Submission No 88

INQUIRY INTO ABILITY OF LOCAL GOVERNMENTS TO FUND INFRASTRUCTURE AND SERVICES

Organisation: Independent Pricing and Regulatory Tribunal NSW (IPART)

Date Received: 26 April 2024

IPART Independent Pricing and Regulatory Tribunal | NSW

26 April 2024

The Hon. Emily Jane Suvaal, MLC
Chair, Standing Committee on State Development
Parliament House
Macquarie Street
Sydney, NSW, 2000

via inquiry submission portal

Dear Ms Suvaal,

2024 Standing Committee on State Development Inquiry – Ability of local governments to fund infrastructure and services

Thank you for the opportunity to provide a submission to the Standing Committee on State Development's Inquiry into the ability of local governments to fund infrastructure and services.

IPART's submission aims to provide some useful background on IPART's functions that are relevant to local government, including setting the rate peg, assessing special variations and minimum rates applications, and making recommendations on contributions plans where councils propose to levy developer contributions above a maximum threshold. It also sets out additional IPART resources and information that may be relevant to the Inquiry and its Terms of Reference.

I would be pleased to provide any further information that will assist the Standing Committee in this important Inquiry.

If you would like further information or to discuss this matter, please don't hesitate to get in touch with me

Yours sincerely,

26/04/2024

Carmel Donnelly PSM
Chair

Submission to Inquiry – Ability of local governments to fund infrastructure and services

April 2024

Local Government »

Acknowledgment of Country

IPART acknowledges the Traditional Custodians of the lands where we work and live. We pay respect to Elders both past and present.

We recognise the unique cultural and spiritual relationship and celebrate the contributions of First Nations peoples.

Tribunal Members

The Tribunal members for this review are:

Carmel Donnelly PSM, Chair
Jonathan Coppel
Mike Smart

The Independent Pricing and Regulatory Tribunal

IPART's independence is underpinned by an Act of Parliament. Further information on IPART can be obtained from IPART's website.

Contents

1 About IPART and its role in local government

The Independent Pricing and Regulatory Tribunal (IPART) appreciates the opportunity to provide a submission to the Standing Committee on State Development's Inquiry into the ability of local governments to fund infrastructure and services (the Inquiry). We consider this important inquiry could provide positive outcomes for councils, ratepayers and communities and we would be pleased to assist the Standing Committee with any further information that would be helpful.

IPART's submission aims to provide some useful background on IPART's role in setting the rate peg, assessing special variations and minimum rate increase applications, assessing contributions plans[a] and other work related to local government. It also sets out additional comments relevant to the Terms of Reference and some IPART resources and information that may be relevant to the Inquiry.

IPART was established under the *Independent Pricing and Regulatory Tribunal Act 1992*. IPART is an independent, strategic agency of the NSW Government, charged with regulating key markets and government services, and providing advice, to ensure effective social, environmental, and economic outcomes for the people of NSW.

IPART has statutory and commissioned roles across the water, energy and transport sectors, local government, human services and other areas such as the NSW biodiversity credits market. IPART helps the people of NSW get value for money through licensing, price setting and monitoring of essential services, as well as industry and market sector reviews and investigations.

IPART operates independently of the government. When making decisions and recommendations, IPART considers how best to protect consumers from unreasonable price increases, improve service provider efficiency and service quality, encourage competition, protect the environment and regulated service provider financially viability.

IPART's role in local government forms part of the broader legislative and policy framework for NSW councils set out in the *Local Government Act 1993* and other legislation, regulations, guidelines and policies. IPART's role in local government relates to:

- the rate peg
- special variations and minimum rates
- local infrastructure contribution plans
- other work and investigations we are asked to undertake (e.g. the recent 2022-23 review of the rate peg methodology).

Last year, IPART published observations that some councils are facing financial sustainability challenges and the Tribunal recommended that an independent review of the financial model for councils be undertaken.[1] We welcome the opportunity to assist the Standing Committee by providing information relevant to this important Inquiry.

[a] Where a council is proposing to levy developer contributions above the maximum cap.

1.1 The rate peg

Councils set and levy rates (and other charges) in accordance with the *Local Government Act 1993* and the rating system it establishes. Within this system, councils set the rating structure and determine the rate levels for each rating category. The total income they can raise through these rates is regulated in several ways – one of which is the local government rate peg (rate peg) which was first introduced in NSW in 1977.[2]

IPART currently sets the rate peg as the delegate of the Minister for Local Government and has done so since 2010. The rate peg represents the maximum amount in percentage terms by which councils may increase their rates income in a year. This means councils can increase their rates income by an amount up to this percentage.[b,3]

However, councils ultimately have discretion when setting rates as to how the impact of rate changes are distributed among ratepayers. Councils may decide that some individual rates increase by more than the rate peg, or by less than the rate peg; or even be reduced, provided the increase in total rates income does not exceed the rate peg.[4]

Box 1.1 Function of the rate peg

We consider the function of the rate peg is twofold:

1. It allows all councils to automatically increase their rates income each year to keep pace with the estimated change in the costs of providing their current services and service levels to households, businesses, and the broader community. This helps ensure that they can maintain the scope, quantity and quality of these services over time without undermining their financial sustainability.
2. It also limits the impact of these automatic increases on ratepayers, by ensuring that councils cannot increase their rates income by more than the estimated change in their costs, and that they engage with their communities if they propose a step change in their rates income to fund improvements in the scope, quantity or quality of their services.

Source: IPART, *Review of the rate peg methodology – Final Report*, November 2023, p 11.

Emerging trends and issues over time have led to the rate peg and the methodology used by IPART to set it, being reviewed and revised, with relevant reviews by IPART undertaken in 2008-09, 2020-21 and 2022-23.[c]

[b] The rate peg applies to councils' total general income collected from rates rather than individual rates. Councils can instead choose to increase their rates income by a lower percentage or reduce or maintain its rates income. If a council increases its rates income by less than the rate peg in a given year, it has up to 10 years to catchup this shortfall (under section 511 of the *Local Government Act 1993*).

[c] In 2022-23 IPART reviewed the rate peg methodology, in 2020-21 we reviewed the rate peg to include population growth and in 2008-09 we reviewed the revenue framework for local government. We also reviewed the local government rating system in 2015-16.

Our most recent review, the 2022-23 review of the rate peg methodology, resulted in our current rate peg methodology and the Tribunal's recommendation to the NSW Government for an independent review of the financial model for councils in NSW.[5]

1.1.1 Our rate peg methodology

Throughout our 2022-23 review we received extensive feedback from stakeholders on how the rate peg methodology could be improved to better reflect the changes in inflation and costs incurred by NSW councils. Our Final Report sets out our rate peg methodology which is intended to produce rate pegs that more accurately reflect council cost changes by using forecasts to measure changes in base costs, and better account for council diversity through the inclusion of council-specific factors and adjustments.

Our rate peg methodology includes:

- A Base Cost Change (or BCC) model) that:
  - measures the percentage change in 3 cost components: employee costs[d], asset costs[e] and other operating costs[f]
  - uses forecasts with 3 separate models for metropolitan, regional and rural councils.
- A productivity factor which is intended to capture savings councils may be able to make, which is currently set at zero.
- A population factor to maintain the amount of rates collected per person in areas that have a growing population to provide councils with the increase in income required to fund services to a larger population.[g]
- A council-specific Emergency Services Levy (ESL) factor to account for changes in councils' ESL contributions.[h]
- Other adjustments, such as one-off adjustments where necessary, such as for local government election costs or potentially for external costs faced by councils or groups of councils, where ratepayers benefit from the activities generating the costs.[6]

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d Primarily wages, measured by the Local Government (State) Award (Award), or, if the Award increase is not known at the time we set the rate peg, the Reserve Bank of Australia's (RBA's) Wage Price Index (WPI) forecast. Changes in the superannuation guarantee will be captured through an additional adjustment where necessary.

e Measured by the RBA's forecast change in the Consumer Price Index (CPI), adjusted to reflect the average 5-year historical difference between changes in the Producer Price Index (PPI) (Road and bridge construction, NSW) and changes in the CPI.

f Measured by the RBA's forecast change in the CPI.

g The population factor is council-specific and adjusts for the change in the residential population of a council area (excluding the prison population).

h Council ESL contributions support the work of emergency services in NSW including the NSW State Emergency Service, NSW Fire and Rescue and NSW Rural Fire Service.

1.1.2 IPART recently reviewed the rate peg methodology

In December 2021, we set the rate peg for the 2022-23 financial year at 0.7% (excluding population growth factors), which was lower than many councils expected during what was a period of relatively high inflation.[7] This was largely because our old methodology used Local Government Cost Index (LGCI), based on changes in costs experienced by councils between 2019-20 and 2020-21 when inflation was relatively low.

