rate path freeze period

- 9 That the rate path freeze policy should apply to the rating categories (ie, Residential, Business, Farming or Mining) of a pre-merger council area, but not its subcategories. 29
- 10 That a new council would only increase the general income of each rating category of a pre-merger council area annually by the rate peg (subject to any adjustments to general income permitted under Recommendation 1, or special variations permitted under Recommendations 4 to 8), **unless:** 29
- the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the new council could (subject to IPART approval) set rates for these categories in accordance with the plan, or 29
 - there is a general land revaluation, and the pre-merger council area does not have a pre-existing rate plan, in which case the new council should set rates in accordance with Recommendation 14. 29

- 11 That a new council should increase the minimum and base amounts for a pre-merger council area annually: 33
 - by the rate peg (subject to any adjustments for special variations under Recommendations 1 and 4 to 8) during the rate path freeze, **unless** 33
 - the pre-merger council had approved and implemented a pre-existing rate plan for minimum or base amount increases, in which case the new council could (subject to IPART approval) set minimum and base amounts in accordance with the plan. 33
- 12 That new councils be exempt from the 50% maximum limit for revenue collected from base amounts for the duration of the rate path freeze period. 35
- 13 That if, as a result of external factors (such as a significant change in the number of rateable properties in a category), the average rating burden within a pre-merger council area's rating category will change by more than 5% plus the rate peg (or any applicable special variations), the new council can apply to IPART to rebalance the rating burden across **all** categories in the pre-merger council area. 37
- 14 That when allocating the rating burden from land revaluations: 39
 - the new council should allocate it to different rating categories in each pre-merger council area using either the relative change method or the fixed share method, **unless** 39
 - the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the new council could (subject to IPART approval) set rates for these categories in accordance with the plan. 39

Implementing the rate path freeze policy

- 15 That the *Local Government Act* 1993 be amended to provide the Minister for Local Government with an instrument-making power that enables the Minister to implement the rate path freeze policy for new councils. This power should be subject to a sunset clause and expire at the end of the rate path freeze period on 30 June 2020. 42

2 Freezing existing rate paths for new councils

This chapter considers our interpretation of the rate path freeze policy, and how it applies to the general income for each pre-merger council area within a new council. We have interpreted the Government's rate path freeze policy to mean that for the four years after a merger, rates for each individual ratepayer would continue to be set so that their rate path follows the same trajectory as if the merger had not occurred.

Given this interpretation, the rate path freeze applies to the general income at the pre-merger council level. As a result, this general income would only be adjusted for external factors.

Further, a new council should not be allowed to equalise rates across its pre-merger council areas using mechanisms that lead to rate increases, because this is inconsistent with the rate path freeze policy. These mechanisms include:

- ▼ imposing special variations on only one pre-merger council area, or
- ▼ rebalancing the allocation of rates, by increasing rates in one pre-merger council area.

However, a new council might be able to equalise rates across pre-merger council areas by setting rates 'below the peg'. A pre-merger council's rate path is a ceiling. A new council would be free to set rates at lower levels within any pre-merger council area in any rating category, which might have the effect of equalising rates across its pre-merger council areas.

2.1 Adjusting rate paths for external factors

To implement the rate path freeze policy, the new council must first consider the general income⁸ of each pre-merger council area in the year the merger takes place.⁹ This general income for the pre-merger council should then be adjusted annually by the following three external factors:

1. the rate peg OR any special variation that has been approved for the pre-merger council

⁸ This is income derived from ordinary rates, special rates and specified annual charges (section 505 of the LG Act). Special rates and charges for water and sewerage are not included in a council's general income.

⁹ That is, the financial year beginning 1 July.

2. the expiry of any temporary special variations that apply to the pre-merger council, and
3. other external factors already permitted under the LG Act. Specifically, these are:
 - 'above the peg' growth in general income attributable to changes in rateable properties
 - catch-up and excess income from the previous year, and
 - adjustments to general income to account for the impact of valuation objections.

This means that the process for calculating the maximum allowable general income would essentially be the same as under the current section 509 of the LG Act, except that general income would be calculated at a 'pre-merger council area' level, rather than over the whole of the new council area.^{10, 11}

We proposed items 1 and 2 in the Issues Paper. We included item 3 following consultation with stakeholders, which we consider is consistent with the rate path freeze policy.

Recommendation

- 1 That the general income for a pre-merger council area should be adjusted annually by the following external factors:
 - the rate peg OR any special variation approved for that pre-merger council area
 - the expiry of any temporary special variations during the rate path freeze period, that apply in the pre-merger council area and are not renewed using a permitted special variation (see Recommendation 6), and
 - other external factors permitted under the *Local Government Act 1993* (NSW) (ie, 'above the peg' growth in general income, catch-up or excess income from the previous year and valuation objections).

¹⁰ Where a pre-merger council area is split between multiple new councils, its general income would be accordingly apportioned. The apportionment would be based on the rates revenue derived from the pre-merger council area's land that is allocated to a new council.

¹¹ Annual charges and special rates outside of general income would continue to be set as they are currently set. The planned Emergency Services Property Levy (announced by the NSW Government on 10 December 2015) would not be affected by the rate path freeze policy.

2.1.1 Analysis and stakeholder comment

Many stakeholders agreed with our interpretation of the Government's rate path freeze policy. While a number expressed reservations about the policy itself, stakeholders accepted that its intent was to freeze pre-merger councils' rate paths so that they follow the pre-merger trajectory.¹² Adjusting rate paths in each pre-merger council area for the external factors outlined would achieve this outcome.

Several stakeholders indicated that 'outside the peg' growth in general income, which is currently permitted under the LG Act, should be included as one of the external factors to adjust council rate paths.¹³ This type of growth typically occurs if a property:

- ▼ becomes rateable, such as when it is no longer subject to an exemption
- ▼ changes rating categories, such as from business to residential, or
- ▼ is subdivided, and so generates additional valuations.

We recognise that this type of 'outside the peg' growth in general income is part of a council's existing rate path.

Some councils indicated that a council's general income is currently adjusted for valuation objections, and this external factor should continue to apply during the rate path freeze policy.¹⁴ Again, we agree that adjusting for valuation objections should be viewed as part of a council's existing rate path.

In addition, we recommend the rate path should be adjusted for 'catch-up' or 'excess' income. This means that a council that inadvertently under-rated in the previous year would not be disadvantaged. Further, a council that charged excess rates would not be allowed to continue to do so.

2.2 Equalising rates during the rate path freeze period

Permitting a new council to equalise rates across its pre-merger council areas – using mechanisms that lead to rate increases – is inconsistent with the rate path freeze policy.

Allowing a new council to change its existing rate paths, solely in response to the merger and in a way that increases rates for some ratepayers, conflicts with the rate path freeze policy. The NSW Government stated that:

- ▼ there will be no change to new councils' existing rate paths for four years

¹² NSW Revenue Professionals (p 4), Willoughby City Council (p 4), Port Stephens Council (pp 11-12), Warringah Council (p 8), Woollahra Municipal Council (p 6), Manly Council (p 4), Cootamundra Shire Council (p 8), submissions to IPART Issues Paper, May 2016.

¹³ For example, Western Plains Regional Council, submission to IPART Issues Paper, May 2016, p 6.

¹⁴ For example, Western Plains Regional Council, submission to IPART Issues Paper, May 2016, p 6.

▼ ratepayers in new councils will:

- have their rates protected against future increases, and
- pay no more for their rates than they would have in their pre-merger council for four years.¹⁵

The Premier has also noted that the mergers would lead to downward pressure on rates over the long term.¹⁶

As outlined in the Issues Paper, the current legal requirement to equalise residential rates within a centre of population¹⁷ may no longer be appropriate, given the larger area covered by new councils. These larger councils may need to have some flexibility to charge different residential rates based on local considerations. This issue will be considered in the Draft Report.

Recommendation

2 That new councils should not be permitted to equalise rates across their pre-merger council areas by:

- applying for new special variations, or
- rebalancing the allocation of rates between pre-merger council areas by increasing rates in any pre-merger council area.

2.2.1 Analysis and stakeholder comment

Several councils indicated they would prefer to equalise rates across their pre-merger areas during the rate path freeze period.¹⁸ That is, they consider that councils should be allowed to redistribute their rating burden between the pre-merger council areas that make up the new council. This position was put forward by metropolitan and non-metropolitan councils, even though non-metropolitan councils do not necessarily have a legal requirement, under section 529(2)(b) of the LG Act, to equalise their residential or business rates.

In the Issues Paper, we proposed that new councils could set rates below the rate peg if they wanted to begin implementing a new rating system during the rate path freeze period (see section 2.3). However, most stakeholders indicated that councils were unlikely to set rates below the peg to facilitate rate equalisation across pre-merger council areas.

¹⁵ See Box 1.1.

¹⁶ See Box 1.1.

¹⁷ Section 529(2)(b) of the LG Act.

¹⁸ For example, Warringah Council (p 10), NSW Revenue Professionals (p 4), Willoughby City Council (p 4), Queanbeyan City Council (p 19), submissions to IPART Issues Paper, May 2016.

Instead, several councils requested the ability to equalise rates by way of either:

- ▼ a new special variation, which would be imposed on only one of the pre-merger council areas, in order to raise its rates to the same level as the other area, or
- ▼ rebalancing the allocation of rates, by increasing rates in one pre-merger council area and lowering rates in the other.

These mechanisms would lead to rate increases for at least some ratepayers in the new council, which would be higher than if the merger had not occurred. Hence, such mechanisms should not be allowed during the rate path freeze period.

Stakeholders gave various reasons for wanting to equalise rates during the freeze, including that:

- ▼ councils will face pressure from ratepayers to equalise rates across the pre-merger council areas¹⁹
- ▼ gradually equalising rates after the freeze would unduly prolong the merger process,²⁰ and
- ▼ not having this ability will add pressure to the transition period where councils are seeking to harmonise services without the ability to harmonise rates.²¹

Rate equalisation might no longer be an appropriate principle given the larger area covered by new councils. Our Draft Report²² will examine whether these larger councils should be able to charge different residential rates within a centre of population after the rate path freeze period expires. These differential rates could be based on local factors, such as the demand for, or cost of supply of, local government services. Hence, stakeholder concerns about post-freeze rate equalisation may be lessened for some councils.

