



Independent Pricing and Regulatory Tribunal

Local Government Rate Peg 2014/15

Local Government — Information Paper
December 2013

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The Tribunal members for this review are:

Dr Peter J. Boxall AO, Chairman

Mr Simon Draper, Part Time Member

Dr Paul Paterson, Part Time Member

Inquiries regarding this document should be directed to a staff member:

Kumi Cuthbertson (02) 9290 8479

Michael Seery (02) 9290 8421

Alison Milne (02) 9290 8443

Independent Pricing and Regulatory Tribunal of New South Wales

PO Box Q290, QVB Post Office NSW 1230

Level 8, 1 Market Street, Sydney NSW 2000

T (02) 9290 8400 F (02) 9290 2061

www.ipart.nsw.gov.au

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1 Executive summary

The Independent Pricing and Regulatory Tribunal (IPART) is responsible for setting the rate peg each year. For 2014/15, we have set the rate peg at 2.3%.

The rate peg determines the maximum allowable percentage increase in general income for most local councils in NSW for 2014/15. Only councils with a special variation for 2014/15 may increase rates by more than the rate peg.¹

We calculated an underlying rate peg of 2.6% using the Local Government Cost Index and deducting a productivity factor. We then deducted 0.3% to adjust for the remainder of the carbon price advance that was already included in the 2012/13 rate peg.

This information paper describes how we calculated the rate peg for 2014/15.

1.1 The components of the 2014/15 rate peg

Under the terms of reference from the Premier, IPART is required to have regard to a Local Government Cost Index (LGCI) and a productivity factor when setting the rate peg.

We calculated the rate peg for 2014/15 as follows:

- ▼ we took the increase in the LGCI for the year to September 2013 of 2.8%, and
- ▼ deducted from it a productivity factor of 0.2%.

This results in an underlying rate peg of 2.6% in 2014/15. We then deducted 0.3% to adjust for the remainder of the carbon price advance that was brought forward into the 2012/13 rate peg.

The underlying rate peg of 2.6% for 2014/15 mainly reflects low inflation and low public sector wages growth in the year to September.

Table 1.1 shows the components of the 2014/15 rate peg.

¹ Under the *Local Government Act 1993*, councils may seek approval to increase their general income by more than the rate peg by applying to IPART for a 'special rate variation'. Currently there are 11 councils that may increase their rates by more than the rate peg amount in 2014/15. Other councils may apply for a special rate variation to take effect from 1 July 2014.

Table 1.1 The 2014/15 rate peg and its components

| Component | Percentage change |
|---|--------------------------|
| Local Government Cost Index (LGCI) | 2.81 |
| Less Productivity factor | -0.20 |
| Underlying rate peg (LGCI less productivity factor) | 2.61 |
| Underlying rate peg (rounded to one decimal place) | 2.6 |
| Less adjustment for earlier carbon price advance | -0.3 |
| Rate peg | 2.3 |

In the remainder of this paper we explain the main components of the 2014/15 rate peg in more detail. In section 2 we highlight the principal features of the LGCI and its increase in the year to September 2013. Then we explain how we determined the productivity factor in section 3 and discuss the second and final adjustment of the carbon price advance in section 4.

2 The rate peg and the LGCI

2.1 What is the rate peg?

Rate pegging is a policy in NSW which limits the allowable increase in councils' 'general income'. General income mainly comprises rates revenue, but also includes certain annual user charges. It excludes stormwater and waste charges, and water and sewerage charges.

The rate peg determines the maximum percentage by which a council may increase its general income in a particular financial year, unless the council has obtained approval for a special variation.

IPART sets the rate peg and approves special variations under a delegation from the Minister for Local Government.² In setting the rate peg, we use a local government cost index and deduct a productivity factor to ensure that councils share efficiency gains with ratepayers.

² Councils with a need for rate increases that exceed the rate peg may apply to IPART for a special variation. For details, see our website at <http://www.ipart.nsw.gov.au>.