The local government sector raised concerns that when inflation is more volatile, such as during the COVID-19 pandemic, councils have difficulty forecasting and planning for a low rate peg outcome.

The Tribunal acknowledged these concerns and resolved to undertake a review of the rate peg methodology. We recognised that aspects of the old methodology were not suited to a volatile economic climate and that the very low rate peg coinciding with rapidly increasing inflation had a negative impact. We welcomed the Terms of Reference from the then Minister.[8]

The 2022 Terms of Reference for the review the rate peg methodology asked IPART to recommend a methodology that is reflective of changes in inflation and costs incurred by local government.[9]

Box 1.2 The LGCI was lagged and backward-looking

The LGCI used independent measures of price changes published by the Australian Bureau of Statistics (ABS) to produce an objective measure of inflation and changes in relevant costs.

Although we used the most up-to-date ABS data available, there was a 2-year lag between the time period that price changes were measured over and when councils could recover these price changes by applying the rate peg to their rates income.[a]

In our 2022-23 review, we found that the 2-year lag does not allow for changes in council costs to be reflected in a timely manner in the rate peg. This can be problematic during periods of cost volatility. This is because when inflation is more volatile, the lag may lead to material differences between what councils receive under the rate peg and how their costs have actually changed. This may temporarily impact councils' funding of the quality and range of services their communities need. The lag may not be a significant concern in periods when inflation is relatively stable.

Source: IPART, *Review of the rate peg methodology – Final Report*, November 2023; IPART, Reweighting of Local Government Cost Index – Fact Sheet, May 2023

Following extensive consultation, our 2022-23 review resulted in major changes to the rate peg methodology (to apply from the 2024-25 financial year),[10] which are intended to be more timely, forward-looking and better account for the diversity of councils.[11]

Consultation with stakeholders

To meet our Terms of Reference, and respond to concerns that stakeholders had raised with us, we identified 5 key issues to be addressed which each related to how well the rate peg reflects costs, including:

- better accounting for the differences between councils
- volatility and lag in the rate peg
- better capturing the change in efficient labour costs
- how new services, activities or external costs should be funded
- improving simplicity and understandability.[12]

Figure 1.1 Consultation we undertook as part of the 2022-23 review

169
Stakeholder submissions to Issues Paper and Draft Report

11
Stakeholder workshops (online, in-person in Sydney and regional areas)

1
Public hearing

2,881
Replies to residential ratepayer survey

515
Replies to business ratepayer survey

44
Participants at ratepayer focus groups

Source: IPART, *Review of the rate peg methodology – Final Report*, November 2023, p 16; ORIMA, *Rate Peg Survey Integrated Report*, April 2023, p 1.; IPART, *Review of the rate peg methodology – Draft Report*, June 2023, p 4.

Throughout the review, many stakeholders made it clear they have broader concerns about how local government services are funded and rates are regulated in NSW.

In submissions, ratepayers told us their prime concern was the affordability of their rates, and the impact rate peg methodology changes would have on their cost of living.[13] Ratepayer feedback included:

- support for the rate peg to encourage financial restraint, noting it could reduce the democratic accountability of councils to their communities on rates
- that councils are not held accountable for large rates increases and that the rate peg provides limited protection due to special variation approvals
- that improved productivity, efficiency and financial management rather than higher rates should address increased council spending and that other options for income be explored.[14]

Councils told us that their primary concern is to achieve and maintain financial sustainability, to use their rates income effectively and efficiently, and to maximise what can be achieved.[15] Key concerns of councils also related to:

- how accurately the methodology measures changes in council costs, and
- the broader regulatory framework for local government and its impact on financial sustainability including the rate peg itself.[16]

Box 1.3 Ratepayer survey and focus groups during IPART's 2022-23 review

To better understand what is important to NSW residents and businesses with respect to the setting of council rates, we engaged ORIMA to undertake a detailed survey of ratepayers and conduct focus groups.

The survey's community sample included 2,881 residential and 515 business rate payers. The survey results covered many aspects of ratepayer preferences. Most ratepayers were generally satisfied with the quality and level of services that their council provides. However, they raised some broad concerns about the performance and regulation of councils such as concern about the equity of rate distributions and a desire for improved communication from councils.

Overall, ratepayers wanted the rate-setting framework to reflect the principles of transparency, accountability, efficiency, and fairness.

Source: IPART, *Review of the rate peg methodology – Final Report*, November 2023, pp 155-173; IPART, *Review of the rate peg methodology – Draft Report*, June 2023, p 4; ORIMA, *Rate Peg Survey Integrated Report*, April 2023; ORIMA, *Rate Peg Focus Groups Research Report*, May 2023.

Changes to the rate peg methodology

IPART implemented its decisions (outlined in our Final Report) on changes the rate peg methodology in setting the rate peg for the 2024-25 financial year. The core rate peg for the 2024-25 financial year for each council (i.e. before applying the council-specific population factor) ranges from 4.5% to 5.5%.[17]

The changes are intended to produce rate pegs that are a somewhat more timely measure of changes in councils' base costs, by referring to forward-looking measures of changes in councils' costs.[18] They will also better account for the diversity among NSW councils and help ensure ratepayers contribute only to costs relevant to their local government area.[19]

Changes to the rate peg methodology included our decisions to:

- Replace the Local Government Cost Index (LGCI) with the simpler Base Cost Change (or BCC) model.[20]
  - The BCC helps to reduce the impact of the lag inherent in the LGCI, as it uses forecasts instead of lagged data. However, the BCC cannot fully eliminate any lag, especially when inflation is volatile, because while forecasts 2 years into the future are informed by current events and recent previous events, they can seldom anticipate volatility.[21] Also, we set and publish the rate peg to apply from 1 July to 30 June in around September of the previous year,[i] resulting in a 9 month lag between when the decision on the rate peg is made and when it is applied.[j,22]
  - Compared with the LGCI, the BCC also helps to reduce volatility in the rate peg as forecasts tend to be more stable than actual inflation when inflation is volatile.[23]
  - The 3 separate BCC models for different council groups (i.e. metropolitan, regional and rural councils) better capture the diversity of councils by reflecting differences in spending patterns between these types of councils. That is, the weightings of the BCC components are specific to each council group.[24]
- Move away from using the average annual change in Emergency Services Levy contributions (or ESL contributions) across all NSW councils, to a separate council-specific ESL factor that reflects the annual change in ESL contributions for each council.[k] Our previous average annual approach meant some councils would over-recover the change in their ESL contribution, while others under-recovered it. Our change to the methodology allows the rate peg to better reflect changes to councils' actual ESL costs.[25]
- Adjust the population factor to more accurately measure the change in councils' residential populations by excluding prison populations.[26]

We decided to continue making additional adjustments on an as-needs basis for external costs and retain the productivity factor with a default value of 0%.[27] While the productivity factor is a valuable potential tool to enhance overall productivity, we note that it may not be the optimal mechanism to incentivise council efficiency and have decided to continue setting it at zero.[28]

We recently published a Fact Sheet for estimating future rate pegs which provides advice on estimating the rate peg to assist councils in long term financial planning. Councils applying for a special variation can use this guidance to estimate future rate pegs for financial years after the year where the rate peg is already set. For example, councils applying for a special variation for the 2025-26 financial year would be able to use the rate peg set by IPART (around September 2024) in their applications.

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i To allow councils to start their IP&R process for the coming financial year in October.

j We considered changing the timing of the rate peg release to reduce the lag between when it is set and when it applies, however, many stakeholders told us it would not be practical due to the impact on the existing council budgeting and planning process.

k The ESL is lagged by one year. ESL contributions were previously captured in the rate peg as a component in the LGCI.

We are establishing a council implementation reference group to advise us on the implementation of changes to the rate peg methodology. The purpose of the reference group will be to identify any practical issues or unintended consequences that might arise from implementation of IPART's decisions. We will shortly consult publicly on draft Terms of Reference for the reference group. We will make the minutes of meetings with the reference group publicly available to support transparency.[29]

We will also consult with ratepayers through ratepayer workshops.[30]

IPART is committed to regularly reviewing the rate peg methodology. For example, the recent changes to the rate peg formula included the retention of the productivity factor, but set at a value of zero, with the recognition of the importance of a comprehensive evidence-based review being conducted prior to any potential change in the productivity factor from its default value of zero.[31] In our Final Report, we also committed to undertake a review of the methodology at least every 5 years.[32]

Recommendation for independent review of councils' financial model in NSW

Our review consultation highlighted that it is in the long-term interests of ratepayers for councils to be financially sustainable and deliver affordable services that their communities want and need. As outlined above, councils told us that their primary concern is to achieve and maintain financial sustainability, to use their rates income effectively and efficiently, and to maximise what can be achieved. Ratepayers also raised some broad concerns about the performance and regulation of councils.[33]

Our decisions on the rate peg methodology may address some of these concerns. But many of the issues raised cannot be addressed by the rate peg or the special variation process. Therefore, we recommended the NSW Government commission an independent review of the financial model for councils to identify improvements. We consider this independent review could provide greater transparency of councils' financial sustainability.[34]

More information about our review of the rate peg methodology is available on our website.

