



**AUSTRALIAN CAPITAL TERRITORY**

**SUBMISSION TO THE  
COMMONWEALTH GRANTS COMMISSION'S  
STAFF DISCUSSION PAPER 2007/22-S:**

*Building Blocks for the Assessment of Capital Related  
Expenses in the 2010 Review*

**AND**

**STAFF DISCUSSION PAPER 2007/26-S:**

*Building Blocks for the Assessment of New Capital  
Expenditure Needs in the 2010 Review: Assessing New Capital  
Expenditure*

**October 2007**



## **VIEWS ON THE COMMISSION'S CAPITAL PROPOSALS**

### **DEPRECIATION**

#### **Are there any recurrent disabilities that are not relevant to average depreciation expenses, and if so, what?**

The ACT supports the assessment of depreciation expense across categories as a simpler and more transparent assessment method. It is clear that demand-type factors are likely to closely align with capital needs and therefore are relevant to depreciation assessments. It is not clear that unit cost factors are relevant to depreciation assessments. The ACT recommends that the Commission review all of the expenditure assessment factors for their relevance to the assessment of depreciation. The Commission's views should then be provided to the States for consideration.

The ACT does not support the continued assessment of natural hazards as this assessment has historically been heavily reliant on judgement, and based on the figures provided by the Commission in the Discussion Paper, any such assessment would not be material.

#### **Are there any special capital disabilities that should be recognised?**

The ACT has not been presented with evidence substantiating a conceptual case as to the validity of any special capital disabilities, and as such does not support their inclusion in the assessment methodology at this time.

### **NEW CAPITAL**

#### **How might new capital expenditure needs be assessed?**

Capital assets are in effect stored future consumption. State-owned assets are consumed in the process of delivering services or raising revenues. The rate of consumption is influenced by a range of factors which may vary over time. For example, the consumption of a road asset would be affected by the density of traffic, which may increase or decrease over time. This is important because the relative rates of consumption of assets held by States, as measured by needs, may differ over time. This means that the needs assessed in the year of acquisition may be different to the needs relating to consumption of the asset during its life.

A further cost of capital is the opportunity cost (holding cost) of the investment in the asset. This may take various forms, depending on the method of financing, including debt servicing costs, lost investment returns or lost opportunity for social dividends from another infrastructure investment.

Ideally a capital assessment would do a number of things:

- be consistent with HFE;
- be simple and transparent;
- match consumption with the needs applicable at the time of consumption;
- be indifferent as to the form of financing, including leasing; and
- avoid any potential grant design effects.

Conceptually, an assessment based on the recurrent impacts of capital would be the preferred model. This would meet the criteria listed above. Such an assessment would include depreciation and holding costs. This is consistent with the model put forward by South Australia (Model A).

An assessment based on the recurrent costs of capital is consistent with the past aim of equalising the operating budget result. It also minimises the opportunity for grant design effects.

Holding costs may be in the form of debt servicing costs, foregone interest earnings or the financing component of leasing costs. South Australia suggests imputing a standard for holding costs. The ACT considers there may be scope for the assessment of holding costs to be based on separate differential assessments for Debt Servicing and Interest Earnings, noting that leasing costs are already included in the assessment category standards. Properly structured these two assessments may be able to overcome concerns that States could influence the relativities calculation by manipulating their financial arrangements.

An alternative model based on the assessment of new capital expenditure (Model B) has also been proposed. The ACT considers that this model is flawed for the following reasons:

- it introduces an element of net worth, but in itself is only a partial assessment of net worth;
- needs are not aligned with the period of consumption, but with the period of acquisition;
- it appears to require an adjustment for the rate of population growth at the time of acquisition even though the consumption of the asset will be affected by future rather than current levels growth rates (the ACT is not convinced of this argument for a population growth rate adjustment); and
- it has the potential to influence financing decisions, particularly if a population growth factor is assessed.

The ACT considers that there may be options for undertaking a recurrent based assessment along the lines proposed by South Australia. Moreover, there may be potential for making assessments for the debt servicing and interest revenue categories that achieves HFE but avoids the need for an imputed holding cost standard. Alternatively, the Commission could explore using just the depreciation standard but adjusting factors to allow for holding costs. The ACT suggests that the Commission might like to explore these options.

### **Should an assessment of non-financial assets be undertaken**

In the past the Commission has limited its assessments to the operating statement (net income). Any extension of equalisation to the balance sheet (net wealth) is fraught with difficulties. The ACT considers there are three major concerns with extending equalisation to the balance sheet:

- it may lead to double counting of equalisation needs;
- not all assets are shown on government balance sheets, particularly undeveloped crown land which is a real and large asset for governments; and
- if the entire balance sheet is not subject to equalisation, where should the line be drawn.

The ACT does not support an assessment of net worth and, as such, the equalisation of the capacity to accumulate financial assets without an assessment of other net worth related assets, such as land and the income (revaluation) derived from it.

If the Commission is now considering a departure from its past practice to one of equalising net wealth, it would need to consider how net wealth would be measured. As noted above, government balance sheets do not include all of the assets available, crown land being a significant example.

Restricting assessments to financial assets alone also has its limitations. A major component of net financial worth for General Government is the value of equity held in Public Non-Financial Corporations (PNFCs). The greater share of the value of this equity relates to physical assets such as pipes and wires. If physical assets are excluded from assessment, it follows that equity in PNFCs should be excluded from the measure of financial net worth. Under the ABS treatment, equity in PNFCs is consolidated out for both the Non-Financial Public Sector accounts and the Total Public Sector accounts. The exclusion of equity or consolidation of accounts results in all jurisdictions having negative net financial worth.