In addition, the rate path freeze policy allows new councils more time to achieve merger savings, which will reduce the need for any future rate increases.

2.3 Retaining discretion to set rates below the rate peg

The rate path freeze policy acts as a 'ceiling' on rate increases, in that it determines the maximum rates that new councils could charge in each pre-merger council area during the rate path freeze period.

¹⁹ NSW Revenue Professionals (p 4) and Queanbeyan City Council (p 19), submissions to IPART Issues Paper, May 2016.

²⁰ Queanbeyan City Council submissions to IPART Issues Paper, May 2016, p 19.

²¹ Wollongong City Council submission to IPART Issues Paper, May 2016, p 10.

²² The Draft Report is due for release in August 2016.

Consistent with our proposal in the Issues Paper, we recommend that new councils retain the discretion to set their rates below this ceiling for any rating category during the rate path freeze period.

This discretion is important to ensure that any amendments to the LG Act reflect the original intention of the Act (ie, to permit councils to change rates by less than the rate peg). This recommendation will also give new councils the option to return some of the financial savings generated by the merger. It is consistent with the Government's policy that mergers put downward pressure on rates.

Recommendation

- 3 That new councils should continue to be allowed discretion to set rates below the rate cap ceiling during the rate path freeze.

2.3.1 Analysis and stakeholder comment

Discussions with council stakeholders indicated that there is strong support for retaining the ability for new councils to set rates at lower levels than the existing rate paths.²³ Some councils argued that, should merger savings eventuate during the rate path freeze period, this recommendation would allow them to pass on these savings to the community through lower rates.²⁴

Other councils supported this recommendation on the basis that it would allow them to start the process of equalisation of rates sooner. For example, Mosman Municipal Council argued that this option would allow a new council, if it had the funds to do so, to lower the rates in one pre-merger council area to make them closer to those in the other.²⁵

It should be noted that most councils have indicated in submissions and other consultation that they are unlikely, in practice, to set rates below the ceiling. Firstly, in their estimate, any merger savings are likely to take more than four years to eventuate. Secondly, setting rates below the cap results in a permanent reduction in general income.^{26, 27}

²³ For example, Port Stephens Council (p 12), Shoalhaven City Council (p 10), Willoughby City Council (p 12), submissions to IPART Issues Paper, May 2016.

²⁴ Warringah Council submission to IPART Issues Paper, April 2016, p 10.

²⁵ Mosman Municipal Council submission to IPART Issues Paper, April 2016, p 6.

²⁶ Unless there is a 'catch-up', of the income foregone by setting rates below the ceiling, within two years.

²⁷ For example, Berrigan Shire Council (p 5), Cootamundra Shire Council (p 9), Greater Taree City Council (p 9), submissions to IPART Issues Paper, May 2016.

3 Permitting special variations during the rate path freeze period

Under our interpretation of the Government's rate path freeze policy, a new council would not, in general, be eligible for new special variations during the 4-year freeze period. This is consistent with the policy's aims,²⁸ and recognises there will be a reduced need for new special variations during the rate path freeze period (particularly for metropolitan merging councils). This is due to councils realising merger savings, accessing government funding available for merger costs and community infrastructure, or using debt financing more efficiently.

This chapter sets out the limited circumstances in which we recommend new councils retain the discretion to apply for new special variations. Specifically, we recommend that new special variations should be allowed:

1. where there is a critical short-term financial need
2. to fund new infrastructure by levying a special rate
3. to renew an expiring temporary special variation that currently funds a service, and the council demonstrates the service would be discontinued if the special variation was not renewed
4. for unrecovered development contributions that are 'above the cap' under the *Environmental Planning and Assessment Act 1979* (NSW), and
5. where former Crown Land has been added to a council's rate base during the rate path freeze period.

By limiting special variations to these five circumstances, our recommendations provide a high degree of rate certainty to ratepayers, which is consistent with the Government's policy. They also provide scope for councils to:

- ▼ address critical or unexpected financial sustainability issues
- ▼ encourage the development of new infrastructure and urban renewal, and
- ▼ maintain existing services.

²⁸ See Box 1.1.

3.1 Temporary special variation to address a critical financial need

A new council should be able to apply for a temporary special variation if it is financially unsustainable due to:

- ▼ one or more of its pre-merger councils having an existing rate path that is financially unsustainable, and merger savings and government funding are insufficient for the new council to achieve sustainability,²⁹ or
- ▼ an external factor that occurs during the freeze (eg, the aftermath of a natural disaster).

Under either scenario, the new council would need to show that it is financially unsustainable over the long term, as reflected in its 10-year financial plan. That is, its operating performance ratio (OPR) is forecast to be:

- ▼ strongly negative (below minus 5%) over the rate path freeze period, and
- ▼ below minus 2% over the 10-year financial plan.

We have selected the OPR as the key measure of financial sustainability because it shows a council's capacity to fund ongoing operating expenditure requirements.³⁰

The special variation would be restricted to the amount required for the new council to achieve financial sustainability, after fully accounting for current and future merger savings, available government funding and available debt financing.

This provides new councils with a strong incentive to identify and realise merger savings, and pursue alternative sources of funding where appropriate.

The special variation would be temporary, and would expire at the end of the rate path freeze period. After this period, new councils would be able to apply for special variations under normal criteria.

To apply for the special variation during the rate path freeze period, the new council would need to address **all** the criteria set out in Table 3.1. These criteria would apply in addition to the Office of Local Government's (OLG's) existing criteria for special variations.

²⁹ In this scenario, the special variation would apply to the pre-merger council areas that are financially unsustainable, increasing the general income that the new council can recover from these areas.

³⁰ A council's operating performance ratio is calculated by dividing its net continuing operating result by its total continuing operating revenue (in each case, excluding capital grants and contributions). Having an operating performance ratio of greater than or equal to break-even over a 3-year average was the benchmark used in our *Fit for the Future* assessments. See *Fit for the Future*, October 2015, p 97.

Table 3.1 Additional criteria for special variations that address a critical financial need during the rate path freeze

Criteria	Comments
1. The new council is financially unsustainable because either: <ul style="list-style-type: none"> at least one of its pre-merger councils is financially unsustainable, and the new council is forecast to remain so post-merger, or the new council becomes financially unsustainable due to an external shock. 	<p><i>Financially unsustainable</i></p> <p>a) Pre-merger council As part of the <i>Fit for the Future</i> process, the pre-merger council: <ul style="list-style-type: none"> indicated it intended to apply for a special variation during the rate path freeze period to improve its financial sustainability was assessed as being financially unsustainable, or had a forecast OPR below 0% by 2019-20 (excluding proposed special variations). </p> <p>b) New council The forecast OPR for the new council is below minus 5% in each year of the rate path freeze period (excluding proposed special variations, but including merger savings), and is forecast to be below minus 2% over the 10-year financial plan.</p> <p><i>External shock</i> Due to an external shock (eg, the aftermath of a natural disaster), the new council's forecast OPR is below minus 5% in each year from the shock until the end of the rate path freeze period, and is forecast to be below minus 2% over the 10-year financial plan.</p>
2. Merger savings and government funding are insufficient to rectify the sustainability issue.	<p>The new council needs to:</p> <ul style="list-style-type: none"> provide details of its merger savings, and indicate why these savings, in conjunction with any additional government funding available to the new council, do not lead to long term financial sustainability over the 10-year financial plan.
3. New council is unable to use debt financing to address the financial need.	<p>The new council needs to demonstrate:</p> <ul style="list-style-type: none"> it would have a debt service ratio above 20% if it used debt financing to address the financial need, and it is unable to access a loan facility from T-Corp.
4. The special variation relates to an immediate need .	<p>Waiting to address the issue after the rate path freeze period would significantly worsen the new council's financial position.</p>

Our analysis suggests that new metropolitan councils are unlikely to have a critical financial need for special variations during the rate path freeze period, absent a large external shock (see Appendix B for more details).³¹

³¹ Based on forecast data supplied by councils, during IPART's *Fit for the Future* assessments, these newly merged metropolitan councils are estimated to have positive OPRs in 2019-20.

A special variation for this purpose may be more relevant for new regional councils. During our *Fit for the Future* process, we assessed that a small proportion of pre-merger councils within these new regional councils to be either:

- ▼ financially unsustainable, or
- ▼ financially sustainable, only on the basis of approval of a special variation that would allow the council to meet financial benchmarks.

These assessments did not factor in merger savings, which may ameliorate these financial issues. Accordingly, our analysis suggests that almost no new councils will be likely to meet the criteria for this special variation.

Recommendation

- 4 That a new council be permitted to apply for a new temporary special variation where there is a critical financial need for the special variation, according to the criteria set out in Table 3.1.

3.1.1 Analysis and stakeholder comment

New council is financially unsustainable

Many stakeholders considered that a new council should be able to apply for a special variation where there is a critical financial need. While we did not include this special variation in the Issues Paper, we agree that new councils should be able to address critical or unexpected financial sustainability issues using a special variation.

Some stakeholders noted that the financial need may arise because a pre-merger council's rate path is financially unsustainable,³² and would not sufficiently improve as a result of the merger.³³ We see merit in this reasoning, and have included the financial unsustainability of a pre-merger council's rate path in the criteria for a 'critical financial need' special variation.

Some stakeholders also thought a financial need could occur post-merger, due to an external factor. For example, where there was a natural disaster³⁴ or catastrophic failure of a council's infrastructure assets,³⁵ and government funding was insufficient to address the problem.³⁶ Again, we have included the financial unsustainability of the new council – due to an external factor – in the criteria for a 'critical financial need' special variation.

³² Greater Taree City Council submissions to IPART Issues Paper, May 2016, p 7.

³³ Wollongong City Council (p 11), Mid-Coast Council (formerly Great Lakes Council) submissions to IPART Issues Paper, May 2016.

³⁴ Shoalhaven City Council (p 10) and Queanbeyan City Council (p 18), submissions to IPART Issues Paper, May 2016.

³⁵ Mosman Municipal Council submission to IPART Issues Paper, May 2016, p 5.