1.1.3 Additional history and other relevant IPART reviews

IPART was first asked to review the rate peg in 2008

Prior to IPART setting the rate peg, the then NSW Minister for Local Government determined the rate peg based on the recommendations of an advisory committee that included representatives from the then Division of Local Government and Treasury. The rate peg reflected the NSW Government's estimates for projected annual increases in costs that a typical council delivering services at levels comparable to the previous year was likely to incur over the next year. The methodology used to determine the rate peg, including what cost indices were used, appeared to be generally based on the change in the Consumer Price Index (CPI) and Average Weekly Earnings.[35]

In 2009, IPART completed its review of the revenue framework for local government which examined the existing rate setting system. In our Final Report, we recommended improvements to the revenue framework and the robustness and transparency of the rate setting process.

We recommended a new framework for regulating council revenue that retained the current rate pegging approach, but with the option of more autonomy for councils.

The recommended framework comprised 2 options for regulating the increase in councils' rates revenue – Option A and Option B. Option A was the default regulatory mechanism for all councils under the recommended framework.

Under Option A, councils' general income would be regulated in one of 2 ways:

- Councils could increase their rates in line with an annual rate peg taking into account the:
  - change in a local-government-specific cost index that is calculated transparently and designed to reflect movements in councils' costs
  - potential for councils to achieve productivity gains via productivity adjustment factor.
- Councils that met specified eligibility criteria could propose and gain approval to implement a medium-term revenue path incorporating variations to the rate peg. The eligibility requirements were intended to improve the links between rate setting and strategic planning and encourage councils to improve their accountability to the community and their efficiency and effectiveness.

Option B was an adjunct to Option A rather than a standalone regulatory mechanism, intended to provide an opportunity for councils to gain greater autonomy in setting rates. Councils would be required to meet specified minimum performance requirements (stricter than those under Option A) before being eligible to apply to operate under Option B, including demonstrating they satisfy more stringent community engagement and accountability criteria for proposed revenue and expenditure plans. After gaining approval to operate under Option B, councils would be able to set rates in accordance with their revenue and expenditure plans indefinitely, as long as they continued to meet the minimum performance requirements and satisfy the community accountability criteria. In contrast, a council operating under Option A would either apply the annual rate peg or obtain approval to increase rates in line with a proposed medium-term revenue path every 4 years.[36]

In 2010, the NSW Government announced that from the 2011-12 financial year, the amount by which councils could increase rates income would be determined by IPART, having regard to the movements of the LGCI and productivity factor. IPART was delegated this function by the then NSW Minister for Local Government.[37]

More information about our review of the revenue framework for local government is available on our website.

Box 1.4 CPI is not necessarily the best measure of councils' cost changes

The Consumer Price Index (CPI) published by the ABS, measures price changes in a 'basket' of goods and services consumed by the typical metropolitan household. This includes goods and services that may not reflect council purchases (e.g. purchases of new dwellings, household items and groceries).

Our 2008-09 review of the revenue framework for local government found that since its introduction, the rate peg had closely corresponded to the change in CPI. However, we found that local government costs had increased substantially more than the change in CPI over the 10 years prior. Based on select council case studies we found that costs increased 6.2% more than the maximum increase allowed by the rate peg (and 7.7% more than the change in the CPI) over this period. Figure 2.2 of this submission also shows that since 2011-12, CPI has generally been lower than the LGCI, with the exception of 2021-22 and 2022-23 where the CPI increased substantially.

Our analysis of council costs suggested that general economic indicators (such as CPI and Average Weekly Earnings) were not a suitable basis for estimating changes in local government costs and can substantially over- or under-estimate increases in these costs. In particular, broad economic indexes do not accurately capture changes in council costs due to changes in the composition of their services or service levels.

We considered it was important that the rate peg is based on cost change estimates that are as accurate as possible and should be set with reference to a local-government-specific cost index to provide more accurate estimates.

We consider that our findings from our 2008-09 review still stand. In our 2022-23 review of the rate peg methodology, we considered that our measure of councils' cost changes should reflect a 'basket' of goods and services that typical councils are known to spend on. This includes employee costs (such as salaries and wages, leave entitlements and superannuation) and asset costs (such as expenditure on roads, parks, and other community facilities). A measure that captures changes in these cost categories is likely to be more cost-reflective for councils than the CPI, which measures changes in costs for metropolitan households.

Source: IPART, *Revenue framework for Local Government – Final Report*, December 2009, pp 135-136 and IPART, Review of the rate peg methodology – Final Report, November 2023, p 53.

IPART introduced the Local Government Cost Index (LGCI) in 2011-12

The LGCI was a price index for councils in NSW, intended to more accurately reflect the changes in unit costs that councils face when providing goods and services to their communities, such as labour, construction and administration costs.[38]

The LGCI was designed to measure the change in price of a fixed 'basket' of goods and services purchased by councils in a given period, relative to the price of that same basket in a fixed, base period. The LGCI was similar in principle to the CPI based on actual increases in prices. The LGCI in the rate peg was applied to all councils based on the average changes.[39]

The LGCI included 26 cost components, such as employee benefits and on-costs, building materials for roads, bridges and footpaths, each of which were weighted to reflect its relative contribution to councils' total costs. At the end of June 2021, major cost components in the LGCI included labour (39%), road and bridge construction (27%), and business services (6%). For further detail on the LGCI cost components and weightings see Appendix B.[40]

As discussed above, we considered the LGCI to be a better measure of councils' costs than CPI, however over time we identified some issues with using a price index, as the LGCI:

- relied on historical data and did not reflect price changes at the time councils experienced them (see Box 1.2)
- did not sufficiently capture the diversity of councils, due to the approach of using average changes[41]
- did not allow for cost increases for councils with growing populations.[42]

More information about the LGCI is available on our website.

From 2022-23 IPART implemented changes to account for population growth

In 2020, IPART was asked to review the rate peg to include population growth.[43]

As local communities grow, councils need to provide additional services to meet the demand of their residents and businesses. Allowing rates to keep pace with population growth enhances councils' ability to provide services and improves their financial sustainability.[44]

Additional costs of population growth had previously been funded within existing rates revenue, subject to adjustment through supplementary valuations, or through other revenue sources (such as grants funding or fees for services) or through special variations. Stakeholder feedback provided as part of our 2020-21 review highlighted issues with the rate pegging system that was leaving growing councils without enough revenue to respond to additional demand for services.[l,45]

As a result of our review, we introduced a population factor from the 2022-23 financial year. This was because we found that, for many councils, additional income from supplementary valuations did not keep pace with population growth, with faster growing councils tending to be unable to recover additional revenue through general income in proportion to their growth.[46]

l Councils are able to increase general income up to a maximum amount (called councils' notional general income) that is adjusted for supplementary valuations issued by the Valuer General. The Valuer General issues supplementary valuations in certain circumstances, including when there are changes in land value (e.g. where land has been rezoned or subdivided) outside the usual 3 to 4-year general valuation cycle.

The population factor allows councils to recover increases in their costs due to servicing an increased population, keeping revenue per capita before inflation consistent, as populations grow. It is calculated as the change in residential population less any increase in general revenue from supplementary valuations. As a result of this change, the calculated rate peg for each council, in part depends on how fast the population is growing in the relevant council area.[m,47]

We considered that maintaining per capita general income would help councils to maintain existing service levels and provide the services their growing communities expect.[48]

More information about our review of the rate peg to include population growth is available on our website.

1.2 Special variations and minimum rates

When councillors decide they need to increase their general income by an amount greater than the rate peg, they can apply to IPART for a special variation.[n] Councils may also apply to increase the minimum amount of rates above the statutory limit.[o] In 2010, special variation and minimum rates determinations were also delegated to IPART by the then Minister for Local Government.

1.2.1 Special variations

Under the *Local Government Act 1993*, a council can resolve to apply to IPART for a special variation to vary general income by an amount greater than the rate peg. In 2010, the then Minister for Local Government delegated the power to approve special variations to IPART.[p]

IPART can approve a special variation for a single year or a specified period of 2 or more years, up to 7 years.[q] A special variation can be permanent or temporary (after which the council's general income must return to the level it would have been if the special variation were never applied).

