



AUSTRALIAN CAPITAL TERRITORY

**SUBMISSION TO THE
COMMONWEALTH GRANTS COMMISSION'S
COMMISSION POSITION PAPER 2008/29:**

Capital

April 2009



Introduction

The 2010 Review has been run as an iterative process between the Commonwealth Grants Commission (the Commission) and the States and Territories (the States) over the course of the past four years. As part of this process the ACT has provided a number of submissions in response to the Staff and Commission Discussion Papers, incorporating subsequent multilateral and bilateral discussions with Commission staff and other States. These submissions outlined the ACT's position as to the validity of the conceptual case behind a number of assessments and the proposed assessment methodologies.

It is noted that in some instances the position adopted by the Commissioners, as detailed in the latest Commission Position Papers, is not necessarily supported by the ACT. In the interests of brevity the ACT has not sought to reiterate the entirety of its previously stated position unless new data or new thinking has been applied. In this light, a lack of objection does not imply support where such support has not been previously stated.

Approach

This paper draws on the analysis and views presented by the Commission in its Discussion Papers, 2008/03, *The Assessment of State Capital Needs* (April 2008) and 2008/29, *Capital*. (September 2008)

In the interests of brevity the following comments relate to the proposals put forward in those papers. The lack of further comment should not be taken as support for the inclusion of a capital assessment or for the proposed method.

General Comments

This submission argues, amongst other things, that, in regard to both Net Lending and Non-replacement Capital Expenditure, the annual movement in population shares based on ABS estimates of population growth is unreliable. Population estimates themselves are not reliable as can be seen by the adjustments required each Census. When assessments are based on the relative change in population estimates, that lack of reliability is amplified. The ACT suggests that a five year rolling average population movement should be used. This would have the advantage of including a Census year in each assessment year and improve the reliability as well as reducing the volatility of the assessment. In effect this would be using a trend estimate of past population change.

Assessment of Physical Capital

Discussion Paper CGC 2008/03 proposed an assessment method for Non-Replacement Capital Expenditure (NRCE) of:

$$\text{Assessed non-replacement capital expenditure} = [(K_1 / P_1) p_{11} \delta_{11}] - [(K_0 / P_0) p_{10} \delta_{10}]$$

In order to drill down to examine the effects of this assessment method, the formula can be re-stated as:

$$\text{Assessed NRCE} = K_1 [(p_{11} \delta_{11} / P_1) - (p_{10} \delta_{10} / P_0)] + \text{NRCE} (p_{10} \delta_{10} / P_0) \text{ (Attachment A for working)}$$

This representation shows how the method has two distinct effects. The first effect is represented by the term: $K_1 [(p_{11} \delta_{11} / P_1) - (p_{10} \delta_{10} / P_0)]$. This component of the assessment provides capacity for jurisdictions to adjust their share of the current stock of capital according to the movement in expenditure disability weighted population shares from the start of the assessment year to the end of the assessment year. For ease of reference this component of the assessment is referred to as the 'Stock' assessment.

The second component of the assessment [i.e. $\text{NRCE} (p_{10} \delta_{10} / P_0)$] provides the capacity for jurisdictions to meet their beginning year expenditure disability weighted population share of NRCE. This is referred to as the flow assessment.

Comments on the Stock Assessment

The stock assessment is extremely large given that it is based on the change in population shares and the movement in relative disabilities, with the resultant ‘factors’ applied to a standard of in excess of \$10,000 per capita (i.e. the per capita stock of physical assets in the current year K_1). In contrast the operating expenditure standard for all expense categories is only (approximately) \$6,000 per capita.

As such, the Stock assessment has the potential to have an inordinate influence on relativities, even where theoretically there is no increase in capital stock in any one year. In fact in a year where there is a reduction in total capital stock, this assessment would still produce large positive and/or negative assessed needs.

The ACT remains concerned about the relevance of the stock assessment. It has been argued that this assessment is similar in its approach to the former Debt Charges assessment. However, this assessment was applied to a standard which reflected the per capita amount of debt servicing costs which did not exceed \$300 per capita whereas the proposed capital assessment applies to a standard of more than \$10,000 per capita.