³⁶ G Mills submission to IPART Issues Paper, May 2016, p 5.

In addition, some stakeholders supported special variations in the context of the new council's financial need arising more generally.³⁷ For example, where the new council is operating with a significant operating deficit, which cannot be solved by efficiency gains or service delivery changes.³⁸

Applications for this special variation should only occur in very limited circumstances, given the funding alternatives available to new councils during the rate path freeze period, the policy aim of maximising rate certainty for ratepayers, and to ensure that new councils are motivated to pursue efficiency gains. If the new council experiences serious financial need because of an external factor, this will likely be picked up by the criteria outlined in Table 3.1.

We consider that very few new councils will meet the financially unsustainable criterion during the rate path freeze period (absent a significant external shock).

- ▼ Estimates of OPRs for new councils indicate they are generally close to or above breakeven, even before accounting for: merger savings; access to government funding; and the ability of new councils to more effectively utilise debt financing.
- ▼ During our *Fit for the Future* assessments, councils proposing mergers estimated their OPRs would improve by between 3% and 10% over the long term from merger savings. This suggests nearly all new councils may have positive OPRs over the long term, once merger savings are factored into the analysis.

Need to exhaust funding alternatives from merger savings, government funding and debt financing

We consider that a new council should be required to exhaust several funding alternatives before it applies for a 'critical financial need' special variation. Namely:

- ▼ savings realised by the new council from merger efficiencies
- ▼ any funds made available to the new council by other levels of government, and
- ▼ debt financing.

For example, new councils will be able to access significant funds from the NSW Government following a merger. They will receive up to:

- ▼ \$15 million to spend on community infrastructure and services (eg, pool refurbishments, new sporting facilities, street beautification, playground replacements, car park expansions, and library upgrades), and

³⁷ Queanbeyan City Council (p 18), City of Ryde (p 9), LG NSW (p 18), submissions to IPART Issues Paper, May 2016.

³⁸ Snowy Monaro Council submission to IPART Issues Paper, May 2016, p 9.

- ▼ \$10 million to cover the upfront costs of the mergers (eg streamlining administrative processes and cutting red tape).³⁹

As another example, new councils may be able to borrow from TCorp to fund projects that make up part of their annual expenditure programs. These loan facilities are available at competitive rates to councils who are deemed 'Fit for the Future' and satisfy TCorp's credit criteria.⁴⁰

Appendix B provides further information on these different funding sources.

3.2 Special variation to fund new infrastructure

New councils should be able to apply for a special variation to fund new infrastructure. While such special variations may reduce certainty for some ratepayers about the amount of their rates during the rate path freeze period, the alternative may cause councils to reduce their infrastructure development to below efficient levels.

This special variation would be granted only in very limited circumstances. That is:

- ▼ to fund **new infrastructure**
- ▼ using a **special rate**, and
- ▼ the special rate would only be levied on parcels of **land that benefit** from the infrastructure.

A special variation for this purpose would:

- ▼ support the Government's urban renewal policy
- ▼ allow councils to more effectively partner with other levels of government to fund major new projects, and
- ▼ facilitate governments using 'value capture' mechanisms to fund new infrastructure.⁴¹

The amount of the special variation would only be to the extent that infrastructure funding could not be sourced from the Government's Stronger Communities Fund.⁴²

³⁹ NSW Government, *Media Release – Stronger Councils for Sydney and Regional NSW*, at <https://www.nsw.gov.au/media-releases-premier/stronger-councils-sydney-and-regional-nsw>, 18 December 2015); NSW Government, *Stronger Councils, Stronger Communities* (<https://www.strongercouncils.nsw.gov.au/>, accessed 30 May 2016).

⁴⁰ <https://www.tcorp.nsw.gov.au/html/localcouncils.cfm>, accessed 30 May 2016.

⁴¹ Value capture allows governments to fund infrastructure by directly charging those who benefit from the infrastructure.

⁴² This fund is discussed in Appendix B.

Councils would need to apply under the special variation process for approval of this special rate. Applications would be assessed using the existing OLG guidelines for special variations.

Recommendation

- 5 That a new council be permitted to apply for a new special variation to fund new infrastructure in its area by levying a special rate under section 495 of the *Local Government Act 1993* (NSW).

3.2.1 Analysis and stakeholder comments

We proposed this special variation in the Issues Paper, and it was broadly supported by stakeholders.⁴³ Several councils specifically agreed with levying a special rate, provided it had the appropriate community consultation.⁴⁴ Port Stephens Council noted that if a community:

...wants new infrastructure and is prepared to pay for it via a special rate following an appropriate community engagement process, then it is implied that they do not seek to be protected from the increase under the rate freeze provisions.⁴⁵

Greater Taree City Council considered this would assist particular works to be undertaken within the new council, which may address disparities in infrastructure provision between pre-merger council areas or meet community expectations for specific infrastructure included in a strategic or community plan.⁴⁶

The Armidale Dumaresq Ratepayers Association thought a new council should only progress with a special variation if it relates to essential infrastructure (eg, roads and bridges), and where it is already planned and approved by the community. Otherwise, it considered that special rates to fund new infrastructure should be deferred until after the rate path freeze period.⁴⁷

IPART considers that councils still need flexibility to fund new infrastructure during the rate path freeze period. We have addressed the concerns raised by the Armidale Dumaresq Ratepayers Association by limiting a new council's ability to apply for this special variation. It must firstly exhaust any funding available to it under the Stronger Communities Fund.

⁴³ For example, NSW Revenue Professionals (p 4), Warringah Council (p 9), Ku-ring-gai Council (p 3), Berrigan Shire Council (p 4), Willoughby City Council (p 4), Leichhardt Municipal Council (p 5), Shoalhaven City Council (p 10), Queanbeyan City Council (p 18), Tamworth Regional Council (p 3), Pittwater Council (p 4), City of Canterbury-Bankstown (p 8), City of Ryde (p 9), Blayney Shire Council (p 8), Lane Cove Municipal Council (p 2), Manly Council (p 4), Woollahra Municipal Council (p 7), Southern Sydney Regional Organisation of Councils (p 7), Burwood Council (p 9), Randwick City Council (p 7), submissions to IPART Issues Paper, May 2016.

⁴⁴ For example, Port Stephens Council (p 12), Willoughby City Council (p 4), Greater Taree City Council (p 7), Marrickville Council (p 5), submissions to IPART Issues Paper, May 2016.

⁴⁵ Port Stephens Council submission to IPART Issues Paper, May 2016, p 12.

⁴⁶ Greater Taree City Council submission to IPART Issues Paper, May 2016, p 7.

⁴⁷ Armidale Dumaresq Ratepayers Association submission to IPART Issues Paper, May 2016, p 3.

3.3 Temporary special variation to renew an expiring special variation that funds a continuing service

New councils should be able to apply for a temporary special variation to renew an expiring special variation that:

- ▼ currently funds a service, and
- ▼ will expire during the rate path freeze period, leading to the service being discontinued by the new council.

A special variation for this purpose is consistent with our interpretation of the rate path freeze policy. It would only be levied on ratepayers in the pre-merger council area that benefit from continuing the service. As such, the rating path in each pre-merger council area would follow the same trajectory as if the merger had not occurred (if the pre-merger council had planned to renew the special variation).

As a special variation for this purpose permits services to continue, it is also consistent with the Government's policy that services should not be disrupted as a result of council mergers. For example, the Minister for Local Government indicated that:

...it will be business as usual for residents in new council areas, with services operating as normal.⁴⁸

The special variation would be temporary, and would expire at the end of the rate path freeze period. After this period, new councils would be able to apply for special variations under normal criteria.

Applications would be assessed using the existing OLG guidelines for special variations.

Recommendation

- 6 That a new council be permitted to apply for a new temporary special variation:
- to renew an expiring special variation that currently funds a service in a pre-merger council area, and
 - the council demonstrates that the service would be discontinued if the special variation were not renewed.

⁴⁸ NSW Government, *Media Release – 19 New Councils Created in NSW Today*, at http://www.fitforthefuture.nsw.gov.au/sites/default/files/19_NEW_COUNCILS_CREATED_IN_NSW_TODAY.pdf, 12-May 2016.

3.3.1 Analysis and stakeholder comment

A few councils requested they be able to renew an expiring special variation, in order to continue to fund long-standing services.⁴⁹ While we did not include this special variation in the Issues Paper, we agree that new councils should be able to apply for a special variation for this purpose.

Both Ku-ring-gai Council and Randwick City Council have funded their environmental services using temporary special variations for around 10 years.⁵⁰ Great Lakes Council has used temporary special variations to fund its environmental and dredging works, a program that has been ongoing for around 20 years.⁵¹ If councils are not able to renew these special variations until after the rate path freeze, these long-standing services may be discontinued.⁵²

Randwick Council noted that the expiry and renewal of such a special variation would maintain the status quo and have no net effect on a ratepayer's burden, and hence is consistent with the rate path freeze policy.⁵³

3.4 Special variation for 'above the cap' development contributions

A new council should be able to apply for a special variation to levy unrecovered development contributions that are 'above the cap' under the *Environmental Planning and Assessment Act 1979* (NSW). The contributions would only be recovered through a special rate on parcels of land that will benefit from the proposed new infrastructure.

Development contributions are payments by developers to councils that are used to fund local infrastructure that meet an increased demand arising from new developments. Currently, if a council's development contributions for an area exceed the relevant cap,⁵⁴ the council may seek to fund the gap by applying for a special variation.^{55,56}

⁴⁹ Randwick City Council (p 8), Ku-ring-gai Council (p 3), Mid-Coast Council (formerly Great Lakes Council) (p 2), submissions to IPART Issues Paper, May 2016.

⁵⁰ Randwick City Council (p 8) and Ku-ring-gai Council (p 3), submissions to IPART Issues Paper, May 2016.

⁵¹ Mid-Coast Council (formerly Great Lakes Council) submission to IPART Issues Paper, May 2016, p 2.

⁵² Ku-ring-gai Council submission to IPART Issues Paper, May 2016, p 3.

⁵³ Randwick City Council submission to IPART Issues Paper, May 2016, p 8.

