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Mr Chow
Local Government Division
Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE VIC 3000

Dear Mr Chow,

Submission on Consultation Paper - Measuring Productivity in the Local Government Sector

Thank you for the opportunity to provide a submission as part of the ESC's consultation on the recently released consultation paper – "*Measuring Productivity in the Local Government Sector*".

Having reviewed the consultation paper, Casey has the following observations, comments and suggestions for consideration in the upcoming discussion papers:

- Applicability of an efficiency factor if the Rate Cap continues to be CPI

When the concept of an efficiency factor was incorporated in the ESC's September 2015 Report, it was in the context of the ESC recommended rate cap being a combination of CPI and WPI.

The sector advocated for the inclusion of the WPI element – noting that it was traditionally higher than CPI – due to the high proportion of the sector's current cost base that was labour related (reflecting that local government is a service-based industry).

The sector's understanding at the time was that the inclusion of an efficiency factor was linked to the inclusion of WPI in the formula to calculate the average rate cap. Put another way, if the rate cap is set at CPI in a particular year, there is already an implicit efficiency factor included.

It is not clear in the consultation paper whether an efficiency factor would only apply if the ESC recommended rate cap of a combination of CPI and WPI was adopted by the Minister, or whether it would apply universally, even if the Minister announced Rate Cap was CPI.

Reference is made to the model used by IPART in NSW. Casey notes that IPART is applying an efficiency factor to a separately developed Local Government Cost Index, which is not canvassed in the consultation paper.

Casey would request more clarity in the upcoming discussion papers on this matter, and recommend that an efficiency factor should not apply if the Minister announced Rate Cap is already CPI or would result in a rate cap lower than CPI.

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- Ability of the proposed approach to allow for externally imposed requirements and quality improvements

Whilst understanding the desire to have a model that is efficient and cost effective to operate and maintain, and which can be readily understood and compared, there are some factors that can impact Councils – including externally imposed requirements – that would not be delineated or excluded in the currently proposed models.

More generally, it appears that the measurement of 'outputs' only captures changes in quantity, and would not capture increases in quality of outputs (which, for the same level of inputs, would represent an increase in productivity.)

Two instances readily come to mind, however, there would be others.

In recent years, there have been significant increases in the EBA levy for Waste disposal at landfill – that has increased from \$9/t in 2009, and is now \$62/t in 2017. Under the models 4 and 5 contained in Table 2.1, this externally imposed cost increase would impact inputs, but not outputs.

Another externally imposed change over the last 5 years, has been the changes in the kindergarten space, which has progressively included an increase in weekly hours from 10 to 15, enhanced qualification requirements for staff and a change in educator:child ratios from 1:15 to 1:11. These quality and quantity changes – which have impacted operating and capital costs (more rooms required) will have various impacts on the inputs for all 5 models, but would once again, not affect the outputs. In this instance, some of the extra costs have been funded by increased operating grants from the Government, or higher fees payable by the parents (partly reflective of increased contact hours) – so the full impact is not directly on General Rates.

It will be vital that whatever model might be finally adopted here, that it has the ability to take into account externally imposed impacts that increase costs, as well as changes in output *quality* – whether that be negative or positive.

- Consideration of demographics in the Outputs

Although only briefly discussed and acknowledged in the consultation paper, the models as currently proposed do not take any account of the impacts on inputs or outputs of different demographics, or the impacts on Councils of changes in demographics over time. There are certain demographics that are more operating and capital expenditure dependent than others, which is not allowed for in the currently proposed models.

Casey would recommend that further analysis should be undertaken on the cost impacts of demographic differences beyond just population size, in particular focussing on the proportion of young and old populations that are most linked to key Council services

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- Approach for Councils that are considered technically efficient

An interesting issue that arises from the concept of “technically efficient”, would be whether the efficiency factor should still apply to those Councils which are already assessed as “fully efficient”, as this could be seen to penalising those Councils which have already taken the required steps to be efficient and effective.

Casey would request that Councils that are already assessed as being fully efficient should not also be subject to an efficiency factor.

This would be an allowable outcome under section 185D (2) of the Local Government Act, as this would be “a class of Councils” for which a separate “effective” cap could be set by the Minister.

