Information Paper – Background for the rate peg ratepayer workshop

6 April 2023

This Information Paper provides background on the rate peg methodology to assist you in providing feedback at our workshops.

We are seeking your views and preferences on 11 key questions related to potential changes to the methodology. We would also like your feedback on whether the options raised in this Information Paper strike the right balance between protecting ratepayers from paying more than what is needed and providing councils with enough funding to provide ongoing services.

1 Labour costs

Labour costs are the largest single component of council expenses, representing around 40% of councils' total expenses on average. Currently we use the Wage Price Index (WPI) for the NSW public sector published by the Australian Bureau of Statistics (ABS) to measure how councils' labour costs are changing.

A key issue for councils is that the NSW public sector WPI mainly captures changes in wages for State government employees and does not always reflect the increases councils are paying to their staff based on award negotiations. Councils suggested that using the wage increases set out in the Local Government (State) Award (the Award) to measure changes in labour costs would improve the cost-reflectivity of the rate peg. Additionally, we have heard from councils that the current 2-year lag in the rate peg is problematic in periods of economic volatility. Moving to the wage increases prescribed in the Award would address the lag, to an extent, as the changes are generally known in advance.[a]

We need to consider if a methodology that is based on wage increases set by the Award is an appropriate measure of efficient labour costs, and whether it would reduce councils' incentives to negotiate effectively and advocate for optimal wages, productivity gains and conditions when participating in award negotiations. Some ratepayers have raised concerns about enabling councils to recoup wage increases set by the Award through the rate peg.

Councils also told us that they are finding it difficult to compete with the private sector in attracting and retaining staff, particularly for specialised roles, and in regional and remote areas of the State. Councils that are unable to offer competitive salaries may find it increasingly difficult to hire skilled and productive staff, leading to reduced productivity, greater vacancies and a potential decline in service quality.

[a] As the Award is renegotiated every 3 years, we would not be able to reflect the increase in the first year of each Award in the year it occurs due to the timing of the rate peg decision.

We are exploring options for a measure of efficient labour costs that reflects the increases necessary to enable councils to compete with other employers in the market to attract appropriately skilled and qualified staff. Potentially, this could be achieved by referring to a measure of labour costs that is representative of both public and private sector wage increases. We expect this would likely lead to higher rate increases when the unemployment rate is low, to reflect a greater level of competition in the labour market and any premiums paid for skilled staff.

We are also exploring a number of forward-looking indicators that we can refer to, including WPI forecasts published the Reserve Bank of Australia, State and Commonwealth treasuries and private financial institutions. Using a forecast would address the lag in the rate peg methodology, but forecasts are prone to error and may lead to a divergence between what is included in the rate peg and actual labour cost changes.

An alternative data source we are considering is the Fair Work Commission's minimum wage decision. This is an independent data source that is determined by an Expert Panel of the Commission through an annual review process. One potential issue with using this data is that changes in the national minimum wage may not reflect changes in councils' efficient labour costs. Additionally, using the Fair Work Commission's minimum wage decision would reduce the lag in the rate peg methodology, but not eliminate it.[b]

We are seeking feedback on

1. What are your views on using the wage increases set out in the Local Government (State) Award to set the rate peg?
2. Should the measure of labour costs in the rate peg reflect the competition councils face in the labour market, from both the public and private sectors?
3. Do you have concerns about using a forecast to measure changes in labour costs for the rate peg?

2 Depreciation

Councils told us in their submissions to the issues paper that the current methodology does not adequately account for the ongoing maintenance, renewal and replacement of assets. Increasing asset costs are caused by 2 key issues:

- Many councils receive grants to construct assets, but they are required to fund the ongoing maintenance of these assets themselves.
- Natural disasters are expected to increase in frequency and intensity due to climate change. These events accelerate wear-and-tear and lead to increasing costs.

[b] There would still be a 1-year lag.

Capturing councils' depreciation expenses in the rate peg methodology would recognise the rising costs to replace and maintain assets, as well as increases in the volumes of depreciation from grant funded assets, accelerated depreciation, or any additional or improved assets not associated with population growth. This means that if an adjustment for depreciation were used in the rate peg methodology it would better reflect increases in the volume of services, unlike other measures such as the WPI and Consumer Price Index (CPI), which are measures of pure price changes.