2.2 What is the LGCI?

The LGCI is the chief component of the rate peg. It is a measure of the annual average change in the prices paid for inputs for ordinary council activities that are funded, in part, from general rate revenue.

The LGCI measures the average change in the prices of a fixed 'basket' of goods and services purchased by councils. The basket of goods and services we use is based on a survey of NSW councils' expenditure, undertaken in 2010.³

We calculated the LGCI using price data from the ABS for the year to the September quarter 2013, compared with the year to the September quarter 2012. This is the latest published ABS data available to us when setting the rate peg.

Table 2.1 shows for each item in the index, its weighting, the change in price for the year to September 2013 and its contribution to the LGCI. The overall change in the LGCI over the year to September quarter 2013 was an increase of 2.81%. The main contributors to this increase were:

- ▼ A 2.6% increase in employee benefits and on-costs, measured by the ABS wage price index for the NSW public sector.
- ▼ A 3.2% increase in construction costs for works, measured by the ABS producer price series for Road and Bridge Construction in NSW.
- ▼ A 14.9% increase in electricity prices, most of which occurred in the September quarter 2012. The increase reflects the impact of the carbon price and higher regulated network charges. Our recent retail electricity price determination foreshadowed moderate price increases on 1 July 2013 and 2014, which will be captured in the ABS measures used in next year's rate peg decision.⁴
- ▼ A 10.5% increase in insurance costs reflecting in part the impact of the NSW and Victorian bushfires and the Queensland floods.

The Emergency Services Levy - for which we construct our own price index (as explained in Appendix B) - increased by 0.3%, which had no measurable effect on the LGCI this year.

³ The survey collected information on actual council expenditure in 2008/09 and 2009/10. For more information, see *Local Government Cost Index - Information Paper*, December 2010, p 24.

⁴ See IPART, *Final Report - Review of Regulated Retail Prices for Electricity - From 1 July 2013 to 30 June 2016*, p 2.

Table 2.1 Calculating the rise in LGCI for the year ended September 2013

| Cost items | Effective weights as at end Sep 2012 (%) | Price change to end Sep 2013 (% annual average) | Contribution to index change (percentage points) |
|--|---|--|---|
| Operating costs | | | |
| Employee benefits and on-costs | 41.8 | 2.6 | 1.10 |
| Plant & equipment leasing | 0.4 | -2.4 | -0.01 |
| Operating contracts | 1.3 | 1.0 | 0.01 |
| Legal & accounting services | 1.1 | 4.2 | 0.05 |
| Office & building cleaning services | 0.2 | 2.7 | 0.01 |
| Other business services | 5.9 | 1.5 | 0.09 |
| Insurance | 1.8 | 10.5 | 0.19 |
| Telecommunications, telephone & internet services | 0.5 | 1.7 | 0.01 |
| Printing publishing & advertising | 0.5 | -4.1 | -0.02 |
| Motor vehicle parts | 0.5 | 0.6 | 0.00 |
| Motor vehicle repairs & servicing | 0.7 | 3.7 | 0.03 |
| Automotive fuel | 1.2 | 1.5 | 0.02 |
| Electricity | 3.4 | 14.9 | 0.50 |
| Gas | 0.1 | 13.4 | 0.01 |
| Water & sewerage | 0.5 | 1.4 | 0.01 |
| Road, footpath, kerbing, bridge & drain building materials | 3.1 | 3.2 | 0.10 |
| Other building & construction materials | 0.8 | 0.0 | 0.00 |
| Office supplies | 0.4 | -2.0 | -0.01 |
| Emergency services levies | 1.4 | 0.3 | 0.00 |
| Other expenses ^a | 8.6 | 2.5 | 0.21 |
| Capital costs | | | |
| Buildings – non-dwelling | 6.3 | 0.1 | 0.00 |
| Construction works - road, drains, footpaths, kerbing, bridges | 13.8 | 3.2 | 0.44 |
| Construction works - other | 1.4 | 3.2 | 0.04 |
| Plant & equipment – machinery | 3.8 | 1.3 | 0.05 |
| Plant & equipment – furniture etc | 0.2 | 0.7 | 0.00 |
| Information technology & software | 0.3 | -8.1 | -0.02 |
| Total change in LGCI | 100.0 | | 2.81 |

^a Includes miscellaneous expenses with low weights in the Index, eg, councillor and mayoral fees.