A council retains the discretion to determine the structure of its rates within these limits. That is, it can set its own rates and fees, as long as its total general income from those sources stays within the approved increase.

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m The rate peg transitioned from a single rate peg for all councils to individualised rate pegs for each council.

n If IPART approves an application for a special variation, it will issue an instrument under section 508(2) or 508A of the *Local Government Act 1993* specifying the amount and year(s) by which the council may increase its general income.

o IPART assists the NSW Office of Local Government, Minister for Local Government and the Governor in amending clause 126 of the *Local Government (General) Regulation 2021* each year, which prescribes the maximum minimum amount of a rate. If IPART approves a minimum rate application, it will issue an instrument under section 548(3)(a) of the *Local Government Act 1993* specifying a minimum rate that is greater than the statutorily prescribed amount.

p By delegation dated 6 September 2010, the then Minister for Local Government delegated to the Tribunal all her functions under sections 506, 507, 508(2), 508(6), 508(7), 508A, 548(3) and 548(8) of the *Local Government Act 1993*, pursuant to section 744 of that Act.

q This does not prevent councils from applying for, or IPART approving, a special variation that takes effect immediately after a 7-year period.

IPART assesses special variation applications made by councils against the criteria set out in the guidelines issued by the NSW Office of Local Government. In summary, these criteria are that the council must:

- demonstrate a financial need for additional income
- provide evidence the community is aware of the need for and extent of rate rise
- establish the impact on affected ratepayers is reasonable
- exhibit (where required), approve and adopt relevant Integrated Planning and Reporting (IP&R) planning documents
- explain and quantify the council's productivity improvements and cost containment strategies
- address any other matter IPART considers relevant.[49]

The special variation application must be supported by a resolution of the elected councillors.

Councils are also required to actively engage residents in discussions about the proposed increase above the rate peg. Councils can do this with public hearings and other community engagement tools that suit their population. IPART will consider how effective each council's community inclusion has been before determining whether it will approve a special variation application.

More information about our role in assessing special variation applications is available in section 2 (F) and on our website.

1.2.2 Minimum rates

Local councils that are seeking to increase minimum rate levels above the statutory limit need to submit minimum rate increase applications to IPART for review and assessment. IPART assesses minimum rate increase applications against the criteria set out in the guidelines issued by the NSW Office of Local Government. The criteria for assessing minimum rates applications require councils to demonstrate a rationale for increasing minimum rates, the impact on ratepayers and community awareness.[50]

More information about our role in assessing minimum rates applications is available on our website.

1.3 Local infrastructure contribution plans

Section 7.11 of the *Environmental Planning and Assessment Act 1979* allows councils to impose conditions on the grant of development consent to developers requiring them to pay contributions towards the cost of providing local infrastructure. Councils may only do this in accordance with a contributions plan.[51] Contributions plans set out the local infrastructure required to meet the demand from new development, and the contributions a council can levy on developers to fund the necessary land and works.

IPART assesses contributions plans that propose contributions above $30,000 per lot or dwelling in identified greenfield areas and $20,000 per dwelling in other areas and makes recommendations to the Minister. We assess whether the contributions plan meets the criteria set out in the Department of Planning, Housing and Infrastructure's Infrastructure Contributions Practice Note (2019 Practice Note). An IPART-reviewed contributions plan entitles the council to levy contributions above the applicable maximum cap.[52]

Between 2011 and 2024, IPART has received 38 contributions plans for review from 12 different councils.

1.3.1 Emerging issues

IPART recently completed its assessment of an amended contributions plan, in which the estimated total cost of providing infrastructure in that precinct has risen substantially since the first iteration of that contributions plan.[53] This increase contributed to a funding gap between the revenue collected from infrastructure charges to date, and the estimated costs of providing that infrastructure. In the council's application, the council proposed to recover the funding gap from the remaining development.[54]

IPART understands this is the first occasion on which there was a substantial unfunded cost that a council proposed to carry forward to future developers. We endeavoured to address the issues and potential impacts arising from the amended contributions plan with careful reference to relevant Practice Notes. However, we found there is a lack of clear guidance on whether the intention is that councils can, and if so to what extent, seek to recover a historical funding gap from remaining development.[55]

In the final report setting out our assessment of that contributions plan, we acknowledged that people living and working in newly developed areas need infrastructure and services. We commented that some councils are facing financial sustainability challenges. We also observed that, in the context of the current demand for housing, cost-reflective developer contributions help ensure that development occurs where the social benefits of the development are greater than its costs and apportioning an unreasonable share of cost increases to developers covered by a contributions plan could have unintended consequences.[56]

We have recommended the Practice Notes and other guidance be revised to provide clear policy for the type of situation that arose in our recently concluded assessment of the amended contributions plan, so increased costs are borne by the appropriate party, whether it be developers or councils or other ratepayers.[57] The issues raised by that contributions plan may be relevant to the Standing Committee's Inquiry.[58]

It may also be relevant to the Inquiry that some council feedback in our consultation refers to increasing demand to provide community facilities for new developments that in the past were provided by the property developers.[59] We have heard that some councils may face increased costs to provide community facilities, above the costs already captured in the rate peg and population factor.

To contribute to improving the system for developer contributions, IPART has recently sought feedback on ways we can improve the timeliness of our assessments, reduce unnecessary complexity and increase transparency and responsiveness. We appreciate the constructive input about our processes so far from councils and other stakeholders, and we will consult further on proposed improvements to our assessment process in coming months.[60]

More information about our role in local infrastructure contribution plans is available on our website.

1.4 Other work relating to local government

IPART also undertakes other work relating to local government and has previously undertaken other reviews relating to local government, such as for:

- Domestic waste management annual charges
  - In 2010, IPART was also delegated the function of specifying the maximum percentage by which councils may vary the amounts of annual charges for Domestic Waste Management (DWM) services for a specified year. IPART decides each year whether or not to set a maximum percentage ('waste peg') by which NSW councils can increase their DWM annual charges. Since 2010, IPART has decided each year it would not limit the variation of these charges. In October 2022, we completed a review of how we exercise our regulatory functions relating to DWM annual charges.[61]
- Prices for Valuer General's services to councils
  - In 2019, IPART determined the maximum prices the Valuer General may charge councils for valuing land for a 6-year period, from 1 July 2019 to 30 June 2025.[62]
- Central Coast Council water prices
  - IPART sets the maximum prices that can be charged by Central Coast Council for water and wastewater services. In 2022, IPART completed its most recent review of the prices that the Central Coast Council as a Water Supply Authority (CCC Water) can charge its customers for these services from 1 July 2022 to 30 June 2026.[63]
- Crown land adjustments
  - IPART can approve a council's application for crown land adjustments. Crown Land Adjustments (CLA's) increase the general income of councils for parcels of Crown land that have become rateable. Crown land is generally exempt from rates.[64]
- Costs of conducting local government elections
  - In 2019, the then Minister for Local Government asked IPART to review the costing methodology applied in determining the amount the NSW Electoral Commission (NSWEC) charges councils who use the NSWEC to administer their own council elections.[65]

2 Additional information relevant to the Inquiry's Terms of Reference

Below we include some additional points relevant to the Terms of Reference for the Committee's current Inquiry including :

a. the level of income councils require to adequately meet the needs of their communities
b. examine if past rate pegs have matched increases in costs borne by local governments
c. current levels of service delivery and financial sustainability in local government, including the impact of cost shifting on service delivery and financial sustainability, and whether this has changed over time
d. assess the social and economic impacts of the rate peg in New South Wales for ratepayers, councils, and council staff over the last 20 years and compare with other jurisdictions
e. compare the rate peg as it currently exists to alternative approaches with regards to the outcomes for ratepayers, councils, and council staff
f. review the operation of the special rate variation process and its effectiveness in providing the level of income councils require to adequately meet the needs of their communities
g. any other related matters.