⁵⁴ Local development contributions are capped at \$30,000 per residential lot or dwelling for greenfield areas, and \$20,000 per residential lot or dwelling for all other areas (Minister for Planning direction under section 94E of the *Environmental Planning and Assessment Act 1979* (NSW)).

⁵⁵ Office of Local Government, *Guidelines for the preparation of an application for a special variation to general income for 2016/17*, January 2016, p 23.

⁵⁶ However, we have never received an SV application for this purpose. Alternatively, a council may seek to fund this gap by applying for government funds under the Local Infrastructure Growth Scheme (<http://www.planning.nsw.gov.au/About-Us/Our-Programs/Local-Infrastructure-Growth-Scheme>, accessed 30 March 2016).

We consider that new councils should be able to apply for a special variation for this purpose during the rate path freeze period. Otherwise, it could limit the funds available to deliver infrastructure required by the new development.

Applications would be assessed using the existing OLG guidelines for special variations.

Recommendation

- 7 That a new council be permitted to apply for a new special variation for unrecovered development contributions that are 'above the cap' under the *Environmental Planning and Assessment Act 1979* (NSW).

3.4.1 Analysis and stakeholder comment

We proposed this special variation in the Issues Paper, and many stakeholders supported it.⁵⁷ Greater Taree City Council noted that infrastructure required to meet the needs of an increasing population should be levied onto new development, so that existing ratepayers are not unduly burdened with the costs.⁵⁸ As such, we recommend new councils should be allowed to apply for this type of special variation.

3.5 Special variation for adding Crown Land to a new council's rate base

A new council should be permitted to increase its general income when former Crown Land is added to its rate base during the rate path freeze period. This occurs by way of a special variation under section 508(2) of the LG Act. The special variation only applies to the general income of the council whose pre-merger area now includes the former Crown Land.

Adding former Crown Land to a new council's rate base may lead to higher demand for its services, an increase in its costs and a loss of ex-gratia payments from governments. Therefore, new councils should have the discretion to apply for a special variation to their general income (above the rate peg limit) to take account of this cost increase or revenue loss.

⁵⁷ For example, NSW Revenue Professionals (p 4), Warringah Council (p 9), Ku-ring-gai Council (p 3), Berrigan Shire Council (p 4), Willoughby City Council (p 3), Leichhardt Municipal Council (p 5), Shoalhaven City Council (p 10), Queanbeyan City Council (p 18), Tamworth Regional Council (p 3), Pittwater Council (p 4), City of Canterbury-Bankstown (p 8), City of Ryde (p 9), Blayney Shire Council (p 8), Lane Cove Municipal Council (p 2), Manly Council (p 4), Woollahra Municipal Council (p 7), Southern Sydney Regional Organisation of Councils (p 7), Randwick City Council (p 7), submissions to IPART Issues Paper, May 2016.

⁵⁸ Greater Taree City Council submission to IPART Issues Paper, May 2016, p 7.

Recommendation

- 8 That a new council be permitted to apply for a new special variation where former Crown Land has been added to its rate base during the rate path freeze period.

3.5.1 Analysis and stakeholder comment

We proposed this special variation in the Issues Paper, and stakeholders generally supported it.⁵⁹ Port Stephens Council noted that it currently applies for Crown Land adjustments to avoid losing income: for example, where a Defence Housing Authority property is sold, and previously the Commonwealth paid equivalent rates on the property.⁶⁰

3.6 Other special variations requested by stakeholders

Stakeholders requested a range of other special variations. In summary, to:

- ▼ equalise services across the pre-merger council areas
- ▼ address a specific need identified by the community, or through the Integrated Planning and Reporting (IPR) process
- ▼ respond to an exceptional circumstance, and
- ▼ recoup revenue lost from a boundary change as a result of the merger.

We consider special variations for these purposes are either inconsistent with the rate path freeze policy, or are adequately addressed by the special variations we have recommended be permitted. It is important to maintain a high threshold regarding what special variations should be permitted during the rate path freeze. Otherwise the rate path freeze policy's aims – to provide rate certainty for ratepayers and allow merger savings to put downward pressure on rates – could be undermined.

We have outlined these special variations in Table 3.2, along with our reasons for not including them in our recommendations.

⁵⁹ For example, NSW Revenue Professionals (p 4), Warringah Council (p 9), Ku-ring-gai Council (p 3), Berrigan Shire Council (p 4), Willoughby City Council (p 4), Leichhardt Municipal Council (p 5), Shoalhaven City Council (p 10), Queanbeyan City Council (p 18), Tamworth Regional Council (p 3), Pittwater Council (p 4), City of Canterbury-Bankstown (p 8), City of Ryde (p 9), Blayney Shire Council (p 8), Lane Cove Municipal Council (p 2), Manly Council (p 4), Woollahra Municipal Council (p 7), Southern Sydney Regional Organisation of Councils (p 7), Randwick City Council (p 7), Burwood Council (p 9), submissions to IPART Issues Paper, May 2016.

⁶⁰ Port Stephens Council submission to IPART Issues Paper, May 2016, p 12.

Table 3.2 Other types of special variations requested by stakeholders

Special variation to:	Stakeholders	IPART's response
1. Equalise services across the pre-merger council areas	<ul style="list-style-type: none"> ▼ Snowy Monaro Council ▼ Marrickville Council ▼ Greater Taree City Council ▼ Cootamundra Shire Council ▼ Riverina Eastern Regional Organisation of Council 	<ul style="list-style-type: none"> ▼ This is inconsistent with the rate path freeze policy. ▼ New councils could: <ul style="list-style-type: none"> – choose to maintain their existing services during the rate path freeze period, or – use merger savings and government funding to fund increases in services if it is desired by the community.
2. Address a specific need identified: <ul style="list-style-type: none"> – by the community, or – through the IPR process 	<ul style="list-style-type: none"> ▼ Manly Council ▼ Woollahra Council ▼ Snowy Monaro Council ▼ Randwick City Council ▼ Marrickville Council ▼ Ashfield Council ▼ Leichhardt Municipal Council ▼ Shoalhaven City Council ▼ North Sydney Council ▼ Burwood Council ▼ Riverina Eastern Regional Organisation of Council ▼ Lane Cove Municipal Council 	<ul style="list-style-type: none"> ▼ Some stakeholders noted it might take some time for the new council to complete the IPR process, potentially up until year 3 of the rate path freeze period. (Mosman Municipal Council; G Mills). ▼ If a matter is not sufficiently critical, it can be deferred until after the rate path freeze period or funded by other means.
3. Respond to an exceptional circumstance	<ul style="list-style-type: none"> ▼ Southern Sydney Regional Organisation of Councils ▼ Berrigan Shire Council ▼ Canterbury City Council ▼ Bankstown City Council 	<ul style="list-style-type: none"> ▼ To be consistent with the rate path freeze policy, it is important to be specific about what constitutes 'exceptional circumstances'. Otherwise, ratepayer certainty could be undermined. ▼ The 'critical financial need' special variation is an example of a well targeted exceptional circumstance special variation.
4. Recoup revenue lost from a boundary change as a result of the merger	<ul style="list-style-type: none"> ▼ Southern Sydney Regional Organisation of Councils ▼ Leichhardt Municipal Council 	<ul style="list-style-type: none"> ▼ While some revenue may be lost due to boundary changes, the new council's costs will be correspondingly lower from no longer providing services to these ratepayers. Merger savings can also be used to help maintain services. ▼ As such, these boundary changes alone are unlikely to constitute a 'critical financial need'.

Source: Various stakeholder submissions to IPART Issues Paper, May 2016.

4 Setting rates in the pre-merger council area during the rate path freeze period

Chapters 2 and 3 outlined our recommended approach for determining the general income of each pre-merger council area, within the new council, during the rate path freeze period. This chapter outlines how we consider the rate path freeze policy should apply when the new council is setting rates **within** each pre-merger council area.

We recommend:

1. applying the rate path freeze policy at the rating category level for a pre-merger council area, but not at the subcategory level
2. increasing base and minimum amounts in a pre-merger council area by the rate peg (adjusted for any permitted special variations)
3. not applying the 50% restriction on base amounts under the LG Act to a new council over the rate path freeze period
4. introducing a 'safety valve' mechanism in the LG Act, which allows the new council to rebalance rates between categories in a pre-merger council area if external factors excessively impact on rates within a category, and
5. distributing the rating burden arising from general land revaluations within each pre-merger council area using a relative change or a fixed share method.

The recommendations in items 1, 2 and 5 above should apply **unless** the pre-merger council had approved and implemented a pre-existing rate plan. In that case, the new council can set rates for the pre-merger council area in accordance with the plan, subject to IPART approval.

Our recommendations should ensure that:

- ▼ the new council is unable to redistribute its rating burden between pre-merger council areas, and
- ▼ rates within a pre-merger council area are no higher than they would have been under its existing rate path.

4.1 Apply rate path freeze policy only to rating categories, not subcategories

Under our recommended approach, a new council would:

- ▼ not be permitted to rebalance rates across the **rating categories** in a pre-merger council area (eg, from business to residential), and
- ▼ be permitted to rebalance rates across the **subcategories** that comprise a rating category in a pre-merger council area (eg, from business subcategory 1 to business subcategory 2).

Rating categories

We propose that the rate path freeze policy applies to the rating categories of a pre-merger council area (ie, Residential, Business, Farming and Mining). This means that the general income derived from each category would only increase by the rate peg,⁶¹ unless:

- ▼ the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the plan could apply (subject to IPART approval), or
- ▼ there is a general land revaluation during the financial year, and the pre-merger council area does not have a pre-existing rate plan, in which case the process outlined in section 4.5 applies.

Subcategories

In the Issues Paper, we proposed that the rate path freeze policy apply at **both** the rating category level and the subcategory level for each pre-merger council area.⁶² However, discussions with stakeholders and further analysis led us to conclude that locking down the rating trajectory at the subcategory level could result in significant rates volatility for individual ratepayers.

In some circumstances, even small changes in land value, or in the number of assessments, could have significant impacts on the rating burden of the remaining ratepayers in that subcategory. We consider this is contrary to the Government's stated policy of providing rates certainty. Instead, councils should have the ability to smooth changes in rates arising from external factors across a larger group, and achieve a higher degree of rate certainty.