Notes: Figures may not add due to rounding. Percentage changes are calculated from unrounded numbers.

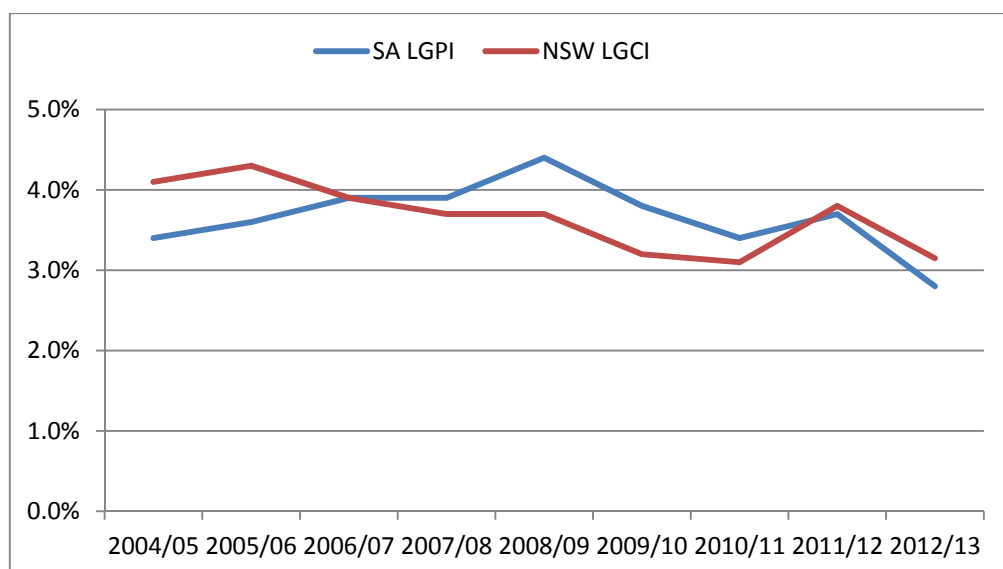
2.3 Comparing the rise in the LGCI with inflation and other relevant indices

The design of the LGCI is similar to the design of the Consumer Price Index (CPI) and the South Australian Local Government Price Index (SA LGPI). But they each measure the average price change of a different basket of goods and services: therefore their annual rates of change will be different.

The CPI 'basket' is based on the spending patterns of households in Australia's capital cities. The LGCI 'basket' is based on the spending patterns of NSW councils. The South Australian LGPI measures a similar basket for South Australian councils.

Figure 2.1 shows the annual percentage changes in the NSW and SA council cost indices since 2004/05. The indices are not identical, but they are both based on a representative range of council costs and can therefore be expected to move more consistently over time than indices that rely on only 1 or 2 price series. Over the 9 years to 2012/13, the average annual rise in both indices has been around 3.7%

Figure 2.1 Annual average changes in local government cost indices in NSW and SA, years to end-June 2013