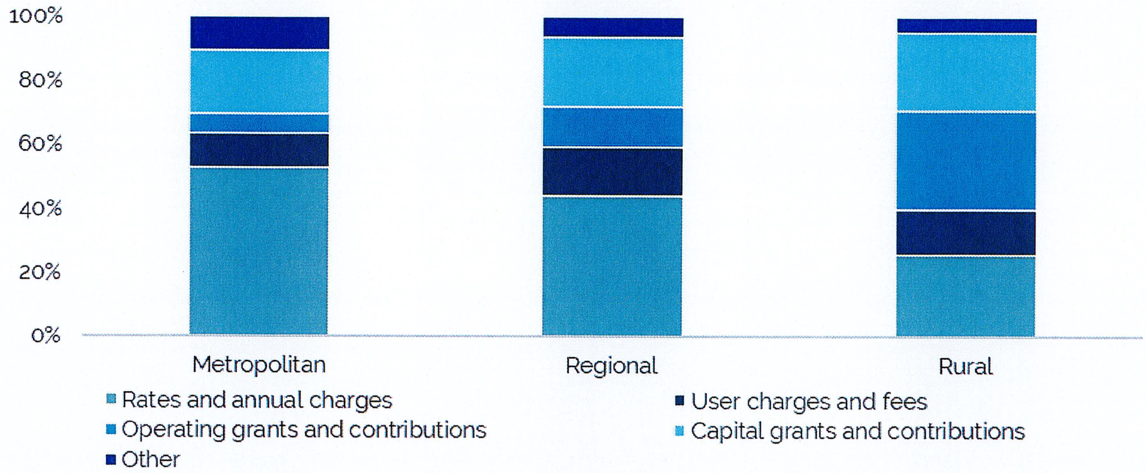
(A) Level of income councils require to adequately meet needs of their communities

In NSW, local councils are funded through a variety of sources, including:

- income received from rates (approximately 32% on average)
- income received from other fees and charges (approximately 29% on average)
- grants and contributions (approximately 31% on average)
- other sources (approximately 8% on average).[66]

In our 2022-23 review of the rate peg methodology we found that income from rates represents one of the main sources of funding for the provision of ongoing council services. The importance of this funding source varies across councils (see Figure 2.1) but, on average, rates income represents around one third of NSW councils' combined total income. Other major sources of income include grants from state and federal governments, infrastructure contributions, and user fees and charges for goods and services councils deliver.[67]

Figure 2.1 Councils' sources of income by council type (2020-21)



Source: Email to IPART, NSW Office of Local Government, 26 April 2023 and IPART analysis.

In consultation for our 2022-23 review, councils raised a range of concerns about how well our old rate peg methodology measured changes in costs.[68] Many councils expressed concerns about a rate peg methodology based on the average change in base costs for all NSW councils. They told us that this would not accurately reflect how their costs are changing, as different councils across the State have different priorities and services they provide to their communities and incur different costs in doing so.

Our analysis showed that councils do spend their money differently. As an example, we observed that asset costs generally represent a larger proportion of total costs for regional and rural councils than metropolitan councils.[69]

As outlined in section 1.1.2, the recent changes to the rate peg methodology are intended to improve how the rate peg reflects changes in councils' costs.

Ability of councils to maintain current service level and financial sustainability

In our 2022-23 review, we found that the number of councils reporting operating deficits increased from 2016-17 to 2020-21, and more than half of all councils do not meet the infrastructure backlog ratio benchmark.[70]

Over the course of our 2022-23 review, many councils told us they are struggling to maintain their current level of service while remaining financially sustainable. They mainly attributed this to:

- the rate peg not fully reflecting the changes in inflation and costs of providing council services
- changes in the amount of income they receive through other funding sources such as grants, and user fees and charges
- historically unsustainable levels of rates income that they feel unable to address through the current special variation process[71]
- cost shifting from state and federal governments and costs outside councils' control.[72]

Consultation during our review also highlighted issues related to the level of income required to cover costs, including that:

- Some councils may have an insufficient rates base. There was support from some stakeholders to identify councils with insufficient rate bases and find a means to establish an appropriate revenue base to achieve financial sustainability.[73] We consider that councils with longstanding financial sustainability issues driven by an insufficient base level of rates income could benefit from a mechanism to reset their base.[74]
- Some councils may need to use rates income if they are unable to recover the full cost of providing the statutory services for which the NSW Government regulates charges (e.g. stormwater management service charges, development approval fees, development contribution caps). Councils told us that some of these charges have not been adequately indexed over time. We consider that statutory charges for services provided by councils should be at fully cost reflective and efficient levels to enhance financial sustainability and improve equity and affordability for ratepayers. They should be appropriately indexed and periodically reviewed to ensure they remain at cost reflective levels.[r,75]

As outlined in section 1.1.2, our recent decisions on the rate peg methodology may address some of these concerns, but many cannot be fixed by the rate peg or the special variation process, leading to our recommendation that the NSW Government commission an independent review of the financial model for councils.[76]

(B) Past rate pegs and increases in costs borne by local governments

We consider that the role of the rate peg is not to constrain the management decisions that local governments are authorised to make, including setting council budgets.[77]

In previous IPART reviews related to the rate peg, we considered increases in some costs borne by local government over time, such as those due to population growth and climate change.

Population growth

As outlined in section 1.1.2, prior to the introduction of the population factor in our rate peg methodology, the rate peg did not account for costs associated with population growth. In recognition of this issue, in 2020 the NSW Government asked IPART to recommend a rate peg methodology that allows the general income of councils to vary in a way that accounts for population growth.

[r] We note that our analysis of income constrained by the rate peg excludes other council income that is needed for other services councils provide including water, wastewater and domestic waste management services. The rate peg does not capture changes in costs for these services.

Our 2020-21 review of the rate peg to include population growth found that our methodology at the time did not adequately compensate councils for population growth.[78] As a result of our review, we introduced a population factor from the 2022-23 financial year. While the introduction of the population factor in the rate peg methodology allows councils to recover increases in their costs due to serving an increased population, we did not apply a population factor retrospectively. We considered a catch-up for historical population growth would be difficult to calculate, could overcompensate councils for the costs of historical population growth and have impacts on ratepayer affordability.[79] However we do note that councils that experienced increased costs due to growth prior to the population factor may have not recovered these costs through the rate peg.

Climate change

In consultation to our 2022-23 review, several council stakeholders described examples of increased costs due to climate change they indicated were often out of their control. Many of these costs were associated with adapting to climate change and natural-related disasters, such as costs of:

- unplanned additional workload and damage to assets requiring earlier repair due to exposure to floods and fires
- increased maintenance of parks and open spaces and increasing the amount of pothole repairs for roads needed due to the impact of climate change and wet weather
- failing infrastructure due to climate change impacts
- accelerated depreciation and deterioration of assets due to the impacts of natural disasters and severe weather events
- additional capital works expenditure and staff costs following weather events and increases in other major expenses including, building materials, utilities and insurances.

Councils described challenges of funding these costs including the view that rate pegging is making it harder to meet the challenges of climate change.

Climate change is one of the most significant issues that will impact the lives of people in NSW now and into the future. We considered whether external costs associated with climate change should be captured in the rate peg methodology and who should pay for the costs of climate change.

We consider that the 'impactor, beneficiary, or taxpayer-pays hierarchy' is appropriate to use to determining who should pay for external costs such as climate change. Ratepayers, their councils, and the broader community have contributed to climate change and would benefit from actions to address climate change, both to mitigate and adapt to climate change. It is reasonable for ratepayers to share the costs to address climate change.

Our new rate peg methodology allows inclusion of additional adjustments on an as needs basis for external costs, where ratepayers benefit from these activities and when we have the necessary information to accurately ascertain the quantum of those costs.[s,80]

(C) Current levels of service delivery and financial sustainability

Below we include some information we consider may be helpful to the Inquiry related to current levels of service delivery and financial sustainability in local government, including the impact of cost shifting, and whether this has changed over time.

Current levels of service delivery

Councils set their service level (including the scope, quantity and quality) in consultation with their community during the Integrated Planning and Reporting (IP&R) process. IPART generally does not explicitly assess the service level in setting the rate peg or when assessing special variation applications, as this is not part of our delegated authority.[81]

The services and activities that each council provides and the cost of providing these services can vary for a number of different reasons, including due to the circumstances of different councils and the preferences of their communities. There is no set requirement of the amount and quality of services that councils are required to provide. Some councils provide additional services to their community such as housing and healthcare. Other councils provide the same services but to a much larger extent (e.g. rural councils maintain more kilometres of roads per capita than metropolitan councils). Also, rural councils may be the provider of last resort for some important services.

Our 2022-23 review found that expenditure by service type varies by council group, that is, whether the council is a metropolitan, regional or rural council.[82] We also noted that our analysis only looked at one aspect of local government, the income received by councils from rates, and did not investigate the quality or scope of the services provided with this income.

