



**NORTHERN TERRITORY VIEWS ON
CGC DRAFT REPORT – ATTACHMENT 20**

CAPITAL

SEPTEMBER 2009

Key Points

- The Territory reiterates its support for the assessment of capital needs and its preference for a direct assessment of these needs on the basis of simplicity and contemporaneity.
- The Territory considers a 50 per cent discount on capital stock disabilities excessive given:
 - the strong link between socio-demographic composition use disabilities and capital needs;
 - the Commission has adopted a very conservative approach in the development of expense use disabilities and to further dilute their influence in this assessment through additional discounting will understate relative needs;
 - the Commission has not assessed capital specific disabilities; and
 - the relationship between some expense use disabilities and capital use may be greater than 1.
- In the interests of simplicity and to provide the most reliable assessment of relative needs the Territory urges the Commission to use unadjusted expense disabilities in the capital and depreciation assessments.
- The Territory considers the use of a four state average inappropriate when determining the materiality of a cost of borrowing disability. The Territory considers a more jurisdiction specific rate would be material and should be assessed.
- The Territory is disappointed that the Commission continues to ignore the impact of the Territory's special circumstances on its capital needs.

This submission details the Northern Territory's views on issues raised in the Commonwealth Grants Commission's (the Commission's) Draft Report, Attachment 20 – *Capital*.

Introduction

The Commission propose to assess capital needs using a direct approach which incorporates an assessment of net investment and net lending. Population growth disabilities are applied to both net investment and net

lending and discounted expense disabilities are proposed to be applied to net investment. The assessment also includes an Other Investment component comprising expenses on land and other non produced assets which are assessed equal per capita (EPC), and a National Network Roads (NNR) component comprising NNR capital grants which are assessed actual per capita (APC).

The Territory reiterates its support for the assessment of capital needs and its preference for a direct assessment of these needs on the basis of simplicity and contemporaneity. However, the Territory considers the proposed discount in relation to expense disabilities excessive and is concerned it will unreasonably understate relative capital needs.

Expense Disabilities

The Commission divide the recurrent expense disabilities applied to net investment expenses into disabilities which influence the level of capital (capital stock disabilities) and disabilities which influence the unit cost of capital (aggregate cost disabilities). The Commission propose to apply a 50 per cent discount to the capital stock disabilities.

The Draft Report indicates the discount is designed to recognise a one to one relationship does not exist between expense use and stock disabilities. While the Territory acknowledges this may be the case for a limited number of expense use disabilities, it considers a 50 per cent discount excessive given:

- it is the link with socio-demographic composition (SDC) cost (rather than use) disabilities which appears weaker. Cost disabilities are responsible for a relatively small proportion of the distribution associated with expense use disabilities;
- the Commission has adopted a conservative approach in the development of expense use disabilities throughout the 2010 Review assessments. For example, the Commission has heavily discounted expense use disabilities in the Justice Services, Housing and Welfare Services, and Services to Communities assessments;

- the Commission has not assessed several capital specific disabilities, such as physical environment or construction costs; and
- the relationship between some expense use disabilities and capital use may be greater than one to one. For example, while there is a clear one to one relationship between public housing tenants and public housing capital costs, there is likely to be a greater than one to one relationship where the tenant is Indigenous due to higher depreciation and capital costs associated with above average wear and tear on the dwelling or due to higher construction costs where Indigenous dwellings are built to higher standards to withstand above average wear and tear and keep repairs and maintenance costs to an average level.

The Territory provided an analysis of the relationship between each expense disability and capital costs in its response to Position Paper 2008/29 which demonstrated a strong relationship between most expense disabilities and capital needs. This analysis is repeated at Attachment A for convenience. The Territory reiterates its view that there is a strong relationship between most expense disabilities and capital and it would be incorrect to assume there is no relationship between SDC cost disabilities and capital. As such and in the interests of simplicity, unadjusted expense disabilities should be applied to capital and depreciation.

Borrowing Costs

The Territory notes that the Commission accepts there is a conceptual case for a differential assessment of borrowing costs and that they consider a five basis point premium for the four smaller states would be appropriate. However, the Commission concludes no assessment is warranted as the additional costs are not material.

The Territory is disappointed that the Commission has adopted the average additional costs of borrowing of the four smallest jurisdictions (five basis points) when determining materiality as opposed to jurisdiction specific rates. The Territory provided the Commission with data showing the additional cost of borrowing faced by the Territory is around ten basis points per annum. The Territory does not accept that its higher borrowing costs are policy choice and

considers a jurisdiction specific cost of borrowing disability would be material and should be assessed.

Northern Territory’s Special Circumstances

The Territory reiterates its view that it faces a number of capital-related disabilities that are not policy influenced, are a result of past Australian Government policy, the early stages of the Territory’s development and higher costs of borrowing. The Territory does not agree that these costs have already been addressed and is disappointed that the Commission continues to ignore the impact of the Territory’s special circumstances on its capital needs.

