Indexation of contribution rates

26 July 2019

1 Indexation of base year contribution rates

This Information Paper explains how IPART will assess the provisions for indexing contribution rates in local infrastructure contributions plans that are submitted to us for review.[1] It explains what we think councils should consider when deciding how to index contribution rates between the adoption of a local infrastructure contribution plan, and a revision of that plan.

Why does IPART assess indexation methods?

The NSW Government has asked IPART to review certain local infrastructure contributions plans which propose contribution rates above a threshold amount.[2] IPART reviews these plans in accordance with criteria set out in the *Local Infrastructure Contributions Practice Note*, January 2019 (Practice Note).[3]

The Practice Note requires us to assess, among other things, whether the proposed development contributions are based on reasonable estimates of the costs of proposed public amenities or public services (public infrastructure). As part of our assessment of reasonable costs, we consider whether the council's proposed method of indexing contribution rates is reasonable.

2 What is indexation?

Indexation is a method of adjusting contribution rates to account for changes in the cost of land or infrastructure over time. It helps to ensure that contributions remain cost-reflective, which means that:

- They signal the costs of developing different areas – which, in turn, can assist in guiding development to where it is most cost-efficient (ie, where the benefits of the development are greater than its costs), and
- Other parties (such as a council's ratepayers) do not have to fund any shortfall between the actual costs of providing public infrastructure and the revenue received from development contributions.

Escalating contribution rates by a representative index allows them to change broadly in-line with changes to the cost of land and works the council is providing, without the need for the council to amend the contributions plan every year.

Clause 32(3)(b) of the *Environmental Planning and Assessment Regulation 2000* (EP&A Regulation) permits changes to contribution rates, without the need to prepare a new contributions plan, to reflect quarterly or annual variations to:

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1 Indexation of contributions rates is permitted in accordance with clause 32(3)(b) of the *Environmental Planning and Assessment Regulation 2000*.

2 Minister for Planning, *Environmental Planning and Assessment* (*Local Infrastructure Contributions) Amendment Direction 2017*, 17 July 2017. The provisions applying to the contributions plans we assess are found in section 7.11 of the *Environmental Planning and Assessment Act 1979* and the provisions applying to Ministerial Directions concerning contributions plans are in section 7.17.

3 Department of Planning and Environment, *Local Infrastructure Practice Note*, January 2019.

- ▽ Readily accessible index figures adopted by the plan (such as a Consumer Price Index (CPI)), or
- ▽ Index figures prepared by or on behalf of a council from time to time that are specifically adopted by the plan.

A contributions plan will typically specify a base contribution rate for each infrastructure category (and possibly separate rates for land and works). In accordance with the regulation, the plan must specify the index that will be used to adjust the base contribution rate, and how frequently the adjustment will occur. Most plans include a formula for the adjustment.

Most councils in NSW prepare contributions plans without discounting future cash flows to their present values. This means councils may not adequately account for the opportunity cost that arises due to the difference in time between when they incur costs to provide infrastructure and when they receive contributions to recover the cost of this infrastructure. Indexing contribution rates may not overcome this problem. Instead, or in addition, councils would need to use a net present value (NPV) approach to calculate their contribution rates.[4]

What is the base contribution rate?

To derive the contribution rates in the base year of the plan (base contribution rates) for each infrastructure category in a plan, councils:

- Estimate the total cost of land acquisition and works required as a result of new development in the plan's catchment area, in current dollar terms, then
- Divide this amount by the size of the catchment area, usually expressed in hectares (ha) of net developable area (NDA) or net increase in population.

Box 2.1 shows a general formula for calculating base contribution rates.

Box 2.1 Contribution rate formula for councils not using an NPV approach

$$DC_0 = \frac{C}{N}$$

Where:

- DC_0 is the base contribution rate (usually expressed in \$ per ha of NDA or \$ per person)
- C is the estimated cost of infrastructure apportioned to the development area
- N is size of the catchment (usually ha of NDA or net increase in population)

Note: the net increase in population is the total anticipated population in the area less any existing residents.

[4] Our technical paper on the subject provides guidance for councils – IPART, *Modelling local infrastructure contributions in a present value framework*, August 2018

How are contribution rates indexed?

In the years between plan reviews, the base contribution rate is indexed using either one rate for both land and works or separate indexes for each sub-component. Box 2.2 below outlines the different methods.