During our review, we heard from ratepayers about their views about levels of service delivery via submissions and our ratepayer survey, which showed that ratepayers had a range of views but were generally positive about the quality and level of services provided by their council.[83] Responses to the ratepayer survey and focus groups showed some ratepayers value council services and would not necessarily like to pay less in rates if that meant services would be reduced.[84]

We also heard from councils about the range of services councils provide including health, welfare, and housing services and their desire for increases in their income for these services. Councils, particularly in regional and rural areas, told us that they are having to step in to provide services as a last resort because they were previously provided by other levels of government or due to a lack of private providers.[85] Councils raised concerns about costs associated with new functions that councils take responsibility for due to legislative change.[86]

s We also considered external costs of cybersecurity and providing community facilities. More information about external costs is available in Chapter 5 and Appendix E of our Final Report.

Current levels of financial sustainability

During our 2022-23 review, council stakeholders expressed concerns about their ability to remain financially sustainable and meet growing demand for new and improved services. They considered that the rate peg has constrained their ability to fully recover the costs of providing services, and this has impacted financial sustainability.[87]

As outlined in section 2 (A) above, our analysis suggests that many, but not all, council financial positions deteriorated from 2016-17 to 2020-21 and more than half of all councils have infrastructure backlog ratios that do not meet the NSW Office of Local Government's benchmark of less than 2%. This suggests that some councils do not currently spend enough on infrastructure renewal works. We also found that the per capita value of Financial Assistance Grants to NSW councils has declined in real terms (although the experience of individual councils is likely to be more varied). [88]

In submissions to our review, ratepayers generally considered that councils' financial sustainability problems reflect unnecessary spending and potential mismanagement. For example, results from our ratepayer survey showed that 34% of respondents thought that councils do not use rates income well enough.[89]

Cost shifting

In our 2008-09 review of the revenue framework for local government, we defined cost shifting as when a higher level of government requires local government to provide a function or service that is not traditionally associated with local government and does not adequately provide for local government to recover the additional costs that this involves.[90]

During our 2022-23 review, we heard from councils that state or federal government decisions that increase the cost base for councils should be reflected in our rate peg methodology. We also heard from some ratepayers in our consultation, that if costs are directly transferred to councils from the NSW Government, that government funding should be provided rather than ratepayers funding these costs.[91]

We considered these types of costs to be external costs and decided to enhance our approach of including additional adjustments to the rate peg on an as-needs basis for external costs. We considered that under this approach, we will be able to include additional adjustments in the rate peg methodology for external costs (such as costs associated with new statutory functions, or costs where restrictions in funding pose challenges to cost recovery) where ratepayers benefit from these activities and when we have the necessary information to accurately ascertain the quantum of those costs.[92]

(D) Social and economic impacts of the rate peg in NSW for ratepayers, councils, and council staff

Below we include some information we consider may be helpful to the Inquiry related to the social and economic impacts of the rate peg in New South Wales for ratepayers, councils, and council staff over the last 20 years and compared with other jurisdictions.

Impacts on ratepayers

As outlined in section 1.1.2, in undertaking our 2022-23 review, we commissioned ratepayer surveys to help understand the perspectives of residential and business ratepayer categories on the rate peg methodology and other rates-related issues. NSW residents generally had positive views about the quality and level of services provided by their local council but were less positive about how well councils communicate about rates and make use of the revenue they raise through rates. The affordability of rates is very important to ratepayers; over half of survey respondents ranked affordability as their first or second most important consideration with respect to rates.[93]

Our ratepayer focus groups showed that there was generally a high level of support for oversight and regulation of council rates. For the most part, participants were not previously aware of the regulatory process (regarding rates).[94]

More information about ratepayer views and comparative rates analysis is available in Appendix D of our Final Report; and ORIMA's *Rate Peg Survey Integrated Report* and *Rate Peg Focus Groups Research Report*.

Impacts on councils

In our 2008-09 review, one of stakeholders' main concerns about the rate pegging approach was that it had constrained local government revenues and expenditures, particularly infrastructure expenditure. As a result, some stakeholders considered it had compromised the long-term financial sustainability of NSW councils and led to infrastructure backlogs. We found that rate pegging had limited the growth of NSW councils' revenue.

As outlined in section 2 (A) above, our 2022-23 review analysis suggests that council financial positions deteriorated from 2016-17 to 2020-21. However, some councils have been able to substitute other sources of revenue, such as user fees and charges, so on average the growth in their total revenues was broadly in line with that in the other states.[95]

We also heard from councils that they are concerned about their ability to remain financially sustainable and simultaneously meet the growing demand for new and improved services from their communities. They consider that the rate peg has constrained their ability to fully recover the costs of providing their current services, and this has negatively impacted their financial sustainability.[96]

As outlined in section 1.1, emerging trends and issues over time have led to the rate peg and the methodology used by IPART to set it, being reviewed and revised. However, many issues cannot be addressed by the rate peg or the special variation process and so we recommended the NSW Government commission an independent review of the financial model for councils.[97]

Impacts on council staff

As stated above, we consider that the role of the rate peg is not to constrain the management decisions that elected councillors in local government are authorised to make – this includes wage negotiations and setting council budgets.[98]

In section 1.1.1, we note that we use the Local Government (State) Award (the Award) in our new rate peg methodology. In our 2022-23 review, we engaged independent economic consultant the Centre for International Economics (The CIE) to provide advice on options for the labour cost indexation in the rate peg. It compared using the ABS NSW Wage Price Index (WPI) for the public sector with other options including the Award, ABS NSW WPI for all sectors and private sector, and the Fair Work Commission minimum wage increase.[99]

More information about this analysis is available on our website in our Final Report and The CIE's *Local government labour cost indexation Final Report*.

Rates regulation in other jurisdictions

Apart from Victoria, the other Australian states and territories do not regulate rates income. Rather, councils are permitted to adjust the level of their rates income to align with their prepared budget for each financial year. However, these councils do need to meet specified requirements before raising rates. For example, several jurisdictions require councils to publish a public notice of rates and an explanation for the rate increases and, in some cases, to consult with the public.[100]

It is also worth noting that what is included in general income can vary from state to state and even from council to council. Service programs can also vary between states, which impacts the scope and quality of services residents receive and the level of rates required to provide these services. Councils in other states may not separate general rates from other charges such as stormwater and domestic waste.[101]

Victoria uses a rate cap method, similar to NSW, which was introduced in the 2016-17 financial year.[102] The rate cap is usually set equal to the December forecast of the CPI from the Victorian Department of Treasury and Finance. The Essential Services Commission (ESC) is responsible for providing advice to the Victorian Minister for Local Government about the rate cap.[103] It should be noted that the Victorian method is also flexible and allows the ESC to recommend variations from the December CPI forecast, as it did for the 2022-23 financial year recommending the rate cap stay within the historical range of 1.5% to 2.5%.[104]

In South Australia, the Essential Services Commission of South Australia (ESCOSA) acts as an advisory body, providing advice to all councils in South Australia across a 4-year cycle. This process operates under the Local Government Advice Scheme established through the *Local Government Act 1999* (SA) and aims to provide independent, risk-based advice to assist councils when making long-term financial and investment decisions for the benefit of ratepayers. ESCOSA has released 2 rounds of advice, one for 2022-23 and one for 2023-24, covering 32 councils.[105]

In Western Australia, Queensland, South Australia, Tasmania and Northern Territory councils have the autonomy to set their rates at the level needed to achieve the required income in their budgets.[106] Each jurisdiction has varying legislative requirements and restrictions on councils, but broadly councils have authority to independently set rates. An example of a restriction is that in Western Australia, a council's income from general rates is limited, such that income from rates cannot exceed 110% of the budget deficiency or be less than 90% of the budget deficiency.[t,107] The ACT does not have local governments and instead land rates are set by the ACT Government.

Our 2022-23 review compared average residential rates in NSW to the average rates in Victoria and South Australia.[u] We found that the NSW average residential rate was lower than both the Victorian and South Australian average rate. In 2020-21, in Victoria the average rate per property was $1,797 (about 50% higher than NSW) and in South Australia the average rate per residential property was $1,633 (about 36% higher than NSW).[v,108]

(E) The rate peg and alternative approaches with regards to the outcomes for ratepayers, councils, and council staff

As explained in in section 2 (D) above, NSW and Victoria are the only states in Australia that directly regulate rates income.

IPART's new rate peg methodology is explained in section 1.1.1 and described by the following formula:

$$\begin{aligned} Rate\ peg = {} & Base\ Cost\ Change\ (BCC)\ model - productivity\ factor + population\ factor + ESL\ factor \\ & + other\ adjustments \end{aligned}$$

As outlined in section 1.1.2, our 2022-23 review resulted in major changes to the rate peg methodology to apply from the 2024-25 financial year. We introduced a somewhat more-timely, forward-looking measure of cost changes that better accounts for the diversity of councils by replacing the Local Government Cost Index (LGCI) with our Base Cost Change (BCC) model.