The population factor includes an allowance for additional assets due to population growth. To avoid double-counting, we would use a measure of changes in deprecation per capita.

One potential issue with using depreciation is that it is an accounting expense that allows a council to recognise part of the cost to replace an asset each year, rather than recognising the full cost at the time of replacement. This means that depreciation expenses may not always align with the actual maintenance, renewal and replacement costs in a given year. However, councils do revalue their assets each year to account for changes in inflation and asset prices, so we would expect depreciation expenses to roughly reflect councils' actual costs of asset maintenance, renewal and replacement over time.

There is also potential for councils to have greater influence over how their depreciation expenses change, compared to using an independent data source such as the CPI or the WPI. This influence would be most prevalent if each council received its own individual rate peg. The influence is reduced if depreciation is calculated for groups of councils, or the sector as a whole. The change in depreciation for a given group could be based on the average change in depreciation per capita for councils within the group. We could also use a rolling average to reduce the impact of changes in any individual council's depreciation expenses in a given year.

We are seeking feedback on

4. We are considering whether councils' depreciation expenses could be used to measure changes in the costs of providing services and infrastructure.

   What are your views on allowing councils to recover changes in depreciation expense per capita through rates?

3 Council diversity

Our current rate peg methodology is mainly based on a measure of cost change for the average council in NSW (i.e. the Local Government Cost Index). Councils have told us that this approach does not accurately reflect how their costs are changing, as different councils across the State have different priorities and services they provide to their communities, and incur different costs in doing so. Further, councils suggested that the rate at which costs are changing can also vary across the State, driven by characteristics such as remoteness. Early findings from our ratepayer survey suggest that a majority of respondents would support a rate peg methodology that is better tailored to the needs and circumstances of each individual council.

Our analysis shows that councils do spend their money differently. As an example, we observed that asset costs generally represent a larger proportion of total costs for regional and rural councils than metropolitan councils.

Some councils have argued for the rate peg methodology to include a measure of base cost change that is unique to each council, based on their reported expenses. We recognise that each council's circumstances may be unique, however, we also need to consider whether a methodology that allows for the pass through of councils' actual costs would remove incentives for productivity and efficiency. This is a concern shared by ratepayers, who have raised issues with the efficiency of council spending. There are also challenges to obtaining timely information on individual councils' cost data (i.e., the lag would remain or potentially increase).

We would like to better reflect the diversity of councils across the State through the rate peg. We consider this could be achieved by developing separate measures of base cost change for groups of 'similar' councils. To establish groups of councils with similar characteristics we can refer to an existing classification such as the council types used by the Office of Local Government (OLG). Under this classification, councils are categorised in 5 council types – metropolitan, metropolitan fringe, regional, rural and remote – based on broad demographic variables. These 5 council types could be combined into 3 broader groups – metropolitan, regional and rural.[c]

We are open to exploring groups based on other characteristics such as road length per capita or population growth.

More information on potential council grouping options is presented in Appendix A to this paper.

We are seeking feedback on

5. Would you support a rate peg approach that is better tailored to your council, based on the typical costs of councils with similar characteristics?

   Potential options for identifying councils with similar characteristics and cost structures are:

   – the existing Office of Local Government council types, or
   – a characteristic such as road length per capita.

   Are there any other classifications or characteristics we should consider?

[c] OLG also uses other groupings (i.e. Groups 1-11) based on the Australian Classification of Local Governments determined by the ABS. These groupings are subsets of the 5 council types.

4 Population factor

4.1 Supplementary valuations

In submissions to our Issues Paper councils told us that we should not adjust the population factor to account for supplementary valuations. Our current methodology deducts any increase in general revenue from supplementary valuations from a council's change in residential population. Supplementary valuations reflect changes in land value, as the value changes so does the rates council can levy against the land. Land value can change due to land being rezoned or subdivided; changes often associated with population growth.

We adopted the approach of adjusting for supplementary valuations because in our Review of the rate peg to include population growth, we found councils were recovering approximately 60% of the costs of population growth through supplementary valuations.[1] Without the adjustment, some councils would be overcompensated for population growth.

