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2022-23 Rate peg methodology review
Independent Pricing and Regulatory Tribunal
PO Box K35 Haymarket Post Shop
Sydney NSW 1240

By email; localgovernment@ipart.nsw.gov.au
Cc: Scott_Chapman@ipart.nsw.gov.au.

Dear Tribunal,

IPART review of the rate peg methodology - 2022-2023

I refer to the Issues Paper released by IPART in September 2022 regarding its review of the rate peg methodology and provide the following feedback.

The NSW Government's policy of rate pegging, and current methodology to determine the peg, hurts the very communities and ratepayers that it was introduced to protect.

The rate peg presumes and undermines councils' ability to consider a range of financial plans and responses, to have a mature and open dialogue with their communities, and achieve the outcomes required for their specific circumstances and environments.

Ultimately the rate peg constrains NSW councils from achieving financial sustainability, adversely impacting their capacity to reliably plan, meet and respond to the existing and rapidly changing requirements of their vastly different communities.

Rate peg failures

The current rate peg methodology fails to acknowledge NSW councils' current financial situation, fails to keep pace with the rising costs they have already experienced, and fails to adequately forecast and plan for the future financial challenges they face, including:

- The existing rates base needs to be independently retested, and refined
- A universal local government cost index (LGCI) for all councils is inadequate
- The basket of goods used to measure the LGCI, and weighting of the individual components, does not reflect the individual experience of all councils
- The LGCI uses historical pricing data to predict future financial needs
- There is no allowance or factor for new or expanding services required of local government, as a directive from other levels of government
- There is no allowance or factor for new and expanding services required to meet changing community demographics, and/or community expectations, and
- There is no allowance or factor to reflect the higher service levels, or increased asset renewal, required to address the growing impacts from climate change.

Given these failures, rate pegging continues to hinder local government's financial capacity to fully provide and address the needs of its growing communities. Community requirements and local expectations continue to increase, particularly as population densities increase to meet State housing targets, however the rate peg methodology is structured and inflexible, and fails to reflect or account for these and other emerging changes to enable appropriate local government response.

In addition to the aforementioned operational cost issues, local government is also responsible for responding to its community's infrastructure requirements, including provision of adequate green space for its growing communities and the acquisition and/or delivery of buildings for additional community facilities. These requirements may be partly funded by developer contribution plans, however the balance must be funded by council's own source revenue including rates. The rate peg fails to incorporate the dramatic escalation of these costs over many years.

The reality is that funding the acquisition of many of these assets is only one aspect. The mandated revaluation of council assets (excluding land) by OLG, under the Local Government Code of Accounting practice, continues to increase the value of these assets which ultimately drives depreciation expense. This increasing cost is then factored into financial ratios that continue to show councils' financial performance is deteriorating because income is not keeping pace with expenditure, and local governments generally do not have sufficient funds to continually undertake the required renewal works, or to replace its assets at the most appropriate times.

This deteriorating situation is borne out by the 178 special rate variations that have been submitted for additional rate funding over the last 10 years, and we know that there have been many other variation requests that have been developed but withdrawn in this time frame. As 165 of these applications were approved, it can be presumed that the financial need has been successfully argued, pointing to an inherent failure in the underlying peg.

To underline this point, the OLG's data identifies many councils are producing consolidated operating deficits, with deteriorating trend lines. The impact of covid in the past three years, has not helped this situation, but that is really an additional impact as the underlying problem has been evident for years before the arrival of the pandemic.

The current rate peg methodology is obviously not providing adequate funding levels for local government, a situation that is further frustrated by cost shifting from other levels of government, which is strangling councils' capacity to adequately provide for its communities needs. As councils then provide long term financial plans, including future expenditure budgets and forward estimates, to live within the income constraints of the rate peg, this will inevitably lead to levels of underserviced demands.

Removal of rate peg

The City recommends the removal of the rate peg, in line with its previous submissions on this subject, and allowing each council to determine the level of rate income it requires to provide for its community.

The rate peg was introduced as a protection for ratepayers against excessive levels of rate increase, at a time before local government was required to plan and report to its community as it is required to do today.

The Integrated Planning and Reporting framework (IPR) requires every council to develop strategic and operational plans, and to regularly engage and consult with its community, to ensure these plans satisfy the quantity and quality of the services and infrastructure required to meet those needs. These plans incorporate transparent financial estimates, including rate income levels, and the impact upon their overall financial sustainability over the short, medium and long term. The community then has the opportunity to have input, or seek to amend these plans, before they are adopted.

The IPR process, together with the democratic process of council elections, provides ample protection against *unnecessary* rate increases while simultaneously enabling local government to ensure its *necessary* income levels are achieved.

Suggested improvements to the rate peg

If the NSW Government requires continuation of a rate peg, the City has provided a number of proposals for consideration, to try and improve the current deficiencies and make the rate peg more fit for purpose. The City recommends a move away from retrospective indices, and a move toward **future-facing metrics** including established government targets and legislative changes, to allow local councils to remain financially sustainable while continuing to work to meeting the needs of its communities.

A revised rate peg should accommodate **external factors** to address the impact of climate change, changing inflation and labour markets, the impact of a pandemic and government policy changes, both domestic and international. These issues have a significant impact on the communities or the cost of and way councils can do business.

The City proposes a multi-pronged approach to accommodate the external factors.

As councils need to make long term improvements, and need greater certainty of future funding, IPART could announce forward-looking minimum pegs for the next 3-5 years that take into account any known or estimated industry wide factors expected to impact financial requirements during the coming years.