⁶¹ Subject to any adjustments permitted to the general income of the pre-merger council area (see section 2.1) or special variations permitted during the rate path freeze period (see Chapter 3).

⁶² In other words, the general income of each rating subcategory would also only increase by the rate peg (subject to the adjustments and special variations referred to in footnote 62).

Recommendations

- 9 That the rate path freeze policy should apply to the rating categories (ie, Residential, Business, Farming or Mining) of a pre-merger council area, but not its subcategories.
- 10 That a new council would only increase the general income of each rating category of a pre-merger council area annually by the rate peg (subject to any adjustments to general income permitted under Recommendation 1, or special variations permitted under Recommendations 4 to 8), **unless**:
 - the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the new council could (subject to IPART approval) set rates for these categories in accordance with the plan, or
 - there is a general land revaluation, and the pre-merger council area does not have a pre-existing rate plan, in which case the new council should set rates in accordance with Recommendation 14.

4.1.1 Stakeholder comments

Stakeholders generally opposed applying the rate path freeze policy to either rating categories or subcategories. Some of the reasons given included that:

- ▼ the rate path freeze policy will increase the upward pressure on rates post-freeze
- ▼ there was no way to capture ‘natural’ sources of growth such as land rezoning, subdivisions or catch up growth from previous years, and
- ▼ freezing category and subcategory level rates is overly prescriptive, and new councils should have the ability to adjust rating structures within pre-merger council areas according to their own circumstances.⁶³

Some of these concerns are addressed by:

1. allowing new councils to apply to continue a pre-existing rate plan (section 4.1.2)
2. allowing rate rebalancing across subcategories (section 4.1.3), and
3. using a ‘safety valve’ mechanism where external factors cause excessive rate rises (section 4.4).

⁶³ Newcastle City Council (p 8), Berrigan Shire Council (p 5), Western Plains Regional Council (p 7), submissions to IPART Issues Paper, May 2016.

4.1.2 New council could apply for an exception if there is a pre-existing rate plan for rating categories

Some councils have indicated they already have a policy in place to alter the relative burden of rates between different rating categories over time, and that a rate path freeze would prevent the new council from implementing this policy. For example, a pre-merger council may have had a plan to slowly shift business from paying 40% of rates to 30% of rates, and be halfway through implementing the plan, with business paying 35% of rates prior to the merger.

Restricting a new council's ability to rebalance between rating categories in accordance with a pre-existing plan may be inconsistent with the rate path freeze policy. This is because the policy aims to maintain an individual ratepayer's rate path trajectory as if the merger had not occurred.

Accordingly, where the pre-merger council had approved and implemented a pre-existing rate plan, which outlines its policy for rebalancing rates across rating categories, the new council should be given the option to continue implementing that plan (subject to IPART approval).

Pre-existing rate plans can take different forms. For example:

- ▼ Cootamundra Shire Council has a policy of rebalancing rates to reduce the burden on businesses relative to residential ratepayers, as part of its effort to encourage business growth within the council area.
- ▼ North Sydney Council on the other hand has a long standing policy of keeping residential to business rates at a ratio of 60:40.

In each case, these policies represent how rates within each pre-merger council area were adjusting each year.

Stakeholders raised concerns about what would constitute a pre-existing rate plan. To address these concerns, we recommend that IPART determines which plans would represent the existing rate path trajectory for a pre-merger council area.

IPART proposes to assess applications on a case-by-case basis against a set of criteria outlined in Box 4.1.

Box 4.1 Assessing pre-existing rate plans

First, a new council would need to apply for IPART's approval if it wants to rebalance rates across the rating categories for a pre-merger council area (or between fixed and ad valorem charges within a category or subcategory, see section 4.2.2). It would need to demonstrate that the proposed rebalancing is in accordance with a pre-existing plan approved and implemented by the pre-merger council.

We would then assess applications against the following criteria:

- ▼ that the rate trajectory plan had been approved by the pre-merger council prior to the merger proclamations, and
- ▼ that the rate trajectory plan has a historical basis (ie, the pre-merger council has implemented it, as shown by rate changes in previous years).

Where IPART is not satisfied that the pre-existing rate plan meets these criteria, the new council would be required to maintain the pre-merger council's rating structure for its categories that was in place when the new council was formed. General income for these categories would increase annually by the rate peg (subject to any permitted adjustments to general income or special variations).

4.1.3 New council could rebalance rates across subcategories (within a rating category)

Excessive rate volatility may arise due to the small number of assessments within a subcategory, particularly business subcategories or residential subcategories covering different centres of population in non-metropolitan councils.

When subcategories are relatively small,⁶⁴ external influences such as land revaluations, businesses relocating, new exemptions, or rezoning, could have a large effect on individual rate assessments. Ordinarily, councils would be able to adjust rates across different subcategories in order to rebalance this burden. This will not be available to new councils if the rate path freeze applies at the subcategory level in a pre-merger council area.

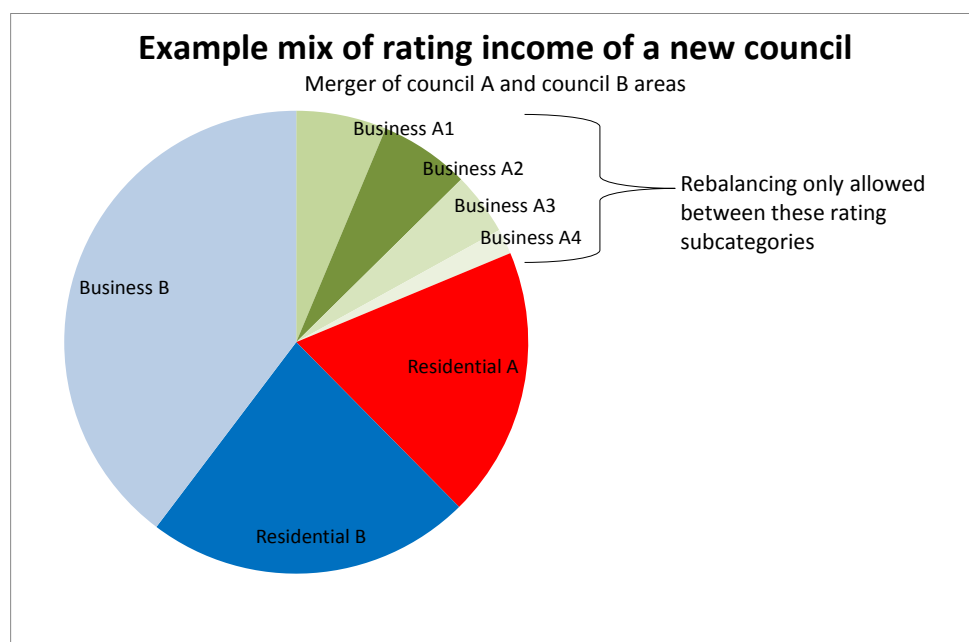
Our recommended approach will allow a new council to smooth out rate changes within a rating category in a pre-merger council area, to reduce overall volatility in individual rate assessments. This provides new councils with the flexibility to reduce excessive volatility caused by external factors at the subcategory level.

⁶⁴ For example, the former Jerilderie Shire Council (a pre-merger area within the new Murrumbidgee Shire Council) has seven farmland subcategories, of which five have fewer than 60 properties each. The most extreme example found is a subcategory of business in Bathurst Council with only 0.46 ratable properties in it i.e. less than half of one plot of land.

Figure 4.1 shows where rebalancing would, and would not be, permitted. In this example:

- ▼ rebalancing is allowed within business subcategories within pre-merger council area A (ie, Business Categories A1 to A4), and
- ▼ rebalancing is not permitted between business and residential categories within pre-merger council area A, or between pre-merger council area A and B.

Figure 4.1 Rebalancing allowed within pre-merger council subcategories



4.2 Increase minimum and base amounts by rate peg (or permitted special variations)

In order to achieve the Government's stated objective of rates certainty for ratepayers, it is necessary to specify how minimum and base amounts can be changed during the rate path freeze period.

We consider that the rate path freeze policy should apply to these amounts. Otherwise, a new council could rebalance the rates it sets for a pre-merger council area between fixed charges (ie, minimum and base amounts) and variable charges (ie, ad valorem amounts). This rebalancing would always result in rate increases for some ratepayers.

Under our recommended approach, a new council would increase minimum and base amounts each year by the rate peg percentage,⁶⁵ subject to:

- ▼ minimum and base amounts being adjusted for any relevant existing, expiring or permitted special variations, and
- ▼ where the minimum amount is set at the maximum amount allowable under the LG Act, it continue being set at this rate.

We proposed this approach in the Issues Paper, and consider it should apply, unless a pre-merger council area had approved and implemented a pre-existing rate plan. In that case, the new council could (subject to IPART approval) set minimum and base amounts for the pre-merger council area in accordance with the plan.

Recommendation

- 11 That a new council should increase the minimum and base amounts for a pre-merger council area annually:
- by the rate peg (subject to any adjustments for special variations under Recommendations 1 and 4 to 8) during the rate path freeze, **unless**
 - the pre-merger council had approved and implemented a pre-existing rate plan for minimum or base amount increases, in which case the new council could (subject to IPART approval) set minimum and base amounts in accordance with the plan.

4.2.1 Analysis and stakeholder comment

Stakeholders generally agreed that this approach would effectively implement the rate path freeze policy.⁶⁶ However, around half of stakeholders requested retaining the discretion to change base and minimum amounts over the rate path freeze period. Most of those requesting this discretion did so on the basis that councils should be allowed to shift the rating burden between rating categories (see section 4.1).

A number of other stakeholders considered that the discretion to change base and minimum amounts could be used to assist rate equalisation.⁶⁷ In other words, new councils could maintain the same income from a ratings category in each pre-merger council area, but adjust the respective base, minimum and ad valorem amounts to partially converge rating structures across pre-merger council areas.

⁶⁵ Under our approach, new councils would be permitted to increase minimum and base amounts below the rate peg only if the increase in general income is below the rate peg percentage. In this case, minimum and base amounts would increase by the change in general income.