Moreover, the assessment does not reflect what States do. The acquisition and disposal of assets takes place over an extended period of time. It does not adjust to annual movements in populations or changes to relative disabilities. The inclusion of an assessment which provides large capital needs for States, even when it is observed that States are not accumulating capital is worrisome on a ‘what States do’ basis.

Revaluation Effects

In effect, the decisions of how to account for capital assets such as land will have a large impact on the annual relativities – irrespective of the underlying needs of States.

The ACT believes that the impact of revaluations on the assessment has not been removed, in contrast to the claims in the Commission Position Paper (2008/29: *Capital*). It is argued that by setting $K_0 = K_1 - \text{NCRE}$ the effect of revaluations is removed from the assessment. The ACT does not believe this is accurate.

The category standard for the stock assessment is theoretically the written down replacement cost of the physical capital stock (i.e. K_1), including any revaluation of the physical improvements plus the appreciation of any real property supporting the assets. Thus the impact of revaluations is captured as K_1 (the level of capital stock at the end of the period) changes over time. When applied to the relative change in disability weighted populations, i.e. $K_1 [(p_{11} \bar{D}_{11} / P_1) - (p_{10} \bar{D}_{10} / P_0)]$, this would increase the needs of States with above average population growth rates. It is only in the flow component of the assessment that revaluation effects do not apply as the standard only includes new capital expenditure – as the weighted population in period zero is applied to the NRCE.

The application of a capital standard that includes revaluation effects is likely to shift needs to those jurisdictions which are the source of a large proportion of the revaluations. Real property tends to appreciate where demand exceeds supply. This is more likely to be the case where population growth is relatively strong. Even where the supply of new land is matched to demand, the price of existing land is likely to appreciate with strong population growth reflecting its relative locational advantage. Land supply is also heavily policy influenced.

For example, the ACT Government Consolidated Financial Accounts for 2007-08 indicate that 24 per cent (approximately \$3,165 million) of the total Written Down Replacement Value (WDRV) of capital stock (\$13,118 million) relates to land. Furthermore, of the increase in WDRV from 2006-07 to 2007-08 of \$1,909 million, \$1,846 million relates to revaluations, including \$734 million for land revaluations.¹

Recent changes in accounting standards will further exacerbate this problem by bringing in the value of land under roads into the balance sheet. The 2007-08 ACT Government accounts do not include the value of land under infrastructure. However, from 2008-09 onwards, in accordance with *Accounting Standard 1051, Land Under Roads*, governments will begin to report the value of land under roads. Governments from this period on are required to include land under newly built roads, and have the option of bringing to account land under roads built before the 2008-09 year. Such land is to be measured at fair value. This change in the accounting standards will increase the proportion of assets which are land and as such, will result in larger annual revaluations. As detailed prior, given that land will appreciate more rapidly in faster growing States the application of a population dilution factor to the total value of capital stock, including land, will overstate the needs of such States.

Assessment Options

Given that it is not clear whether assessing revaluations using relative population growth rates will provide equalisation. Options for managing this issue include:

- not undertaking a stock assessment;
- removing the relative population movements from the calculation of assessed capital expenditure and just using relative movements in per capita expenditure disabilities;
- discounting the stock assessment standard to remove the estimated impact of revaluations; or
- discounting the stock assessment disabilities to remove the estimated impact of revaluations.

Some of the concerns mentioned above regarding the stock assessment are equally applicable to the flow assessment. The movement in stock levels from one period to the next includes, acquisitions, disposals and revaluations, less depreciation. To avoid the complications of the stock assessment, it is necessary to ensure that revaluations are not included in the calculation of NRCE.

Assessment of Net Financial Assets (NFA)

As the ACT understands it, the objective of assessing net financial assets is to provide each State with the capacity to have an equal per capita stock of financial assets. This would therefore enable each State to earn an equal per capita investment return. The assumption in this is, therefore, that there is no non-policy difference between states as to the earning rate on investments. The ACT questions the validity of this assumption.

