

Independent Pricing and Regulatory Tribunal  
New South Wales

# Review of local government election costs

Issues Paper

April 2019



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## Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

**Submissions are due by 10 May 2019.**

We would prefer to receive them electronically via our online submission form <[www.ipart.nsw.gov.au/Home/Consumer\\_Information/Lodge\\_a\\_submission](http://www.ipart.nsw.gov.au/Home/Consumer_Information/Lodge_a_submission)>.

You can also send comments by mail to:

**Local government election cost review**

Independent Pricing and Regulatory Tribunal

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Late submissions may not be accepted at the discretion of the Tribunal. Our normal practice is to make submissions publicly available on our website <[www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au)> as soon as possible after the closing date for submissions. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed above.

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If you would like further information on making a submission, IPART's submission policy is available on our website.

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# 1 Introduction

The NSW Electoral Commission (NSWEC)<sup>1</sup> is legislated to administer and report on ordinary elections and by-elections for the NSW State Government. The NSWEC also conducts local government elections, and elections for a range of government, public and commercial organisations on request.

The NSWEC provides a range of election services for councils that choose to engage it to run their local government elections.<sup>2</sup> These services include:

- ▼ Arranging polling places, ballot papers and equipment
- ▼ Recruiting and training election officials
- ▼ Managing the vote count and publishing election results.

The NSWEC conducts local government elections on a full cost recovery basis.<sup>3</sup> The NSWEC currently recovers its costs from councils either:

- ▼ By direct allocation to an individual council, where it can attribute specific activities to that council, or
- ▼ On a per elector basis (ie, the amount a council pays depends on the number of electors in its area), for 'general-type' activities and indirect costs.

The Premier has requested IPART to recommend a costing methodology for determining the amount the NSWEC charges councils when it administers their ordinary elections.

This paper outlines our proposed approach to the review. It explains the review process, identifies the key issues we will need to consider, and seeks comments from stakeholders.

## 1.1 What has IPART been asked to do?

The Premier has asked IPART, under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992* (the IPART Act), to recommend a costing methodology to be applied in determining the amount the NSWEC charges councils which use it to administer their ordinary elections. The Terms of Reference (ToR) ask us to:

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<sup>1</sup> The NSW Electoral Commission is made up of three members, headed by the Electoral Commissioner. The NSW Electoral Commission is supported by a staff agency, also known as the NSW Electoral Commission. In our review, we refer to the three members of the Electoral Commission and the staff agency collectively as the NSWEC unless otherwise indicated.

<sup>2</sup> Under Section 296 of the *Local Government Act 1993* (the LG Act), the general manager of the council is responsible for conducting local government elections. The legislation allows for the general manager to administer the elections personally or for the council to enter into an arrangement with an electoral services provider such as the NSW Electoral Commission.

<sup>3</sup> A review was conducted by the Council on the Cost and Quality of Government in 2005. The review recommend for local government elections to be conducted on a full cost recovery basis. This was implemented for the first time for ordinary elections in 2008.

- 
- ▼ Review the NSWEC's existing methodology for determining the amount to be charged to councils which use the NSWEC to conduct their elections
  - ▼ Consider whether it is appropriate for the amount charged to be limited to the direct and unavoidable costs of conducting a council's election
  - ▼ Have regard to the market for electoral services in which the NSWEC operates
  - ▼ Have regard to any differences in the costs involved in conducting elections in metropolitan and regional areas
  - ▼ Have regard to any other matters we consider relevant.

Our full ToR is listed in Appendix A.

## 1.2 How will we conduct this review?

For this review, we will conduct a public consultation process and our own research and analysis. We will consult with key stakeholders, including councils, state government agencies (eg, NSWEC, NSW Treasury), private providers of election services) and the public.

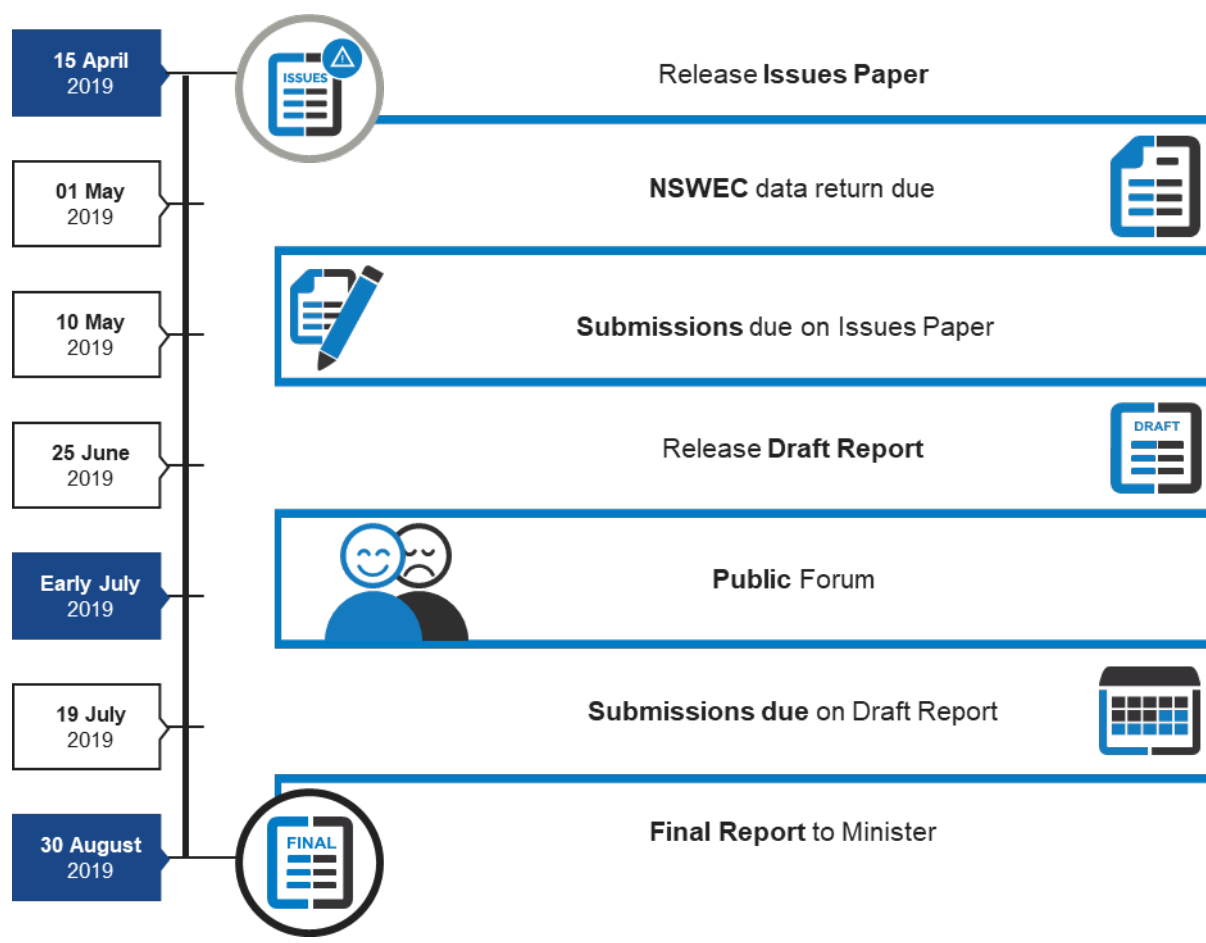
This Issues Paper is the first step in our public consultation process. It describes and seeks comment on our proposed approach for the review. We invite all interested parties to make submissions in response to this paper by **10 May 2019**. Details on how to make a submission are provided on page 2 of this paper.

We will release our Draft Report on 25 June 2019. There will be an opportunity for interested parties to make submissions in response to the Draft Report before our Final Report is provided to the Minister for Local Government on 30 August 2019.

Figure 1.1 provides an indicative timetable for the review. We will provide updates on our website at [www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au) as the review progresses.



**Figure 1.1** Indicative timetable for the review



### 1.3 How this paper is structured

The rest of this Issues Paper provides more information on the review, our proposed approach and the key issues we will need to consider:

- ▼ Chapter 2 provides the context for the review
- ▼ Chapter 3 outlines our proposed approach to the review
- ▼ Chapter 4 explains how we will identify the election services provided by the NSWEC and assess the level of competition in the market in which the NSWEC operates
- ▼ Chapter 5 explains how we will assess the efficient costs of providing these services
- ▼ Chapter 6 explains how we will allocate the efficient costs between State Government and councils
- ▼ Chapter 7 explains how we will allocate the council-share of costs across councils and assess the impact of our recommended costing methodology on stakeholders.

## 1.4 Issues on which we seek comment

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2	When would a council prefer to use a private provider, rather than the NSWEC, to conduct its elections?	15
3	What scope is there for private providers to offer councils:	15
	– The full range of election services currently provided by the NSWEC?	15
	– A more limited range of election services?	15
4	To what extent would the range of services offered by private providers vary by a council's geographic location (ie, metropolitan, regional or rural) or size (ie, small, medium or large)?	15
5	What are the barriers to competition in the provision of election services to councils?	15
6	What factors might lead to changes in the costs incurred by the NSWEC, and over what time period are these changes likely to occur?	19
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10	Do you agree that NSWEC's direct costs should be allocated between the State Government and councils using the impactor pays principle (ie, those that create the need for the cost to be incurred should pay the cost)?	30
11	Should NSWEC's indirect costs be allocated:	30
	– Using the impactor pays principle	30
	– With a focus on putting NSWEC on an even footing with private providers (ie, ensuring its indirect costs are allocated to councils where they would be incurred by an efficient competitor to the NSWEC), or	30
	– On some other basis (and if so, what)?	30

- 
- 12 Do you consider the allocation of NSWEC's costs to councils should be made with reference to incremental costs (lower bound), standalone costs (upper bound), or somewhere in between this range? 30
  - 13 How should indirect costs (eg, centralised locations for collating ballots ready for data entry and councils' share of the costs that are common to State and local government elections) be shared between councils? For example, should they be allocated on a 'per elector', or some other basis? 33
  - 14 Are the costs involved in conducting elections substantially different for metropolitan, regional and rural councils? If yes, what are the drivers for those differences? 33
  - 15 Do you agree with our proposed approach for assessing the impact of our recommendations on stakeholders? Are there any other issues we should consider? 33

## 2 Context for the review

This chapter provides the context for the review, including information about:

- ▼ The range of services provided by the NSWEC
- ▼ Contestability of local government election services
- ▼ The NSWEC's existing costing methodology
- ▼ Recent regulatory changes.

### 2.1 The NSWEC provides a range of election related services

The function of the NSWEC is to provide a range of election related services for administering elections and regulating the electoral environment.

