Making a Bad Situation Worse for Ratepayers

A Response to IPART's Draft Report on Rate Peg

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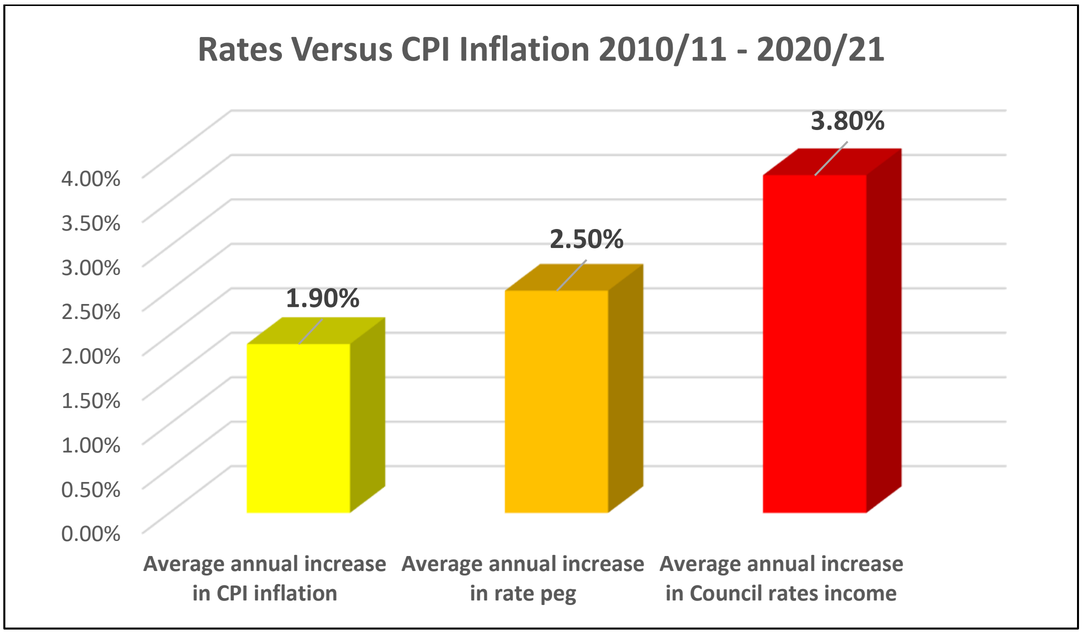


Contents

1 Transparency About Past and Future Rate Increases

1.1 What will be the Impact of this Draft Report on Future Rate Increases?

1.1.1 This is the first question many ratepayers will ask. Unfortunately, the Draft Report does not explicitly answer it. In fact, the Draft Report appears evasive and even misleading on this key question.

1.1.2 It is, however, evident that the proposals in this Draft Report, including the introduction of perverse incentives into Council salary negotiations (see section 2 below), will lead to rate peg rising even faster relative to CPI than under the previous methodology. **IPART should be transparent with ratepayers about this.**

Recommendation 1

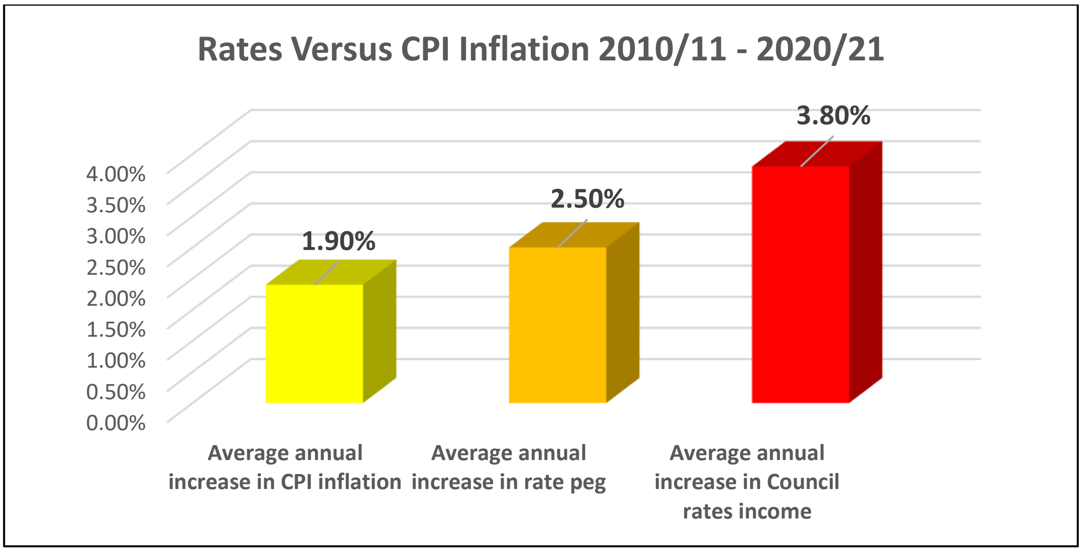
IPART should be transparent with ratepayers that the proposals in this Draft Report, including the perverse incentives created in salary negotiations, will lead to rate peg rising even faster relative to CPI inflation than under the previous methodology.

1.2 Rates in NSW Already Rose Twice as Fast as CPI Inflation 2010/11 to 2020/21

1.2.1 An analysis of rate increases over the past decade under the previous rate peg methodology is an important starting point. This historical information can then be compared with the increases that would have occurred if the new methodology had been in place. Unfortunately, the Draft Report does not include this basic historical information.

1.2.2 IPART did, however, set out average annual increases in rate peg and rates income (rate peg plus special variations, etc) in its original Issues Paper in September 2022. Back then, IPART considered this important information for the review. Now, however, this information is curiously absent from the Draft Report.

1.2.3 Comparing the data from IPART's Issues Paper with data on CPI inflation from the Reserve Bank, however, we can see both rate peg and actual rates (after adding special variations) have risen significantly faster than CPI inflation. The graph below shows this for the ten-year period covered by IPART's Issues Paper.