Councils have told us this adjustment is creating unexpected outcomes and leading to decreases in rates income per capita. Some fast-growing councils received a 0% population factor because of the adjustment for supplementary valuations. Councils argued that increases in costs per capita are not necessarily linear and there can be one-off large increases in costs to provide services to newly developed areas, such as new infrastructure.

We are considering alternative measurements of supplementary valuations that would be more representative of the changes in land values that occur due to changes in population growth. For example, we are considering adjusting only for supplementary valuations of residential land instead of supplementary valuations of all rateable land. This could be more appropriate because changes in residential land values are more likely to be caused by changes in population. On the other hand, it may be less likely that changes in land value for land categorised as farmland, mining or business are caused by population changes.

4.2 Prison populations

The population factor in our current rate peg methodology aims to maintain a council's per capita income as its population grows. This should allow councils to continue delivering services as their communities grow.

In submissions to our Issues Paper and our public workshops, ratepayers raised concerns that prison populations were being included in their council's residential population. The ratepayers submitted that the population factor was providing the council with additional revenue for increases in prison populations that it did not require, as the prison should not affect council costs. We are interested in hearing from you on whether there are any costs incurred by councils associated with these facilities that should be reflected in the rate peg.

The population factor uses estimated residential population (ERP) data from the ABS to track the population growth in local government areas. The ABS confirmed this data includes prison populations.

The ABS also releases data that measures the changes in the prison population of each facility in the State, known as the Prisoners in Australia publication. It would be possible to use this data to deduct the change in the number of prisoners from the change in a council's residential population. If IPART adopted this approach, the population factor could be based on the change in councils' non-prisoner residential population.

We are seeking feedback on

6. How should our methodology account for supplementary valuations and the additional revenue they provide councils? Would ratepayers support basing supplementary valuations on residential properties or all properties in the council area?

7. Do you support excluding prisoners from our measurement of the change in residential population?

5 Productivity

Our current rate peg methodology includes a potential factor to account for productivity gains in the local government sector.

Since 2018-19, the productivity factor has been set at zero as a default to recognise that improvements in productivity are already reflected, to an extent, in the ABS price indexes we currently use to measure changes in councils' costs. However, we retain discretion to deduct a productivity factor if there is evidence of productivity improvements in the local government sector that have not been fully incorporated in the LGCI.

Councils mainly advocated for the productivity factor to be removed or remain at zero. They considered that they already actively pursue efficiency in order to remain financially sustainable, and deducting a productivity factor would only penalise councils for efficiency gains and disincentivise innovation.

Ratepayers raised that IPART does not currently have an established method for measuring productivity in the local government sector, and suggested that we develop a credible way to measure councils' productivity, then publish these results or apply a productivity factor to the rate peg.

We are considering whether there is a role for the productivity factor to remain in the rate peg methodology, to signal that we expect councils to become more efficient over time. We are seeking feedback on how to measure for productivity, the use of appropriate indicators and evidence for productivity improvements.

We are seeking feedback on

8. How could the rate peg methodology encourage productivity in the local government sector?

6 Costs due to external changes

In submissions to our Issues Paper and at public workshops we heard from councils that new and external costs are being placed on local government. Many submissions commented on a range of costs that are not captured by the current methodology. When we discuss external costs, we mean costs driven by external changes, that are out of councils' control.

Examples of external costs include:

- the Emergency Services Levy (ESL) that all councils are required to pay to the government to support emergency services
- local government election costs
- operational costs that emerge from infrastructure that may be gifted or transferred to councils
- costs driven by climate change
- costs associated with new functions imposed on councils through legislative change.

Some councils, particularly in regional and rural areas, also told us they are having to step in and provide services that were previously provided by other levels of government such as health and housing services.

Submissions to our Issues Paper from some ratepayers indicated that they opposed capturing external costs in the rate peg and considered that councils should manage these costs. For example, by increasing their efficiency and re-prioritising services. Early findings from our survey of residential ratepayers suggested there was limited support for capturing external costs through the rate peg.