The NSWEC administers elections for:

- ▼ The Parliament of NSW
- ▼ The NSW Aboriginal Land Council
- ▼ Local government councils (on request)
- ▼ Commercial, statutory and service organisations (on request).

The NSWEC is also responsible for regulating the electoral environment. This includes:

- ▼ Maintaining registers of political parties, candidates, agents, third-party campaigners and lobbyists
- ▼ Publishing disclosures of political donations and electoral expenditure
- ▼ Regulating compliance with election related legislation.<sup>4</sup>

This review focuses on the services the NSWEC provides in administering local government elections. Voting in local government elections is compulsory for enrolled voters in NSW.

### 2.2 Local government elections can be run by the NSWEC or a private provider

Local government elections are conducted every four years, on the second Saturday in September.<sup>5</sup> Prior to 1987, Town and Shire Clerks were responsible for conducting local government elections. This responsibility was transferred to the NSWEC in 1987 with the passage of the *Local Government (Elections) Amendment Act 1987*. The NSWEC became the sole provider for local government elections.

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<sup>4</sup> NSW Electoral Commission, *Annual Report 2016-17*, p 28.

<sup>5</sup> Section 287 of the LG Act.

In 2005, the Council on the Cost and Quality of Government conducted a pricing review of local government elections and recommended the change to a full cost recovery methodology. This was first introduced for ordinary elections in 2008.<sup>6</sup> The change in costing methodology led to an increase in costs charged to councils and resulted in a number of complaints from councils.

In response to councils' concerns, the State Government approved an amendment to the LG Act in 2011, which transferred the responsibility for conducting local government elections to the general manager of the council concerned. This gave councils the option to run their own election, or enter into a contract with an election service provider (eg, the NSWEC or a private provider).

Thirteen of the 150 councils at the 2012 elections chose a private provider – the Australian Election Company – to manage their elections.<sup>7</sup> A subsequent review found that, for most of these councils, the cost of the private provider was less than the projected cost of engaging the NSWEC to conduct their elections. The councils made a combined estimated saving of around \$1 million.<sup>8</sup>

Despite the introduction of contestability for election services, the NSWEC remains the dominant provider of these services. At this stage, the Australian Election Company remains its sole competitor. Its market share of elections was 8.7% in 2012, decreasing to 4.7% in the 2016 and 2017 elections, when it managed 6 of 127 elections.<sup>9</sup> The Australian Election Company has mainly serviced larger metropolitan and regional councils (eg, Penrith City Council, Kempsey City Council).

NSW is the only state to currently offer contestability in the provision of local government election services.

### **2.3 The NSWEC currently recovers its costs from councils and the State government**

Under the NSWEC's current funding model, councils are required to meet the costs of conducting their elections, with the exception of some NSWEC services such as enrolment and non-voting services, which are provided by the NSWEC at no cost to councils.

The NSWEC uses a 'bottom-up approach' for estimating the cost of conducting local government elections. It starts by identifying the projects and associated activities required for the elections, and then itemises volume and unit costs for each project, and the timing of tasks. The estimated costs of budget items derived using this approach are tested against the cost schedule from a previous election.<sup>10</sup>

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<sup>6</sup> The full cost recovery methodology was introduced for by-elections following the review.

<sup>7</sup> The NSWEC managed elections for 136 councils (NSW Electoral Commission, *Report on the 2012 Local Government Elections*, p 13). One council managed its election internally (Joint Standing Committee on Electoral Matters, *Inquiry into the 2012 Local Government Elections*, p 13).

<sup>8</sup> Department of Premier and Cabinet, *Review of 2012 Council Run Elections*, p 10.

<sup>9</sup> Elections were conducted in two tranches due to council amalgamations. The NSWEC managed 121 elections (NSW Electoral Commission, *Report on the 2016 Local Government Elections*, p 7 and NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 6.)

<sup>10</sup> NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 21.

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The costs for individual projects are allocated to specific councils via direct allocation if the cost is incurred in specific council areas. Otherwise, the costs are shared between councils on a per elector basis.

### 2.3.1 Major cost items of local government elections

The total cost to the NSWEC of the 2016 and 2017 local government elections was \$50.9 million.<sup>11</sup>

Election official wages accounted for \$15.1 million of expenditure in the 2016 and 2017 elections.<sup>12</sup> This represents approximately 44% of the total cost charged to councils. Election officials are recruited to undertake preparatory work for the elections and manage operations on polling day. Due to the cyclical nature of elections, the NSWEC recruits a significant number of temporary staff for conducting local government elections.

Rent for office accommodation and polling places collectively accounted for approximately 8% of the total cost charged to councils. The NSWEC does not own the office space and polling places it uses for elections and must acquire these through short-term leases.

The communication campaign also represented a considerable share of election expenditure. The NSWEC provides a range of targeted materials to reach sections of the community such as people of non-English speaking background, people with a disability and Aboriginal voters to promote election awareness and participation.

Other major cost items of the elections include logistics, IT support and ballot paper production.<sup>13</sup>

### 2.3.2 Funding models in other jurisdictions

Local government elections are funded in different ways across the states of Australia.

In Victoria, under the *Electoral Act 2002*, the Victorian Electoral Commission (VEC) is responsible for conducting all Local Government general elections and by-elections. Councils have the option to choose between postal voting and attendance voting, and voting is compulsory for all residents on the electoral roll under the age of 70.

The VEC uses a marginal cost recovery model for local government elections. This means that core costs<sup>14</sup> are not recovered from the councils.<sup>15</sup> Some cost items currently funded by councils under the NSWEC's costing methodology are considered to be core costs by the VEC.

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<sup>11</sup> This is comprised of \$14.76 million (\$13.371 million in direct costs and \$1.384 million in election management fees) charged to councils for elections in 2016, \$19.17 million (\$17.253 million in direct costs and \$1.914 million in election management fees) charged to councils for elections in 2017 and \$17.0 million (based on the NSWEC's *Report on the 2017 Local Government Elections*) recovered from the State Government to cover the additional costs incurred in conducting elections in two tranches.

<sup>12</sup> NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 22.

<sup>13</sup> NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 22.

<sup>14</sup> The VEC defines core costs as those that would normally be incurred by the VEC as part of delivering its electoral services for the Victorian State Parliament, State Government and certain statutory elections.

<sup>15</sup> Victorian Electoral Commission, *Local Government Information Series 2016, Costing Local Government Elections*, pp 1-2.

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Conversely, there are some costs the VEC recovers from councils that are funded by State Government under the NSWEC's current model (eg, managing non-voting).

In Western Australia (WA), the Western Australian Electoral Commission (WAEC) is responsible for conducting all local government postal elections and can also conduct voting in person elections on request under the *Local Government Act 1995*. Postal voting was first introduced in WA in 1995 and has become more popular over time as it is more convenient for electors and generally results in higher voter turnout compared to attendance voting. This is an incentive for councils in WA as voting in local government elections is not compulsory.

The WAEC conducts local government elections on a full accrual cost recovery basis, similar to the NSWEC. Councils are provided with cost estimates prior to the elections, and the actual cost incurred is passed on after the elections.<sup>16</sup>

## 2.4 Recent regulatory changes impact on local government elections

The Joint Standing Committee on Electoral Matters (JSCEM) recommended regulatory changes in two separate inquiries it conducted in 2012 and 2017. The following regulatory changes were introduced through the *Local Government (General) Amendment (Elections) Regulation 2018*:

- ▼ Countback system to fill casual vacancies when casual vacancies arise within 18 months of the original election
- ▼ Universal postal voting
- ▼ Weighted inclusive Gregorian method for counting votes.

### 2.4.1 Inquiry into the 2012 local government elections

An inquiry was conducted by the JSCEM following the 2012 local government elections. In its inquiry, the Committee considered several possible legislative changes to improve the efficiency of how elections are conducted and maximise voter participation.

The inquiry recommended the introduction of a countback system to fill casual vacancies when casual vacancies arise within 18 months of the original election. This removes the need for by-elections within the first 18 months. The rationale for this was that the by-election process is costly and favours parties with larger support bases, which may not result in the 'replacement' councillor from the original election being selected. In its recommendation, the Committee considered the success of countback systems used in Victoria, Tasmania and the ACT, and determined that a similar system should be introduced in NSW. Councils will be able to use countback following the 2020 elections.

The inquiry also recommended removing eligibility requirements for postal voting, and granting councils the option to conduct their elections entirely via a postal ballot rather than through attendance voting. Again, the Committee considered the positive impacts of postal voting in other states on cost and voter turnout and concluded that universal postal voting

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<sup>16</sup> Western Australian Electoral Commission, *2017 Local Government Ordinary Elections*, p 18.

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should be allowed in NSW. Councils may resolve to use universal postal voting for elections following the 2020 local government elections.

#### **2.4.2 Inquiry into preference counting**

The JSCEM's 2017 inquiry into preference counting in local government elections in NSW highlighted issues with the current system of random preference allocation<sup>17</sup>, specifically the lack of reproducibility and its adverse impact on public confidence in the electoral system. The Committee recommended changing to a system of fractional transfers known as the weighted inclusive Gregory method (WIGM)<sup>18</sup> for future local government elections. One key advantage of WIGM is that it is reproducible on a recount, which is necessary for the introduction of the countback system.

This change will take effect on 11 September 2020, immediately before the 2020 local government elections.<sup>19</sup>

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<sup>17</sup> Under the *Local Government (General) Regulation 2005*, candidates must reach a quota to be elected. When a candidate reaches the quota based on first preferences, surplus votes for the candidate are distributed to the remaining candidates based on numbered preferences.

Under random preference allocation, preferences are determined based on a random sample of ballot papers. These preferences are then used to transfer surplus votes to other candidates.

<sup>18</sup> Under a fractional transfer system, preferences on all ballot papers are taken into account to determine the number of surplus votes received by other candidates. WIGM is a fractional transfer system that differentiates between votes which are transferred more than once.

<sup>19</sup> Office of Local Government, *Circular No 18-47 Amendments to the election provisions of the Local Government (General) Regulation 2005*.



## 3 Proposed approach to the review

We have developed a proposed approach for establishing our costing methodology for this review. The approach aims to ensure we consider all the matters specified in our terms of reference (see Box 3.1), and take account of the contextual issues outlined in Chapter 2.

### **Box 3.1 Matters specified in our terms of reference**

Our terms of reference ask us to recommend a costing methodology to be applied in determining the amount NSWEC charges councils which use it to administer their ordinary elections. We are to have regard to:

- ▼ NSWEC's existing methodology for determining the amount to charge councils
- ▼ Whether it is appropriate for the amount charged to be limited to the direct and unavoidable costs of conducting council elections
- ▼ The market for electoral services in which the NSWEC operates
- ▼ Any differences in the costs involved in conducting elections in metropolitan and regional areas
- ▼ Any other relevant matters.