1.2.4 This information is important for a review of rate peg for the following reasons:

- It provides context for the review and the decision makers.
- It provides a yardstick by which to measure the impact of the new methodology set out in this draft report.
- It is relevant evidence to assist in judging the central premise driving this review, namely that Councils and their political allies claim Council sustainability has been impacted by insufficient rates income.
- It raises an important question that should have been central to this review, namely: if rates income has increased double the rate of CPI inflation over ten years, what are the causes (and therefore possible solutions) driving Council deficits and sustainability concerns?

Recommendation 2

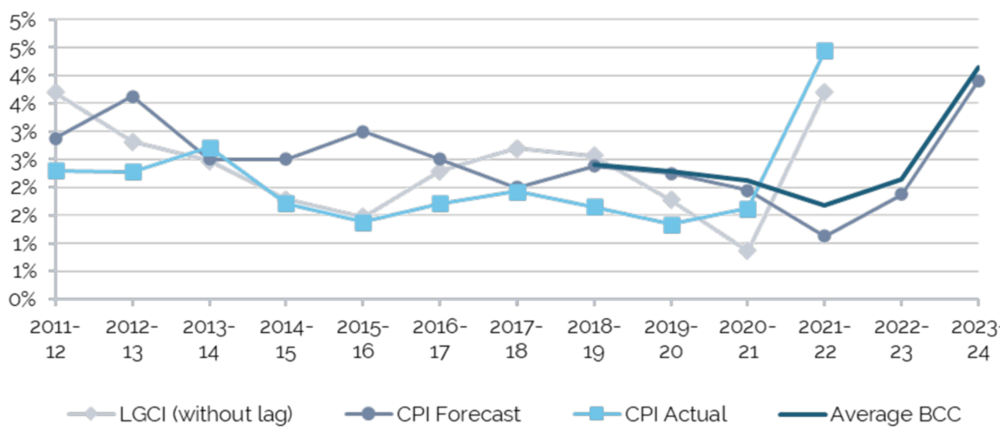
For transparency, IPART should include in its Final Report a graph showing the average annual increase in both rate peg and rates income compared with CPI over the decade 2010/11 to 2011/12 (the same period as covered by similar data set out in its original Issues Paper for this review).

1.3 The Impact of Base Cost Change (BCC) on Rate Peg

1.3.1 There is a lack of transparency in the Draft Report with respect to the impact the new methodology for calculating Council costs - Base Cost Change (BCC) - will have on rate increases.

1.3.2 The Draft Report does compare IPART's preferred BCC measure with CPI inflation at figure 3.1 (page 29) as shown below.

Figure 3.1 Comparison of changes in the LGCI, draft BCC and measures of CPI



Note: the average BCC is the BCC for all councils combined.
Source: IPART analysis

1.3.3 The problem with this graph, however, is that there are only four years within it where BCC is compared with CPI: 2018/19, 2019/20, 2020/21 and 2021/22. A slightly longer comparison (six years rather than four) is shown on page 46 of the Draft Report for "alternative BCC" versus CPI, but for some strange reason only four years are shown for IPART's preferred BCC on page 30.

1.3.4 BCC should be calculated right back to 2010/11 so that it can be compared to CPI inflation over a longer period. This will provide transparency for ratepayers around the likely level of rate increases there would have been relative to CPI inflation if the new methodology proposed in this draft report had been in place.

Inaccurate and Misleading Statement in the Draft Report

1.3.5 The Draft Report also makes an incorrect and misleading statement when it states immediately before the above graph: *"We note that our draft BCC is higher than the CPI in some years, and lower in other years (plural)?"* In fact, there is only one year in which BCC is lower than actual CPI (and that year was an anomaly because of the unexpected and historically unusual surge in CPI). There do not appear to be any years at all in which BCC is lower than forecast CPI.

1.3.6 The statement is therefore inaccurate with respect to the past, and misleading about future years as it gives the impression there will be little difference between BCC and CPI in future. **In fact, BCC is likely to be significantly higher than CPI over the long term. IPART should be honest and transparent with ratepayers about this.**

What is the Impact on Future Rate Increases?

1.3.7 It should also be noted that the graph compares BCC with CPI inflation. What ratepayers are really interested in is how rate peg itself will compare with CPI. Whilst there is a strong correlation between BCC and rate peg, they are not quite the exact same thing.

1.3.8 In addition to rate peg, ratepayers are also be interested in the average annual rate increase (i.e., rate peg plus Special Variations plus population factor, +ESL, etc). Whilst this cannot be worked out for the future (special variations can't be predicted), it could be calculated for previous years so that there is transparency on how rate peg and average rates would have moved relative to CPI over the past ten years based on LGCI and BCC respectively. **This would provide a meaningful comparison between the two methodologies.**

The Effect of Perverse Incentives in the new Methodology on the Comparison

1.3.9 It is important to note, however, that BCC can only be calculated using historic data on local government pay awards. It takes no account of behavioural changes due to perverse incentives with respect to those pay awards in the new methodology (see section 2 below). **IPART should make this clear in its report through a disclaimer.**

The Effect of Emergency Service Levy (ESL) Changes on the Comparison

1.3.10 In various parts of the Draft Report, there are graphical comparisons between LGCI and BCC (for example the graphs on pages 27, 30, 31 and 107). LGCI has historically included Emergency Services Levy (ESL) whereas this is excluded from BCC and is to be added to rates as a separate element. This means that either ESL should be removed from LGCI in these comparisons, or its should be added back to BCC. The Draft Report should ensure and confirm that this is the case. Otherwise, it is comparing apples with oranges.

Recommendation 3

For transparency, IPART should publish a graph showing what the annual percentage increases would have been in its preferred measure of Base Cost Change (BCC) for each year back to 2010/11, and how this would have compared with the annual percentage increases in LGCI and CPI inflation over the same years.