⁶⁶ For example, Warringah Council submission to IPART Issues Paper, May 2016, p 9.

⁶⁷ For example, Leichhardt Municipal Council submission to IPART Issues Paper, May 2016, p 6, Western Plains Regional Council submission to IPART Issues Paper, May 2016, pp 6-7.

We consider that this practice is equivalent to allowing new councils to change their rate paths purely in response to the merger, which would result in rate increases for some ratepayers. Consequently, this should not be allowed during the rate path freeze period. This is consistent with our position on new councils equalising rates using mechanisms that lead to rate increases (see section 2.2).

Some stakeholders also noted that the impact on rates of the triennial land revaluation process can be smoothed by changes to base and minimum amounts.⁶⁸ Our approach maintains the balance between fixed and ad valorem charges, and therefore rating structures do not need additional adjustments for land valuation changes over the rate path freeze period. Further, we have introduced a 'safety valve' mechanism for new councils to use if external factors excessively impact on rates within a category (see section 4.4).

4.2.2 New councils could apply for an exception if there is a pre-existing rate plan for fixed charges

Where a pre-merger council has approved and implemented a pre-existing rate plan, which outlines how minimum or base amounts will be set, the new council should be given the option to continue implementing that plan (subject to IPART approval): that is, changing the base and minimum amounts in their pre-merger council area in accordance with the plan.⁶⁹ This is consistent with the Government's policy of maintaining a ratepayer's rating path trajectory as if the merger never occurred, as well as our recommended approach for applying the rate path freeze policy to rating categories (see section 4.1.2).

A new council would need to apply for IPART's approval if it wanted to change minimum and base amounts for a pre-merger council area. It would need to demonstrate that the proposed changes are in accordance with a pre-existing plan approved and implemented by the pre-merger council. We would assess applications on the criteria outlined in Box 4.1.

⁶⁸ For example, The Hills Shire Council, submission to IPART Issues Paper, May 2016, p 5.

⁶⁹ This could include a formal policy of increasing base amounts to mitigate changes in rates following land revaluations.

4.3 Waive base amount restrictions for new councils

The revenue generated from a base amount cannot exceed 50% of the total revenue from any particular rating category or subcategory.⁷⁰ However, if the rating trajectory for base amounts is frozen over a 4-year period (as we recommend in section 4.2), the 50% cap for base amounts might be exceeded in two cases:

- ▼ Where boundary changes have resulted in a new council acquiring a part of a pre-merger council. The part acquired may have more than 50% of its revenue coming from base amounts.
- ▼ If more high density properties are built in an area, the rate path freeze may cause a new council to exceed the 50% cap.

Consequently, we recommend that this 50% cap on the amount of revenue that can be recovered from base amounts for a category or subcategory should not apply to new councils over the rate path freeze period. Furthermore, new councils would have limited flexibility to set base amounts, if Recommendation 10 is followed.

After the rate path freeze period expires, new councils would again be subject to any cap on base amounts set out in the LG Act. However, since the rate path freeze policy would no longer apply at this time, new councils would be able to implement their new rating structures, and accordingly adjust their base amounts to ensure compliance with the LG Act.

Recommendation

- 12 That new councils be exempt from the 50% maximum limit for revenue collected from base amounts for the duration of the rate path freeze period.

4.3.1 Analysis and stakeholder comment

In consulting with councils, we were made aware of two cases where the 50% maximum for base amounts could be exceeded in a given ratings category or subcategory.

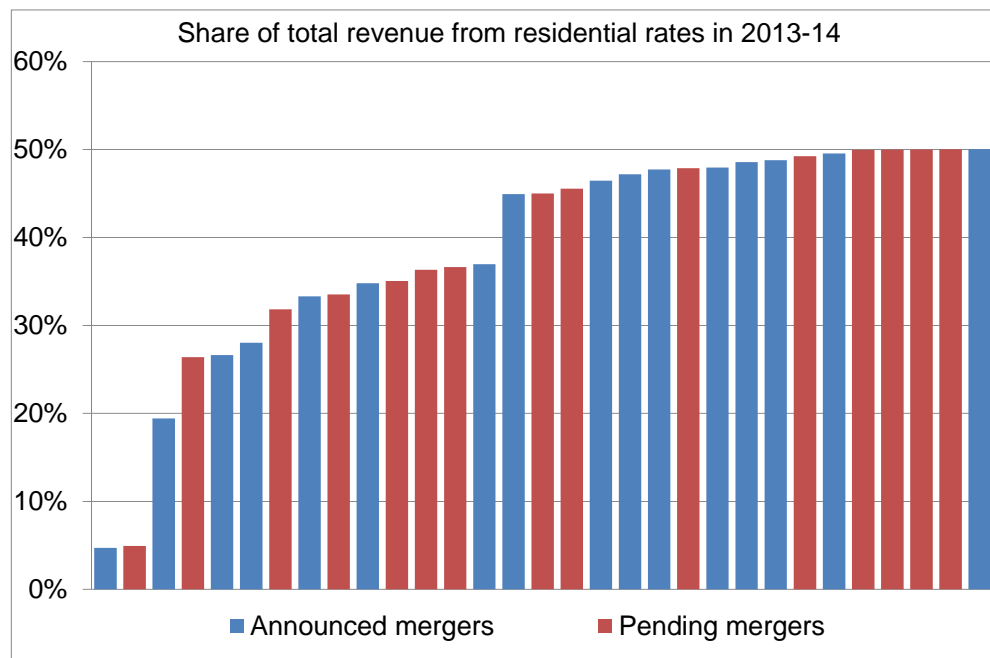
Firstly, where the council merger process results in boundary changes, and a new council acquires parts of other council areas. Some of the acquired areas in the new council may only comprise a small proportion of the previous pre-merger council area. To implement the rate path freeze policy, each rating category within every respective pre-merger area would need to be treated as a separate subcategory. Currently, if more than 50% of revenue from one of these subcategories comes from base amounts, the LG Act is breached.

⁷⁰ Section 500 of the LG Act.

Secondly, if a change in the mix of ratepayers in a rating category increases the collection of base amounts relative to ad valorem rates.⁷¹ This is most likely to occur due to an increase in high-density apartments, which will typically increase the revenue from base rates relative to ad valorem rates, potentially resulting in a breach of the 50% cap for base amounts.

In 2013-14, base amounts accounted for nearly 50% of the general income from residential property in a number of pre-merger council areas (see Figure 4.2). It is likely the 50% cap for base amounts will be exceeded in some pre-merger council areas over the rate path freeze period, if their existing rate paths are maintained. This is because more high density apartments will be built over the four years.

Figure 4.2 Residential base amounts in pre-merger council areas, 2013-14



Note: Pre-merger councils that adopted a base amount for residential property in 2013-14.

Data source: Ratings return data provided by councils to OLG.

The simplest way to resolve this issue, while retaining rate certainty, is to amend the LG Act to exempt new councils from the 50% cap for base amounts over the rate path freeze period.

⁷¹ See Woollahra Municipal Council submission to IPART Issues Paper, May 2016, p 7.

4.4 Rebalancing between rating categories to avoid excessive rate increases

Our recommended approach to imposing the rate path freeze at the category, rather than subcategory level, provides a measure of protection from rate volatility for ratepayers. However, there remains the possibility that due to external factors (eg, a large business shutting down, or a rezoning moving a number of properties between categories⁷²) a rating category may experience a significant variation in its average rate level. This is more likely in regional and rural areas where, even at the category level, there can be relatively few properties within each category.

In order to achieve the Government's stated objective of rates certainty, we recommend a 'safety valve' be implemented. Councils could apply to rebalance rates across categories in a pre-merger council area where maintaining the existing rate path trajectory would result in excessive rate increases to the average rate within a category.⁷³

We propose that an excessive rate increase should be defined as more than a 5% increase in average rates above the rate peg (or any applicable special variations) for a given category.

Councils would need approval from IPART, which would assess the reasonableness of the new council's rebalancing plan. The plans themselves should be designed to minimise overall volatility in individual rate assessments.

Recommendation

- 13 That if, as a result of external factors (such as a significant change in the number of rateable properties in a category), the average rating burden within a pre-merger council area's rating category will change by more than 5% plus the rate peg (or any applicable special variations), the new council can apply to IPART to rebalance the rating burden across **all** categories in the pre-merger council area.

4.4.1 Analysis

This recommendation to allow rebalancing across categories would **not** allow councils to rebalance rates **between** pre-merger council areas. Rather, the rebalancing would only occur **within** a pre-merger council area.

⁷² For example farmland or industrial land being rezoned residential and developed into apartments.

⁷³ This option addresses issues within pre-merger council areas rather than any disparities between separate pre-merger council areas.

The safety valve can reduce the impact of external factors on rates during the rate path freeze period, whilst still providing more certainty for ratepayers. The requirement to have proposals approved by IPART would ensure that councils cannot use this process to commence rebalancing between pre-merger council areas during the rate path freeze period. However, they would be able to respond to excessive volatility.

This recommendation was not in our Issues Paper so stakeholders have not commented on it specifically. However, the majority of council submissions advocated for greater flexibility across the board to set rates during the merger process.

Box 4.2 offers a practical case study of the potential volatility in rates under the current rate path freeze at the category and subcategory level and the need for a 'safety valve' mechanism.

Box 4.2 Case Study – Tumbarumba Shire Council

- ▼ In 2013-14, the former Tumbarumba Shire Council had fewer than 200 business assessments across its three business categories. Just two individual parcels of land accounted for about 13% of the total business category's share of notional general income.
- ▼ If either or both of these businesses were to cease or to move to a different rating category,^a the remaining businesses within the pre-merger council area would face substantial increases in their rates, if the council were forced to maintain its current balance between farmland, residential and business categories.
- ▼ Under our recommended approach, the new Snowy Valleys Council could respond to this situation by applying to IPART for permission to rebalance the rating burden across each of the former Tumbarumba Shire Council's rating categories in order to lessen the impact on each individual rate payer.

^a Currently these parcels of land are rated 'business – inundated lands'.