The sections below set out the six main steps in this approach, and then outline what we propose to consider at each step. Chapters 4 to 7 discuss each step in more detail and identify the issues on which we seek stakeholder comment.

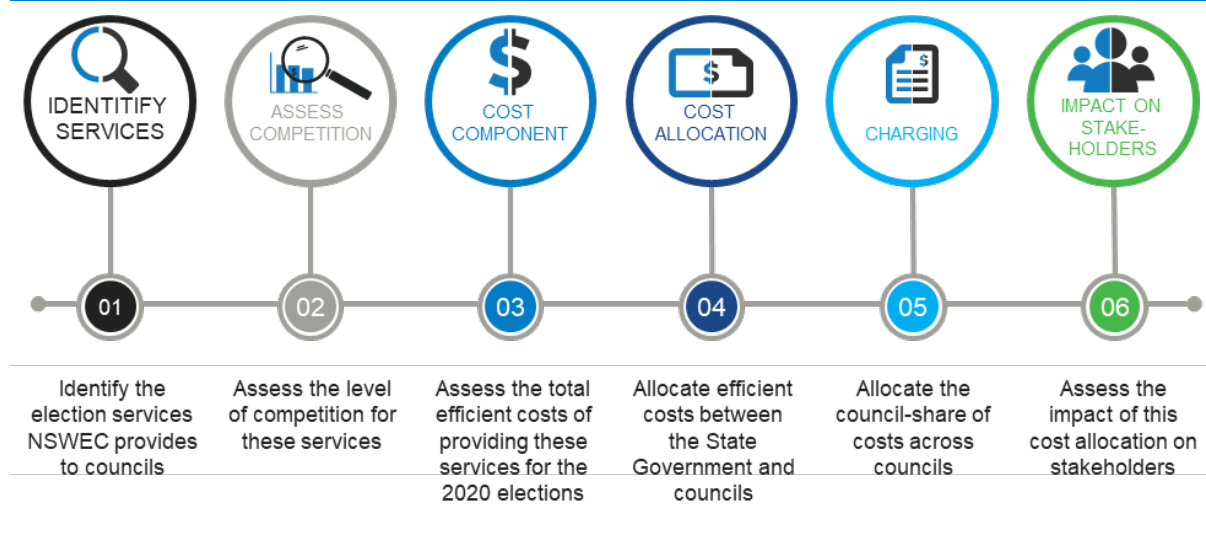
### **3.1 Overview of our proposed approach**

In developing our costing methodology, we propose to undertake six main steps:

1. Identify the election services NSWEC provides to councils
2. Assess the level of competition for providing these services
3. Assess the efficient costs of providing these services
4. Allocate these costs between the State Government and councils
5. Allocate the council-share of costs across councils
6. Assess the impact of this cost allocation on stakeholders.

Our proposed approach is summarised in Figure 3.1.

**Figure 3.1 Our proposed approach**



### 3.2 Identify the election services NSWEC provides to councils

As the first step in our approach, we propose to identify those services the NSWEC provides for local government elections, and the costs attributed to each service. This will allow us to unbundle NSWEC's services, so we can examine the level of competition, efficient cost and appropriate cost allocation for each service (ie, apply the subsequent steps in our proposed approach).

We will also look at the reasons for NSWEC offering these services, and how NSWEC determines the level of service required.

### 3.3 Assess the level of competition for providing these services

In the second step, we will assess the state of the market for local government election services. The aim of this step is to understand the current level of competitiveness in the market, and the possible development of competition over the next few years.

Our findings on the degree of competition in the market affect subsequent steps in our approach. In particular, the type of oversight required to ensure NSWEC's costs are efficient, as well as the way these efficient costs are allocated between the State Government and councils (ie, the third and fourth steps of our approach).

Chapter 4 contains further information on steps 1 and 2 of our proposed approach.

### 3.4 Assess the efficient costs of providing these services

Our preliminary analysis indicates that the market for election services is highly concentrated. Therefore, we intend to use our standard 'building block' method to calculate NSWEC's total efficient costs. This involves estimating the NSWEC's operating costs, and setting allowances for a return of capital, return on capital, tax and working capital.

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We intend to engage an external consultant to assist us in assessing the reasonableness of the NSWEC's proposed expenditure.

We discuss step 3 of our proposed approach in more detail in Chapter 5.

### **3.5 Allocate these efficient costs between the State Government and councils**

In the fourth step, we will decide how to allocate the NSWEC's efficient costs between the State Government and councils. To do this, we will classify NSWEC's election service costs as either 'direct' or 'indirect'<sup>20</sup> and seek stakeholder comment. We are likely to allocate direct costs using the impactor pays principle (ie, those that create the need for the cost to be incurred should pay the cost).

In relation to indirect costs, we will consider our findings on the level of competition for election services (step 2 of our proposed approach) when deciding on the best method for allocation. If there is the potential for effective competition, indirect cost should be allocated between the State Government and councils in a competitively neutral way. Otherwise the impactor pays principle should apply.

Chapter 6 provides more detail on step 4 of our proposed approach.

### **3.6 Allocate the council-share of costs across councils**

In the fifth step of our proposed approach, we will determine the optimal way to allocate the council-share of efficient costs among councils. We will identify which costs should be charged to an individual council directly and which costs need to be shared between councils, and the basis upon which they should be shared.

As part of this process, we will look at how to structure the allocation to ensure it is cost-reflective and avoids creating cross-subsidies between councils.

### **3.7 Assess the impact of this cost allocation on stakeholders**

Our final step involves considering how our proposed costing methodology would impact on stakeholders, such as ratepayers, councils, the State Government and potential competitors to the NSWEC.

As required by our terms of reference, we will have regard to NSWEC's existing costing methodology as part of this step. This will assist us to understand the current impacts on stakeholders and how they may change using our proposed approach.

Chapter 7 contains further information on steps 5 and 6 of our proposed approach.

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<sup>20</sup> 'Direct costs' are the costs NSWEC would avoid if it did not provide the election service. The remaining costs are 'indirect costs'.

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IPART seeks comments on the following

- 1 Do you agree with IPART's proposed approach for this review? Are there any alternative approaches that would better meet the terms of reference, or any other issues we should consider?

## 4 Identify the election services and assess the level of competition for providing these services

The first two steps in our proposed approach for the review are to:

- ▼ Identify the election services NSWEC provides to councils
- ▼ Assess the level of competition for providing these services, including the current level of competition and the possible development of competition over the next few years.

The sections below discuss how we propose to undertake these steps, including the information we will collect and analyse and the issues we will consider.

IPART seeks comments on the following

- 2 When would a council prefer to use a private provider, rather than the NSWEC, to conduct its elections?
- 3 What scope is there for private providers to offer councils:
  - The full range of election services currently provided by the NSWEC?
  - A more limited range of election services?
- 4 To what extent would the range of services offered by private providers vary by a council's geographic location (ie, metropolitan, regional or rural) or size (ie, small, medium or large)?
- 5 What are the barriers to competition in the provision of election services to councils?

### 4.1 What are the election services the NSWEC provides to councils?


The first step in our proposed approach is to identify those services the NSWEC provides when managing local government elections (as distinct from its enforcement and State election functions). As outlined in Chapter 2, NSWEC provides a range of services to the councils that engage it. This covers:

- ▼ Recruiting and training election staff
- ▼ Arranging polling places, ballot papers and equipment (such as polling booths)
- ▼ Managing the count and publishing election results.<sup>21</sup>

In addition, there are some services that NSWEC provides for all councils, including those that choose to conduct their own elections. For example, NSWEC is responsible for maintaining the NSW electoral roll (in conjunction with the Australian Electoral Commission). It also supplies all councils with electoral roll products for their elections, including a list of voters registered to automatically receive postal votes.

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<sup>21</sup> NSW Electoral Commission, *Annual Report 2016-17*, p 20.



Other elections services provided by the NSWEC include running a state-wide communication campaign to promote election awareness and optimise enrolments, and a call centre for election related enquiries.

We will ask the NSWEC to provide us with a comprehensive data set covering all the local government election services it provides to councils (at the individual council level), and the (historic and forecast) costs attributed to each service. This will allow us to unbundle NSWEC's services, so we can examine the level of competition, efficient cost and appropriate cost allocation for each service.

This may also facilitate a comparison of the market for, and cost of, different election service options. For example, providing a traditional, 'polling booth' election compared to one entirely using postal voting.

We will examine the reasons for NSWEC offering its range of services, and how it determines the level of service required. That is, whether it provides the service (and at a particular level) in response to its internal service charter, Government policy, legislative requirement or council request. NSWEC's costs will vary according to the range and level of services it provides. We explore the link between services levels and costs further in the third step of our proposed approach (see Chapter 5).

## **4.2 What is the level of competition for election services?**

We propose to consider the degree of competition in the market for local government election services, since it affects subsequent steps in our approach. In particular, the type of oversight required to ensure the NSWEC's costs are efficient, as well as the way its costs are allocated between the State Government and councils (ie, the third and fourth steps of our approach).

It is important to review the efficiency of the NSWEC's costs if it is operating in a monopoly (or near-monopoly) market. The lack of current or potential competitors could lead to NSWEC recovering an inefficiently high level of costs from councils. In contrast, if there is effective competition, the risk of losing councils to competing service providers would create incentives for NSWEC to keep its prices in line with the efficient costs of supplying its election services.

Similarly, the cost allocation between the State Government and councils could differ depending on whether the market is (or has the potential to be) competitive. We may consider an allocation primarily based on the 'impactor pays' principle for a monopoly market, whereas ensuring costs are allocated in a way that puts the NSWEC on an even footing with private providers could be a key allocation criteria for a competitive or potentially competitive market.

#### 4.2.1 Current level of competitiveness in the market

The market for local government elections appears to be highly concentrated. Despite the introduction of contestability in 2012,<sup>22</sup> the NSWEC remains the dominant provider of election services, with a market share of around 95%.<sup>23</sup>

There is only one private provider – the Australian Election Company – operating in the market. As Chapter 2 noted, it managed around 9% of local government elections in 2012, with its market share decreasing to around 5% for the 2016 and 2017 elections. It has mainly serviced larger metropolitan and regional councils (eg, Penrith City Council, Kempsey Shire Council).<sup>24</sup>

At this stage, by being the dominant provider in such a highly concentrated market, the NSWEC may not experience sufficient competitive pressures to ensure its costs are efficient.