During consultation for the review, some stakeholders proposed that the rate peg be based on the CPI.[109] As part of our review, we also considered Victoria's methodology.[110] The ESC's recommended rate cap is typically determined with reference to 2 indicators – the forecast change in the CPI and forecast change in the WPI from the Victorian Department of Treasury and Finance. The ESC sets a uniform cap applicable to all councils.

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t As defined by the Local Government Act 1995 (WA).

u The data for Victoria only provides for the average rate per property. The data for South Australia does provide for the average residential rate per property. This difference should be noted as the average rate per property for Victoria will include rates for business, farming and mining rated properties while the data for NSW and South Australia is only residentially rated properties.

v Councils in other states may not separate general rates from other charges such as stormwater and domestic waste. The data we have used is 'rates per property' but this may include other charges.

Victoria's methodology is flexible, and advice to the Minister can include a recommendation for adjustments to be applied in setting the cap for all councils, a grouping of councils or any individual council. The Victorian approach has the advantage of simplicity; however, we believe our BCC approach effectively captures changes in councils' costs because it uses targeted indices for the 3 main cost categories (see section 1.1.2).

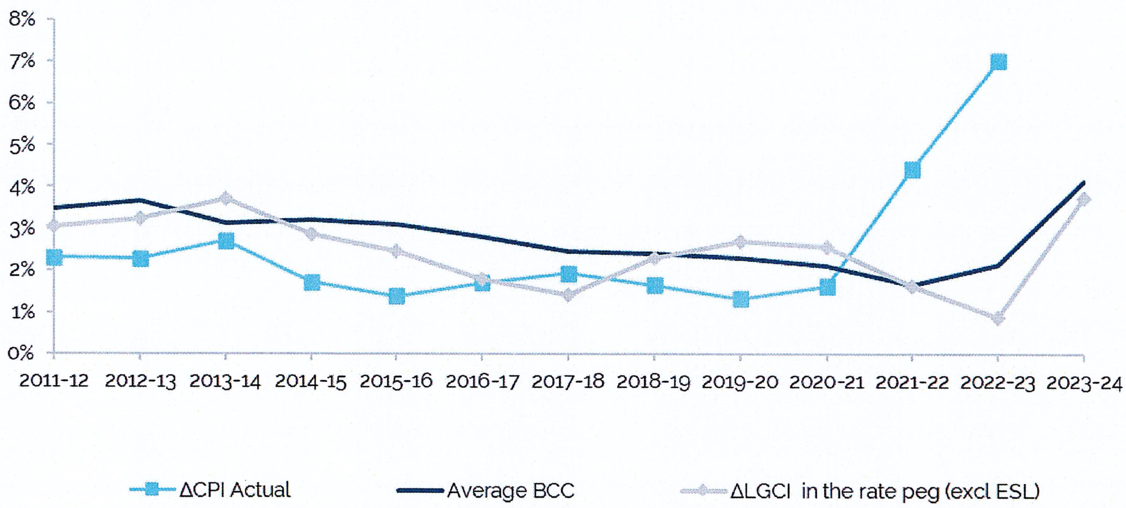
Our intention is not to produce a rate peg that is either higher or lower than the change in CPI, but to more accurately reflect changes in councils' costs. Although we consider CPI is not necessarily the best measure of councils' cost changes (see Box 1.4), it is a relevant measure when considering the impact of the rate peg on households.

Comparison of different approaches

Figure 2.2 compares the variations between the annual percentage changes in the LGCI of our previous methodology, our current BCC model, and the historical All groups CPI (Australia)[w] published by the ABS over the period 2011-12 to 2022-23. Changes in the LGCI and the BCC are extended to include 2023-24.

The change in the LGCI (in the year it was included in the rate peg) was higher than the change in CPI in all but one of the years until 2020-21, and in the subsequent years. Similarly, our adopted BCC would have been higher than the change in CPI between 2011-12 and 2020-21 and lower in the subsequent years. The BCC would have been less volatile than the change in the LGCI over the period, and more responsive to the higher inflation at the end of the period.

Figure 2.2 Comparison of changes in the LGCI, BCC and measures of CPI



Note: The average BCC is the BCC for all councils combined. The BCC is calculated based on the historical Award and does not take into account any potential impact on the Award of using it to set the rate peg. The change in CPI is measured as the average of four quarters divided by the average of four quarters in the previous year.

Source: IPART analysis, IPART, Review of the rate peg methodology – Final Report, November 2023, p 54.

[w] For consistency with the LGCI, the change in CPI is measured as the average of 4 quarters divided by the average of 4 quarters in the previous year. This measure differs from headline inflation, which is measured quarter-on-quarter.

More information about other alternative options we considered for measuring the base cost changes is available in Appendix B of our Final Report.

(F) Operation of the special rate variation process and its effectiveness

As set out in section 1.2.1, IPART assesses special variation applications against the criteria in the guidelines issued by the NSW Office of Local Government.

Overview of the assessment process

IPART assesses each application on its merits. In doing so, IPART may consider factors such as the size and resources of the council, the size of the increase requested, current and previous rate levels, the purpose of the special variation, and compliance with applicable guidelines and the conditions of previous special variations.[111]

If IPART approves a special variation, it will issue an instrument setting out the maximum percentage by which a council can increase its general income in a given year, and the conditions of that approval (typically minimum annual reporting requirements to ensure transparency and accountability). The percentage increase specified in a special variation replaces the rate peg—it is not an incremental increase on top of the rate peg. However, if the rate peg for a given year exceeds the approved special variation amount for that year, the council can use the rate peg instead of the approved special variation as the upper limit for increasing its general income.

Volume of applications and purpose

Apart from the 2022 Additional Special Variations process outlined below, since being delegated the role in 2010, IPART has processed 186 special variation applications. Of these:

- 138 were approved
- 38 partly approved
- 10 declined.[x]

The number of special variation applications in a given year changes from year to year. From 2011-12 to 2023-24 (inclusive) there were an average of 14 applications for special variations per year. However, the number of applications received per year was generally higher in the earlier 2010s with 32 applications processed for 2014-15, and there have been generally lower levels in recent years with an average of 8 applications per year in the last 5 years from 2020-21 to 2024-25. There are 9 applications for 2024-25.[112]

[x] The calculated number of special variations approved, partly approved, or declined do not include additional special variations.

Councils apply for special variations for a variety of reasons.[113] Often this is to address financial sustainability issues. This could be due to operating costs exceeding their current rate peg only revenue pathway, which impacts a council's ability to maintain existing services. Some councils also need the extra uplift in revenue to maintain, renew or upgrade their core infrastructure, in line with community expectations. In some cases, new infrastructure funded with grant funding leads to higher depreciation costs, for example following natural disasters.[114]

Some special variations are to fund discrete projects (such as swimming pools) and occasionally the purpose of a special variation is to fund a discretionary service or asset where there is community support for this and the community has demonstrated a willingness to pay, such as an environmental levy.

Additional special variations process

In 2022 (for the 2022-23 financial year) there was a one off 'additional special variations' process.[y] This was in response to the 2022-23 rate peg being set at 0.7% (excluding population growth factors).[115] The rate peg for the 2022-23 financial year was determined in the low inflation environment at the beginning of the COVID-19 pandemic. However, the following period of high inflation and global uncertainty increased councils' costs. Some councils demonstrated that without additional funds they would not be able to deliver the projects they had already consulted on and included in their budgets.

The additional special variation process gave councils an opportunity to apply to increase their rates above the level of the rate peg for 2022-23, to a maximum of 2.5%. A separate process and criteria for assessing these additional special variations were developed by the NSW Office of Local Government.

IPART approved applications by 86 NSW councils to increase their rates above the level of the annual rate peg through this process.[116]

Stakeholder feedback on the process

In our 2022-23 review of the rate peg methodology, we heard some stakeholder feedback on the special variations process.

During our consultation, we heard that some councils have been historically underfunded and increasing their rates income by the rate peg each year is not enough to close the gap between their current income and the true cost of delivering their current services.[117]

Although councils in this position could apply for a special variation to close this gap, some are reluctant to do so, even when it is necessary as they consider the process is resource-intensive and can become contentious. Some stakeholders consider it can be perceived by ratepayers as a sign of financial mismanagement and inefficiency.[118]

y Applications for an additional special variation are assessed against guidelines provided by the NSW Office of Local Government.