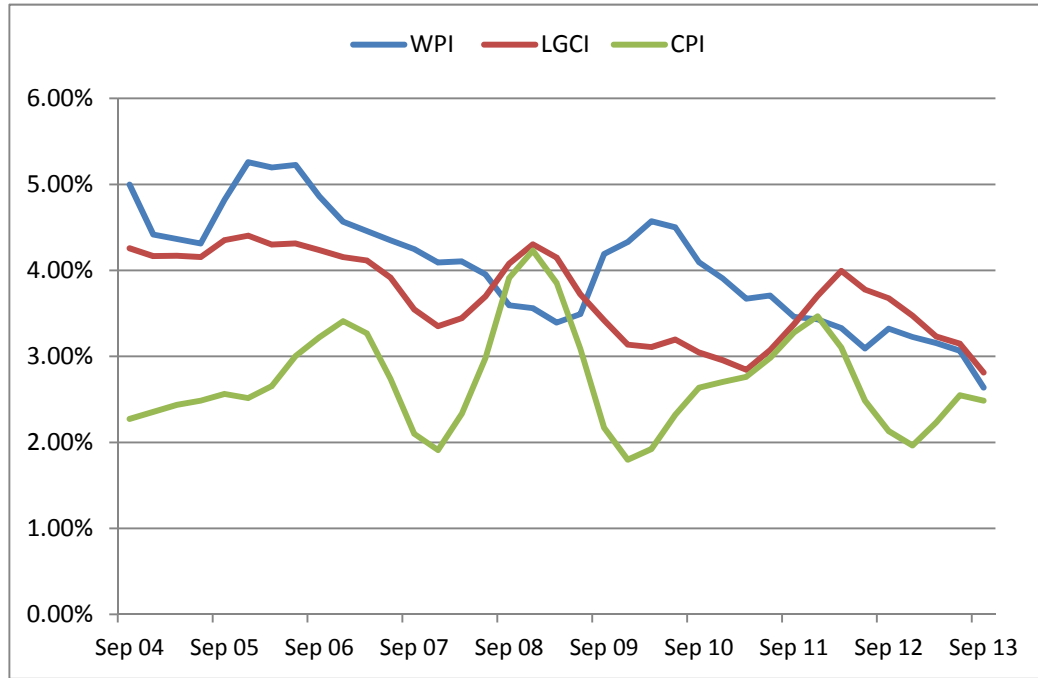


Note: To aid comparison we have measured the changes in both indices in financial years.

Sources: IPART and www.adelaide.edu.au/saces/economy/lgpi/.

Figure 2.2 shows the increases in the LGCI, CPI and the NSW public sector Wage Price Index (WPI). For the year to September 2013, the annual average increase in the Sydney CPI was 2.5% compared with a 2.8% rise in the LGCI.

Figure 2.2 Rolling annual change for each quarter for the LGCI, WPI and CPI



Source: ABS, various data release for consumer, producer and labour prices; and IPART.

Annual increases in the LGCI have usually been higher than the increases in the Sydney CPI because the LGCI includes labour costs, and these generally rise faster than inflation.

Over the past 5 years, the average annual increase in the WPI has been 3.5%. Over the same 5 years, the average annual increase in the LGCI was 3.3% and, in the Sydney CPI, it was 2.5%.

2.4 Comparing the historical LGCI and rate peg with CPI levels

Table 2.2 compares the rate peg (and its adjustments) with the actual annual increases that have occurred in the Sydney CPI since 2008/09. The rate peg is usually higher than the annual increase in consumer prices.

Table 2.2 Historical increases in the LGCI, rate peg and the CPI

| Year | LGCI ^a | Productivity factor | Underlying Rate Peg | CPA | Rate Peg | CPI ^b |
|----------------------|-------------------|---------------------|---------------------|------|----------|------------------|
| 2008/09 ^c | na | | na | | 3.2 | 3.1 |
| 2009/10 ^c | na | | na | | 3.5 | 2.3 |
| 2010/11 ^c | na | | na | | 2.6 | 3.0 |
| 2011/12 | 3.0 | -0.2 | na | | 2.8 | 2.5 |
| 2012/13 | 3.4 | -0.2 | 3.2 | +0.4 | 3.6 | 2.5 |
| 2013/14 | 3.7 | -0.2 | 3.5 | -0.1 | 3.4 | na |
| 2014/15 | 2.8 | -0.2 | 2.6 | -0.3 | 2.3 | na |

^a Calculated as the rise in the year to the September quarter in the year prior to the rate peg year. For example, for 2011/12 the LGCI rose 3.0% in the year to September 2011 and the rate peg for 2011/12 was 2.8%.