#### 4.2.2 Potential barriers to entering the market

The development of competition in the market for local government election services depends on the barriers that constrain new private providers from entering the market, and from increasing their market share. If these barriers are low, effective competition is likely to develop over time. But if they are high, competition or the threat of competition may remain insufficient to put pressure on the incumbent to charge efficient prices and offer innovative services.

Our preliminary analysis has identified start-up costs as a potential barrier to entry. High set-up costs – which cannot be recovered on exiting the market – reduce the number of potential new entrants to the market. In particular, recent regulatory changes mean that private providers may need to substantially invest in their IT systems before they can offer the full range of local government election services.<sup>25</sup>

Under the new regulations, manual counting of elections and distribution of preferences are no longer possible. Instead, election service providers need to have IT systems in place to administer a new method of preference allocation (the weighted inclusive Gregory method or ‘WIGM’).<sup>26</sup>

It may be costly and duplicative for private providers to set up this preference allocation software. Further, as the incumbent, NSWEC may have large economies of scale,<sup>27</sup> making it

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<sup>22</sup> Since the 2012 elections, councils have been able to choose whether to use the NSWEC to run their elections, engage a private provider or manage their own elections.

<sup>23</sup> At the 2016 and 2017 local government elections, it managed 122 of the 128 elections. NSW Electoral Commission, *Report on the 2016 Local Government Elections*, p 7 and NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 6.

<sup>24</sup> Department of Premier and Cabinet (DPC), *Review of 2012 Council Run Elections*, p 3, NSW Electoral Commission, *Report on the 2012 Local Government Elections*, p 13, NSW Electoral Commission, *Report on the 2016 Local Government Elections*, p 7 and NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 6.

<sup>25</sup> These technology costs are in addition to the typical costs of establishing a business, such as hiring staff and the costs of establishing an office, marketing and insurance.

<sup>26</sup> Office of Local Government, *Frequently Asked Questions* (<https://www.olg.nsw.gov.au/sites/default/files/Administration%20of%202020%20Elections%20-%20FAQs.pdf>, accessed 11 April 2019).

<sup>27</sup> If this is the case, its average costs would decrease as the numbers of councils it services increases.

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difficult for private providers to compete with it for this service. The NSWEC may also have economies of scope in the combined provision of election services that are potentially contestable and those that are not.

#### **4.2.3 Opportunities for effective competition in a limited range of services or areas**

In assessing the state of the market, we will consider whether effective competition is only likely for a limited range of services, rather than for each service currently offered by the NSWEC. For example, private providers may:

- ▼ Focus on providing core election services, such as arranging ballot papers and managing the vote count, but not ancillary services. These ancillary services include the election materials NSWEC develops for voters with a culturally and linguistically diverse background or disability.
- ▼ Look at providing election services that do not involve high levels of initial investment. For example, NSWEC could become the sole provider of the preference allocation service referred to above, and private providers would compete with it for other election services.
- ▼ Target services where new technologies or methods are emerging. They may look at introducing digital voting to local council elections<sup>28</sup> or conducting the elections entirely by postal voting.<sup>29</sup>

We will also consider whether there may be more competition for providing election services to larger metropolitan/regional councils, compared to smaller councils or ones located in rural areas. For example, private providers may find it unviable to service some rural councils due to higher costs.

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<sup>28</sup> NSWEC used online and telephone voting for the State Government elections in March 2019 (<https://www.elections.nsw.gov.au/Voters/Other-voting-options/iVote-online-and-telephone-voting>, accessed 3 April 2019). However, it is not yet available for local government elections.

<sup>29</sup> See Chapter 2 for more information on universal postal voting.



## 5 Assess the efficient costs of providing election services

Our preliminary analysis indicates that the market for election services is highly concentrated. Therefore, the next step in our proposed approach for the review is to assess the efficient costs of providing election services. The sections below discuss the key components of this step, including the information we will collect and analyse and the issues on which we are seeking stakeholder feedback. These components are:

- ▼ Understanding the costs the NSWEC incurs (and is expected to incur) in providing election services.
- ▼ Deciding on an approach to estimating efficient costs. We propose to use our standard approach – the ‘building block’ method – but will consider an alternative approach, on which we are seeking feedback.
- ▼ Assessing efficient costs using the building block method, should we use this approach.

### IPART seeks comments on the following

- 6 What factors might lead to changes in the costs incurred by the NSWEC, and over what time period are these changes likely to occur?
- 7 Is a base level of service provision to all councils appropriate? For what types of election services offered by the NSWEC might councils opt for a different level of service?
- 8 How should we assess the efficient costs of providing election services to local councils? Do stakeholders support our use of a ‘building block’ approach to calculate the NSWEC’s efficient costs and revenue requirement? If not, what alternative method would be appropriate?
- 9 What firms or industries are comparable to the NSWEC in terms of their exposure to market risk? What percentage of debt rather than equity would an efficient provider of election services be able to sustain to finance its assets (ie, the gearing level)?

### 5.1 What costs does the NSWEC incur in providing election services?

As set out by the NSWEC,<sup>30</sup> the major expenditure items of elections are:

- ▼ Salaries.
- ▼ Rent for office accommodation and polling places.
- ▼ Communication campaigns.
- ▼ Ballot paper production.

The major cost items and their proportional contribution to the 2017 and 2016 cost to councils of election services provided by the NSWEC are shown in Table 5.1 below.

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<sup>30</sup> NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 21.

**Table 5.1 Cost to councils of election services provided by the NSWEC, by component (\$m, nominal)**

Expenditure item	2017	2017	2016	2016
	\$m	%total	\$m	%total
Election official wages	8.301	43%	6.765	46%
Logistics	1.339	7%	1.276	9%
Information Technology support	0.917	5%	0.904	6%
Ballot paper production	0.600	3%	0.719	5%
Returning Officer accommodation	0.899	5%	0.661	4%
Vote counting and results	0.708	4%	0.576	4%
Polling place hire	0.730	4%	0.479	3%
Communication campaign	0.639	3%	0.378	3%
Call centre	0.216	1%	0.260	2%
Enrolment expenses	0.293	2%	0.216	1%
Other costs	2.613	14%	1.138	8%
Election management fee	1.914	10%	1.384	9%
<b>Total costs</b>	<b>19.169</b>	<b>100%</b>	<b>14.756</b>	<b>100%</b>

**Note:** The NSWEC recovered \$17.0 million from the State Government for the 2016 and 2017 local government elections to cover the additional costs incurred in conducting elections in two tranches.

**Source:** NSW Electoral Commission, *Report on the 2017 Local Government Elections*, pp 20-27. NSW Electoral Commission, *Report on the 2016 Local Government Elections*, p 25. IPART calculations.

### 5.1.1 Costs have increased over time

The 2008 local government elections were the first ordinary elections conducted on a full cost recovery basis. The elections were delivered at a total cost of \$25.9 million for 148 councils. While the introduction of election contestability for the 2012 elections accompanied a fall in the costs incurred by the NSWEC, the NSWEC only conducted 92% of elections. This translated into an increase in the cost of election services provided by the NSWEC of 13.7%, on a per elector basis, over the four year period (see Table 5.2).

For the 2012 elections, councils that chose to conduct their own elections identified the cost of using the NSWEC as the main reason for this decision.<sup>31</sup> The total costs incurred by the 14 councils that conducted their own elections in 2012 was \$5.5 million. Although the NSWEC did not provide fixed quotes for election costs to individual councils, it did supply councils with escalation factors that could be applied to costs for the 2008 elections to estimate potential costs for 2012.<sup>32</sup>

Based on the NSWEC's cost estimation formula, the total cost for the 14 councils would have been \$6.5 million, had the elections been conducted by the NSWEC. The councils saved \$1.0 million (or 15%) in aggregate, though experiences in conducting their own elections varied between councils.<sup>33</sup> Most councils were able to conduct their elections at a cost that

<sup>31</sup> Department of Premier and Cabinet (DPC), *Review of 2012 Council Run Elections*, p 9. DPC found that "The main argument by councils for returning the conduct of elections to them was their concern about the rising costs of elections conducted by the NSWEC and a belief that they could do it cheaper."

<sup>32</sup> Department of Premier and Cabinet (DPC), *Review of 2012 Council Run Elections*, p 10.

<sup>33</sup> Department of Premier and Cabinet (DPC), *Review of 2012 Council Run Elections*, p 10.

was less than their estimated costs of engaging the NSWEC to conduct the election. Six councils were able to conduct the 2012 elections at a lower actual cost than the cost they incurred for the 2008 NSWEC conducted elections.<sup>34</sup>

The 2016 and 2017 elections were conducted in two tranches due to council amalgamations. The NSWEC received an additional \$17.0 million<sup>35</sup> in funding from the State Government to cover the costs incurred in holding the elections over two tranches. The cost to councils and cost per elector for the 2016 and 2017 elections in Table 5.2 below is not directly comparable to previous elections due to this additional funding.

**Table 5.2 Cost to councils and per elector cost of election services provided by the NSWEC (\$nominal)**

	Total cost (\$ million)	Cost per elector (\$)
2008	25.9	5.71
2012	23.4	6.49
2016 and 2017	33.9 <sup>a</sup>	7.22 <sup>b</sup>

<sup>a</sup> The first tranche of elections in 2016 were delivered at a cost to councils of \$14.76 million. The second tranche of elections in 2017 were delivered at a cost to councils of \$19.17 million. The NSW Government also provided \$17.0 million to cover the cost of conducting elections in two tranches. Based on the NSWEC's Report on the Local Government Elections, the \$33.9 million does not include duplicate costs.

<sup>b</sup> The NSWEC did not publish the cost per elector for the 2016 and 2017 elections. This has been estimated using the total cost and total number of electors.

**Source:** NSW Electoral Commission, Report on the 2012 Local Government Elections, p 14 and IPART calculations.

### 5.1.2 Future costs are also likely to change

The escalation factors provided by the NSWEC to estimate the costs of local government elections in 2012 included mark-ups for four items:

- ▼ Increases in wages in the public sector. Election official wages account for the most substantial share of election expenditure.
- ▼ Increases in operational costs (approximated using CPI).
- ▼ Increases in number of electors being serviced.
- ▼ Potential economy of scale losses due to the introduction of contestability.<sup>36</sup>

We will consider the impact of these drivers for changes in 'business as usual costs' as part of the review.

As set out in Chapter 2, the Joint Standing Committee on Electoral Matters (JSCEM) recommended regulatory changes in two separate inquiries in 2012 and 2017, which are expected to come into effect in future elections. These changes are:

- ▼ Countback to fill casual vacancies when casual vacancies arise within 18 months of the original election (in place after the 2020 elections).
- ▼ Introducing the option of universal postal voting (available after the 2020 elections).

