NORTHERN TERRITORY VIEWS ON CGC STAFF DISCUSSION PAPERS 2007/22, 26, 33-S

BUILDING BLOCKS FOR THE ASSESSMENT OF CAPITAL RELATED EXPENSES IN THE 2010 REVIEW

OCTOBER 2007

Key Points

- The Territory supports depreciation expenses being allocated across relevant expenditure categories.
- Depreciation expenses should be assessed using recurrent disabilities because of simplicity and an improved correlation to actual expenses.
- In the 2004 Review, the Commission acknowledged that it was unable to capture the Territory's special circumstances in respect to capital needs.
- The special circumstances relate to the infrastructure deficit inherited at the time of self-government and the infancy of the Territory's development relative to other states.
- The Territory's preference for assessing new capital expenditure needs is the proposed direct capital assessment with the application of recurrent expense disabilities together with adjustments to reflect the Territory's special needs and higher cost of borrowing.
- The application of a special adjustment factor is considered necessary as reference to a national standard is unsuitable to fully capture the Territory's unique capital disabilities.

Introduction

This submission provides the Northern Territory's views on issues raised in the Commonwealth Grants Commission's (the Commission's) Staff Discussion Papers 2007/22-S, 2007-26-S, 2007/33-S and follow-up meetings in August and October. This submission should be read in conjunction with the Northern Territory's submission on debt charges and depreciation that responded to the 2005 Update Terms of Reference. Certain sections of that paper have been incorporated into this submission.

Depreciation

The Territory supports the assessment of replacement capital expenditure needs through a depreciation assessment. The Territory also supports the assessment of depreciation expenses in the category to which they relate.

For the 2010 Review, all states supported the Commission's proposal to allocate depreciation expenses across the relevant expenditure categories. The Commission is seeking state views on whether there are any recurrent disabilities that are not relevant to average depreciation expenses. The Territory considers that the application of recurrent expenditure disabilities to depreciation expenses is a simple way of assessing depreciation needs and that any exclusion of specific disabilities would be subjective, add significantly to complexity, and may not have a material impact on assessments at a category level.

Figure 1 shows the assessed and actual depreciation expenses across all categories used in the *2007 Update*. While the current depreciation assessment appears to work reasonably well for most states, there is clearly a wide variation between the assessed and actual for the Australian Capital Territory and the Northern Territory.

Figure 1 – Depreciation Assessment 2007 Update, Actual v Assessed 2005-06

This 'unexplained' variation is unlikely to result from policy influences but rather reflects the specific needs of the Territories relating to more recently constructed assets and less than full recognition of disabilities including socio-demographic composition, location, administrative scale, wages input costs, service delivery scale and physical attributes such as climate.

Previous state submissions have suggested that socio-demographic factors are not relevant to the major components of capital costs such as feasibility studies, design, management and the like. The Territory fundamentally disagrees with this position, particularly in relation to Aboriginal land, where consultation is required at each stage of development and usually results in additional costs being incurred through approval processes, design, feasibility, inspection requirements and sitting. That Aboriginal land is generally in remote or very remote locations compounds cost impacts.

Physical environment impacts include construction cost premiums related to cyclones, shorter asset life spans (or higher construction costs) as a result of termites, humidity, and flooding. In many remote areas, skilled tradesmen are not available making rectification of minor problems difficult.

Figure 2 compares the assessed depreciation expenses, derived from applying recurrent expense disabilities (excluding depreciation), and actual depreciation expenses. Under this methodology there is closer alignment between actual and assessed expenses across all states. This implies that the application of recurrent expenditure disabilities is an appropriate indicator for depreciation needs. The correlation between actual and assessed would increase from 0.85 to 0.89 under the revised methodology.

Figure 2 – Depreciation using recurrent disabilities, Actual v Assessed 2005-06

New Capital Expenditure Needs

The Commission's papers and those submitted by South Australia present two options for assessing new capital expenditure needs, a holding cost approach or a direct assessment approach.

The Territory preference is for a direct assessment approach on the basis of simplicity and because it achieves equalisation in a more timely manner. The holding cost approach, while theoretically equal in net present value terms over time, would require assumptions in relation to depreciation rates and discount rates which are likely to be contentious and, if incorrectly applied, may lead to different outcomes than those under the direct approach.