^b The CPI is the actual CPI as measured by the ABS for the year ended June.

^c Prior to 2011/12, the rate peg was set by the Minister of Local Government on advice from the Department of Local Government (DLG) and NSW Treasury. The LGCI was first used when IPART set the 2011/12 rate peg.

2.5 What the LGCI does not measure

The LGCI measures the average change in prices for a basket of inputs that councils purchase. The LGCI does not measure the following factors, which are important to individual councils:

- ▼ the effect of cost and price changes on an individual council's expenditure pattern, because the weights in the LGCI reflect the average spending pattern across all NSW councils
- ▼ local price impacts eg, competition with local mining companies may cause higher wages for certain staff, or natural disasters may lift local building material prices
- ▼ the effects of population growth
- ▼ any council or community desires to increase the quality of existing services or provide new services or increase expenditure on infrastructure renewal.

2.6 Re-examining the price series used in the LGCI

During 2013 we re-examined the ABS price indices we used last year to ensure that they remain the most relevant in relation to movements in council cost items. We did not find any published price series to be more suitable than those we used last year and have therefore retained the same series listed in Appendix A.

We intend to survey councils and undertake a comprehensive review of the LGCI in late 2014.

3 The productivity factor

The rate peg includes a productivity factor to allow ratepayers to share the efficiency gains made by councils. The productivity factor of 0.2% has not changed in recent years.

We have determined a productivity factor of 0.2% for 2014/15. As explained in section 3.2 below, the productivity factor has been informed by the long-term average of multifactor productivity in the market sector and a consideration of specific factors affecting local government.

The following sections outline the rationale for including a productivity factor in the rate peg and explain how we set the productivity factor for 2014/15.

3.1 Rationale for a productivity factor

IPART's terms of reference from the Premier require us to have regard to the LGCI and a productivity factor when setting the rate peg. This follows from a recommendation we made in our 2009 report, *Revenue Framework for Local Government*, that the rate peg should allow ratepayers to share in the efficiency gains made by their councils, since this is what happens in competitive markets.

In market-oriented sectors of the economy, the pressures of competition usually provide sufficient incentive for a business to share any potential productivity (or efficiency) improvements with consumers through lower prices.

As local councils have suggested, they seek to make, and do make, efficiency and productivity gains over time, as do other sectors of the economy. Such gains may come from various sources, such as higher educational and skills levels of council staff and contractors, or from improved technology that is built into the latest capital equipment.

Evidence from other sectors of the economy shows that productivity improvements tend to occur over time. However, a rise in the LGCI makes no allowance for the higher productivity that result as councils make more efficient use of their inputs. We therefore take account of both economy-wide productivity trends as well as specific factors affecting local government when we determine an appropriate productivity factor for local government.

3.2 How is the size of the productivity factor determined?

This year we have maintained the productivity factor for local government at 0.2%. This is the same productivity factor we applied to the 2013/14 rate peg.

Last year we derived a benchmark productivity factor across all the industry sectors that we regulate using a cost index of inputs.⁵ This productivity factor focused on *multifactor* rather than *labour* productivity and took industry-specific factors into account.

We took the long-term annual average increase in the ABS measure of aggregate gross output market-sector multifactor productivity. Based on a 15-year annual average rise, we calculated a benchmark productivity factor of 0.3%.⁶ We then considered factors that are specific to the industry and discounted the productivity factor that we applied to local government to 0.2%.⁷

The ABS no longer publishes the measure of aggregate gross output market-sector multifactor productivity. We will therefore review the methodology for determining a benchmark productivity factor during 2014.