<sup>34</sup> Department of Premier and Cabinet (DPC), *Review of 2012 Council Run Elections*, p 11.

<sup>35</sup> NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 20.

<sup>36</sup> Department of Premier and Cabinet, *Review of 2012 Council Run Elections*, pp 9-10.

- ▼ Weighted inclusive Gregorian method (in place for the 2020 elections).

Implementing these changes is likely to affect the NSWEC's costs in conducting local government elections in the future.

### 5.1.3 Costs are linked to service levels

In determining the NSWEC's efficient costs, we will need to consider relating actual and proposed expenditure to service quality outcomes, and ensuring an appropriate matching of service quality levels with local councils' willingness to pay. We will request the NSWEC to provide information on the drivers of its proposed expenditure program and what its proposed expenditures will imply for service quality and performance.

In particular, we will request that the NSWEC demonstrate:

1. What are the election services to be delivered over the review period, including service levels; that is, the quantity, quality and scope of the election services provided by the NSWEC to local councils?
2. How has the NSWEC ascertained the appropriate service levels it plans to provide over the review period and how are these service levels related to forecast costs? Where service levels are determined by Government policy or regulation, specific references for that policy or regulation should be provided.
3. What are the costs and benefits arising from substantially exceeding service levels and is there any evidence of councils' willingness to pay for increased service levels or standards?

## 5.2 We propose to estimate the efficient costs of providing election services using the 'building block' method

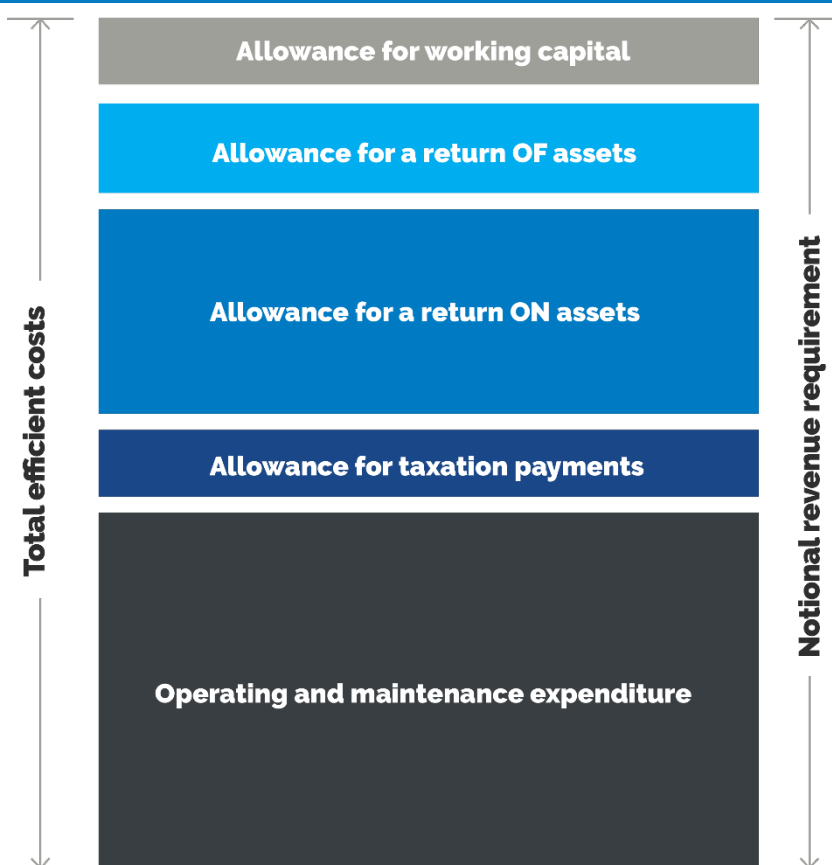
The third step in our approach is to estimate the efficient costs of providing election services. To do this, we propose to use our standard 'building block' method to calculate the NSWEC's notional revenue requirement (NRR) in the lead up to, and in conducting, the 2020 elections (ie, over the review period). The NRR represents our view of the total efficient costs of providing local government election services.

As shown in Figure 5.1, the building block costs of service provision include:

- ▼ **Operating expenditure**, which represents our estimate of the NSWEC's forecast efficient operating, maintenance and administration costs.

- ▼ A **return on the assets** the NSWEC uses to provide the services, which provides a return on the prudent and efficient investment in those assets. This is our assessment of the opportunity cost<sup>37</sup> of the capital NSWEC invests, and ensures the NSWEC can continue to make efficient investments in capital. To calculate this amount, we decide on the prudent and efficient levels of past and forecast capital expenditure, the value of the NSWEC's regulatory asset base (RAB),<sup>38</sup> and the appropriate weighted average cost of capital (WACC<sup>39</sup>) to apply to the RAB.
- ▼ A **return of those assets** (regulatory depreciation). This allowance recognises that, through the provision of election services, capital infrastructure wears out over time, and revenue must recover the cost of maintaining the RAB.
- ▼ Meeting **tax obligations**, which reflects the forecast tax liability for a comparable commercial business.
- ▼ **Working capital**, which represents the holding cost of net current assets and allows the NSWEC to meet its cash flow requirements.

**Figure 5.1 Building block approach to calculating efficient costs and notional revenue requirement (NRR)**



**Note:** Proportions are illustrative only.

<sup>37</sup> The opportunity cost of using capital for one purpose is the expected revenue forgone from investing that capital in its best alternative use.

<sup>38</sup> The regulatory asset base is our estimate of the economic value of assets needed to deliver election services.

<sup>39</sup> The WACC for a business is the expected cost of its debt and equity, weighted to take account of the relative share of debt and equity in its capital structure.

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The sum of these allowances is the NRR. In determining the NSWEC's NRR, we will assess the prudent and efficient operating and capital costs of delivering election services. This will include an assessment of any efficiency gains the NSWEC can reasonably achieve over the review period.

### **5.2.1 We could adopt an alternative approach to setting the NRR given election services are not capital-intensive**

We typically use the building block approach to establish the NRR in capital-intensive industries. Figure 5.2 shows an alternative to the building block method is to set the NRR based on a 'cost build-up' approach. The cost build-up approach is more appropriate for businesses that do not own substantial capital assets. In contrast to the building block approach, where we estimate a RAB (and allow for a return on and of capital), the cost build-up involves the following:

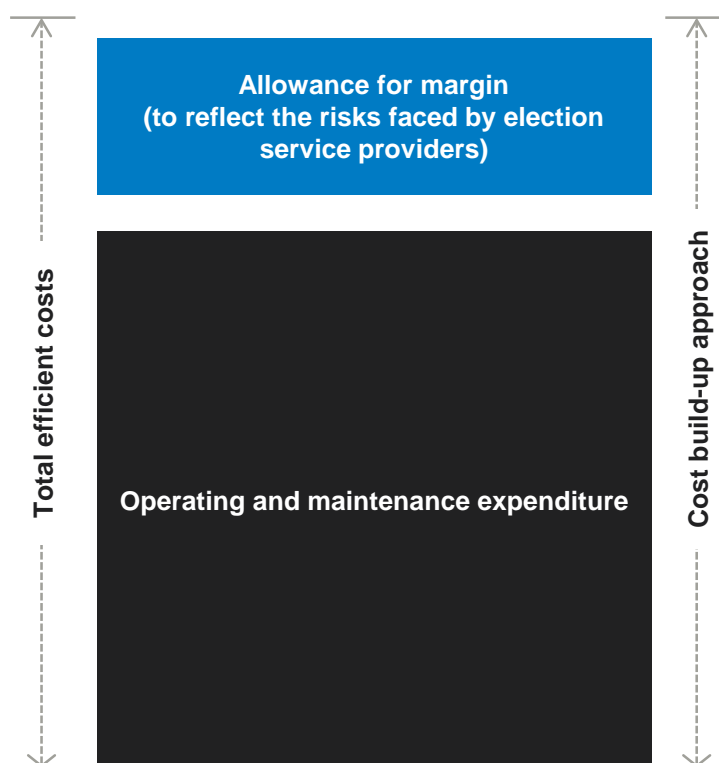
- ▼ Estimating the efficient operating and maintenance costs of providing election services.
- ▼ Allowing for an efficient margin.

The purpose of the margin allowance is to compensate the NSWEC for committing capital. The margin required to attract capital depends on the level of market (or systematic<sup>40</sup>) risk the NSWEC faces in providing election services. One way of establishing a reasonable margin allowance would be to benchmark it to comparable listed companies that share similar characteristics to the NSWEC and face similar market risk.

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<sup>40</sup> Systematic risk is the result of exposure to overall economic or market conditions. Non-systematic risk is the variability in the returns to equity holders resulting from factors uncorrelated with overall economic conditions. Non-systematic risk is also referred to as diversifiable or firm-specific risk and this is not compensated for via the margin.

**Figure 5.2 Cost build up method**



**Note:** Proportions are illustrative only.

### 5.3 How we would assess efficient costs using the building block model


The building block approach is commonly used by IPART and other regulators to estimate the total revenue a business needs to recover the efficient costs of providing services to the required standard over the review period.

The building block approach typically includes the following components:

- ▼ An efficient level of operating expenditure (operating, maintenance and administration expenses)
- ▼ An allowance for a return on assets
- ▼ An allowance for a return of those assets (depreciation)
- ▼ An allowance for tax and working capital.

#### 5.3.1 Efficient operating expenditure

The allowance for operating expenditure reflects our view of the efficient level of operating costs a business will incur in providing its services over the review period. Operating costs commonly include labour costs (ie, salaries), utilities and communication costs, and administration costs (eg, rent, training, insurance, etc). Some costs would be business-specific, eg, the NSWEC also incurs additional operating costs including (but not limited to) communication campaigns and ballot paper production.



We will estimate these costs based on detailed information provided by the NSWEC on its historical and projected operating expenditure. Only efficient costs will be included in the allowance for operating expenditure. Efficient costs represent what an efficient service provider would incur in providing the services at the quantity and level demanded by local councils.

We propose to engage an external consultant to review, analyse and evaluate the NSWEC's proposed operating costs and to make recommendations on the efficient level of costs that should be reflected in the NRR we set.

The costs incurred by the NSWEC in providing election services are largely related to operating expenditures (ie, expenses arising in the normal course of providing election services) as opposed to capital expenditures (ie, investments in assets made to provide services going forward). Therefore, our decision on the efficient level of operating expenditure is a critical step in determining the NSWEC's NRR.

As outlined above, given operating expenditure is likely to be the largest component of the NRR, we are also considering an alternative approach to setting the NRR (see section 5.2.1). This could be considered in the case of the provision of services such as elections services, which are not capital-intensive.