Under the proposed assessment method, Net Lending (flow) in a period is defined as the change in Net Financial Assets (stock) from the beginning of the period to the end of the period (i.e. $NFA_1 - NFA_0$). Assessed Net Lending is derived by deducting an equal per capita share of the Net Financial Assets at the beginning of the period from an equal per capita share of the Net Financial Assets at the end of the period. The assessment is therefore driven by the change in population shares (or relative population growth from the beginning of the period to the end of the period). In effect, faster growing States will be assessed as

¹ Australian Capital Territory Government Consolidated Financial Report for the Year Ended 30 June 2008 (p. 48). www.treasury.act.gov.au/about/publications

requiring higher net lending. However, faster growing States may in fact have a relative advantage in accumulating net lending.

The assessment method seeks to provide GST funding on an annual basis to enable states to adjust their NFA to the equivalent of a population share of the current national aggregate of NFA, on the implicit assumption that in the period immediately before, the states have the capacity to hold a population share of the NFA. Thus the assessment calculates assessed expenditure using the aggregate NFA and movements in population shares since the previous assessment period.

The method assumes that differences between the states in the actual per capita share of NFA are policy-related and that no non-policy influences impact on the actual per capita level of NFA (apart from relative population growth rates). Where non-policy differences impact on the rate of NFA accumulation the proposed methodology will fail to capture this impact on States actual per capita shares of NFA and lead to incorrectly equalised shares of NFA.

In addition, evidence is outlined below which indicates that faster growing States have a greater capacity to accumulate NFA through higher profitability of the PNFCs. This is not appropriately captured in the proposed methodology and leads to a result which overstates the needs of States with above average population growth rates.

NFA Assessment Category Scope

Included in the assessment category for NFA are the following elements of GFS:

- investments (including cash, loans and other financial investments);
- equity held in Public Non-financial Corporations (PNFCs);
- less:
- borrowings (including deposits held and Advances repayable);
- superannuation Liabilities;
- other employee liabilities (e.g. Long service leave and other Leave owing); and
- other Liabilities (such as finance leases).

Typically the largest component is equity held in PNFCs. In fact nationally, if equity held in PNFCs is excluded the remaining NFA is negative. This is the case for most individual states as well. Refer Table 1.

Table 1: Net Financial Worth (excluding PNFCs) \$m

State	30-Jun-99	30-Jun-00	30-Jun-01	30-Jun-02	30-Jun-03	30-Jun-04	30-Jun-05	30-Jun-06	30-Jun-07
NSW	-27,777	-23,990	-22,881	-24,326	-25,296	-24,976	-24,932	-28,006	-27,065
Vic	-20,138	-19,057	-18,164	-18,711	-20,811	-18,311	-16,754	-18,867	-16,355
Qld	2,107	2,858	17	-198	-1,797	1,108	5,101	1,295	1,609
WA	-6,136	-6,489	-6,528	-6,644	-6,796	-6,228	-5,640	-4,328	-4,419
SA	-9,767	-6,927	-6,063	-6,431	-6,529	-7,570	-9,176	-7,757	-6,666
Tas	-3,306	-2,887	-2,785	-2,761	-2,725	-2,570	-2,468	-2,584	-2,871
ACT	-1,426	-1,142	-970	-469	-478	-523	-952	-1,069	-642
NT	-2,216	-2,451	-2,672	-3,035	-3,078	-3,023	-3,128	-3,255	-3,541
Total	-68659	-60085	-60046	-62575	-67510	-62093	-57949	-64571	-59950

Source: Derived from Tables 231 – 238, ABS Publication 5512.0, Government Finance Statistics, Australia 2006-07

The proposed assessment, therefore primarily relates to PNFCs. By implication then the proposed assessment assumes that each state is able to accumulate an equal per capita surplus from the operation of these corporations.