If councils are required to provide more services or fund additional costs without increasing revenue to match this expenditure, there may be risks to the ongoing services councils provide. In these cases, it may be more appropriate for councils that consider they need to increase their income (e.g., due to external costs) beyond the rate peg to apply for a special variation and consult with the community on their preferences. This would enable consultation with ratepayers about options for delivering certain services or infrastructure and community preferences where trade-offs are involved.

There may be other types of costs where there is a case for capturing the costs in the rate peg. We are considering these costs carefully. For example, the ESL is an external cost which is already factored into the current rate peg methodology. However, it is currently reflected as an average across all councils.[d] In practice, the costs of councils' ESL contributions can vary greatly. Regional and rural councils in particular tend to have higher ESL contributions. We are considering options for more accurately capturing changes in ESL costs in the rate peg methodology, including whether there should be an individual factor for each council. We recognise that each council is required to make an ESL contribution that is specific to them each year and must pay it from their income.

[d] For some years the NSW Government has funded the annual changes in ESL contributions for councils. Where that has happened, it has not been included in the rate peg.

We are seeking feedback on determining what external costs should be captured in the rate peg and how, and what an appropriate balance would be between recovering external costs through the rate peg, special variations and other potential sources.

We are seeking feedback on

9. What costs driven by external changes, outside of councils' control, should be captured in the rate peg?

10. What is the appropriate balance between recovering external costs through the rate peg, special variations and other sources?

7 Ratepayer affordability

Ratepayers have expressed concerns about the affordability of rates and told us that the rate peg has not protected them from paying more than what is needed to provide ongoing services. We heard calls from ratepayers for increases to councils' income to be pegged at the rate of inflation. Ratepayers considered that if they were expected to limit or reduce their costs in the current economic environment, then councils should also be expected to.

We also heard from submissions that although the rate peg may protect ratepayers in the short-term, ratepayers may experience higher, intermittent rate shocks over the long-term through a council applying for a special variation.

We recognise the current economic context of high inflation and cost of living pressures, and the challenges ratepayers face.

We would like to achieve an appropriate balance between providing councils with enough funding to provide their ongoing level of services while protecting ratepayers over the long term. We are seeking to improve how we measure councils' costs so that ratepayers contribute towards a level of costs that better reflects what their councils require to meet community expectations.

We heard from some councils that they were struggling to maintain their current level of service while remaining financially sustainable. Early findings from our survey of NSW ratepayers indicated that many preferred councils to increase rates to maintain funding of services that they currently provide, rather than reduce service levels and minimise rates. We are interested in your feedback on whether the potential options presented at the workshops would address the concerns of ratepayers and the need for rates income to be sufficient to support council sustainability.

We are seeking feedback on

11. How can the rate peg methodology better support ratepayer affordability?

A Potential council groupings

One option we are considering is to group councils into 3 groups based on their council type determined by OLG.

The 3 potential groups are:

- Metropolitan – includes Metropolitan and Metropolitan Fringe councils
- Regional – includes Regional Town/City councils
- Rural – includes Rural and Large Rural councils.

We are considering combining OLG's 5 council types into 3 groups to balance the need to better account for council diversity with maintaining simplicity. Having more groups could lead to a slight improvement in cost-reflectivity, but would result in fewer councils in each group and potentially greater volatility.

Alternatively, we could group councils based on other common characteristics.

As an example, we are also considering groups based on councils' road length per capita. We selected this measure because it is a significant driver of councils' costs, and it is also a relevant proxy for other council characteristics such as remoteness.

The 3 potential groups are:

- Group 1 – based on a road length per capita less than 10m
- Group 2 – based on a road length per capita between 10m and 100m
- Group 3 – based on a road length per capita of 100m or more.

Table 1 shows which the groups each council would fall under, based on the options outlined above.

Our preliminary analysis of potential groups found that councils that fall under Metropolitan would fall under Group 1 based on road length per capita, councils that fall under Regional would fall under Group 2 based on road length per capita, and councils that fall under Rural would fall under Group 3 based on road length per capita. We have highlighted councils for which this trend does not apply in red.