Recommendation 4

The following statement on page 29 of IPART's draft report is inaccurate with respect to the past, and misleading with respect to the future: *"We note that our draft BCC is higher than the CPI in some years, and lower in other years (plural)?"* This should be redrafted to reflect the comparison more accurately between BCC and CPI over a minimum of ten years.

Recommendation 5

For transparency, IPART should calculate and publish what the actual rate peg would have been each year back to 2010/11 using the new BCC methodology and compare this with both LGCI and CPI inflation for the same years.

Recommendation 6

For transparency, IPART should calculate and publish what the average percentage annual rate increase (rate peg + special variations + population factor etc) would have been each year back to 2010/11 using the new BCC methodology and compare this with LGCI and CPI inflation for the same years.

Recommendation 7

For on-going transparency, IPART should commit to publishing each year in future what the annual rate peg would have been under LGCI, and maintain a table comparing BCC rate peg, LGCI rate peg, and CPI inflation each year after the new methodology is introduced. This will also be useful for the five-year review that IPART says it intends to undertake.

Recommendation 8

IPART should include a clear disclaimer in its Final Report that all data on preferred BCC is based on historic local government pay awards and does not take into account labour costs under BCC would have been higher if the new methodology removes the incentive for Councils to negotiate lower salary increases.

Recommendation 9

Wherever in the Draft Report there is a comparison between LGCI and BCC (for example pages 27, 30, 31 and 107), the ESL component should be removed from LGCI to ensure a fair comparison with BCC as the latter does not include ESL.

2 Employee Costs

2.1 Local Government (State) Award Versus Other Measures

2.1.1 IPART is seeking further views from stakeholders on its preferred method of using the Local Government (State) Award (hereafter "the Award") to calculate labour costs within the BCC.

2.1.2 **It remains my view that using the Award to calculate labour costs is a deeply flawed methodology because Councils have no incentive to negotiate lower Award salary increases when they know these increases will be passed straight on to ratepayers through the new rate peg methodology.**

2.1.3 IPART has provided no explanation as to why it is ignoring such an obvious economic flaw.

2.1.4 IPART also appears to be ignoring the opinion of the independent economist – the Centre of International Economics (CIE) – that it hired to advise on this very point:

> The CIE found that:
>
> - The Award performed well against other indexation options based on The CIE's assessment, however its main weakness is how it interacts with the wage negotiation process, which could lead to very significant unintended consequences. The CIE considered that if the rate peg is directly linked to the Award increases, then negotiations for award increases could alter significantly — councils would have much less incentive to keep wage increases constrained and would also much prefer wage increases to changes in conditions. The CIE also noted that this measure would be aligned to when councils will face cost increases with the exception of when negotiations are occurring, where this may not necessarily be the case and there may be a gap in timing.[39]

2.1.5 Again, IPART has provided no explanation for ignoring this advice.

2.2 Suggested "Mitigation" of Unintended Consequences

2.2.1 IPART does put forward some possible "mitigators" to reduce the risk of Councils negotiating higher salaries. IPART does not, however, assess their effectiveness. Instead, IPART says *"we are considering whether current mitigating factors are sufficient."* It is curious that IPART should be so adamant the Award is its preferred method whilst at the same time admitting it is unsure whether possible mitigators would be effective in reducing the risk of perverse incentives.

> Some stakeholders have raised concerns about using the Award increases in the rate peg. We acknowledge that there is a risk, and we are considering whether current mitigating factors are sufficient. These include:
>
> - Councils are required, as part of the IP&R process, to consult with their communities on their long-term financial plans and expected cost increases (including increases in employee costs).
> - Ratepayers have the ability to oppose their council's decisions by voting the elected council out of power at the next election.
> - Once council representatives and unions come to an agreement on the Award (including the wage increases), this needs to be approved by NSW Industrial Relations Commission, which is bound by its wage fixing principles. This could reduce the risk of councils seeking to pass through unreasonable wage increases through the rate peg.

2.2.2 **In my opinion, the "mitigating factors" listed above are insufficient. I set out below my concerns with respect to each one in turn.**

Are Council Consultations on IP&R Long-term Financial Plans an Effective Mitigator?

2.2.3 IPART provides no explanation as to how consultations by *individual Councils* on their own long-term financial plans through the IP&R process would act as an effective mitigator on *sector wide* negotiations.

2.2.4 There are hard practical reasons why such consultations would not act as an effective mitigator:

- IP&R consultations are often poorly organised, and participation is extremely low. Only a tiny minority of the community participates. People have busy lives and little confidence their participation will make a difference.
- IP&R consultations are held at *individual Council level* whereas Award increases are negotiated at *sector level*. The ability for the former to directly impact the latter is minimal.
- IP&R consultations may present financial estimates, but they do not ask direct questions or seek specific feedback from the community on future sector wide salary negotiations.
- IP&R consultations by individual Councils are based on estimates which could be very different to the final increases negotiated at sector level. There is no consultation on the final increase after the negotiations have concluded.
- Councils can ignore the feedback because they know no Council individually can be held directly responsible for an outcome negotiated at sector level. It is too easy for individual Council Leaders to claim they had nothing to do with the final outcome.
- Council run consultations are not immune from bias, misleading information, loaded questions or flawed interpretations of feedback. IPART has shown itself in the past completely disinterested in investigating complaints about such bias whilst accepting at face value Council consultation reports in its determinations.

2.2.5 Overall, it is simply naive to think that consultations by individual Councils on IP&R estimates, often poorly run and sparsely patronised, can have an impact on the real c of sector wide negotiations. Nor would voters perceive any direct accountability of their own individual Council for the final outcome of a sector wide negotiation. Frankly, ratepayers have had enough of phoney consultations being used to legitimise decision making influenced by vested interests behind closed doors.

Are Local Elections an Effective Mitigator?

2.2.6 As above, there is no direct link between an individual Council and the final Award increase negotiated sector wide. Councils won't be held accountable at the ballot box for an excessive Award increase (leading to excessive rate increase) unless voters can see a direct link between their own Council leadership and the final Award increase that was negotiated. Local politicians are unlikely to provide a "smoking gun" confirming such a link. In practice, it is too easy for local Councils to say this was not their decision, but rather the outcome of a sector wide negotiation, and it is therefore not their fault rates have to go up.