4 Final adjustment of the carbon price advance

The introduction of a carbon price from 1 July 2012 affected the prices that local councils paid for some of their inputs. Because the LGCI is a lagged index, the 2012/13 rate peg did not reflect the introduction of the carbon price. Therefore, we included a carbon price advance in the 2012/13 rate peg of 0.4% to assist councils to meet higher prices arising from its introduction.

Our decision to include a carbon price advance in the 2012/13 rate peg was an exception to our practice of basing the LGCI on past, known increases in prices. We decided to provide councils with additional cash flow in the 2012/13 rate peg to help them meet the higher expenditure as a result of the carbon price.

At the time of setting the 2012/13 rate peg we announced that the carbon price advance would be reversed once the effect of the carbon price started flowing through to prices used in the LGCI. We would be double-counting the effect of the introduction of the carbon price if we did not adjust in later years for the advance given in the 2012/13 rate peg.

⁵ For a detailed explanation of the methodology see IPART, *Adjusting Industry Cost Indices to Share Productivity Gains with Customers*, October 2012, available on the IPART website at <http://www.ipart.nsw.gov.au>.

⁶ Source: ABS Cat no. 5260.0.55.002 *Experimental Estimates of Industry Multifactor Productivity, Australia: Detailed Productivity Estimates*, 7 December 2011, Table 15.

⁷ IPART, *2013/14 Rate Peg, Local Government - Information Paper*, November 2012, pp 8-9.

We have adjusted for the carbon price advance in 2 steps. In accordance with our announcement, the first adjustment of 0.1% occurred last year in the 2013/14 rate peg. The second and final adjustment of 0.3% is included this year in the 2014/15 rate peg.⁸

4.1 Repeal of the carbon price

The newly elected Australian Government has introduced legislation into Parliament to repeal the current carbon price.⁹ If the carbon price were to be abolished from 1 July 2014, the lagged nature of the LGCI means that any effect on prices of goods and services of the abolition would be captured in the 2015/16 rate peg at the earliest.

As noted in the previous section, in 2012/13 we included an additional increase of 0.4% in anticipation of the carbon price. This effectively brought forward councils' ability to pay for the increased costs. It meant that councils were not out of pocket during the time lag between the carbon price being introduced and its effects being captured in the LGCI. We have adjusted for this 0.4% advance over 2 years as the effects of the carbon price flows through to the calculation of the rate peg.

This approach has added additional complexity over a number of years which has not always been well understood by stakeholders.

In the event of the carbon price being repealed by the Government, we have decided to allow the price effects to be reflected in the calculation of the rate peg in the normal way. That is, over time, price effects will be captured in the calculation of the LGCI and flow through to the rate peg in the same way as any other changes in prices.

⁸ For more detail, see IPART, *Rate Peg 2012/13 – Information Paper*, December 2011. The LGCI does not capture the effect on council costs of the rise in prices for fuel used in non-transport and off-road transport. This effect was too small to alter the size of the first CPA withdrawal.

⁹ The Australian Government introduced the Clean Energy Legislation (Carbon Tax Repeal) Bill 2013 into Parliament on 13 November 2013.