**What are the main drivers of new capital expenditure that should be taken into account? Is population growth the main driver of State capital needs? Do States provide new capital when their populations grow (or is it in advance or arrears?)**

The need for infrastructure is driven by service demands which in turn are affected by, in the main, demographics. Thus far circumstantial evidence provided by Western Australia supporting the assessment of new capital expenditure has failed to persuade the ACT that the accumulation of non-financial assets is forward looking. In fact, it is the ACT's experience that budgetary constraints are placed on aggregate State capital expenditure based on the overall fiscal outlook.

Further investigation should be undertaken to determine 'what States do' rather than relying upon mathematical models.

The ACT Government, and most likely all jurisdictions, have documented procedures for capital management. These include the need to develop a justification based around service need, options for delivery and costs and benefits. Capital initiatives are prioritised and approval is subject to fiscal constraints.

**How do we ensure that the methods we adopt for assessing new capital expenditure needs do not create grant design inefficiencies? For example, how should new capital acquired through leasing, subsidies to trading enterprises and PPPs be assessed?**

The choices faced by governments in how to deliver services and, in particular, the extent to which services are provided through capital investment rather than recurrent expenditure are highly policy driven. Furthermore, choices as to how infrastructure is funded are also highly policy influenced. This area of government policy is more open to grant design inefficiency than perhaps any other area. Accordingly, any assessment methodology should seek to minimise the opportunity for grant design inefficiency.

The ACT considers that an assessment of actual capital expenditure, will provide opportunities for grant design inefficiencies, potentially influencing financing decisions. In contrast, an assessment based on recurrent costs of capital would be indifferent to the form of financing. While both models of possible capital assessment, so far proposed, have limitations, the ACT is persuaded that avoiding grant design inefficiencies is very important and should be given a high

priority in choosing an assessment method. This is one of the key reasons the ACT prefers a recurrent assessment approach, such as proposed under Model A.

The ACT considers that:

- leasing costs for infrastructure should continue to be assessed as part of the functional recurrent costs assessments;
- subsidies to PTEs for capital acquisition should not be assessed, or assessed EPC, as PTEs are not currently within the scope of the standard budget; and
- the net recurrent costs to States of PPPs should be included in the recurrent functional standards. Gross expenditures and gross revenues, generally costs or income to the private sector partner should be excluded.

There is a strong case for recognising that smaller states do not have the same access to Public/Private Partnerships (PPPs) as larger states do, and hence that small states do not have access to the efficiency and cost savings that PPPs can deliver governments. The Commission should consider whether disabilities for this should be assessed separately or as part of the administrative scale assessment.

#### **Will transitional arrangements be required if we move from a debt charges assessment to a direct assessment of new capital expenditure needs?**

It is possible that transitional arrangements will be required, however, this is dependent on the assessment method adopted.

### **OTHER ISSUES**

#### **Should capital grants be treated by inclusion?**

The continued inclusion of capital grants is supported. Capital grants substitute for alternative funding arrangements and can differ considerably between States in per capita terms.

#### **Are there any material, differential borrowing costs that can be reliably estimated?**

The ACT considers that debt services expenditure and interest revenue should be netted off and assessed EPC, given the high degree of policy influence and the opportunity presented by separate needs assessments for grant design inefficiencies. If, however, a gross debt services assessment is undertaken, the ACT has previously provided evidence to the Commission that identifies the higher cost of borrowing for smaller jurisdictions. This evidence was provided as part of the ACT's Final Submission to the 2004 Review in October 2003, in response to Draft Assessment Paper 2003/57.

#### **Is there a case to include an accumulated budget result adjustment?**

The inclusion of an accumulated budget result adjustment is not supported. Such an adjustment would be assessing periods outside the assessment period which have previously been subject to equalisation.

The ACT is not convinced that a dilution effect exists or, if it does, that it is relevant to fiscal equalisation. As discussed previously, the inclusion of net worth is problematic. It is the case

that States receive considerable income from asset revaluation, much of which is linked to land ownership. This income is not recorded in the standard government accounts, and it would be expected that jurisdictions with higher population growth rates would be the beneficiaries of higher revaluation incomes. A partial assessment of net worth would fail to properly capture such effects and would therefore potentially over-equalise some States.

**Should interest earnings be treated EPC?**

The treatment of interest earnings by EPC is supported.

**ASSESSING NEW CAPITAL EXPENDITURE CGC 2007/26-S**

**Should any model include the changes to the per capita level of capital over time?**

For the reasons provided above, no assessment of changes to the stock of capital per capita should be made.

**Should any model include variables to account for the different capital to output ratios and different types of people using different amounts of capital per capita?**

No assessment of capital stock per capita should be made.

**Do capital costs vary between locations within and between States?**

It is most likely that capital costs vary between locations. However, the different influences are likely to be numerous and difficult to measure. Therefore, it may be prudent not to attempt to assess such differences.

**Can adjustments 3 and 4 be conceptually justified and measured reliably?**

For the reasons already provided, an assessment of capital stock is not supported.

**Comments on staff proposed treatment of intra-State migration, private assets, economic development influences or other drivers.**

The ACT notes that all jurisdictions face changing demographics and therefore demand for services within regions. This can increase the need for capital in some regions and reduce the need in other regions. States have the ability to sell or modify existing infrastructure to finance new infrastructure in other regions. Therefore, it is considered that no assessment for intra-state migration is warranted.

The ACT supports an EPC assessment for private assets and economic development.