Appendix A: Expense Disabilities and Physical Assets

Administrative Scale

Administrative scale recognises the unavoidable costs each state incurs to provide the minimum unavoidable service, regardless of the size of the state.

The Territory considers this disability should be applied to physical assets because physical assets, in the form of head-office space and equipment, comprise a proportion of the minimum cost of providing government services.

Location

Location recognises differences in the cost of providing labour and non-labour resources inter and intra-state. The Territory considers this disability should be applied to physical assets because the cost of labour affects the price of construction and major repairs/upgrades. The Territory notes that while some assets may be manufactured interstate the cost of freight may offset any perceived savings. The Territory also notes the proposed labour assessment is largely based on private sector wages which include construction industry wages.

Non-labour costs are also relevant to physical asset expenses as differences in freight costs and availability will impact the cost of construction materials and plant and equipment both inter and intra-state.

Service Delivery Scale

Service delivery scale recognises the diseconomies of scale associated with providing physical assets (such as schools and police stations) in sparsely populated areas.

The Territory considers service delivery scale has a direct influence on capital expenses as physical assets such as schools in sparsely populated areas have higher capital to student ratios (all other things being equal) because infrastructure is not infinitely scalable. Similar logic applies to police stations and health centres.

Cross Border

The cross border disability recognises cross border use of services such as schools, in New South Wales and the Australian Capital Territory.

The Territory considers this disability applies to capital expenses as states with cross-border users, such as students, will need to increase the level of physical assets (e.g. classrooms) provided to maintain the average capital to client ratio.

Schools Education – Socio Demographic Composition

The socio-demographic composition (SDC) disability recognises that different population group's use services at different rates and they have different per unit service delivery costs.

The Commission currently propose use weights for age, Indigeneity and non-policy influences on the number of post-compulsory enrolments. The Territory considers these influences relevant to capital expenses as states will need to provide more (less) physical assets if they experience high (low) use rates to maintain the average capital to student ratio.

The Commission currently propose cost weights for Indigeneity, low SES and school sector. The Territory considers that the Indigeneity and low SES cost weights should be applied to physical assets as the provision of additional services will often necessitate additional office space for planning, policy and co-ordination staff. For example, the Territory's Department of Education and Training has around twenty central and regional office staff which focus on remote schools policy and accelerated literacy programs including many programs specifically targeted at Indigenous students. The provision of additional services to Indigenous students may also involve provision of additional teacher housing in remote areas.

The Territory considers the adjustment for non-government schools also applies to physical assets as states with a higher proportion of non-government students will have lower government school classroom requirements (all other things being equal).

The Territory broadly agrees that the presence of Indigenous or low SES students is unlikely to result in additional classrooms. However, these high needs students often receive focused tutoring in relatively small classes which result in a higher capital to student ratio compared to other students.

The Territory acknowledges that it is unlikely that cost weights are as applicable to capital as use weights but considers it would be incorrect to assume there is no relationship and in the interests of simplicity both use and cost SDC weights should be applied to capital.

Post Secondary Education – Socio Demographic Composition

The Commission currently propose use weights for Indigeneity, remoteness and non-English speaking background (NESB). The Territory considers these influences relevant to capital expenses as states will need to provide more (less) capital if they experience high (low) use rates to maintain the average capital to student ratio.

Admitted Patients – Socio Demographic Composition

The Commission currently propose use weights for age, Indigeneity, SES and country of birth. The Territory considers these influences relevant to capital expenses as states will need to provide more (less) physical assets if they experience high (low) use rates to maintain the average capital to patient ratio.

The Territory understands the Admitted Patients assessment SDC factor incorporates a number of cost weights which are imbedded within the AIHW data. The Territory considers these cost weights are likely to impact capital expenses as they reflect, among other things, the longer length of stay of some patients. Similar to higher use, longer use of admitted patient services necessitates more capital to provide the average capital to patient ratio.

The imbedded cost weights may also reflect the higher use of more costly diagnostic related groups (DRG's) by some patient types. To the extent that the DRG's are more expensive due to the equipment used these costs will also impact capital expenses.

Community Health Services – Socio Demographic Composition

The Commission currently propose use weights for age, sex, Indigeneity, remoteness and SES. The Territory considers these influences relevant to physical assets as states will need to provide more (less) capital if they experience high (low) use rates to maintain the average capital to patient ratio.

Under the proposed Community Health Services assessment the SDC factors above are offset by the level of service provision met by the non-state sector. The Territory considers this has a similar impact to lowering use rates and that the net impact is applicable to capital expenses.

Welfare and Housing – Socio Demographic Composition

The Commission currently proposes use weights for Indigeneity and SES. The Territory considers these influences relevant to capital expenses as states will need to provide more (less) physical assets if they experience high (low) use rates to maintain the average capital to client ratio.