2.2.7 IPART also needs to understand the impact that rate peg has had in weakening democratic accountability for rate increases. Councils often sell the message that rate peg is set by IPART, not themselves. Voters are less likely to blame Councils for rate increases they perceive as having been set by somebody else (IPART). This may be unfair because Councils can set a rate lower than rate peg, but it is perception that is important at the ballot box and Councils have large communications departments peddling their spin.

2.2.8 This is also why, in my opinion, the argument for a Council pricing regulator is finely balanced. It can be a good thing if the pricing regulator genuinely protects ratepayers from monopoly pricing. If, on the other hand, the pricing regulator continually approves rate increases well in excess of CPI, then it does more harm than good as democratic accountability for those increases is significantly weakened. This is discussed further in section 8.

2.2.9 Finally, whilst acknowledging this is not a common circumstance, there are Councils such as the Central Coast where local democracy has been suspended for four years. During that time, excessive rate hikes have been imposed on the community by unelected bureaucrats. This is taxation without representation. It may not be common, but it does happen and should not be overlooked.

Is the NSW Industrial Relations Commission an Effective Mitigator?

2.2.10 IPART claims the NSW Industrial Relations Commission (IRC) Wage Fixing Principles might reduce the risk of Councils passing on unreasonable wage increases through rate peg. IPART does not explain how? No scenarios are presented in which the IRC would block an unreasonable wage agreement. Nor does IPART define "unreasonable." An accumulation of smaller increases in excess of what would have occurred under incentivised negotiations can make a huge difference on the rates base over time. If IPART is to rely on this mitigation it needs to explain in more detail how it would work in practice.

2.2.11 The IRC does not exist to protect ratepayers. Councils do not earn revenues through competition in competitive markets. **Under what scenario and what precise rule does IPART think the IRC would intervene?** If IPART is to rely on this mitigation, then as a minimum it should contact the IRC and ask it to clarify these points. There is nothing in the Draft Report to suggest the IRC has been contacted or provided any comfort about the circumstances in which it would intervene.

Recommendation 10 **The Local Government (State) Award should NOT be used to calculate labour costs in the BCC as there would be no incentive for Councils to control salary costs when negotiating the Award if these are passed straight through to ratepayers through rate peg.**
Recommendation 11 **If IPART insists on using the Local Government (State) Award to calculate labour costs in the BCC, then it should explain in detail: (1) WHY it thinks this will not remove the incentive for Councils to control salary costs; and (2) WHY it is ignoring the advice of the consultant (Centre for International Economics) it hired to advise on this point.**

Recommendation 12 **IPART should give serious consideration to the arguments set out in section 2.2 explaining why each of the "mitigations" suggested in the Draft Report will NOT prevent unintended consequences from using the LG Award to calculate labour costs.** **If IPART disagrees with these arguments, it should explain WHY in its Final Report and how precisely it sees these mitigations working in practice.**
Recommendation 13 **IPART should ask the Industrial Relations Commission (IRC) to explain under what specific rules and scenarios it would intervene to block a negotiated Local Government (State) Award salary increase as being too high. The IRC response should be published in IPART's Final Report.**

2.3 Reserve Bank Wage Price Index (WPI) Forecast

2.3.1 IPART also seeks feedback from stakeholders on whether the Reserve Bank Wage Price Index (WPI) forecast should be used as an alternative to the Award for calculating labour costs.

2.3.2 In my opinion, the all-sector forecast WPI is also flawed as it includes private sector wages. Movement in private sector wages are not reflective of cost increases faced by Councils. Private sector firms earn revenues in competitive markets. There are market disciplines in place to determine wage levels in accordance with their commercial objectives. The all-sector WPI forecast is not therefore reflective of cost increases faced by Councils.

2.3.3 IPART explains in its report that Councils have complained during their lobbying that public sector WPI does not account for premiums they have to pay to attract staff in specialist areas. Using the sector wide WPI, however, would increase salaries of ALL employees not just those in specialist areas. It is a sledgehammer to crack a nut. Instead, Councils should address shortages in specialist areas through more targeted methods, for example, grading specialist roles higher so they sit higher in the pay scales or paying special allowances rather than higher base salaries.

2.4 Alternative Measures of Labour Costs Worth Considering

2.4.1 IPART asks in the draft report if there are alternative measures of labour costs worth exploring.

2.4.2 A measure based on CPI inflation (as in Victoria) should receive serious attention. Throughout the economy, CPI is a measure that everyone understands. Households use CPI when thinking about household budgets. Employees and employers use CPI to inform wage negotiations. Throughout the economy "real" increases are measured relative to CPI, for example "real wage increases" are wage increases minus CPI; "real interest rates" are interest rates minus CPI, etc. CPI therefore has the benefit of being simple, widely understood, and transparent. Forecasts of CPI are also widely available addressing the lag concern – albeit in my opinion the lag concern is overstated (see next paragraph).

Concerns About Time Lags are Overstated

2.4.3 When considering alternative measures, IPART should be cautious about giving too much weight to the lag effect. This effect evens out over time. Councils may be concerned that rate peg is below CPI this year, but when CPI falls they will gain a windfall. Thit is not necessarily the case when forecasts are used and turn out to be wrong. This may be the next thing Councils complain about – though only if it works against them.

2.4.4 IPART should also be very careful about changing methodologies in response to a rare event, namely the recent unexpected and unusually large spike in CPI. It is impossible to design a methodology that deals effectively with every rare event (some of which are unforeseen) – and attempting to do so may create additional unforeseen problems. Rare events can be better addressed through special variations as occurred last year.

Recommendation 14

The All-Sector Wage Price Index (WPI) should NOT be used to calculate labour costs in the BCC as it includes private sector wage increases and is not therefore reflective of cost increases faced by local Councils.