Source: Ratings return data provided by councils to OLG

4.5 Distributing the rating burden arising from land revaluations

Every three years, a pre-merger council area will typically undergo a general land revaluation. We consider that changes in the rating burden arising from land revaluations should be distributed:

- ▼ according to the relative change method, or the fixed share method, with the choice of method at the discretion of the new council, **unless**
- ▼ the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the plan could apply (subject to IPART approval).

We note that the impact of land valuation changes on individual ratepayers could be mitigated during the rate path freeze period by deferring the land revaluation process until after this period expires. However, we have not recommended this deferral, since delaying the revaluation process could result in larger valuation changes, and introduce a greater degree of 'rate shock', after the rate path freeze period.

Recommendation

14 That when allocating the rating burden from land revaluations:

- the new council should allocate it to different rating categories in each pre-merger council area using either the relative change method or the fixed share method, **unless**
- the pre-merger council had approved and implemented a pre-existing rate plan for rebalancing rates between categories, in which case the new council could (subject to IPART approval) set rates for these categories in accordance with the plan.

4.5.1 Analysis and stakeholder comments

We propose new councils would have the discretion to determine how the rating burden is distributed according to either the:

- ▼ **relative change method:** rates for each category are determined by the relative change in the total land value of that rating category against other categories within the pre-merger council area, or
- ▼ **fixed share method:** the rating income derived from each category increases by the rate peg, to fix the percentage share of rates revenue.

The relative change and fixed share methods are outlined in Box 4.3 and Figure 4.3. Importantly, there is no issue if the pre-merger council areas have different re-valuation dates, as their incomes are treated separately during the rate path freeze.

Box 4.3 The relative change and fixed share methods

- ▼ These methods determine how the rating burden is distributed between rating categories when land revaluations occur. They apportion out the increases in general income from the rate peg (or any applicable special variations).^a
- ▼ The revaluation process typically occurs once every three years. If there is not a land revaluation, then each ratepayer's rates will increase by the other mechanisms outlined in this chapter.

Relative change method

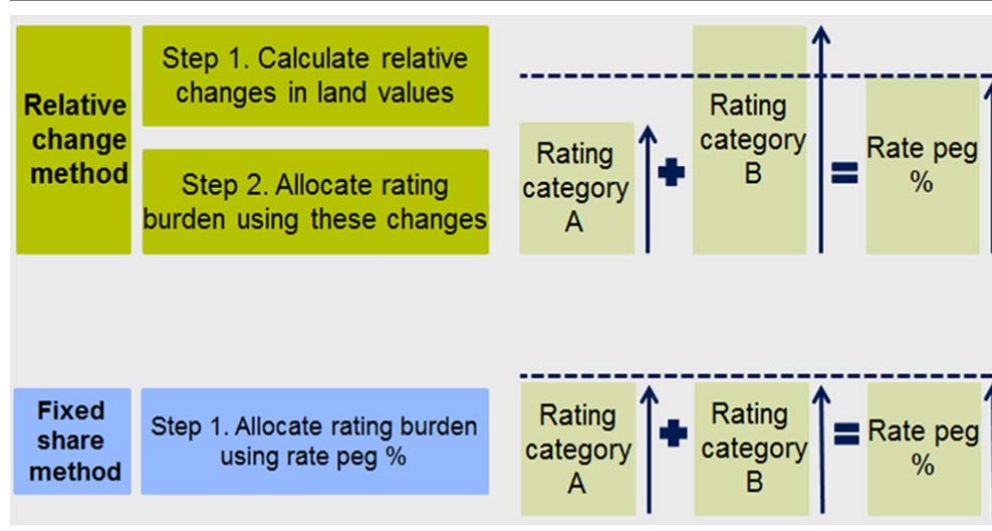
- ▼ Under this method, the change in rates for a category would be determined by the change in land value in that category relative to the average across all categories, scaled by the rate peg.
 - For example, if business land values increased by more than residential land values, business rates would increase by more than the rate peg and residential rates would increase by less than the rate peg, but the council's overall income would increase by the rate peg.
- ▼ For an individual ratepayer, if their land value increases by more (less) than the average across the *pre-merger council area*, then their rates will increase by more (less) than the rate peg.

Fixed share method

- ▼ Under this method, rates for each category of land would be increased by the rate peg (irrespective of changes in land values).

^a They do not address other events that shift the rating burden between categories (eg, changes in a property's rating category).

Figure 4.3 Relative Change and Fixed Share methods in practice



Some councils expressed reservations about being limited to these two methods when allocating increases in rates from the rate peg. They considered these methods might not take into account existing council rating structures, and how the rating burden is apportioned by individual councils.⁷⁴ However, submissions did not outline alternative methods for distributing rate cap rises amongst ratepayers other than a removal of the rate path freeze policy itself.

Submissions discussing the two methods showed a slight preference for the relative change method, however this was not universal. We therefore recommend retaining both these methods for new councils to use when distributing the rating burden arising from land revaluations, and councils being given the discretion to choose which method to use. This discretion should be used to limit the impact on individual ratepayers as far as possible.

These two methods are only relevant where a pre-merger council has not approved and implemented a pre-existing rate plan for rebalancing rates between categories. Where such a plan exists, the new council could apply for IPART's approval to rebalance rates in accordance with the plan. This approval process is discussed in section 4.1.2.

⁷⁴ For example, Former Corowa Shire Council (p 4), Eurobodalla Shire Council (p 6) and Leichhardt Municipal Council (p 6), submissions to IPART Issues Paper, May 2016.

5 Implementing the rate path freeze policy

In order to implement the Government's policy of freezing rate paths as described in Chapters 2 to 4, it will be necessary to amend the LG Act. The current LG Act does not provide a mechanism for implementing the rate path freeze as described. This chapter outlines three different legislative options that would allow rate paths to be frozen, and discusses our preferred method.

5.1 Recommended option for implementing the rate path freeze

In the Issues Paper we presented three different methods for implementing the rate path freeze policy:

1. amending the LG Act to introduce a new instrument-making power for the Minister for Local Government (**preferred**)
2. amending the LG Act to expand the Governor of NSW's proclamation power,⁷⁵ or
3. providing for a rate path freeze entirely through amendments to Chapter 15 of the LG Act and Regulations.

Overall, we consider that Option 1 is the best method to implement the rate path freeze. It offers the Government the best mix of flexibility, implementation speed and transparency during the rate path freeze period. The instrument-making power would need to be drafted to limit the Minister's power to maintain existing rate paths over the rate path freeze period.

While Option 3 would provide greater transparency, it would require substantial amendment to the LG Act and Regulations. Also, it is unlikely to be sufficiently flexible in responding to unexpected events that arise over the 4-year period.

Recommendation

- 15 That the *Local Government Act 1993* be amended to provide the Minister for Local Government with an instrument-making power that enables the Minister to implement the rate path freeze policy for new councils. This power should be subject to a sunset clause and expire at the end of the rate path freeze period on 30 June 2020.

⁷⁵ With the Governor's proclamation of the new councils on 12 May 2016 this option is still technically possible, but would require the proclamations to be modified.

5.2 Analysis and stakeholder comments

In order to implement the rate path freeze policy as described, an instrument-making power would need to be able to vary or displace certain provisions in the LG Act as they apply to a new council during the four years following the merger. Such variation or displacement would only be appropriate to the extent that it is necessary in order to implement the rate path freeze policy.⁷⁶

The instrument would need to:

- ▼ set out the methodology that new councils must apply when setting rates for each pre-merger council area, including:
 - how general income is to be calculated for each pre-merger council area
 - how existing special variations for pre-merger councils are to be treated in these calculations
 - how the rating burden is to be distributed between categories and subcategories of land
 - how base and minimum amounts for each rate are to be set, and
- ▼ specify the circumstances where a new council could seek approval to depart from the rate path freeze policy.

One approach to implementing our recommendations in Chapter 3 would be to amend the OLG guidelines to provide the circumstances where new councils are eligible for special variations, and the criteria IPART is to use to assess the applications. Alternatively, the new 'rating instrument' could also contain provisions on special variations.

5.2.1 Stakeholder comments

On balance, stakeholders agreed with our preferred option of a new instrument-making power for the Minister. Reasons for this varied, but in general were focused on the speed and flexibility of this option to address problems as they occur compared to the alternatives.⁷⁷ However, some stakeholders were concerned that Option 1 decreased the level of transparency in decision making, and gave too much power to the Minister.⁷⁸

⁷⁶ For example, sections 498(3) and 499(4) of the LG Act provide that ad valorem and base amounts may not differ within a category or subcategory except where the value of land "was last determined by reference to different base dates" and the Minister for Local Government approves the relevant amounts. A 'rating instrument' would need to displace this to the extent necessary for merged councils to comply with the rate freeze policy as described.

⁷⁷ Woollahra Municipal Council (p 8), City of Parramatta Council (p 6), The Hills Shire Council (p 6), submissions to IPART Issues Paper, May 2016.

⁷⁸ LGNSW (p 19), Wollongong City Council (p 14), submissions to IPART Issues Paper, May 2016.

While there was little support for Option 2, some councils did prefer Option 3. These stakeholders thought that it provided greater certainty, transparency and accountability with regard to the operation of the rate path freeze.⁷⁹ That said, other stakeholders were concerned that Option 3 would lead to complex changes to the LG Act, and that it would limit the ability to make changes to adapt to new circumstances as they arise.

When implementing Option 1, several stakeholders noted that the Minister should consult with councils to build trust about the process, and that the instrument should be as tightly limited to the rate path freeze as possible.⁸⁰ Other stakeholders indicated they would support Option 1, subject to the inclusion of an explicit sunset clause for the instrument.⁸¹ The only council to support Option 2 also did so on the basis that it limited Ministerial powers during the 4-year rate path freeze period.⁸²

⁷⁹ For example, Newcastle City Council (p 10), City of Ryde Council (p 10), Berrigan Shire Council (p 5), Ku-ring-gai Council (p 5), submissions to IPART Issues Paper, May 2016

⁸⁰ Snowy Monaro Regional Council (p 10), Marrickville Council (p 6), City of Ryde Council (p 10), submissions to IPART Issues Paper, May 2016.

⁸¹ For example, Queanbeyan City Council submission to IPART Issues Paper, May 2016, p 20.

⁸² Marrickville Council submission to IPART Issues Paper, May 2016, p 6.