Box 2.2 Indexation of contribution rates

Method 1 – index contributions by CPI

$$DC_1 = \frac{DC_0 \times CPI_1}{CPI_0}$$

Where:

- DC_1 is the contribution rate in the next period
- DC_0 is the base contribution rate
- CPI_1 is the value of the consumer price index in the next period
- CPI_0 is the value of the consumer price index in the base period

Method 2 – index contributions separately for land and works

$$DC_1 = DC_{works(1)} + DC_{land(1)}$$

$$DC_{works(1)} = \frac{DC_{works(0)} \times WVI_1}{WVI_0} \qquad DC_{land(1)} = \frac{DC_{land(0)} \times LVI_1}{LVI_0}$$

Where:

- DC_1 and DC_0 are as defined in method 1
- DC_{works} and DC_{land} are the contributions for works and land respectively
- WVI is the value of a works value index
- LVI is the value of a land value index

What if the council has already incurred costs?

Clause 32(3)(b) of the EP&A Regulation allows changes to **contribution rates** to reflect movements in the CPI or other indexes if adopted by the plan.

Clause 25I of the EP&A Regulation applies when the council is **preparing a new contributions plan** (including formally amending an existing plan). It requires the council to index costs already incurred by the CPI (All Groups) for Sydney.[5] This means that when calculating the base contribution rate, the cost of land that the council already owns and has acquired for public infrastructure may not exceed the acquisition cost, indexed by the CPI (All Groups) for Sydney. Similarly, the cost of works completed may not exceed the actual costs indexed by the CPI (All Groups) for Sydney.

5 *Environmental Planning and Assessment Regulation 2000*, cl 25I.

3 General guidance on indexation methods

In all contexts, we consider it reasonable for councils to index contribution rates using the CPI (All Groups) for Sydney for the cost of land, works and administration.

This approach is consistent with the Act, Regulation and policy guidance from the Department of Planning, Industry and Environment (DPIE).[6] It is also easy for all stakeholders to understand and for councils to apply. Councils do not incur any cost in preparing the index, and changes in the contribution rates are likely to be less volatile than if an alternative approach was used.

However, the CPI might not track the change in prices for land and works in a contributions plan as closely as other indexes.

When assessing whether an alternative approach is reasonable we will have regard to the relevant clauses in the EP&A Regulation, as well as the potential trade-offs between accuracy (in how the index tracks costs), transparency (in how the index is calculated), ease of applying the index (to determine contribution amounts) and cost of maintaining the index.

In our view, if councils deviate from using CPI then a decision about a suitable alternate index requires consideration of:

- The composition of land and works in the plan
- The type and location of development to which the plan applies (eg greenfield vs infill and metro vs non-metro)
- The stage of development within the plan's catchment area, and
- The stage of delivery of infrastructure in the plan.

For example, it would be unreasonable to depart from CPI indexation when most of the expenditure on the land and/or works in the plan has already occurred, or where there is an agreement for it to be provided by a specific developer.[7]

We consider it is generally reasonable for a council to adopt different indexes for the cost of works and/or land already incurred and for the cost of works and/or land yet to be incurred. However, we note that this makes the calculation of contributions payable at a particular time more complex.

We expect councils using an alternative to CPI for either the cost of works or the cost of land (or both), to provide an explanation in their application for assessment, and include supporting information where it could assist in our understanding of how the index is intended to be applied. We also encourage councils to explain their approach in the plan itself, to support stakeholder engagement when the draft plan is exhibited.

We note that indexation of contributions rates should not replace regular review of the plan, as outlined in Box 3.1.

6 In addition to requirements from the Act and Regulation, clause 26(1) of the EP&A Regulation requires contributions plans to be prepared having regard to relevant Practice Notes adopted by the Secretary of the Department of Planning, Industry and Environment.

7 A works-in-kind or Planning Agreement will typically 'lock-in' a price for the works/land the developer agrees to provide.

Box 3.1 The importance of regular plan review

Councils should periodically review contributions plans to ensure they adequately reflect the latest planning assumptions (including population estimates) and best estimates of the cost of providing public infrastructure. Regular review helps to ensure that councils do not recoup too much or too little from developers.

The *Development Contributions Practice Notes July 2005* (2005 Practice Notes) suggest councils commit to reviewing plans at least every five years, or more regularly where an area is growing rapidly[8].

While the indexation of contribution rates is an important consideration for councils when preparing plans, indexation should not replace regular review the contributions plan.

Source: The Department of Infrastructure, Planning and Natural Resources, *Development Contributions Practice Notes*, July 2005

4 Indexation of contributions for works costs

In most plans assessed by IPART to date, councils have chosen to index the cost of works by the ABS CPI (All Groups) for Sydney, which we consider reasonable. Alternatives include:

- An Australian Bureau of Statistics (ABS) Producer Price Index (PPI), and
- Construction cost indexes produced by private companies.

Generally speaking, we consider the better of these alternatives is using an ABS PPI for each specific category of works. Table 4.1 shows our preferred indexes for roads and stormwater management works and open space embellishment.[9] However, there may be instances where it is reasonable to use an index other than those listed in Table 4.1.