Typically the PNFC consists of organisations that are commercially focussed. Revenues are sourced from the sale of goods and services and the net worth of these organisations are derived from accumulated operating surpluses. Types of organisations that make up PNFCs include:

- energy producers, distributors and retailers;
- water and Wastewater corporations;
- totalisator agencies;
- land management corporations;
- port authorities; and
- insurance companies.

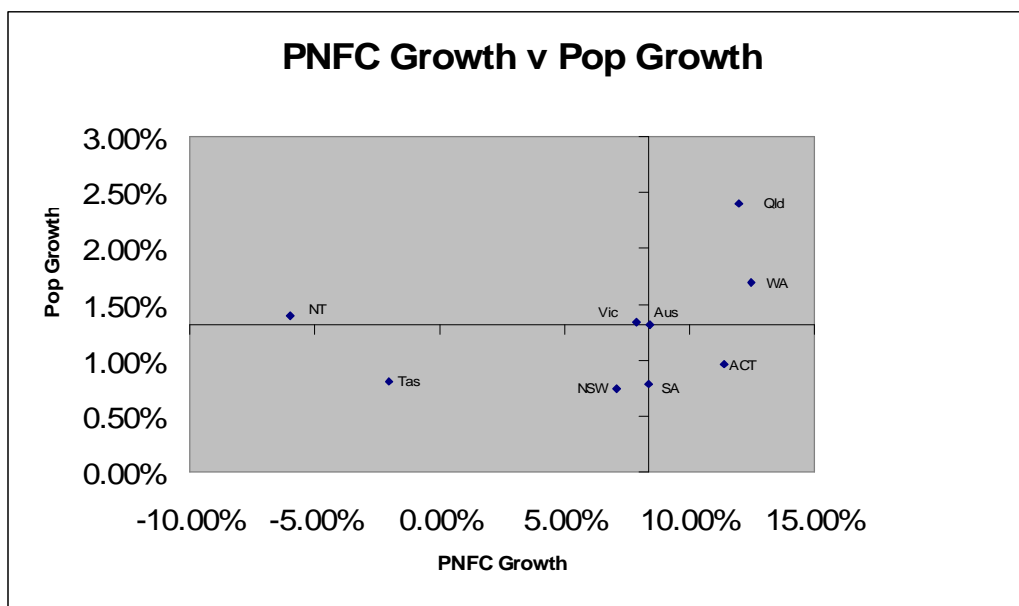
The ability for these organisations to operate commercially is not consistent across states. At one extreme, it is not possible for the ACT to have a Port Authority, whereas the public ownership of a port authority in those states which are export oriented or are entry points for imports could and does generate considerable net worth.

It could also be argued that electricity generation is more likely to be lucrative for those states which have a ready supply of coal or gas, as compared with those states that are required to import their energy needs or source energy in an expensive way.

Clearly, geographical situation, natural endowment and economic strength will impact on the profitability of PNFCs. In effect, some states due to their advantages are able to accumulate equity in PNFCs at a higher rate than less advantaged states.

Chart 1 compares the average annualised rate of growth in Equity in PNFCs with the average annual population growth, over the five years from 2001-02 to 2006-07. It shows that the fastest rate of accumulated equity occurs in those states with the fastest growing populations. Conversely, those states with slower population growth tend to have slower accumulation of equity in PNFCs.

Chart 1: Average Annualised Growth in Equity in PNFCs and Mean Resident Population, 2001-02 to 2006-07



Source: ABS Mean Resident Population, ABS Government Finance Statistics 2006-07

In many instances PNFCs are statutory or natural monopolies. Some of these operate relatively free of regulation and are able to access monopoly rents. In other cases they operate within a regulatory scheme which restricts profits to a reasonable return on assets. However, they are also often capital intensive organisations and the value of equity is often driven by asset revaluations as much as by accumulated profits.

The ACT Government *Consolidated Financial Report 30 June 2008* shows that after payment of dividends the total change in equity was almost entirely accounted for by asset revaluations.²

In past reviews, the Commission has considered that it was not appropriate to assess disabilities for public sector commercial operations. This conclusion was based on arguments relating to economic efficiency and considerable doubt as to how any relative disadvantage might be measured. Accordingly, the net operating balance of PNFCs has not been subject to equalisation in the past. The proposed assessment for Net Financial Assets, including Equity in PNFCs, may in fact provide a distribution of GST towards those states which have an advantage in respect of the accumulation of Equity in PNFCs.