If, however, IPART insists on providing a Hobson's choice between the Award and All Sector WPI, the latter is the least bad option for ratepayers.

Recommendation 15

IPART has asked if there are other measures of labour costs worth exploring. The following measures should be seriously considered as superior to both the Award and the all-sector WPI:

1. **A measure based on CPI as in Victoria**
2. **The public sector WPI with Councils advised to consider more targeted means to address shortages in specialised areas, such as higher grading of specialist roles or the payment of specialist allowances. Such allowances would work through into the public sector WPI as Council salary increases contribute to it.**

3 Productivity and Efficiency

3.1 No Evidence Insufficient Rates Income Has Caused Deteriorating Finances

2.3.1 The Draft Report states that Councils have told IPART they need higher rate pegs to support financial sustainability. In Appendix D, IPART notes that the financial position of Councils deteriorated between 2016/17 and 2020/21 with more Councils reporting operational deficits and deteriorating Operational Performance Ratios (OPRs).

2.3.2 There is no evidence in the Draft Report, however, to suggest this deterioration in financial performance has been caused by insufficient rates incomes. **As noted above in paragraph 1.2.2, rates income grew double the rate of CPI inflation over the ten-year period 2010/11 to 2020/21.** This suggests that insufficient rates income is unlikely to have been the cause of deteriorating financial performance.

2.3.3 Other factors need to be investigated such as the quality of management (the sector largely promotes from within), inefficiency, low productivity, failure to innovate, insufficient prioritisation, and culture within the sector. It is disappointing that, whilst identifying a deteriorating financial performance, this review has not investigated the cause(s).

2.3.4 Instead, an assumption appears to have been made that throwing more ratepayers money at the problem will solve it. Unfortunately, throwing more public money at poorly managed and inefficient organisations rarely delivers improved long-term performance. On the contrary, it merely creates a “bail out culture” in which those organisations find it easier to seek ever more public money than implement the reforms needed to improve their own performance. Unless these issues are addressed, Councils will keep coming back for more.

3.2 No Specific Proposals in the Draft Report to Incentivise Higher Productivity

2.3.1 It is extremely disappointing that the Draft Report provides no specific measures to incentivise higher productivity or efficiency. The Draft Report acknowledges the need for higher productivity but proposes nothing to incentivise it.

2.3.2 In the absence of any specific proposals to incentivise productivity, the Draft Report falls back on a frankly absurd claim that the rate peg itself incentivises efficiency and productivity:

> We consider that the rate peg, the focus of this review, can help to drive improvements in councils' performance by creating incentives for them to improve efficiency and productivity by constraining increases in councils' rates income to a measure of cost changes estimated using relevant macroeconomic indicators.

IPART does not explain how automatically compensating Councils for all their cost increases (including those they are themselves responsible for such as negotiated salary increases) could possibly incentivise higher productivity? Councils are given all this extra money up front, so why would they need to improve productivity? The proposals in this Draft Report to increase rate peg even more will simply make matters worse.

2.3.3 In fact, the whole IPART system perversely incentivises lower efficiency and lower productivity. For example, inefficient Councils tend to have lower OPRs thereby meeting IPART’s main criterion for special variations. The increases in rate peg proposed in the Draft

Report have also been justified with reference to deteriorating OPRs. IPART is perversely incentivising lower efficiency and productivity through its methodologies and decisions. These matters should be included in the wider review of the Council financial model recommended on page 110 of the draft report.

3.3 The Productivity Factor Continues to be Set at Zero

3.3.1 The Draft Report proposes no increase in the productivity factor which continues to be set at zero. A productivity factor set at zero effectively means there is no productivity factor. It means the rate peg automatically compensates Councils for any increase in their costs as measured by BCC regardless of productivity. This means there is no incentive for Councils to improve productivity or efficiency.

3.4 No Link Between Productivity and Award Salary Increases

3.4.1 In lobbying for a rate peg based on Award salary increases rather than public sector pay indicators, Councils have effectively argued they want to pay higher salaries than the rest of the public sector and have these higher salary costs reflected in the BCC and rate peg. Yet, they also do not want a productivity factor in the BCC. What do Councils' think pays for real pay increases in the real World?

3.4.2 Throughout economic history, higher living standards as reflected by higher real wages have been paid for by productivity. Councils, on the other hand, seem to want higher salaries without delivering the productivity improvements that would normally pay for them.

3.4.3 If higher salaries within Councils are not paid for through higher productivity, then this can only lead to one of two things: either, financial unsustainability; or, higher real rates for ratepayers whose own real living standards must decline to balance out the wage-productivity equation. This is completely unjust. If Councils are concerned the current rate peg methodology does not enable them to pay the higher salaries they would like to pay, then they should earn those higher salaries through higher productivity.

3.4.4 It is also time Senior Management remuneration was looked at as in recent years it has been out of control and completely divorced from performance. Why is nobody looking at that?

3.5 Measuring Productivity

3.5.1 At present, there is no credible measure of Council productivity (output per employee). IPART would add value if it were to develop such a measure. This would also help IPART properly assess productivity as one of its five criteria for Special Variations – an area where IPART is currently floundering badly.

3.5.2 Whilst IPART may claim it has included productivity as a separate Special Variation criterion, this is worthless if IPART has no reliable method of measuring productivity (output per employee) across Councils. Instead, IPART takes at face value anecdotal examples provided by Councils which rarely tell the whole story.

3.5.3 A credible measure of productivity could also lead to results for all Councils being published annually thereby promoting accountability and incentivising improvements.