Similar to the principles outlined above in relation to depreciation, the Territory considers that new capital expenditure needs should be assessed based on recurrent expenditure disabilities. While population growth is a key determinant of capital requirements, factor such as socio-demographic composition, physical environment, input costs, and location are also key influences on capital costs.

For instance, Indigeneity and remoteness are two key factors influencing the Territory's service delivery costs. Indigenous people utilise services such as health and law and order disproportionately to their share of the population necessitating higher capital provision. Costs of providing capital in remote areas are considerably higher than in urban areas due to a range of factors including freight, availability and cost of labour and lack of competition. The Territory's dispersed population also results in diseconomies of scale where capital is sometimes unable to be fully utilised due to relatively small service populations.

Net interest on Net Financial Worth

Within the framework of a direct approach to assessing new capital expenditure needs the Territory considers that an equal per capita assessment of net interest on net financial worth is only appropriate if:

- states cost of borrowing is similar; and
- states had capital needs met equally both at the current time and historically.

Cost of borrowing

A cost of borrowing factor acknowledges that smaller states have a higher cost of borrowing due to liquidity (relatively small volumes of debt).

Based on recent borrowing history, the Territory's premium on new borrowings is around 10 basis points. Historically, this margin has been higher (for example 15 basis points in 2002) which is reflected in carrying costs for previously issued debt. The Territory considers there is minimal default risk differential between governments in Australia, hence any differential is indicative of a perception of liquidity risks to borrowers.

The cost of borrowing factor should be applied to gross interest expenses. Based on current gross general government debt of around $1.7 billion, an average age of debt of approximately 4 years and an estimated average premium of 14 basis points, this equates an additional impost of around $2.4 million per year for the Territory or approximately $11.50 per capita.

Historical context around capital needs.

An equal per capita assessment of net interest is only appropriate if capital needs are met equally between jurisdictions, both historically and at the current time. In the event that a state was to be brought from a below state-like level of infrastructure to a normal standard over time, it would require greater per capita capital expenditure (and in most cases additional associated debt) over and above that indicated by expenditure disabilities. To the extent that the original status of that state was not attributable to policy choice, the higher costs represent a disability that would not be recognised using population growth, composition or expenditure disabilities. For example, at the time of self-government, all states other than the Territory had developed infrastructure such as ports and railways. For the Territory this investment has occurred since self-government and illustrates the infrastructure deficit at that time.

Historical context for the Territory.

The Northern Territory has two broad classes of special capital need that impact on its quantity of borrowing requirement:

- a deficit of essential capital infrastructure inherited at the time of self-government; and
- the need to fund major infrastructure projects associated with a state's early development.

The existence of these needs can be observed in both the level and the pattern of Northern Territory per capita capital expenditure[1] since 1978-79 (see Figure 3). Between 1978-79 and 1985-86 the per capita level of capital spending in the Northern Territory was between three and five times the Australian standard.

The high level of capital expenditure in the early years of self-government represents a concentrated investment in schools, police stations, housing, and essential services.[2] The rise in capital spending after 2000-01 is due to major infrastructure projects.