### **5.3.2 Efficient capital expenditure**

Under the building block method, there is no explicit allowance for capital expenditure in the NRR. Instead, efficient capital expenditure is added to the RAB and recovered through the allowances for a return on assets and depreciation (discussed below).

To decide the level of prudent and efficient capital expenditure to add to the RAB in each year of the review period, we will consider the level of capital expenditure needed to provide election services at the quantity and level demanded by local councils. We propose to engage an external consultant to assess the required level of capital expenditure that ensures services are delivered efficiently.

### **5.3.3 Estimating the allowance for a return on assets**

The allowance for a return on assets represents the cost of capital invested in an efficient business through equity and debt investments. Including a return on assets ensures that efficient investment continues into the future to meet growth in demand and maintain the business's long term viability. For a capital-intensive business, this allowance typically represents a large proportion of the total revenue requirement.

To estimate the allowance for a return on assets, we propose to:

- ▼ Determine the value of the initial Regulatory Asset Base (RAB)
- ▼ Decide on an appropriate rate of return
- ▼ Multiply the value of the asset base by the rate of return.



## Valuing the initial RAB

The RAB refers to the value of a business's assets used to provide the relevant services, which are funded by shareholders. If we were to use a building block to determine the NRR for the NSWEC's election services, we would establish the value of an initial RAB. The RAB would be valued in real terms and adjusted for CPI annually. Once the value of the initial RAB is established, this value is 'rolled forward' at the end of each year of a review period. That is, it is adjusted to reflect capital expenditure, asset disposals, depreciation and CPI over the year.

The primary assets associated with providing election services are likely to include general office plant and equipment, furniture and fixtures, electronic data processing equipment (hardware) and intangibles such as software, etc. To decide on the level of the initial RAB we will examine NSWEC's historical capital expenditure and how it relates to the quantity and quality of election services provided to councils. We intend to engage an external consultant to assist us in assessing the reasonableness of this expenditure.

## Deciding on the appropriate rate of return

We propose to decide on the appropriate rate of return by using our standard approach for calculating the Weighted Average Cost of Capital (WACC), which we undertook extensive public consultation on and reviewed in 2018.<sup>41</sup> Our methodology for calculating the WACC is set out in Appendix A.

### Box 5.1 What is the WACC?

The WACC is our estimate of the efficient cost of capital for in the provision of election services. It is a hypothetical benchmark of a business's efficient cost of debt and equity. It is a weighted average to take account of the relative shares of debt and equity that a business might have.

We use the WACC to calculate the return on assets that we allow the business (in this case, the NSWEC), by applying it to the value of the regulatory asset base (RAB). We look at setting the WACC to encourage the optimal level of investment in the business.

As part of deciding on an appropriate rate of return for the NSWEC, we try to identify proxy companies that have a comparable exposure to market risk. Ordinarily, that is done by examining firms in the same or similar markets.

### 5.3.4 Estimating an allowance for depreciation

The allowance for a return of assets, or depreciation, is intended to ensure that the capital the business (or its owner) invests in the assets is returned over the useful life of each asset. To estimate this allowance, we need to decide on the appropriate:

- ▼ Asset lives
- ▼ Depreciation method.

<sup>41</sup> IPART, Review of our WACC method – Final Report, February 2018.

We propose to review information provided by the NSWEC on expected and remaining asset lives in the first instance, and consider advice from an external consultant on the reasonableness of these asset lives.

We propose to use the straight-line depreciation method to calculate the depreciation for non-land assets.<sup>42</sup> This means that the total value of the asset base is recovered evenly in each year over the expected life of the assets.

### 5.3.5 Estimating allowances for tax and working capital

Other building blocks include allowances for tax and working capital.

#### Tax allowance

The inclusion of a tax allowance is consistent with our building block framework and meets IPART's principle that a business's revenue should be as close as possible to that of a well-managed, privately owned firm, operating in a competitive market. This includes any taxes payable on the business's taxable income.<sup>43,44</sup>

Typically, we calculate the tax allowance for each year by applying a 30% statutory corporate tax rate (adjusted for gamma<sup>45</sup>) to the business's (nominal) taxable income.<sup>46</sup> In March 2017, the Commonwealth Government enacted legislation that introduced different rates of corporate income tax for businesses of different sizes. Under the legislation, from 1 July 2018 a business with an aggregated turnover of less than \$50 million (base rate entities) will pay 27.5% tax, while companies with a higher turnover must pay 30% tax on all their taxable income.<sup>47</sup>

If the NSWEC's notional taxable income were less than \$50 million, we would apply the lower tax rate.

The tax allowance is one of the last building block items we calculate, due to its dependence on other items such as operating cost allowances and WACC parameters.

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<sup>42</sup> Land assets do not depreciate.

<sup>43</sup> IPART, *The incorporation of company tax in pricing determinations – Final Decision*, December 2011, p 5.

<sup>44</sup> While it does not appear that the NSWEC makes tax equivalent payments to Treasury, it is operating a fee-for-service business in a contestable market. For competitive neutrality reasons, the NSWEC's fees should include a tax component – in the same way that a private provider's fees include tax.

<sup>45</sup> Under a post-tax framework, the value of franking credits (gamma) enters the regulatory decision only through the estimate of the tax liability. Our current estimate of gamma is 0.25.

<sup>46</sup> For this purpose, taxable income is the NRR (excluding tax allowance) less operating cost allowances, tax depreciation, and interest expenses. As part of calculating the appropriate tax allowance, the business is required to provide forecast tax depreciation for the review period. Other items such as interest expenses are based on the parameters used for the WACC (the nominal cost of debt is the sum of the nominal risk free rate and nominal debt margin), and the value of the RAB.

<sup>47</sup> This rate will reduce to 26.0% in 2020-21 and 25.0% in 2021-22. *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017*.

## Working capital allowance

The working capital allowance recognises that a business may need to hold excess cash in order to fund its day-to-day activities,<sup>48</sup> and compensates the business for the economic holding costs of this cash.

We have recently reviewed our approach to setting the working capital allowance.<sup>49</sup> Our method for calculating the allowance involves two main steps. For each year of the review period, we will:

1. Calculate the net amount of working capital the business requires.
2. Calculate the return on this amount by multiplying it by the nominal post-tax WACC.<sup>50</sup>

To calculate the net amount of working capital the business requires, we use the following formula:

$$\text{Net working capital} = \text{receivables} - \text{payables} + \text{inventory} + \text{prepayments}$$

Where:

- ▼ Receivables means payments not yet received for goods and services already delivered.
- ▼ Payables means payments not yet made for goods and services already received.
- ▼ Inventory means goods held in stock by the business that are inputs into the production process and are necessary for it to meet its service obligations (eg, spare parts and other inputs).<sup>51</sup>
- ▼ Prepayments means payments made by the business in advance of receiving goods or services (eg, insurance premiums paid in advance).

Our method for establishing the key parameters used in calculating the working capital allowance are set out in Table 5.3 below.

**Table 5.3 Key parameters in calculating the working capital allowance**

Item	Method
Receivables, non-water businesses	Measured in days of total revenue on a case-by-case basis, guided by <ul style="list-style-type: none"><li>▼ Method for water businesses and</li><li>▼ Actual historical receivables where suitable information is available.</li></ul>
Payables	30 days of opex and net capex <sup>a</sup>
Inventory	Fixed real \$ amount, having regard to actual business practice and
Prepayments	Fixed real \$ amount for businesses that can reasonably demonstrate prudence and efficiency. Otherwise zero as a default.
Rate of return	Nominal post-tax WACC

<sup>a</sup> Net capex means capital expenditure net of cash capital contributions.

Source: IPART

<sup>48</sup> This can arise where there is a substantial timing difference between when expenditure occurs and when revenue is received.

<sup>49</sup> IPART, *Review of working capital allowance – Policy Paper*, November 2018.

<sup>50</sup> The WACC is discussed in Appendix B. For further information about how we calculate the WACC, see IPART, *Review of our WACC method, Final Report, Research*, February 2018.

<sup>51</sup> For regulated utilities inventory does not include goods held in stock for sale, eg, water held in a reservoir.

## 6 Allocate efficient costs between the State Government and councils

In the fourth step of our proposed approach, we will decide how to allocate the NSWEC's efficient costs of managing local government elections between the State Government and councils. To do this, we will consider:

- ▼ The classification of NSWEC's costs as either direct or indirect
- ▼ Our findings on the level of competition and efficiency of these costs (from steps two and three, as described in Chapters 4 and 5).

Our standard approach is to apply the impactor pays principle when allocating costs.<sup>52</sup> While this may be appropriate for direct costs, we need to consider the level of competition for election services when deciding on the best method for allocating indirect costs. We will also review the overall cost allocation, and consider where the total costs allocated to councils should lie on the range between a lower band (incremental costs) and upper bound (standalone costs).

Each of these matters is discussed below, including the issues on which we are seeking stakeholder comment.

### IPART seeks comments on the following

- 10 Do you agree that NSWEC's direct costs should be allocated between the State Government and councils using the impactor pays principle (ie, those that create the need for the cost to be incurred should pay the cost)?
- 11 Should NSWEC's indirect costs be allocated:
  - Using the impactor pays principle
  - With a focus on putting NSWEC on an even footing with private providers (ie, ensuring its indirect costs are allocated to councils where they would be incurred by an efficient competitor to the NSWEC), or
  - On some other basis (and if so, what)?
- 12 Do you consider the allocation of NSWEC's costs to councils should be made with reference to incremental costs (lower bound), standalone costs (upper bound), or somewhere in between this range?

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<sup>52</sup> Our preference for the impactor pays principle is consistent with our approach across a range of services, where we have generally adopted or promoted the following funding hierarchy:

1. Preferably, the party that created the need to incur the cost (the impactor) should pay in the first instance
2. If that is not possible, the party that benefits (the beneficiary) should pay. Further, it is preferable for direct beneficiaries to pay, but if that is not possible then indirect beneficiaries should pay. In some cases, the impactor and the beneficiary are the same
3. In cases where it is not feasible to charge either impactors or beneficiaries (for example, because of social welfare policy, public goods, externalities, or an administrative or legislative impracticality of charging), the government (taxpayers) should pay.

## 6.1 We will classify NSWEC's efficient costs as direct or indirect

After establishing the efficient costs of NSWEC's local government election services in step three (see Chapter 4), we plan to classify them as either 'direct' or 'indirect' costs.

- ▼ **Direct costs** are all the capital and operating costs incurred by NSWEC which are directly and exclusively traceable to managing council elections. They may include venue procurement, ballot paper printing and election staffing costs.
- ▼ The remaining costs are **indirect costs**. They include overheads (eg, administration or legal costs) and costs that are common to State and local government elections (eg, registration of voters on the electoral roll).