Forward-looking **minimum pegs** would give a level of security to councils against sudden income shortfalls, and potentially provide far greater consistency in councils forward projections in their long-term financial plans. They could enable councils to compile their IPR suite of documents and plan for longer-term actions that are essential to achieving the challenging goals required and expected of local government.

The City agrees with IPART's suggestion of changing the rate peg methodology to account for material differences in inflation and costs incurred by different councils. The City supports the further exploration of introducing council group types to differentiate rural and metropolitan councils, which could also potentially be done by using the existing OLG local government groups.

The City recommends a consideration of factors that might reflect costs for:

- the needs of changing communities,
- increased demand for new or broadened services,
- increased expectation of service levels, and
- evolving targets imposed on councils by other levels of government.

The rate peg should also include a **resilience factor** to respond to the growing need for local governments to plan for and respond to natural disasters like floods, droughts, bushfires and pandemics, while continuing and significantly advancing the long overdue efforts to address the impacts of climate change.

The NSW State has experienced many recent natural disasters and local governments continues to struggle with providing adequate and timely responses to their communities in need. It is imperative that the level of rate income generated by local government is sufficient to ensure it can provide the planning and action required in this space.

The resilience factor needs to be incorporated into each council's rate peg because every council has a responsibility to take action now. The 33 councils that make up metropolitan Sydney collaborate and contribute to Resilient Sydney, a program for metropolitan Sydney to build the capacity of individuals, communities, institutions, businesses and systems to survive, adapt and thrive in the face of chronic stresses and acute shocks.

While these variables are difficult to quantify, data is already gathered and used by the insurance industry, to weight risks and issue facing different areas, that endeavour to reflect their unique challenges. The City advocates that IPART should investigate existing data sources that could be explored, and tested, that would help quantity the additional financial support required for specific local government areas.

In addition to addressing these specific factors, IPART could consider also introducing a simple **annual information gathering exercise** to allow council/s to identify any "new" critical factors that may need to be accommodated within its own rate peg to maintain financial sustainability. A simple administrative process that CEO (or General Manager) provides each year, having already incorporated the new broader rate peg increases, could eliminate the present political sensitivities around special variation applications.

IPART could also improve the rate peg methodology by seeking to reflect a changing demographic. The City has a high transient population, visitors, international students, day tourists, and homeless – as do a number of councils - which it services without any specific funding mechanism. Many councils also have increasing ageing populations, that may not increase their overall population numbers, but who may result in higher levels of service and facilities demand. Noting that mandatory pensioner rebates, without any compensating increase in their mandatory rebate from $250 per rateable property, leaving a growing gap for many councils to fund. Other councils have increasing numbers of holiday tourists, that pose a different set of demands on their services and infrastructure, which also continues to increase over time.

There are several reputable organisations providing forward looking population figures across local government areas with anticipated changing demographic information that IPART could leverage.

Population factor

The City was very supportive of the inclusion of a population factor to the rate peg calculation. The current format however will not always achieve its goal of allowing councils general rate income to grow with its population for two main reasons.

Firstly, for councils like the City, there was no ability to adjust the base rate income to account for growth in population that occurred before the new methodology was introduced, and therefore the City continues to operate from a lower rating base.

Secondly, the current formula incorrectly assumes that a council's supplementary valuations will not reduce its rate revenue if its population increases. The formula is designed to allow councils to grow by the greater of its population growth percentage or the supplementary growth percentage. However, councils with negative supplementary growth are unable to achieve additional income to support its growing population.
An example where this occurred is shown below.

IPART's formula for the 2022/23 rate peg was

$$Rate\ peg = change\ in\ LGCI - productivity\ factor + other\ adjustments\ + population\ factor$$

$$change\ in\ population = \max\left(0, \frac{ERP\ 2020}{ERP\ 2019} - 1\right)$$

$$supplementary\ valuations\ percentage = \max\left(0, \frac{supplementary\ valuations}{notional\ general\ income\ yield}\right)$$

In this formula:

supplementary valuations means the total value of adjustments to a council's general income for 2019-20 that the council made under paragraphs 509(2)(b) and (c) of the *Local Government Act 1993* (LG Act). This is the amount recorded as 'plus/minus adjustment' for 2019-20 in each council's 'Special schedule – Permissible income for general rates' for 2019-20 submitted to the Office of Local Government (OLG) in accordance with OLG's *Local Government Code of Accounting Practice and Financial Reporting*.

notional general income yield means the general income of the council for 2019-20 prior to adjustment under paragraphs 509(2)(b) and (c) of the LG Act.

A Sydney metropolitan council's published 2019/20 Financial Statements showed that during 2019/20 its annual rate income was reduced by 0.3% through supplementary changes, while in the same period its population grew by 0.2%. If the formula was achieving its goal, this council should have achieved a net increase of 0.2% in line with its population growth. An actual population increase factor of just 0.2%, resulting in a nett 0.1% *reduction* in income.

Valuation basis of council rates

Though outside the scope of this review, the City resubmits its preference for land rates to be based on capital improved value (CIV).

IPART has previously noted that the use of CIV for rating purposes would provide a far better and fairer proxy of ratepayers' wealth and ability to pay and would improve the alignment of growing local government areas with the required rate income growth.

Should you wish to speak with a Council officer about this submission, please contact Suzi Flynn, Revenue Manager on [redacted] or at [redacted]

Yours sincerely

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Monica Barone
Chief Executive Officer