Recommendation 16 **The productivity factor should be set higher than zero to incentivise improvements in productivity and efficiency.**
Recommendation 17 **IPART should develop a measure of Council productivity (output per employee) that can be applied to all Councils and published annually. This measure could also be used to support assessments against the productivity criterion in the Special Variation process.**
Recommendation 18 **The independent review of the financial model for Councils recommended by the Draft Report on page 110 should include the following:** **1 The actual causes of deteriorating financial performance of Councils as highlighted in this Draft Report.** **2 Average annual increases in rate peg and annual average increases in rates since 2010/11 relative to CPI inflation over the same period.** **3 The overall funding model.** **4 The quality of management across the local government sector and how it can be improved.** **5 Trends in Senior Management remuneration within the local government sector and its relationship with performance.** **6 Efficiency and productivity across the local government sector and how improvements in these can be incentivised.** **7 The culture within the local government sector.** **8 How to encourage innovation within the local government sector.** **9 The role, performance, and independence of the pricing regulator, IPART.**

4 Separate BCC Models for Different Council Groups

4.1 The Average Rate Across NSW Should not be Impacted

4.1.1 Whilst I have no objection in principle to the three separate Council groups, the devil is often in the detail. IPART should therefore publish the impact on average rate levels across NSW and for individual Councils.

4.1.2 This change, however, should not of itself lead to an increase in average rates across NSW. IPART should be transparent and publish calculations confirming this is the case.

4.1.3 The stated reason for the three groups is that they are sufficiently different in character that they may experience different cost changes to one another. A rate peg based on an average cost change across the whole of NSW will not necessarily reflect cost changes within each of the three groups.

4.1.4 This is reasonable, but by simple logic, if some Councils experience higher costs than the BCC average, then it follows that other Councils will experience lower costs than the BCC average.

4.1.5 If rate peg is to be set higher for some Councils where their costs increase more than the BCC average, then it should be set lower for other Councils with cost increases below the BCC average.

4.1.6 The key point here is that this change of itself should not lead to an increase in the average rate across NSW. The average rate across NSW in five years' time should be no different to what it would have been if there had been just one BCC and no separate Council groups.

Recommendation 19

The introduction of three BCCs for three Council groups should not of itself lead to an increase in the average rate across NSW. The average rate across NSW in five years' time should be no different to what it would have been if there had been just one BCC and no separate Council groups.

In the interest of transparency, IPART should publish calculations to demonstrate this is the case.

5 External Costs

5.1 A Further Burden on Ratepayers

5.1.1 The Draft Report invites views on whether stakeholders support IPART establishing a process to develop adjustment factors for groups of Councils to increase rate peg to cover specific external costs (defined as costs supposedly outside a Council's control).

5.1.2 Increasing rate peg to fund external costs will place further burdens on ratepayers and increase yet further the gap between rate increases and CPI inflation.

5.1.3 In the real World, all organisations face increased costs outside their control - as do households. There is nothing special about Councils in this respect. Indeed, Councils passing on external costs to ratepayers just creates another external cost to be faced by households and businesses.

5.1.4 Most organisations, and indeed households, deal with this within their existing budgets. Councils should adjust existing budgets and reprioritise to ensure resources are matched to strategic and community priorities. Councils will also better insulate themselves from such cost pressures if they improve efficiency and productivity.

5.1.5 IPART's own economic advisor, the CIE, when investigating this issue found little evidence about the overall cumulative materiality of positive and negative changes on Council costs, and that it is not possible to separate out costs from external factors.

> The CIE's analysis found that Option 2 and, to some degree, Option 4 are feasible. However, The CIE identified that there is little evidence about the overall cumulative materiality of positive and negative changes on councils' costs and how much are already included in the Local Government Cost Index (LGCI). Its assessment on historical cost data showed that cost data is too variable, and it is not possible to separate out costs from external factors.[91]

Adding (and subtracting) external costs to rate peg over complicates the process and increases the costs of bureaucracy. It is better to leave this for Councils to deal with through better management and prioritisation.

Recommendation 20

External costs should not be added to rate peg. Rather than creating yet another burden for ratepayers, Councils should deal with external costs through prioritisation within existing budgets and through better management, efficiency, and productivity.

6 Population Factor

6.1 Why No Population Factor for Declining Populations?

6.1.1 The Draft Report still does not explain why Councils require a higher rate peg when their populations increase, but not a lower rate peg when they decrease?

6.1.2 This means that even if there was no net population increase across NSW at all, with population increases for some Councils balanced out by population decreases for others, there would still be a positive population factor in the rate peg across the State as a whole. This is because the averaging of positive population factors (where populations rise) with zero population factors (where populations fall) would still create a positive average. For this reason, the population factor will always drive up the gap between average rate increase and CPI across NSW.

6.1.3 The population factor should also be adjusted for economies of scale. Managed well population growth should provide opportunities for Councils to reduce the per capita costs of their services and improve efficiency. More customers should mean economies of scale in service delivery. Fixed costs are spread over a larger number of customers meaning unit costs of service provision (cost per capita) should fall.

Recommendation 21 **IPART should explain why Councils need a higher rate when their populations rise, but not a lower rate peg when they fall.**
Recommendation 22 **The population growth factor should be adjusted for economies of scale as extra customers should provide opportunities for efficiencies through lower per capita cost of services.**

7 Implementation Options

7.1 Year of Implementation

7.1.1 The Draft Report invites stakeholder views on the year of implementation of the new BCC. Whichever year is chosen there will be a year missed out and this could be favourable or unfavourable to ratepayers. For this reason, it seems sensible to remove uncertainty and just get on with it with a full implementation in 2024/25.

7.1.2 Councils may receive a slightly lower rate peg under this scenario, but waiting a further year may deliver a windfall for them. Also, they will make up for any lower rate peg in 2024/25 over the ensuing years as BCC will deliver larger rate pegs than LGCI.

7.1.3 In considering alternative options, the Draft Report presents a "true up" approach *"so that Councils would be no worse off under the new methodology"* (to quote the Draft Report). Typically, IPART seems less concerned about ratepayers being no worse off. If a true up approach is used, it should ensure not only that Councils are no worse off, but also that they are no better off.

7.2 Local Government Reference Group

7.2.1 The Draft Report recommends on page 55 that a Local Government Reference Group be established to advise on the implementation of the new methodology. The Draft Report does not mention any ratepayer representation. This may be an oversight. It is crucial that ratepayers are represented on this group.