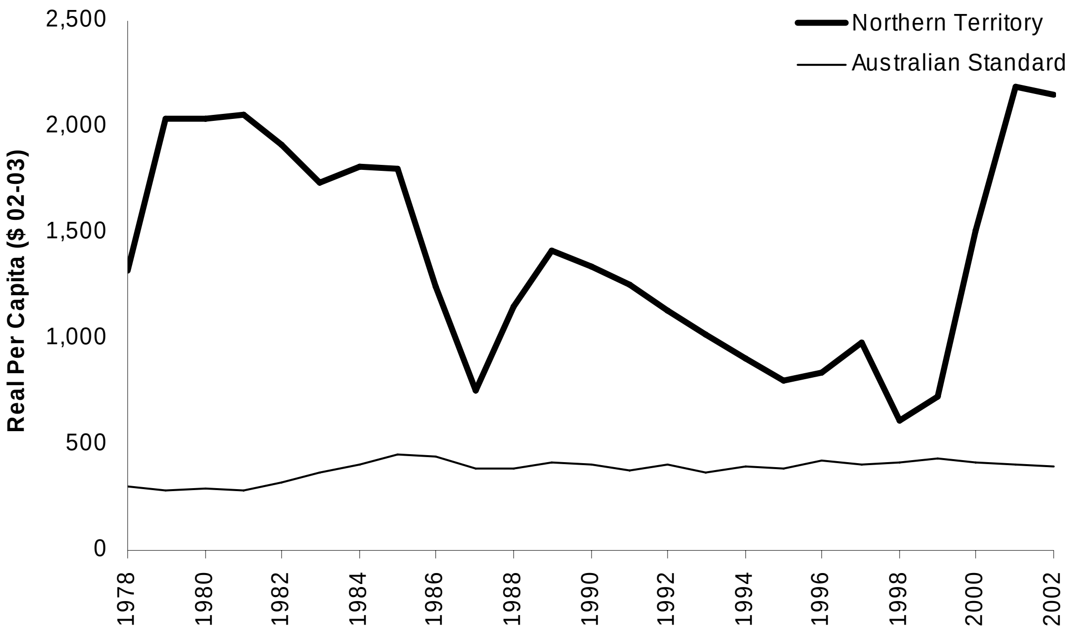
The comparatively late concentration of capital investment in the Northern Territory is reflected in the accumulation of nominal expenditure on fixed and second hand assets. In 2002-03 the Northern Territory's accumulation of nominal expenditure on fixed and second hand assets since self government was $19 489 per capita. The Australian standard accumulation over the same period was $5 971 per capita. Significantly, the Australian standard accumulated expenditure on fixed and second hand assets over the entire accumulation period since 1961-62 was $6 746 per capita.

The size of the differences revealed by the actual expenditure data suggests that there exist large disabilities that would not be captured under the proposed direct

[1] Purchases of new and second hand non-financial assets *less* land purchases and national roads grants
[2] See Appendix A.

assessment. These disabilities are reflected in the high debt charges faced by the Territory.

Figure 3 Real Per Capita Capital Expenditure, 1978-79 to 2002-03



Existence of External Influences

The issue of capital infrastructure deficit was raised to the Commission in the Territory's supplementary submission on debt charges for the 2004 Review and submission in response to the 2005 Update terms of reference. The Memorandum of Understanding in respect of Financial Arrangements Between the Commonwealth and a Self Governing Northern Territory (the MOU) gives recognition to the Northern Territory's special infrastructure needs at the time through various arrangements relating to the transfer of capital and the allocation of capital assistance.

The overall amounts of revenue assistance, capital assistance, and access to the Commonwealth semi-government borrowing program were based on assessments of both the levels of relevant provisions in previous years and the special needs of the Northern Territory.[3] In this way the Australian Government explicitly recognised that prior levels of funding would be inadequate to allow the Northern Territory to operate in a state-like manner. As a consequence overall capital investment was concentrated in the years after self government, not evenly spread over the capital accumulation period used in the debt charges assessment.

[3] Paragraph 18, MOU

Evidence for this proposition includes the pattern of capital expenditure in the Northern Territory since 1978, and the high level of general purpose capital grants paid to the Northern Territory in the years immediately following self government.

Privatisation

Significant privatisation activity since the 1990's has resulted in a dramatic improvement in the states' collective net debt position and a corresponding reduction in the (net) debt charges standard. Under the proposed approach there would not be any assessment of states' differential capacities to reduce net debt and therefore (net) debt charges though privatisation.

The Territory's submission responding to the 2005 Terms of Reference provides details of privatisation by state to 2001. While the majority of larger states had significant levels of assets to privatise together with competitive markets, this was not true for the two Territories. As a result the Territory's ability to reduce debt levels through privatisation was not comparable to the more mature states.

Debt Charges

The Territory's per capita gross debt level is considerably higher than other states and reflects the higher than average capital requirements since self-government together with an above average level of debt which was transferred to the Territory upon self-government. This level of inherited debt, which is largely carried through to the current day, makes any assumption in relation to equal levels of debt inappropriate.

The deficit in capital infrastructure at self government should therefore be fully recognised as a need associated with quantity of borrowing.

Summary

The Territory faces a number of capital-related disabilities that are not policy influenced, are as a result of past Australian Government policy, the early stages of the Territory's development and higher cost of borrowing. Recognising that the Commission are trying to capture these assessments on a nationally scale there is clearly a case for a special factor for the Northern Territory, consistent with the special factor for the Australian Capital Territory.