## 6.2 We propose to allocate direct costs using the impactor pays principles

Using the impactor pays principle for NSWEC's direct costs means they would be allocated between the State Government and councils on the basis of whichever party created the need to incur the cost.

We consider the impactor pays principle leads to efficient outcomes, as it signals to parties the full costs of providing services to them. This should mean they will only demand a service up to the level where the benefit they receive from the service exceeds (or is at least equal to) the costs incurred in supplying the service. That is, it should help to ensure services are not supplied at inefficiently high levels.<sup>53</sup>

Through councils engaging NSWEC to run their elections, this leads to it incurring direct costs. As councils are the impactors, they should pay these costs.

## 6.3 We plan to allocate indirect costs using a screening criteria and cost drivers

For each of NSWEC's indirect costs, we plan to initially screen whether they should be:

- ▼ Allocated 100% to the State Government
- ▼ Allocated 100% to councils or
- ▼ Have a different apportionment applied to them (ie, because they are joint or common costs).

Our criteria for this initial screening process may depend on the level of competition in the market – both now and in the future, as assessed in step two of our approach.

In a monopoly market, we may adopt the impactor pays principle to allocate NSWEC's indirect costs. As an example, NSWEC undertakes State-wide awareness campaigns to inform voters about the election and their voting options.<sup>54</sup> Under an impactor pays allocation, these costs could be allocated to councils, since engaging NSWEC has led to it incurring the awareness campaign costs.

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<sup>53</sup> That is, where the benefits parties derive from the services would be less than the costs incurred in supplying them.

<sup>54</sup> NSWEC, *2016-2017 Annual Report*, p 21.

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However, if there is the potential for effective competition, we need to ensure indirect cost are allocated between the State Government and councils in a competitively neutral way. Using the example above, the cost of an awareness campaign could be allocated to the State Government, depending on whether this service was viewed as ‘non-commercial’ in nature. That is, we would consider whether an efficient competitor would be likely to undertake the service as part of its arrangement to run a council’s election, and if not, allocate the cost to the State Government.

Through the initial screening process, we may establish that some indirect costs are joint or common to the State Government and councils. We will then identify relevant cost drivers and use them to apportion these costs. The cost drivers should have a cause-and-effect relationship with these indirect costs being incurred.

#### **6.4 We will consider upper and lower bounds for cost allocations to councils**

After applying these approaches to allocating direct and indirect cost, we will review the overall cost allocation between the State Government and councils. The total costs allocated to councils should lie within the following range:

- ▼ A lower bound representing the **incremental cost** of providing election services to councils. This represents the costs the NSWEC would avoid if it did not provide these services. Incremental costs are calculated as the sum of direct costs and incremental overheads.
- ▼ An upper bound representing the **standalone cost** of these services. These are the costs a new and efficient competitor would incur in providing only local government election services.

There are no common costs allocated to councils under an incremental cost approach.<sup>55</sup> Conversely, under the standalone costs approach, councils fund all costs of an efficient competitor. Therefore, the difference between these approaches reflects the level of common costs allocated to councils.

Only allocating incremental costs to councils lowers their share of election service costs, which minimises the financial burden on them. However, allocating standalone costs to councils may promote competition from private providers of these services.

We will determine where the total costs allocated to councils lie within this lower and upper bound range.

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<sup>55</sup> Incremental costs generally exclude any indirect costs that remain unchanged whether the election services is provided or not. Indirect costs such as some personnel functions, payroll administration and other overheads may be avoided if the service not be provided. However, other overheads or corporate services cannot be avoided, such as CEO salaries, billing and IT system costs.

## 7 Allocate share of costs across councils and assess the impact on stakeholders

The final two steps in our proposed approach for the review are to:

- ▼ Allocate the council-share of costs across councils
- ▼ Assess the impact of this cost allocation on stakeholders.

The sections below discuss how we propose to undertake these steps and the issues on which we are seeking stakeholder comment.

### IPART seeks comments on the following

- 13 How should indirect costs (eg, centralised locations for collating ballots ready for data entry and councils' share of the costs that are common to State and local government elections) be shared between councils? For example, should they be allocated on a 'per elector', or some other basis?
- 14 Are the costs involved in conducting elections substantially different for metropolitan, regional and rural councils? If yes, what are the drivers for those differences?
- 15 Do you agree with our proposed approach for assessing the impact of our recommendations on stakeholders? Are there any other issues we should consider?

### 7.1 We will allocate the council-share of costs between councils

Once we have the council-share of efficient costs (from step four), we need to allocate those costs between councils. This step will identify which costs should be charged to a council directly and which costs need to be shared between councils, and the basis upon which they should be shared.

When we set prices, our overarching principle is that prices should be cost-reflective. This means that prices should only recover sufficient revenue to cover the prudent and efficient costs of delivering the services. This sends an appropriate price signal to councils and encourages an efficient level of election service use and provision.

Prices should also avoid creating cross-subsidies. These occur where some individual councils pay less than the incremental costs of providing election services to them, and others pay more than the standalone costs of providing services to them.

The NSWEC currently recovers costs from the councils that engage it to conduct local government elections either:

- ▼ By direct allocation to an individual council
- ▼ On a per elector basis (ie, the amount a council pays depends on the number of electors in its area).<sup>56</sup>

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<sup>56</sup> PwC, *Calculation of NSW Electoral Commission service charge to local government*, October 2016.

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As a result of allocating some costs on a per elector basis, councils with a larger elector base contribute more to election costs than councils with a smaller elector base.

Adopting an impactor pays approach (ie, that the party who create the need to incur a cost pays that cost) suggests that we would charge direct costs directly to each council. This is cost-reflective and removes the potential for cross-subsidies.

To allocate the appropriate proportion of indirect costs to councils, we propose to identify a cost driver to isolate the costs that relate to providing local election services to an individual council. For example, we could split costs based on the following:

- ▼ The proportion of total direct costs incurred to service each council
- ▼ The number of electors in each council
- ▼ The number of candidates in each council
- ▼ The average number of electors per polling booth in each council
- ▼ Some other basis.

We invite stakeholder views on the appropriate cost drivers or approach for allocating indirect costs across councils.

## **7.2 We will assess the impact of this cost allocation on stakeholders**

We will consider how our proposed costing methodology impacts on various stakeholders, including:

- ▼ Small, medium and large councils
- ▼ Metropolitan, regional and rural councils
- ▼ Ratepayers in those councils.

The purpose of our review is to ensure a robust methodology for determining costs is applied, in order to minimise the financial burden on councils and ratepayers and ensure local government elections are conducted efficiently and cost effectively.

Under the NSWEC's current costing methodology, costs incurred in specific council areas are allocated to individual councils, and other costs are shared between councils based on elector numbers.<sup>57</sup> Our assessment of the council-share of costs may result in a different cost allocation outcome for councils. This is likely to affect small, medium and large councils in varying ways.


The NSWEC analysed per elector costs from the 2012 local government elections and noted differences in the cost of conducting elections for metropolitan, regional and rural councils. Metropolitan councils were the lowest cost to service at \$6.21 per elector, followed by regional and rural councils at \$6.53 per elector and \$7.30 per elector respectively.<sup>58</sup>

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<sup>57</sup> NSW Electoral Commission, *Report on the 2017 Local Government Elections*, p 21.

<sup>58</sup> NSW Electoral Commission. *Report on the 2012 Local Government Elections*, p 39.





We are interested in stakeholder views on whether the costs involved in conducting elections are substantially different for metropolitan, regional and rural councils, and the drivers for those differences.

Given that annual increases in councils' general incomes are constrained by the rate peg (with the exception of councils that apply for a special variation), we will need to assess the potential impact of our costing methodology on councils' budgets and ratepayers in those councils.

We will also consider the impact on the State Budget for those costs not recovered from councils.

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## A Terms of Reference



**Gladys Berejiklian MP**  
Premier of New South Wales

Ref: A2850418

7 FEB 2019

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

Dear Dr Boxall,

Please find enclosed terms of reference for the Tribunal to conduct a review of local government election costs pursuant to section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992*.

Yours faithfully,

**Gladys Berejiklian MP**  
Premier

## Terms of Reference – Costs of Conducting Local Government Elections

I, Gladys Berejiklian, Premier of New South Wales, under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992*, approve the provision of services by the Independent Pricing and Regulatory Tribunal (**IPART**) to the Minister for Local Government with respect to the costs of conducting local government elections, in accordance with the following terms of reference.

### Background

In NSW, local government elections are generally conducted every four years, on the second Saturday in September. The next ordinary elections for councils are scheduled to be held in September 2020.

Under Part 6 of the *Local Government Act 1993* (the **Act**), councils may arrange for the NSW Electoral Commissioner (**NSWEC**) to administer their election, or the council's general manager may administer the election on the council's behalf. In practice, where the general manager of a council administers its election, the council will generally engage a commercial electoral services provider to assist the general manager with the conduct of the election.

In recent times, the vast majority of councils have engaged the NSWEC to conduct their elections. For example:

- in 2016, the NSWEC conducted 75 ordinary elections for councils, and 5 councils' elections were administered by their general managers
- in 2017, the NSWEC conducted 46 ordinary elections for councils; and 1 council election was administered by its general manager.<sup>1</sup>

Councils are required to meet the costs of conducting their elections. That is the case irrespective of whether an election is administered by the NSWEC or by the council's general manager. NSWEC services required for local government elections, such as enrolment and non-voting services, are, however, provided by the NSWEC at no cost.

In the case of NSWEC administered council elections, the NSWEC provides councils with an estimate of costs in advance of the council's election, so that the council may determine whether to use the NSWEC to conduct its election. Where an election is administered by the NSWEC, the council will be invoiced for the costs of its election by the NSWEC.

Councils using the NSWEC are generally required to enter an arrangement with the NSWEC for the election well in advance of the election.<sup>2</sup> An arrangement can, however, be entered into at any time before the election if the council has resolved to enter the arrangement and the Electoral Commissioner is satisfied there are exceptional circumstances that make it necessary or desirable for the Electoral Commissioner to administer the election.<sup>3</sup>

The NSWEC uses a comprehensive costing model to identify and allocate its costs to the relevant councils. The NSWEC's costing model for the most recent ordinary elections for councils in 2017 is summarised in its Report on the Local Government Elections 2017 and extracted at **Schedule A**.

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<sup>1</sup> Local government elections were conducted in two tranches in 2016 and 2017.