Recommendation 23 **Either Councils or ratepayers will be worse off whatever implementation year is selected, so it makes sense to implement the change in 2024/25 rather than creating uncertainty through further delays.**
Recommendation 24 **If a "true up" approach is used during the implementation year to ensure (as the Draft Report says) *"that Councils would be no worse off under the new methodology,"* then "true ups" should also ensure no Councils are better off (or ratepayers worse off).**
Recommendation 25 **The Local Government Reference Group recommended by the Draft Report to oversee implementation should include ratepayer representation.**

8 Is IPART Doing More Harm than Good as a Pricing Regulator?

8.1 Ratepayers Have Not Been Protected from Monopoly Pricing

8.1.1 As noted in paragraph 2.2.8 of this submission, the argument for a Council pricing regulator is finely balanced. It can be a good thing if the pricing regulator genuinely protects ratepayers from monopoly pricing. If, on the other hand, the pricing regulator continually approves rate increases well in excess of CPI, then it does more harm than good by undermining democratic accountability for excessive increases.

8.1.2 It is clear that IPART has not protected ratepayers from monopoly pricing. Average rates across NSW increased twice as fast as inflation between 2010/11 and 2011/12. Now, we have a new rate peg methodology likely to increase that gap further. To ratepayers, it seems that whatever Councils lobby for they get.

8.2 Councils are Being Protected by IPART from Accountability for Rate Increases

8.2.1 Despite lobbying for higher rates, Councils are quite happy to evade accountability by blaming them on IPART. For example, the Administrator of Central Coast Council recently claimed July's 14% water rate increase was set by IPART and CCC "doesn't have a say in that." Here are his exact words:

"The other thing to note in there is they (the water rates) have gone up by what IPART, IPART determines the pathway and the speed of the increase they (IPART) set that for this Council, Council doesn't have a say in that."

He didn't mention, of course, that IPART had approved a four-year increase that CCC itself had applied for the previous year!

8.2.2 Councils are ultimately responsible for rate increases and can set a rate lower than rate peg. The problem, however, is public perception. Councils have large communications departments. The public is led to believe that Councils are not responsible for these large rate increases because they are set centrally by IPART, and all Councils have the same rate increases. This means they are not held accountable at the ballot box for rate increases they lobby IPART for.

8.2.3 IPART, in rubber stamping rate increases significantly higher than CPI, is not doing good to protect ratepayers from monopoly pricing. It is, however, doing harm in helping Councils avoid democratic accountability for excessive rate increases.

8.3 State Government Also Uses IPART to Evade Accountability

8.3.1 There is also a need for more transparency about the relationship between State Government and IPART. State Government appoints IPART. The State Government Office of Local Government (OLG) is responsible for the regulations that IPART uses to assess special variations. Even this current review of rate peg and its Terms of Reference were approved by State Government.

8.3.2 In fact, this current review was initiated back in February 2022 when the Minister for Local Government met with the Chair of IPART. IPART took no minutes of that meeting (possibly in breach of the State Records Act), but a letter from the Minister to the IPART Chair was subsequently made public following a Freedom of Information request.

8.3.3 The letter is attached at annex A and shows that the Minister expressed concern about the impact of rate peg levels on Council sustainability, and indicated she sought a solution to the "broader Local Government Sector concerns." The letter then requests a review of rate peg methodology (this current review).

8.3.4 This letter raises questions about IPART independence and the lack of transparency with respect to State Government contacts with IPART. It should be noted that State Government has been accused of cost shifting to Local Government thereby transferring State Government costs to the ratepayer through higher rates. In the interest of transparency, the letter should be published as an annex to IPART's Final Report.

8.3.5 In addition, all future contacts between Ministers or Senior State Government Public Servants and IPART Tribunal Members or Executives should be recorded, and minutes of meetings displayed on IPART's website.

Recommendation 26

The wider review of the Council Financial Model should consider abolishing IPART's role in pricing regulation (except in special circumstances such as where local democracy has been suspended), as this is helping Councils evade democratic accountability for excessive increases without protecting ratepayers from them.

Recommendation 27

In the interest of transparency, the letter sent to the Chair of IPART from the Minister of Local Government (attached at annex A) which effectively initiated this current review of rate peg, should be included as an appendix to IPART's Final Report.

Recommendation 28

All future contacts between Ministers or Senior State Government Public Servants and IPART Tribunal Members or Executives should be recorded, and minutes of meetings displayed on IPART's website.

9 Table of Recommendations

Recommendation 1 **IPART should be transparent with ratepayers that the proposals in this Draft Report, including the perverse incentives created in salary negotiations, will lead to rate peg rising even faster relative to CPI inflation than under the previous methodology.**
Recommendation 2 **For transparency, IPART should include in its Final Report a graph showing the average annual increase in both rate peg and rates income compared with CPI over the decade 2010/11 to 2011/12 (the same period as covered by similar data set out in its original Issues Paper for this review).**
Recommendation 3 **For transparency, IPART should publish a graph showing what the annual percentage increases would have been in its preferred measure of Base Cost Change (BCC) for each year back to 2010/11, and how this would have compared with the annual percentage increases in LGCI and CPI inflation over the same years.**
Recommendation 4 **The following statement on page 29 of IPART's draft report is inaccurate with respect to the past, and misleading with respect to the future: *"We note that our draft BCC is higher than the CPI in some years, and lower in other years (plural)?"* This should be redrafted to reflect the comparison more accurately between BCC and CPI over a minimum of ten years.**
Recommendation 5 **For transparency, IPART should calculate and publish what the actual rate peg would have been each year back to 2010/11 using the new BCC methodology and compare this with both LGCI and CPI inflation for the same years.**
Recommendation 6 **For transparency, IPART should calculate and publish what the average percentage annual rate increase (rate peg + special variations + population factor etc) would have been each year back to 2010/11 using the new BCC methodology and compare this with LGCI and CPI inflation for the same years.**
Recommendation 7 **For on-going transparency, IPART should commit to publishing each year in future what the annual rate peg would have been under LGCI, and maintain a table comparing BCC rate peg, LGCI rate peg, and CPI inflation each year after the new methodology is introduced. This will also be useful for the five-year review that IPART says it intends to undertake.**
Recommendation 8 **IPART should include a clear disclaimer in its Final Report that all data on preferred BCC is based on historic local government pay awards and does not take into account labour costs under BCC would have been higher if the new methodology removes the incentive for Councils to negotiate lower salary increases.**

Recommendation 9

Wherever in the Draft Report there is a comparison between LGCI and BCC (for example pages 27, 30, 31 and 107), the ESL component should be removed from LGCI to ensure a fair comparison with BCC as the latter does not include ESL.