Table 1 Potential council groupings

Metropolitan		Regional		Rural	
Council	**Road length grouping**	**Council**	**Road length grouping**	**Council**	**Road length grouping**
Bayside	Group 1	**Lake Macquarie**	**Group 1**	**Bellingen**	**Group 2**
Blacktown	Group 1	**Maitland**	**Group 1**	**Dungog**	**Group 2**
Blue Mountains	Group 1	**Newcastle**	**Group 1**	**Leeton**	**Group 2**
Burwood	Group 1	**Shellharbour**	**Group 1**	**Muswellbrook**	**Group 2**
Camden	Group 1	**Wollongong**	**Group 1**	**Nambucca Valley**	**Group 2**
Campbelltown	Group 1	Albury	Group 2	**Snowy Valleys**	**Group 2**
Canada Bay	Group 1	Armidale Regional	Group 2	**Yass Valley**	**Group 2**
Canterbury-Bankstown	Group 1	Ballina	Group 2	Balranald	Group 3
Central Coast	Group 1	Bathurst Regional	Group 2	Berrigan	Group 3
Cumberland	Group 1	Bega Valley	Group 2	Bland	Group 3
Fairfield	Group 1	Broken Hill	Group 2	Blayney	Group 3
Georges River	Group 1	Byron	Group 2	Bogan	Group 3
Hills	Group 1	Cessnock	Group 2	Bourke	Group 3
Hornsby	Group 1	Clarence Valley	Group 2	Brewarrina	Group 3
Hunters Hill	Group 1	Coffs Harbour	Group 2	Cabonne	Group 3
Inner West	Group 1	Dubbo Regional	Group 2	Carrathool	Group 3
Ku-ring-gai	Group 1	Eurobodalla	Group 2	Central Darling	Group 3
Lane Cove	Group 1	Goulburn Mulwaree	Group 2	Cobar	Group 3
Liverpool	Group 1	Griffith	Group 2	Coolamon	Group 3
Mosman	Group 1	Kempsey	Group 2	Coonamble	Group 3
North Sydney	Group 1	Kiama	Group 2	Cootamundra-Gundagai Regional	Group 3
Northern Beaches	Group 1	Lismore	Group 2	Cowra	Group 3
Parramatta	Group 1	Lithgow	Group 2	Edward River	Group 3
Penrith	Group 1	Mid-Coast	Group 2	Federation	Group 3
Randwick	Group 1	Mid-Western Regional	Group 2	Forbes	Group 3
Ryde	Group 1	Orange	Group 2	Gilgandra	Group 3
Strathfield	Group 1	Port Macquarie-Hastings	Group 2	Glen Innes Severn	Group 3
Sutherland	Group 1	Port Stephens	Group 2	Greater Hume	Group 3
Sydney	Group 1	Queanbeyan-Palerang Regional	Group 2	Gunnedah	Group 3
Waverley	Group 1	Richmond Valley	Group 2	Gwydir	Group 3

Metropolitan		Regional		Rural	
Willoughby	Group 1	Shoalhaven	Group 2	Hay	Group 3
Woollahra	Group 1	Singleton	Group 2	Hilltops	Group 3
Hawkesbury	**Group 2**	Tamworth Regional	Group 2	Inverell	Group 3
Wollondilly	**Group 2**	Tweed	Group 2	Junee	Group 3
		Wagga Wagga	Group 2	Kyogle	Group 3
		Wingecarribee	Group 2	Lachlan	Group 3
		Snowy Monaro Regional	**Group 3**	Liverpool Plains	Group 3
				Lockhart	Group 3
				Moree Plains	Group 3
				Murray River	Group 3
				Murrumbidgee	Group 3
				Narrabri	Group 3
				Narrandera	Group 3
				Narromine	Group 3
				Oberon	Group 3
				Parkes	Group 3
				Temora	Group 3
				Tenterfield	Group 3
				Upper Hunter	Group 3
				Upper Lachlan	Group 3
				Uralla	Group 3
				Walcha	Group 3
				Walgett	Group 3
				Warren	Group 3
				Warrumbungle	Group 3
				Weddin	Group 3
				Wentworth	Group 3

[1] IPART, *Review of the rate peg to include population growth – Final Report*, October 2021, p 22.