The ACT considers that there would appear to be no basis for assuming that States have an equal per capita capacity to generate net worth from PNFCs. Accordingly, the ACT considers that equity in PNFCs should not be included in the category standard.

One of the reasons previously provided for the inclusion of capital in the Commission's standard budget is that GST revenues are used to acquire capital and, ipso facto, the distribution of GST revenues between States should take account of any non-policy differences in the need for capital acquisition. However, it is the case that under usual circumstances, GST revenues are not normally used to acquire net worth in

² Ibid. p. 8

PNFCs. Rather, the acquisition of net worth in PNFCs is from accumulated surpluses arising from the sale of goods and services to the market, and from the revaluation of assets.

The ACT contends that PNFCs should be excluded from the NFA category standard on the grounds that:

- there are non-policy differences between the states in their capacity to acquire equity in PNFCs, which have not been subject to equalisation and nor should they; and
- GST revenues are not used to acquire equity in PNFCs.

The options for dealing with PNFCs include:

- remove PNFCs from the standard for the category; or
- discount the assessment to recognise the problem.

The second option is a less than optimal solution and should only be adopted as a last resort. It does not really address the issue, but just dilutes the consequences of the problem.

The first option presents some difficulties in that the standard for the category will be negative. This suggests that the population dilution effect will actually benefit faster growing states as they will have a lower negative NFA per capita. A possible alternative would be to aggregate the negative NFA standard with the positive Net Physical Assets standard into a single 'Net Assets' category. This would reduce the complexity of the capital assessment.

Conclusion

The ACT considers that the assessment methods proposed in Discussion Paper 2008/29 should be amended as follows:

- the scope of the category, Net lending should be changed to exclude Equity in PNFCs;
- the resultant mainly negative standard should be amalgamated with Non-replacement Capital Expenditure;
- the amalgamated category should be assessed without a population dilution factor, recognising that there is no evidence that such an impact exists and some evidence that the opposite impact may be influencing actual per capita capital stock; or
- the amalgamated category should be assessed on a heavily discounted basis to remove the impact of revaluations on the standard per capita stock levels; and
- the assessment should be based on a rolling five year average of population shares rather than year by year.

Algebraic Expression of Proposed Capital Assessment

Proposed: $\text{Assessed NRCE} = [(K_1 / P_1) p_{i1} \delta_{i1}] - [(K_0 / P_0) p_{i0} \delta_{i0}]$

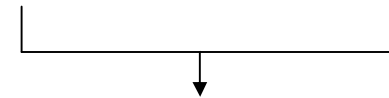
Assume: $K_0 = K_1 - \text{NRCE}$

Thus: $\text{Assessed NRCE} = [(K_1 / P_1) p_{i1} \delta_{i1}] - [(K_1 - \text{NRCE}) / P_0] p_{i0} \delta_{i0}$

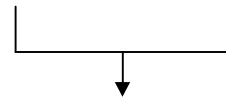
Rearrange: $\text{Assessed NRCE} = (K_1 / P_1) (p_{i1} \delta_{i1}) - (K_1 / P_0 - \text{NRCE} / P_0) (p_{i0} \delta_{i0})$

$$\text{Assessed NRCE} = (K_1 / P_1) (p_{i1} \delta_{i1}) - (K_1 / P_0) (p_{i0} \delta_{i0}) + (\text{NRCE} / P_0) (p_{i0} \delta_{i0})$$

Gives: $\text{Assessed NRCE} = K_1 [(p_{i1} \delta_{i1} / P_1) - (p_{i0} \delta_{i0} / P_0)] + \text{NRCE} (p_{i0} \delta_{i0} / P_0)$



Referred to as the Stock component
of the assessment



Referred to as the Flow component
of the assessment