Appendices

A Component Price Indexes

Table A.1 LGCI cost items and the price indexes that measure their changes

| Recurrent cost items | Component price indexes^a |
|---|---|
| Employee benefits and on-costs | WPI - Public sector, NSW |
| Plant & equipment leasing (excluding waste management) | PPI - 663 Other goods & equipment rental and hiring |
| Operating contracts (excluding waste management) | PPI - 729 Other administrative services |
| Legal & accounting services | PPI - 693 Legal & accounting services |
| Office & building cleaning services | PPI - 7311 Building & other industrial cleaning services |
| Other business services | PPI - 7299 Other administrative services n e c |
| Insurance | CPI - Insurance Services, Sydney |
| Telecommunications, telephone & internet services | CPI - Telecommunications, Sydney |
| Printing publishing & advertising | PPI - 16 Printing (including reproduction of recorded media) |
| Motor vehicle parts | CPI - Spare parts and accessories for motor vehicles, Sydney |
| Motor vehicle repairs & servicing | CPI - Maintenance and repair of motor vehicles, Sydney |
| Automotive fuel | CPI - Automotive fuel, Sydney |
| Electricity | CPI - Electricity, Sydney |
| Gas | CPI - Gas & other household fuels, Sydney |
| Water & Sewerage | CPI - Water & sewerage - Sydney |
| Road, footpath, kerbing, bridge & drain building materials | PPI - 3101 Road & bridge construction, NSW |
| Other building & construction mats | PPI - 3020 Non-residential building construction, NSW |
| Office supplies | CPI - Audio, visual & computer media & services, Sydney |
| Emergency services levies | IPART index of council ESL per rateable property |
| Other expenses | CPI - All groups, Sydney |
| Capital cost items | |
| Buildings – non-dwelling | PPI - 3020 Non-residential building construction, NSW |
| Construction works - road, drains, footpaths, kerbing, bridges | PPI - 3101 Road & bridge construction, NSW |
| Construction works - other | PPI - 3101 Road & bridge construction, NSW |
| Plant & equipment – machinery | PPI - 231 Motor vehicle & motor vehicle part manufacturing |
| Plant & equipment – furniture etc | PPI 24 Machinery & equipment manufacturing |
| Information technology & software | CPI - Audio, visual & computer equipment & services, Sydney |

^a Detailed data sources are set out in IPART, *Local Government Cost Index – Information Paper*, December 2010. 'WPI' = ABS Wage Price Index, 'PPI' = Producer Price Index and 'CPI' = Consumer Price Index.

B Emergency Services Levies

The local government sector, the insurance industry and the state government contribute to the cost of maintaining the 3 emergency service agencies: Fire & Rescue NSW, the Rural Fire Service and the State Emergency Service. The statutory contributions are called 'emergency services levies' (ESL).

Of the total cost of running the emergency services, the insurance industry funds 73.7%, NSW local councils 11.7% and the state government funds the balance.

There is no ABS price series that estimates the cost movements in this sector, so we have used the change in the ESL rate paid by councils per rateable property to calculate a price series for use in the LGCI.

To estimate the ESL per rateable property payable by councils in NSW, we divide the total ESL payable by councils (data supplied by NSW Treasury) by the number of rateable properties (data supplied by DLG) to derive an 'effective rate of council ESL'. For the latest year, we use Treasury's budget estimates for the councils' share of the cost of providing emergency services and reasonable estimates about the growth in the number of rateable properties.

Table B.1 estimates the average council ESL per property over the past 5 years.

Table B.1 Percentage change in the effective rate of the council ESL

| | 2009/10 | 2010/11 | 2011/12 | 2012/13 | 2013/14 ^a |
|---|-------------|--------------|--------------|--------------|----------------------|
| NSW rateable properties | 2,906,613 | 2,932,273 | 2,948,744 | 2,965,215 | 2,996,650 |
| Council contributions to: | | | | | |
| Fire & Rescue NSW (\$m) | 64.0 | 69.6 | 69.9 | 68.9 | 70.5 |
| Rural Fire Service (\$m) | 23.5 | 29.7 | 31.8 | 30.5 | 33.3 |
| SES (\$m) | 5.5 | 7.0 | 7.5 | 9.5 | 10.0 |
| Total contributions (\$m) | 93.1 | 106.2 | 109.1 | 109.0 | 113.7 |
| Effective rate of council ESL (contribution per property) (\$) | 32.0 | 36.2 | 37.0 | 36.8 | 37.9 |
| Change in effective rate of council ESL (%) | -0.7 | 13.2 | 2.1 | -0.7 | 3.2 |

a. The latest year of councils' ESL contributions are based on Treasury budget estimates. The number of rateable properties is extrapolated by 0.6% using their actual growth rate in 2012/13.

Notes: Numbers may not add due to rounding.

Source: NSW Treasury, DLG and IPART calculations.