Table 4.1 Producer Price Indexes for indexing contributions towards works costs

Works category	Producer Price Index (PPI)
Roads	ABS PPI Road and Bridge Construction Index for NSW
Stormwater management	ABS PPI Road and Bridge Construction Index for NSW
Open space	ABS PPI Non-Residential Building Construction Index for NSW

Source: ABS, Producer Price Indexes, Australia, Table 17: Output of the Construction Industries, subdivision and class index numbers.

When assessing the indexation method councils use to index the cost of works, we will consider the extent to which the index is likely to accurately reflect movements in the cost of the works over time.

In our assessment, when councils deviate from CPI we will ask for evidence that the alternative method chosen is reflective of costs in the plan.

8 DPIE, *Development Contributions Practice Notes*, July 2005
9 Community facilities are not on the Essential Works List in the *Practice Note 2019*.

5 Indexation of contributions for land costs

On average, land costs represented 40% of the reasonable costs in the plans IPART assessed between October 2011 and September 2018.

Unlike the cost of works, which are procured in a relatively homogeneous market with minimal regional price variation (within major cities), the price of land and property can vary significantly between locations. In April 2018, IPART published an Information Paper on our assessment process for land costs.[10] It focuses on the estimates that inform the base contribution rate in a contributions plan, but it does not go into detail about how the land component of contribution rates should be indexed.

Most plans that we have assessed include provisions to index contributions for land using the same index that is adopted to adjust contributions for works (usually the ABS CPI (All Groups) for Sydney). However, in several plans we have recently assessed or are assessing, councils have proposed using a land or property value index to adjust the contribution rate for land.

Our assessment of indexation for land costs

In assessing the indexation method council use for the cost of land in a contributions plan we will consider the reasonableness of the approach in the context of the plan.

In all contexts, we consider it is reasonable for councils to index contribution rates for the cost of land in a contributions plan by CPI (All Groups) for Sydney. Indexing using CPI is widely accepted and understood in the context of adjusting government rates over time for the impact of cost inflation. Even though CPI may not track changes in the costs of land in a plan as well as other methods, we consider this approach to be reasonable.

However, consistent with our preliminary position published in our April 2019 Discussion Paper, we acknowledge that there are circumstances where a land value index (LVI) may be an appropriate alternative to indexing using CPI.[11]

There are a range of different methods councils could employ to account for changing land values. Approaches may include indexing contribution rates by:

- The ABS Established House Price Index for Greater Sydney
- An index of land or dwelling values developed by a property data provider on a city wide, local government area (LGA) or other geographic basis
- An index constructed from precinct-specific land value appraisals undertaken on behalf of council, or
- An index of unimproved land values published by the NSW Valuer General or constructed using NSW Valuer General data.

Our position is that if councils choose not to index the land component of contributions using the ABS CPI (All Groups) for Sydney, then the most suitable alternatives are to use:

- The ABS Established House Price Index for Greater Sydney[12], or

10 IPART, *Contributions plan assessment: land costs Information Paper*, April 2018.
11 IPART, *Indexation of Contribution Rates Discussion Paper*, April 2019.
12 The ABS Established House Price Index for Greater Sydney is likely to only be reasonable for councils in the Greater Sydney area.

- A readily accessible index of prices across a broad geographic basis produced and published by a third-party provider.

These indexes are readily available and understood by stakeholders. Further, they represent price changes in the broader property market.

The land in contributions plans is often made up of land with different zonings, constraints, lot sizes and development potential, which can have a significant impact on the base year price, and the movement in the underlying cost of land after the plan is adopted.

In our view, the most suitable alternative to using CPI is an index that is constructed to account for the likely change in the price of the land in the plan (which may not change at the same pace as other land within a plan's catchment).[13] If this is not possible, then we consider a LVI based on a broader geographic region to be the more reasonable alternative.

A LVI that is based on a broader area has the advantage of being less volatile and susceptible to compositional bias, while still tracking the general direction and magnitude of change in the cost of land in a region.

Our assessment will consider the context of each plan. We acknowledge that an approach that may be suitable in one context may not be suitable in another context, and there may be other reasonable approaches which we have not mentioned in this Information Paper.

When a council includes a LVI in its contributions plan for our assessment, we will ask the council to provide information to demonstrate that the LVI will reflect the likely change in the value of the land over time that the council needs to acquire for public infrastructure.

Further, councils should ensure that the methodology used to index land costs is transparent. We suggest councils include a clear explanation of the methodology when exhibiting the plan to facilitate stakeholder review, understanding and feedback, and publish the results of the index on their websites after the plan has been adopted.

13 For example, the price of land not being acquired by the council for public infrastructure may increase due to subdivision or other improvements.