Further to our earlier enquiry to the ESC in relation to Fig 2.2 (pg 13), Casey looks forward to understanding where it ranks in terms of this efficiency analysis.

- Inclusion of population, rather than households in Outputs

As a general rule, Councils provide services and infrastructure for people, rather than strictly households.

In all of the proposed models, households are used as a measure in the outputs. Noting the disparity in average household size across Victoria, it is possible that this could have a static effect in the Data Envelopment Analysis. This would be particularly so if “true” outputs increase with population, not just households, in which case a more densely populated Council area could - all else being equal - show as less technically efficient if only measuring households.

Consideration is requested for the running of an alternate model – similar to Table 2.1 – with the replacement of “households” with “population”, to ascertain if that has a material impact.

Noting that the concept of household is well understood, another option here, at least for modelling and investigation, could be the use of a weighted average of population and households for the outputs under the various models.

- Comments on specific approaches for setting the efficiency factor

Casey offers the following comments on the specific methodologies used for the different approaches to estimate an efficiency factor.

Nominal Value

- The ESC has floated on page 26 the potential use of the Notional value due to uncertainties in setting ‘required efficiency gains’ and appropriate timeframes, potentially as part of a staged approach.
- The ESC proposes increasing the efficiency factor until it reaches 0.2 per cent, on the basis that this is “at the top of the range of results generated”. However, 0.2 per cent is in fact *above* the range of results generated by all three approaches.
- Given the early days, Casey believes it would be prudent to take a more conservative approach to setting the cap, at the top of the range of the Data Envelope Analysis (0.09%), particularly given the uncertainty in relation to the choice of the proxy value (see below).
- Casey reiterates that the effect of the efficiency factor should not reduce the rate cap below CPI.

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Proxy

- Casey notes that, of all the potential proxy measures of multifactor productivity presented in Table 3.1, more than half are negative.
- Of the four measures over the 5–10 year period recommended by the consultants (Deloitte Access Economics), three are negative.
- Casey notes that Deloitte Access Economics preferred using the weighted index of 3 industries “which most best reflect local government expenditure”, rather than the 16 market sector index.
 - Using the weighted 3-industry index would have resulted in a negative value over any of the analysed timeframes.
- Despite this, the ESC has chosen the 16 market sector index.
- Casey requests more evidence and justification for the ESC recommending the use of the 5-year, 16-industry average, which happens to result in the sole positive proxy number amongst those considered appropriate by Deloitte.
- Casey would note that the 3 industries excluded from the ABS data are those that are closest to the services and role of Local Government, and are difficult to measure productivity in. Which is also similar to Local Government – as it is hard to measure the value of output (quantity and quality) for services when the recipient of the services may not be directly paying for them
- Finally, Casey notes that the proposed approach for dealing with negative values on page 20 is selective, and could potentially have a ‘ratchet effect’ over time that may affect the financial viability of councils by requiring unrealistic productivity gains, particularly if productivity data fluctuates.
 - Although the third option is more complicated, it would provide a more accurate result and mitigate the risk of this ratchet effect.

Data Envelopment analysis

- [As noted previously], Casey notes that the measures of outputs used in the data envelopment analysis does not capture the *quality* of those outputs.
 - For example, if a Council chose to collect rubbish only monthly instead of weekly, this would not affect the measure of outputs in the models (with the possible exception of model 3)
- Although this results in a simpler model, it reduces the accuracy of the measure and may tend to understate productivity improvement in Councils
- Casey is unable to provide final comments on the reasonableness of this approach without knowing the proposed “required efficiency gain” or “timeframe for efficiency gains”
- Casey would request that Councils that are already assessed as being fully efficient should not also be subject to an efficiency factor.
- Finally, if the Data envelope analysis is used, Casey supports the multiple group basis, on the basis of the structural differences and different cost structures that different council types face as shown in Appendix A.

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If you require any clarification or further discussion on the matters raised in this submission, please contact Council's Chief Financial Officer, Mr Andrew Davis.

Yours faithfully



Mike Tyler
Chief Executive Officer

13/10/17