<sup>2</sup> Section 296(3) of the Act provides that an election arrangement for the Electoral Commissioner to administer all elections of a council can be entered into if: (a) the council resolves at least 18 months before the next ordinary election that such an arrangement is to be entered into; and (b) the arrangement is entered into no later than 15 months before the next ordinary election.

<sup>3</sup> Section 296(5) of the Act.

## **Matters for consideration**

IPART is requested to provide a report to the Minister for Local Government recommending a costing methodology to be applied in determining the amount the NSWEC charges councils which use the NSWEC to administer their ordinary elections.

The purpose of the IPART's review is to ensure a robust methodology for determining costs is applied, in order to minimise the financial burden on councils and ratepayers and ensure local government elections are conducted efficiently and cost effectively.

In undertaking the review, IPART is to:

- review the NSWEC's existing methodology for determining the amount to be charged to councils which use the NSWEC to conduct their elections
- consider whether it is appropriate for the amount charged to be limited to the direct and unavoidable costs of conducting the council's election
- have regard to the market for electoral services in which the NSWEC operates
- have regard to any differences in the costs involved in conducting elections in metropolitan and regional areas
- have regard to any other matters it considers relevant.

## **Consultation**

IPART should consult with relevant stakeholders and NSW Government agencies as part of its review. It may also hold public hearings and publicly release a draft report.

## **Reporting**

IPART is to submit its final report to the Minister for Local Government by Friday 30 August 2019.

## **Schedule A – Extract from NSWEC Report on the Local Government Elections 2017<sup>4</sup>**

### **Financial and Funding Arrangements**

#### Funding of Local Government Elections

Councils are required to meet the costs of conducting their elections. While the NSW Government does not provide direct funding for local government elections, some NSWEC services required for local government elections, such as enrolment and nonvoting services, are provided by the NSWEC at no cost.

For the second tranche of 46 councils, whose elections were conducted on 9 September 2017, the NSWEC issued budget estimates totalling \$20.87 million. The actual expenditure came in under budget, at \$19.17 million.

The election management fee, which had been estimated at \$7.62 per elector, was delivered at \$7.01 an elector. We charged a total of \$1.914 million in fees, down from the \$1.919 million estimate issued to councils. Independent accounting firm PriceWaterhouseCoopers was engaged to conduct a review of the level of NSWEC overhead, as applicable to the delivery of the LGE event.

The NSW Government has provided the NSWEC with additional funding of \$17.0 million to assist in conducting the 2016 and 2017 local government elections. This funding reflected the additional costs incurred in conducting the elections in more than one tranche.

#### Council Costing Model for the 2017 Local Government Elections

The NSWEC undertook a comprehensive budget estimation process, identifying and calculating estimated costs for individual council expenses. The broad process for developing the budget for the 2017 Local Government Elections and individual council budgets involved five major stages.

All 2017 Local Government Elections projects and associated activities were identified and quantified.

The budget estimates were then developed, using a 'zero based' or 'bottom-up' budget methodology that involved itemising volume and unit costs for each project, the tasks for each month and identifying the financial years 2016/17 and 2017/18 which were impacted.

Those costs which could be attributed to the council amalgamations activity and effort associated were quantified and charged to the state government appropriation.

We then undertook substantive testing of these budget items and their estimated costs, using the most reliable cost schedule available that is the 2016 Local Government Elections.

Finally, we allocated the costs for each project to individual councils using the applicable methodology for the activity involved in each project. The methodologies applied were either:

- cost per elector
- actual costs incurred in specific council areas and/or
- allocation for Regional Returning Officer based on elector numbers.

This enabled equitable sharing of overheads applicable to all councils separately from costs specific to each council.

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<sup>4</sup> NSW Electoral Commission's *Report on the Local Government Elections 2017*, page 21. A copy of the report is available on the NSW Electoral Commission's website at [www.elections.nsw.gov.au/About-us/Reports/Election-reports](http://www.elections.nsw.gov.au/About-us/Reports/Election-reports)

## B Weighted Average Cost of Capital (WACC)

To determine the WACC, our current WACC methodology is:

1. Establish a WACC range and midpoint by:
  - a) Estimating a feasible range based on long-term average and a feasible range based on current market data
  - b) Using the midpoints of these two feasible ranges as the upper and lower bounds of the WACC range
  - c) Using the average of the upper and lower bounds as the midpoint of the WACC range.
2. Choose a WACC point estimate from within the final WACC range based on our WACC decision rule. Our default position is to select the midpoint. However, we consider whether it is appropriate to choose a point other than the midpoint having regard to the level of economic uncertainty.

We use our uncertainty index<sup>59</sup> as a measure of economic uncertainty, and select the midpoint if the uncertainty index is within or at one standard deviation from the long-term average of zero. If the uncertainty index is more than one standard deviation from the long-term average of zero, we consider selecting a point other than the midpoint within our final WACC range.

We established this framework as part of our review of the WACC methodology in 2013 and made several changes regarding how we estimate the cost of debt and expected rate of inflation in our 2017 review.<sup>60</sup> We publish biannual market updates in February and August, which show our estimated WACC ranges for the industries we regulate such as water, transport and retail gas. We also publish a spreadsheet containing our WACC calculations.<sup>61</sup>

### B.1 Calculating the real post-tax WACC

We use a real post-tax WACC to estimate the allowance for a return on capital and incorporate tax directly as a separate cost building block in the revenue requirement.

We estimate the post-tax WACC using the following formula:

$$WACC = E(R_d) \times \frac{D}{V} + E(R_e) \times \frac{E}{V}$$

where:

- ▼  $E(R_d)$  is the expected cost of debt,
- ▼  $E(R_e)$  is the expected cost of equity, and

<sup>59</sup> [http://www.ipart.nsw.gov.au/Home/Industries/Research/Reviews/WACC/Uncertainty\\_Index\\_Model](http://www.ipart.nsw.gov.au/Home/Industries/Research/Reviews/WACC/Uncertainty_Index_Model) accessed on 28 February 2019.

<sup>60</sup> IPART, Review of our WACC method – Final Report, February 2018.

<sup>61</sup> <https://www.ipart.nsw.gov.au/Home/Industries/Special-Reviews/Regulatory-policy/WACC> accessed on 28 February 2019.

- ▼  $\frac{D}{V}$  and  $\frac{E}{V}$  are the proportions of debt and equity in the entity's capital structure, respectively.  $\frac{D}{V}$  is referred to as a "gearing ratio".

We adjust the resulting post-tax WACC for expected inflation to obtain the real post-tax WACC.

## B.2 Calculating the cost of debt

The cost of debt is the rate that a business is expected to pay debt holders to fund its assets through debt financing, and is calculated as follows:

$$E(R_d) = R_f + \text{Debt margin}$$

where:

- ▼  $R_f$  is the risk-free rate, which is the rate of return an investor would require on a risk-free investment, and
- ▼ *Debt margin* is the compensation above the risk-free rate required by debt holders for credit, liquidity and maturity risks.

We apply a target term-to-maturity of 10 years and a BBB credit rating. Our cost of debt includes a debt raising cost allowance of 12.5 basis points.

## B.3 Calculating the cost of equity

The cost of equity is the rate of return required by shareholders on an equity investment. We estimate the expected cost of equity using the following Capital Asset Pricing Model:

$$E(R_e) = R_f + \beta_e \times MRP$$

where:

- ▼  $R_f$  is the risk-free rate as described above,
- ▼  $\beta_e$  is the beta of a stock  $e$ , and
- ▼ *MRP* is the market risk premium, which is expected rate of return over the risk-free rate that investors would require for investing in the market portfolio.

We estimate ranges for the expected cost of equity using current market data and long-term averages. As set out below, we will review and determine the value of the equity beta for a business such as the NSWEC as part of our review.



## B.4 Market-based and industry-specific parameters

The parameters underlying the WACC calculation can be grouped into two categories:

- ▼ **Market-based parameters**, which include risk-free rate, debt margin, inflation rate and MRP. These parameters are common to businesses in all industries.
- ▼ **Industry-specific parameters**, which include equity beta and gearing ratio. These parameters are specific to the business's particular industry.

### B.4.1 Estimating the market-based parameters

#### Risk free rate

The risk-free rate is used as a point of reference in determining both the cost of equity and the cost of debt within the WACC. It is used as a base rate to which an equity or debt risk premium is added to reflect the riskiness of the specific business for which the rate of return is being derived.

In line with our updated WACC methodology, we will use the 10-year Commonwealth Government Security yields published by the RBA and estimate the historic risk-free rate as a 10-year trailing average and the current risk free-rate as a short-term trailing average with the length of this term matching the regulatory period.

#### Debt margin

The debt margin represents the cost of debt a company has to pay above the nominal risk-free rate.

In line with our WACC methodology, we will use the 10-year corporate bonds rated as BBB, and estimate the historic debt margin as a 10-year trailing average and the current debt margin as a short-term trailing average with the length of this term matching the regulatory period.


#### Inflation rate

The inflation rate is used to convert the nominal post-tax WACC into a real post-tax WACC. We use the expected rate of inflation over the regulatory period. For this parameter we will use a 10-year geometric average of the 1-year RBA inflation forecast and the middle of the RBA's target band of inflation (currently at 2.5%) for the remaining years of the regulatory period.

#### Market risk premium

The market risk premium (MRP) is the expected rate of return over the risk-free rate that investors would require for investing in a market portfolio. The MRP is an expected return and is not directly observable. Therefore, it needs to be estimated through proxies. In line with our WACC methodology, we will use both current market data and long-term averages. For the:

- ▼ **Current market data:** we will establish an MRP range using our six MRP methodologies to estimate the cost of equity

- 
- ▼ Long-term averages: we will use an MRP range of 5.5% to 6.5% with a midpoint of 6.0%, based on the historical arithmetic average of the excess market return over the risk-free rate, to estimate the cost of equity.

## **B.4.2 Estimating industry-specific parameters**

### **Equity beta**

The equity beta measures the extent to which the return of a particular security varies in line with the overall return of the market. It represents the systematic risk of a security that cannot be avoided by holding it as part of a diversified portfolio. The equity beta does not take into account business-specific or diversifiable risks.

In each price review we conduct, we determine the value of the equity beta for the relevant business. We do this by estimating the equity betas of (listed) comparable firms, and considering the equity betas that other regulators have applied to comparable businesses (where relevant).

### **Gearing ratio**

The gearing ratio is the proportion of debt to total assets in the business's capital structure. Regulators commonly adopt a benchmark, efficient capital structure rather than the actual capital structure of the business, to ensure that customers do not bear the costs associated with an inefficient capital structure.

Similar to our proposed approach for determining the equity beta, we propose to estimate the gearing ratios by considering gearing ratios of comparable businesses.