Independent Pricing and Regulatory Tribunal

IPART
New South Wales

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Natural Disaster Funding Arrangements
Productivity Commission
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Contact Nicole Haddock

Dear Commissioners

PRODUCTIVITY COMMISSION'S NATURAL DISASTER FUNDING ARRANGEMENTS, DRAFT REPORT

We welcome the opportunity to respond to the Productivity Commission's *Natural Disaster Funding Arrangements, Draft Report.* In general we support the findings and recommendations of the Productivity Commission's Draft Report. In particular, we support the hierarchy-based framework for allocating cost/risk ownership. In our experience in considering fees for Local Land Services, this approach is effective.

Our response to your draft report focusses on:

- Developing benchmark costs for infrastructure
- Insurance arrangements
- Cost benefit analysis
- Asset management by councils
- Local government funding of infrastructure
- Fire services levy.

Developing benchmark costs for infrastructure

In April 2014 we released our final report responding to the NSW Government's request for IPART to advise on benchmark costs and how councils can establish the efficient costs of providing essential local infrastructure. Details about the review and the final report are available at http://www.ipart.nsw.gov.au/Home/Industries/Local_Govt/Reviews/Benchmark_Costs/Benchmark_costs_for_local_infrastructure_contributions.

We developed benchmark or reference costs for essential infrastructure items in four categories – roads and transport facilities, stormwater management, open space embellishment and community facilities. Councils can use the benchmark costs as a guide in estimating the costs of infrastructure for the purpose of levying infrastructure contributions, with the onus on councils to justify deviations from the benchmark costs.

The methodology for calculating benchmark costs and reference costs is set out in the Final Report. In establishing the benchmark costs, our consultants, Evans & Peck, used their own database, supplier/subcontractor quotes and published costing guides, and tested their calculations with councils. In this way IPART established benchmark costs for a total of 169 infrastructure items and sub-items, and reference costs for seven infrastructure items.

The methodology for determining the scope and efficient cost of each benchmark item was to:

1. define an appropriate performance outcome
2. define the minimum scope of the infrastructure item to meet the appropriate performance outcome
3. identify the typical scope of work to deliver the infrastructure item
4. create additional discrete items and sub-items for some of the items to reflect different performance outcomes or common variants of the scope, and quantity bands to reflect the difference in costs experienced as a result of economies of scale
5. calculate the efficient cost for each item or sub-item using the most accurate information available and a costing method, such as first principles ('bottom up') or reference pricing ('top down').

The benchmark cost of an infrastructure item is made up of 3 components:

- the base cost, which reflects the typical efficient cost of providing the item within the defined scope (this cost covers direct costs of supply and construction, contractor indirect costs, margin costs and council on-costs)
- location and congestion adjustment factors added to the base cost to account for variations in the cost of infrastructure because of different geographical settings, regional prices, access to materials and congestion settings (recommended factors can be applied in specified circumstances to different types of infrastructure)
- contingency allowances to account for uncertainty in the planning, design and delivery of infrastructure items, with recommended allowances to be applied according to type of infrastructure and project planning stage.

Reference costs provide an indicative range of costs, above and below the median of the possible distribution of cost outcomes for the infrastructure item being considered (for instance a range from a complex project to a simple solution). The methodology to determine reference costs was similar to that used for benchmark costs, however the cost for reference items is presented as a total cost rather than a unit rate, including the base cost and appropriate contingency allowance.

To keep the benchmark costs relevant and current, we recommended first that IPART update the benchmark base costs annually, and publish them on our website. We nominated the most appropriate ABS Producer Price Index to escalate base costs of each infrastructure type. In addition, we recommended that we regularly review the scope and costings of each of the benchmark items.

Insurance

We note that the Productivity Commission's preferred funding reform option (option 2) includes an insurance arrangement with voluntary take up. In our original submission we advocated for compulsory insurance to avoid potential moral hazard by local councils self-insuring, or not insuring and ultimately relying on State or Commonwealth taxpayer assistance. Further, by taking out insurance, councils would weigh up the premium costs against implementing mitigation strategies.

As the Productivity Commission acknowledges, the risk of moral hazard would also apply where states and territories may elect to take out insurance, as provided by the Commission's preferred option. We note that the voluntary nature of the insurance scheme under Option 2 may, in fact, increase the potential for moral hazard and adverse selection to occur. Therefore, we recommend that the Commission consider measures which may counteract such consequences.

The Productivity Commission recommends that state, territory and local governments should further investigate non-traditional insurance products for roads (Recommendation 3.4). We agree with this recommendation, acknowledging that there can be challenges with non-traditional options including availability and potentially cost effectiveness issues.

We also consider that there need to be clear decisions about which roads (and other public assets) should be insured, allocating responsibility between state and local governments.

Cost-benefit analysis

We support the approach in the Draft Report that robust and transparent processes, including cost-benefit analysis, should underpin decision-making both in the provision of public infrastructure generally (Recommendation 4.10), and in selecting mitigation projects (Recommendation 3.2). Given our observations about the capacity and capability of smaller councils to undertake cost-benefit analysis, we agree with the Commission's view that states and territories are generally best placed to coordinate, identify and prioritise mitigation activities in their jurisdictions. Nevertheless, the arrangements should be implemented in a way that provides incentives for the Councils to be responsible for their mitigation, resilience and recovery activities rather than shifting responsibility to the State Government.

Asset management and registers

As the Draft Report notes, NSW has legislative requirements for councils to have asset management strategies, and undertake asset management planning. We have observed that councils generally are becoming more rigorous in preparing their asset management plans, although they vary considerably in the sophistication of the documentation. While we have not specifically assessed plans on this basis, we would tend to agree with the Commission's view that there is limited evidence of their effectiveness in relation to natural disaster risk management.

We also note that the operating licences of the water authorities IPART regulates require asset management plans and for authorities to report against them. As our original submission noted, risk management in the context of dam safety is not only a matter of capital expenditure, but should also consider other options such as warning systems, evacuation strategies and preventative measures to protect property from damage.

Local government funding for infrastructure

In a recent review that we undertook about assessing the financial viability of councils,[1] we noted that many NSW councils have zero or very low debt. This means that, historically, current ratepayers have incurred higher rates than necessary to fund long-life capital investment which would benefit future generations. This is an issue of intergenerational equity. Councils have not been spending on renewal of infrastructure, and there are now backlogs. Potentially councils could borrow to fund capital investment to reduce the backlogs. The criteria that we recommended to assess the financial viability of councils include a debt service ratio benchmark which should encourage the use of debt and more responsible funding of long-lived assets. Debt enables benefits and costs of long-life assets to be shared more equitably between current and future generations of ratepayers.[2]

Fire services levy

We agree with the Productivity Commission's assessment of the NSW fire services levy, noting the distortionary effects it has on insurance prices and affordability. This was discussed in our Review of State Taxation (June 2008) where we recommended removing the fire services levy and replacing it with a corresponding increase in local government contributions and rates. This would increase the contribution from all property owners via local government rates.

1 IPART, *Review of criteria for fit for the future, Final Report,* September 2014.

2 IPART, *Review of criteria for fit for the future, Final Report,* September 2014, pp 35-36.

If you need further explanation of our benchmarking review, or have any questions about this submission, please contact Ms Nicole Haddock

Yours sincerely

Peter J. Boxall AO
Chairman