Appendices

A Terms of Reference



Dr Peter Boxall AO
Chairman
Independent Pricing and Regulatory Tribunal
PO Box K35
HAYMARKET POST SHOP NSW 1240



Reference: A1444504

18 DEC 2015

Dear Dr Boxall

Pursuant to section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992*, I am writing to request the Tribunal undertake a review of the Local Government rating system in accordance with the attached Terms of Reference.

The implementation of an efficient and equitable rating system is a key component of the Government's *Fit for the Future* reforms, and will ensure all councils are able to implement sustainable fiscal policies and reforms over the longer-term.

Critically, the Tribunal's review should seek to recommend a legislative or regulatory approach to support the Government's policy of freezing existing rate paths for a period of four years for councils that merge as part of the *Fit for the Future* process.

An interim report outlining options and recommendations to achieve this commitment should be provided to the Minister for Local Government within six months. A final report addressing all aspects of the terms of reference should be provided to the Minister within 12 months.

Should you have any questions or wish to discuss this matter further, please contact Mr John Clark, Executive Director, Local Government Reform on 9228 3570 or john.clark@dpc.nsw.gov.au

Yours sincerely

MIKE BAIRD MP
Premier

End: Terms of Reference, Local Government Rating System in NSW

Terms of Reference

The Local Government Rating System in NSW

I, Mike Baird, Premier of New South Wales, approve the provision of services by the Independent Pricing and Regulatory Tribunal (IPART) under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992* (IPART Act) to the Minister for Local Government for the review of the local government rating system in accordance with these 'terms of reference'.

General

IPART is to undertake a review to identify and make recommendations for potential reforms to the rating system for local government in NSW. These recommendations will aim to:

- Enhance the ability of councils to implement sustainable and equitable fiscal policy and
- Provide the legislative and regulatory approach to achieve the Government's policy of freezing existing rate paths for four years for newly merged councils.

In investigating and making recommendations for this review, IPART is to consider:

- a) the performance of the current rating system and potential improvements, including consideration of:
 - the rating burden across and within communities, including consideration of apartments and other multi-unit dwellings;
 - the appropriateness and impact of current rating categories and exemptions, mandatory concessions and rebates;
 - the land valuation methodology used as the basis for determining rates in comparison to other jurisdictions;
 - the impact of the current rating system on residents and businesses of a merged council and the capacity of the council to establish a new equitable system of rating and transition to it in a fair and timely manner.
 - the objectives and design of the rating system according to recognised principles of taxation.
- b) current examples of municipal best practice rating policies and schemes;
- c) the impact of the current and alternative frameworks for the rating system on communities and businesses and their capacity to pay; and
- d) any other matter IPART considers relevant.

In undertaking its review under these Terms of Reference, IPART is to take account of:

- the importance of Integrated Planning and Reporting in determining the revenue required to deliver services and infrastructure;
- the current financial sustainability of local government in NSW, including the findings and deliberations of the NSW Treasury Corporation report Financial Sustainability of the NSW Local Government Sector, 2013;
- the findings and deliberations of the Independent Local Government Review Panel and subsequent Government response;
- the NSW Government's policy of encouraging urban renewal; and
- the NSW Government's commitment to protect NSW residents against excessive rate increases and to providing rate concessions to pensioners.

Public consultation

IPART should consult with relevant stakeholders and NSW Government agencies by releasing an Issues Paper and Draft Report for their review on the IPART website. IPART should also consult with the Fit for the Future Ministerial Advisory Group.

IPART may also hold public hearings for the purposes of this review.

Timeframe

An interim report with recommendations on the legislative and regulatory approach to achieve the Government's policy of freezing existing rate paths for four years for newly merged councils should be submitted to the Minister for Local Government within 6 months of signing of the Terms of Reference.

A final review report should be formally submitted to the Minister for Local Government within 12 months of signing of the Terms of Reference.

Governance

IPART should provide progress briefings at regular intervals or as requested to the Chief Executive, Office of Local Government.

The Minister for Local Government will decide on the timing of release of the final report.

Supporting information and recommendations

IPART is to collect relevant material and data to establish the impacts to councils, communities and NSW of the current rating system, and to provide reasons for any recommendations for reform.

Background

The Independent Local Government Review Panel (Panel) made a number of recommendations regarding general reform of the local government system in NSW, including options to strengthen the revenue base of local government.

As part of its response to the Panel, the NSW Government has agreed to commission IPART to undertake a further review of the rating system reflecting on issues raised by the Panel regarding the equity of the current system.

The Government also committed to introduce a new Local Government Act from 2016. This review will inform the rating provisions in the new Act.

B The financial need for special variations given merger savings, government funding and debt financing

New councils' financial need for special variations over the freeze period will be reduced because of:

- ▼ merger savings
- ▼ access to government funding, and
- ▼ the ability to use debt financing more efficiently.

B.1 Realising merger savings

Mergers are forecast to lead to improvements in councils' expenditure and financial sustainability.⁸³ This was evident during the *Fit for the Future* process, where business cases submitted by councils suggested that merger savings from Sydney Metropolitan mergers could be at least \$1.8 billion over a 20-year period.⁸⁴ Further, several councils indicated that merger efficiencies were forecast to improve their OPRs by 3-10% per annum (see Table B.1).

Table B.1 Improvements in OPRs for merging councils, 2014-15 and 2019-20

Proposed merger	Pre-merger OPR (2014-15)	Post-merger OPR (2019-20)
Auburn, Burwood & Canada Bay	0.4%	3.1%
Randwick & Waverley	1.7%	11.4%
Young, Boorowa & Harden	-3.7%	6.5%

Source: *Fit for the Future*, October 2015, p 37.

It is highly unlikely that any new metropolitan councils would have a critical financial need for a special variation over the rate path freeze to address financial sustainability (absent a large external shock).

- ▼ In *Fit for the Future* assessments, only six metropolitan councils merging, or subject to merger, indicated an intention to apply for a special variation (19%).

⁸³ According to a report prepared by KPMG on behalf of the NSW Government, the proposed mergers have the potential to generate a net financial benefit to councils of around \$2.0 billion across over the next 20 years (NSW Government, *Local Government Reform: Merger impacts and analysis*, December 2015, p 2).

⁸⁴ IPART, *Assessment of Council Fit for the Future Proposals*, October 2015, p 40.

- ▼ Five of these six metropolitan councils only intended to apply for one-year special variations, with rate rises, excluding the rate peg, of less than 10%.
- ▼ In these cases, it would be expected that the merger savings for these councils would be greater than the income generated by the special variations proposed under *Fit for the Future*.

B.2 Accessing government funding

New councils will be able to access significant funds from the NSW Government. They will receive up to:

- ▼ \$15 million from the **Stronger Communities Fund** to spend on community infrastructure and services (eg, pool refurbishments, new sporting facilities, street beautification, playground replacements, car park expansions, and library upgrades),⁸⁵ and
- ▼ \$10 million from the **New Council Implementation Fund** to cover the upfront costs of the mergers (eg, streamlining administrative processes and cutting red tape).⁸⁶

Councils may redirect any unspent funding for merger costs to community projects.⁸⁷

In the case of an external shock leading to a critical financial need, the new council may receive additional funding from State or Commonwealth Governments. For example, grants under the NSW Government's Natural Disaster Assistance Scheme.⁸⁸ Again, the new council would need to take these funds into account before applying for the special variation.

B.3 Using debt financing more efficiently

We consider there is scope for many new councils, particularly ones in metropolitan areas, to use debt financing instead of a special variation to assist with their financial needs over the rate path freeze period.

⁸⁵ Funding of \$10 million is provided to a new council formed as a result of two councils, or parts of two councils, merging. Funding of \$15 million is provided to a new council formed as a result of three or more councils, or parts of three or more councils, merging. NSW Government, *Stronger Communities Fund Guidelines*, May 2016, p 3.

⁸⁶ NSW Government, *Media Release – Stronger Councils for Sydney and Regional NSW*, at <https://www.nsw.gov.au/media-releases-premier/stronger-councils-sydney-and-regional-nsw>, 18 December 2015; NSW Government, *Stronger Councils, Stronger Communities* (<https://www.strongercouncils.nsw.gov.au/>, accessed 30 May 2016).

⁸⁷ NSW Government, *Stronger Councils, Stronger Communities* (<https://www.strongercouncils.nsw.gov.au/>, accessed 30 May 2016).

⁸⁸ Councils can apply for grants under this scheme to meet certain costs of emergency work to restore essential services (eg, providing emergency levee banks) (<https://www.emergency.nsw.gov.au/for-the-community/disaster-assistance/natural-disaster-assistance-schemes.html>, accessed 26 May 2016).

The majority of councils merging, or that are subject to a merger proposal, are forecast to have very low debt service ratios (DSRs) of less than or equal to 5% over the 4-year freeze period.⁸⁹

- ▼ Over 10% of these councils indicated that they would have zero debt (ie, a DSR of 0%) on average over the 4-year freeze period.
- ▼ Around 70% of these councils indicated their average DSR over the 4-year freeze period is forecast to be greater than 0%, but less than or equal to 5%.

These DSRs are significantly below the threshold of 20% that is often used to indicate further borrowing may be financially unsustainable.

New councils may be able to borrow from TCorp to fund projects that make up part of their annual expenditure programs. These loan facilities are available at competitive rates to councils who are deemed 'Fit for the Future' and satisfy TCorp's credit criteria.⁹⁰

As such, before deciding to apply for a special variation over the rate path freeze period, new councils should firstly explore opportunities to borrow cost effectively, and use prudent debt management to address their financial needs. For some new councils, this may mean reconsidering the pre-merger council's aversion to borrowing.

⁸⁹ A council's debt service ratio is calculated by dividing its cost of debt service (interest expense and principal repayments) by its total continuing operating revenue (excluding capital grants and contributions). Having a debt service ratio of greater than 0% and less than or equal to 20% over a 3-year average was the benchmark used in *Fit for the Future*. *Fit for the Future*, October 2015, p 98.

⁹⁰ <https://www.tcorp.nsw.gov.au/html/localcouncils.cfm>, accessed 30 May 2016.