Ratepayers were generally supportive of the rate peg as a measure to protect ratepayers from unreasonable rate increases. However, some considered that the rate peg is currently failing to adequately protect ratepayers. Specifically, it was suggested that large special variations may be circumventing the role of the rate peg and contributing to affordability challenges,[119] as well as helping councils avoid democratic accountability for excessive rate increases.[120]

(G) Any other related matters

In our 2022-23 review of the rate peg methodology, stakeholders made it clear that they have concerns about council's performance and financial sustainability, and the affordability of rates in the current cost of living climate.[121]

Changes to our rate peg methodology were intended to respond to many of the issues raised in consultation, however many of the issues raised cannot be addressed by the rate peg or the special variation process. In our review, key themes raised by stakeholders included:

- transparent governance and better accountability
- streamlining frameworks and processes
- better financial sustainability for councils
- ensuring rates affordability and equity of the rating system
- better engagement with the community to build trust and understanding.[122]

We identified a range of matters that the NSW Government, NSW Office of Local Government, and councils could consider. These measures may improve the equity of the rating system and local government revenue framework, better support councils to serve their communities, and better support councils' financial sustainability in the longer term. These measures are:

- Better targeting eligibility criteria for rates exemptions. This would help to ensure ratepayers do not subsidise the costs of providing council services to properties where it is not justified on efficiency and equity grounds.
- Allowing councils to use the Capital Improved Value method to set the variable component of rates to ensure they can set equitable and efficient rates for all residential and business ratepayers, regardless of their property type.
- Ensuring that statutory charges reflect the efficient costs incurred by councils in providing statutory services, so councils do not need to use rates income to cover the costs of providing these services.
- Developing a mechanism to enable councils found to have insufficient base rates income to achieve financial sustainability.
- Supporting councils to serve their communities more effectively to build community trust in councils. This could include improvements in how councils undertake and implement their integrated planning and reporting.
- Alternative funding mechanisms, such as targeted grants, should be considered to support councils to provide essential social services to disadvantaged or vulnerable communities, with special attention to the unique challenges faced by rural and regional areas.

- A comprehensive state-wide evaluation of existing pensioner concessions should be conducted, along with the exploration of additional initiatives to enhance support for vulnerable ratepayers. Clear communication and proactive promotion of available assistance options offered by councils are essential.
- Methods to increase the confidence ratepayers have in the rating system should be explored, which could involve introducing additional constraints (i.e. conditions) on the rate peg.[123]

Appendices

A 2022-23 consultation

Stakeholder consultation undertaken as part of the 2022-23 review of the rate peg methodology is summarised in Box A.1.

Box A.1 Consultation during our 2022-23 review

Issues Paper consultation

We published an Issues Paper in September 2022 and invited submissions from all interested parties. We received 96 submissions, most of which were from councils and council organisations. We also held 7 public workshops – 3 in-person workshops in Wagga Wagga, Sydney, and Tamworth, and 4 online workshops – in late November and early December 2022.

We undertook our own analysis, sought expert advice, and considered the stakeholder views we heard through our consultation. Given the diversity of these views, we developed a range of options for improving the rate peg methodology and undertook further consultation to test and refine these options before making our draft decisions.

Technical workshops

In March and April 2023, we held 4 technical workshops (one with ratepayers and 3 with representatives from local government including councils, and academics). We limited the number of stakeholders we invited to participate in these workshops to allow for a more targeted and technical discussion of the options for each element of the rate peg methodology.

Ratepayer survey and focus groups

In addition, we engaged ORIMA, a specialist market and social research company, to undertake 2 NSW-wide surveys to better understand the views of residential and business ratepayers. ORIMA carried out these surveys in November 2022 and March-April 2023 respectively. ORIMA also held 5 focus groups – 3 with residential ratepayers and 2 with business ratepayers – to further explore the survey results.

Draft Report consultation

In June 2023, we published our Draft Report. We considered all views we received as part of our draft decisions and recommendations. We received 73 submissions, most of which were from councils and council organisations. Lastly, we held an online Public Hearing on 18 July 2023, which was attended by 115 stakeholders. This provided another opportunity for stakeholders to have their say on our draft decisions.

Source: IPART, *Review of the rate peg methodology – Final Report*, November 2023, pp 15-16.

B Local Government Cost Index weights

The Local Government Cost Index (LGCI) included 26 cost components, such as employee benefits and on-costs, building materials for roads, bridges and footpaths, each of which were weighted to reflect its relative contribution to councils' total costs.[z,124]

To measure the annual change in each cost component, we used an appropriate inflator. In most cases, this was a price index published by the ABS. This was intended to provide transparency and independence in estimating cost changes.[125]

Table B.1 shows the cost components in the LGCI, the inflators we used to measure changes in each component, and their weights at the end of June 2021.

More information about the LGCI is available on our website.

z The index was constructed following a survey of councils in NSW about their expenditure in 2008-09 and 2009-10. We collected data on councils' expenditure every 4-5 years to update the weights of the cost components. We reweighted the LGCI based on the results of the 2015 and 2019 cost surveys of councils to ensure the relativities between cost items remained accurate. The reweighted LGCI applied from 2017-18 and 2021-22 respectively.

Table B.1 LGCI cost components, inflators, and weightings

Cost component	Inflator	Weight as at end June 2021 (%)
Operating costs		
Employee benefits and on-cost	Wage Price Index (WPI) – Public sector, NSW	38.6
Plant and equipment leasing	Producer Price Index (PPI) – 663 Other goods and equipment rental and hiring	0.3
Operating contracts	PPI – 729 Other administrative services	2.1
Legal and accounting services	PPI – 693 Legal and accounting services	0.8
Office and building cleaning services	PPI – 7311 Building and other industrial cleaning services	0.3
Other business services	PPI – 7299 Other administrative services (not elsewhere classified)	6.2
Insurance	Consumer Price Index (CPI) – Insurance, Sydney	1.2
Telecommunications, telephone and internet services	CPI – Telecommunication equipment and services, Sydney	0.4
Printing, publishing and advertising	PPI – 16 Printing (including the reproduction of recorded media)	0.6
Motor vehicle parts	CPI – Spare parts of accessories for motor vehicles, Sydney	0.3
Motor vehicle repairs and servicing	CPI – Maintenance and repair of motor vehicles, Sydney	0.4
Automotive fuel	CPI – Automotive fuel, Sydney	0.7
Electricity	CPI – Electricity, Sydney	1.9
Gas	CPI – Gas and other household fuels, Sydney	0.1
Water and sewerage	CPI – Water and sewerage, Sydney	0.4
Road, footpath, kerbing, bridge and drain building materials	PPI – 3101 Road and bridge construction, NSW	2.5
Other building and construction materials	PPI – 3020 Non-residential building construction, NSW	0.7
Office supplies	CPI – Audio, visual and computing media and services, Sydney	0.3
Emergency services levy	IPART index based on data provided by NSW Treasury	1.5
Other expenses	CPI – All groups CPI, Sydney	8.4
Capital costs		
Building – non-dwelling	PPI – 3020 Non-residential building construction, NSW	4.2
Construction works – road, drains, footpaths, kerbing, bridges	PPI – 3101 Road and bridge construction, NSW	22.0
Construction works – other	PPI – 3101 Road and bridge construction, NSW	2.5
Plant and equipment – machinery, etc.	PPI – 231 Motor vehicle and motor vehicle part manufacturing	3.0
Plant and equipment – furniture, etc.	PPI – 24 Machinery and equipment manufacturing	0.1
Information technology (hardware and software)	CPI – Audio, visual and computing equipment and services, Sydney	0.6

Note: CPI: Consumer Price Index and PPI: Producer Price Index.
Source: IPART, *Rate peg for NSW councils for 2023-24 – Information Paper*, September 2022, p 9.

C List of IPART resources

Below we list IPART resources that may be relevant to the Inquiry.

IPART reviews relating to the rate peg and financial sustainability

- 2024 review of the council financial model in NSW (withdrawn)
- 2022-23 review of the rate peg methodology
  - IPART 2023 Final Report
  - ORIMA *Rate Peg Survey Integrated Report*
  - ORIMA *Rate Peg Focus Groups Research Report*
  - The CIE's *Local government labour cost indexation Final Report*
- 2020-21 review of the rate peg to include population growth
  - IPART 2021 Final Report
- 2008-09 review of the revenue framework for local government
  - IPART 2009 Final Report

More information about IPART's local government functions, other reviews and related work

- IPART's governing legislation
- The rate peg
  - Previously used Local Government Cost Index (LGCI)
- Special variations and minimum rates
- Local infrastructure contributions plans
- Domestic waste management annual charges
- Annual Report on IPART's local government functions
- 2015-16 review of the local government rating system
- Other local government reviews
- Prices for Valuer General's services to councils
- Central Coast Council water prices
- Crown land adjustments
- Costs of conducting local government elections

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