Recommendation 10

The Local Government (State) Award should NOT be used to calculate labour costs in the BCC as there would be no incentive for Councils to control salary costs when negotiating the Award if these are passed straight through to ratepayers through rate peg.

Recommendation 11

If IPART insists on using the Local Government (State) Award to calculate labour costs in the BCC, then it should explain in detail: (1) WHY it thinks this will not remove the incentive for Councils to control salary costs; and (2) WHY it is ignoring the advice of the consultant (Centre for International Economics) it hired to advise on this point.

Recommendation 12

IPART should give serious consideration to the arguments set out in section 2.2 explaining why each of the "mitigations" suggested in the Draft Report will NOT prevent unintended consequences from using the Award.

If IPART disagrees with these arguments, it should explain WHY in its Final Report and how precisely it sees these mitigations working in practice.

Recommendation 13

IPART should ask the Industrial Relations Commission (IRC) to explain under what specific rules and scenarios it would intervene to block a negotiated Local Government (State) Award salary increase as being too high. The IRC response should be published in IPART's Final Report.

Recommendation 14

The All-Sector Wage Price Index (WPI) should NOT be used to calculate labour costs in the BCC as it includes private sector wage increases and is not therefore reflective of cost increases faced by local Councils.

If, however, IPART insists on providing a Hobson's choice between the Award and All Sector WPI, the latter is the least bad option for ratepayers.

Recommendation 15

IPART has asked if there are other measures of labour costs worth exploring. The following measures should be seriously considered as superior to both the Award and the all sector WPI:

3. **A measure based on CPI as in Victoria**
4. **The public sector WPI with Councils advised to consider more targeted means to address shortages in specialised areas, such as higher grading of specialist roles or the payment of specialist allowances. Such allowances would work through into the public sector WPI.**

Recommendation 16

The productivity factor should be set higher than zero to incentivise improvements in productivity and efficiency.

Recommendation 17

IPART should develop a measure of Council productivity (output per employee) that can be applied to all Councils and published annually. This measure could also be used to support assessments against the productivity criterion in the Special Variation process.

Recommendation 18

The independent review of the financial model for Councils recommended by the Draft Report on page 110 should include the following:

- **The causes of deteriorating financial performance of Councils as highlighted in this Draft Report**
- **Average annual increases in rate peg and annual average increases in rates since 2010/11 relative to CPI inflation over the same period.**
- **The overall funding model.**
- **The quality of management across the local government sector and how it can be improved.**
- **Trends in Senior Management remuneration within the local government sector and its relationship with performance.**
- **Efficiency and productivity across the local government sector and how these can be incentivised.**
- **The culture within the local government sector.**
- **How to encourage innovation within the local government sector.**
- **The role, performance, and independence of the pricing regulator, IPART.**

Recommendation 19

The introduction of three BCCs for three Council groups should not of itself lead to an increase in the average rate across NSW. The average rate across NSW in five years' time should be no different to what it would have been if there had been just one BCC and no separate Council groups.

In the interest of transparency, IPART should publish calculations demonstrating this is the case.

Recommendation 20

External costs should not be added to rate peg. Rather than creating yet another burden for ratepayers, Councils should deal with external costs through prioritisation within existing budgets and through better management, efficiency, and productivity.

Recommendation 21

IPART should explain why Councils need a higher rate when their populations rise, but not a lower rate peg when they fall.

Recommendation 22

The population growth factor should be adjusted for economies of scale as extra customers should provide opportunities for efficiencies through lower per capita cost of services.

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Annex A

Letter from Minister for Local Government to the Chair of IPART Effectively Initiating This Review.

The Hon. Wendy Tuckerman MP
Minister for Local Government

Ms Carmel Donnelly PSM
Chair
Independent Pricing and Regulatory Tribunal
PO Box K35
HAYMARKET POST SHOP NSW 1240

Via email: ipart@ipart.nsw.gov.au

Dear Ms Donnelly

Thank you for our meeting on 24 February 2022 regarding the setting of the Rate Peg for local councils by the Independent Pricing and Regulatory Tribunal (IPART) under s 506 of the *Local Government Act 1993*.

As discussed, I am concerned about the impacts that the rate peg being set at such a level may have on immediate local government sustainability and liquidity and I appreciate the willingness you have shown to work together on a solution to address this and broader local government sector concerns.

Following our conversation, I intend to request a review by IPART of the rate peg methodology including the Local Government Cost Index. I understand that you are amenable to such a review. I would like to announce this review to the local government sector as soon as possible to address ongoing sector concerns so would appreciate confirmation of your willingness to undertake the review as a matter of priority. I will ask for a Terms of Reference to be drafted and will seek your input on those.

Should you or your officers wish to discuss this matter further please do not hesitate to contact Ms [redacted] Office of Local Government on 04[redacted] or at [redacted]olg.nsw.gov.au.

I look forward to continuing to work with you on matters important to the sector.

Yours sincerely

[redacted]

The Hon. Wendy Tuckerman MP
Minister for Local Government

CC: The Hon. Dominic Perrottet MP, Premier of NSW
The Hon Victor Dominello MP, Minister for Customer Service and Digital Government

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8