The proposed Welfare and Housing assessment also incorporates an Indigenous cost weight designed to capture the additional costs associated with managing and maintaining Indigenous housing. Although maintenance of housing stock is a recurrent expense, Territory Government housing in remote areas needs to comply with the many and varied environmental health standards (EHS) requirements which increase the cost of remote, predominately Indigenous, housing.

The Territory estimates EHS requirements increase the cost of a dwelling by up to \$80 000 for a typical 3 bedroom dwelling. EHS requires that houses be particularly robust not only in construction elements such as walls, floors and ceilings, but also in relation to individual components such as doors, cupboards, wardrobes, hinges and light switches which must be impact resistant. As such, the Territory considers applying the Indigenous cost weight to housing related capital expenses appropriate as it provides a proxy for additional EHS related costs.

Territory Housing also employs a number of centralised policy officers who develop and co-ordinate Indigenous housing policy designed, among other

things, to minimise repairs and maintenance costs associated with overcrowding and inappropriate tenant behaviour and maximise sustainable Indigenous tenancies through initiatives such as the life skills program. These staff require office space and as such influence capital expenses.

Justice Services – Socio Demographic Composition

The Commission proposes use weights for Indigeneity, age, sex and SES. The Territory considers these influences relevant to capital expenses as states will need to provide more (less) capital if they experience high (low) use rates to maintain the average capital to client ratio.

Services to Communities – Water and Electricity Costs and Concessions

The water and electricity disability recognises differences between states in the cost of providing water and electricity services and differences between state in subsidies to individuals for the provision of electricity and water services. The Commission have concluded concessions generally target low income population groups.

To the extent that subsidy and concession expenses incorporate a capital as well as pricing element the Territory considers the disabilities would be applicable to any physical assets held by the general government sector.

Services to Communities – Indigeneity

The Indigeneity disability recognises the differences between states in the costs of providing community development (planning and governance) services to discrete Indigenous communities.

Services to Indigenous communities expenses includes both capital and recurrent expenditure. For example, the Territory funds the provision of essential services and associated infrastructure in Indigenous communities as well as community planning and development functions. The Territory considers this disability is directly applicable to physical assets as states with a relatively large share of Indigenous communities will, all other things being equal, require more physical assets (such as power, water and sewage infrastructure) to provide people in these communities with the average capital to client ratio.

Roads

The Commission acknowledges that road length and road use impact capital expenses. The Territory supports this conclusion.

The Commission propose assessing roads expenses using a modified National Transport Commission (NTC) model. However, the Commission have excluded NTC expenditure item F3, which captures most capital related road expenditure, from their model.

The model used by the NTC in its heavy vehicle pricing determinations incorporates capital expenditure (NTC Expenditure Item F3) and attributes it to the relevant cost driver. As noted by the Commission, the cost drivers in the NTC model impact differently on capital and recurrent expenses. However, the Territory considers the Commission should include expenditure item F3 in the roads assessment so that the resultant 'average' weights can be applied to both capital and recurrent roads expenditure. This approach would facilitate a simpler assessment of capital and recurrent roads expenses.

Transport Services – Transport Subsidies

The transport subsidies disability recognises differences between states in the average per capita subsidies in non-urban areas and urban areas of different sizes.

The Territory considers that to the extent transport subsidies incorporate both a pricing and a capital subsidy the transport subsidy disability should be applied to physical transport assets held in the general government sector. However, the Territory notes that transport assets are not generally owned by general government service providers and under the proposed weighted distribution of physical assets approach this will mean the inclusion/exclusion of this disability is largely irrelevant.

Services to Industry – Economic Environment

The economic environment disability recognises that the differences between states in the cost of providing services to industries are related to population, the size of industry sectors and the number of establishments/business in an industry.

The Territory considers this disability should be applied to physical assets as states with an above average number of firms and/or larger industries will require more capital to maintain the average capital to client ratio necessary to deliver services to industry.

Schools Education – Transport of School Children

This disability recognises state expenses on transport of school children. The paper states the average state policy is to acquire school transport services from private contractors and as a result this disability is unlikely to impact on capital expenses if the proposed weighted distribution of physical assets within the general sector approach is adopted.

First Home Owners Scheme

The Territory notes an actual per capita assessment is proposed for first home owner's scheme expenses and that these expenses do not include capital expenses. As a result, under the proposed weighted distribution of physical assets approach the disability will not be applied to capital expenses.

The Territory supports this approach.

Native Title and Land Rights

If Native Title and Land Rights are assessed on an actual per capita basis the Territory supports the proposal not to apply the disability to physical assets. However, the Territory notes some native title and land rights expenses are related to capital projects (for example, road and pipeline construction). In the interests of simplicity the Territory considers all native title and land rights expenses be assessed as recurrent expenses using an actual per capita assessment.

Natural Disasters

If natural disasters expenses are recurrent expenses and are assessed on an actual per capita basis the Territory supports the proposal not to apply the disability to physical assets.