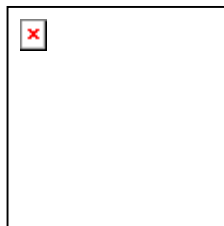




AUSTRALIAN CAPITAL TERRITORY

**SUBMISSION TO THE
COMMONWEALTH GRANTS COMMISSION'S
COMMISSION DISCUSSION PAPER 2008/03:
*The Assessment of State Capital Needs***

June 2008



Comments on the direct approach

The ACT is not in favour of using the direct approach to the assessment of capital.

It should be recognised from the outset that assessing the stock of non-financial assets and net financial assets is an unprecedented step which expands the scope of equalisation from operating statements to balance sheets. This shift changes the nature of equalisation from one where assessed needs are aligned with the consumption of assets to one which assesses accumulated assets on the basis of current disabilities.

However, the shift to the balance sheet is only partial. Major differences exist between jurisdictions in their accounting treatment of assets and liabilities. As examples:

- land is not generally reflected in the balance sheets of governments, unless it is held by public non-financial corporations (PNFCs) and in such circumstances it is treated as a financial asset; and
- some states maintain superannuation assets and liabilities on the general government balance sheet while most retain these off balance sheets.

In order to ensure policy neutrality and avoid grant design effects resulting from the differing accounting treatments the determination of the average policy for each asset class would be required. In circumstances where a minority of jurisdictions do not follow the average policy their balance sheets would need to be adjusted to reflect the policy differences. To do this would be complex, however, without such adjustments the opportunities for grant design are significant.

The proposed assessment methodology (Discussion Paper 2008/03, page 9, Paragraph 56,) can be restated as:

$$\text{Equation 1} = K_1 [(P_{11}/P_1)\bar{\delta}_{i1} - (P_{i0}/P_o)\bar{\delta}_{i0}] + NRCE_1 [(P_{i0}/P_o)\bar{\delta}_{i0}]$$

In effect this is two assessments:

The first (which we will refer to as Assessment One) is the notional redistribution of the total capital stock according to changes in the assessed expenditure weighted population share for the current year. This assessment effectively has a standard of around \$10,000 per capita, in comparison to the total recurrent expenditure standard of \$6,300. This assessment has the potential to substantially influence the overall relativities, with a change in the relative weighted population of just one one-hundredth of one percent resulting in a redistribution of \$20 million.

The second (Assessment Two) is the distribution of Non-replacement Capital Expenditure according to assessed expenditure weighted population shares (for the prior period) applied to the Non-replacement Capital Expenditure standard.

In regard to Assessment One, the ACT is concerned because:

- it is entirely backward focussed;
- it seeks to notionally redistribute the total capital stock accumulated over an average of 40 plus years;
- it does so on the basis of current expenditure disabilities; and
- it does not reflect what states do (for example, states do not close or remove roads that have been previously built even though its population may decline in a relative sense);

In regard to Assessment Two, this proposed assessment is essentially forward looking and again uses current disabilities to assess the forward need for capital (although capital is acquired in one period, its use and consumption is spread over many years). Assessment Two also introduces potential grant design effects of an order that is greater than in any other assessment.

By its nature the acquisition of capital is lumpy. The utility of capital however, extends over many years. Ideally the assessment of capital should be based on consumption rather than acquisition. The ACT recommends that the Commission give further consideration to an assessment of capital consumption, sometimes referred to as the holding cost method. This approach is more closely related to what states do and is intuitively more comprehensible.

In the event that the holding cost method is not acceptable, the ACT recommends that only Assessment Two above be included in the calculation of relativities and that Assessment One not be undertaken. This approach would avoid the revisiting of the past using current circumstances.

Implications for grant design on the ratio of financial to non-financial assets held

The proposed method has negative implications for grant design effects as it has the potential to influence finance decisions and/or accounting treatments, particularly given the unsymmetrical application of disability factors to financial and non-financial assets.

States have a number of options available to them in order to gain access to infrastructure. Some of which include holding capital assets outright, and others include utilising capital owned by the private sector through lease or Public Private Partnership (PPP) arrangements. Furthermore, more populous States can access fully cost recoverable PPPs, such as toll roads. Unlike the determination of levels of service provision or revenue raising effort, States are largely able to determine the most appropriate financing structure free from political repercussions (as the outcome to the public is normally the same regardless of the structure). This gives rise to the ability of States to choose a financing structure which maximise their GST revenues.

The discussion paper outlines the proposal to apply expense disability factors to non-financial assets and also effectively applies a population growth disability to both financial and non-financial assets. Given that States are able to easily move assets between a non-financial and financial structure, it is anticipated that the unsymmetrical application of disabilities will provide incentives for grant design.

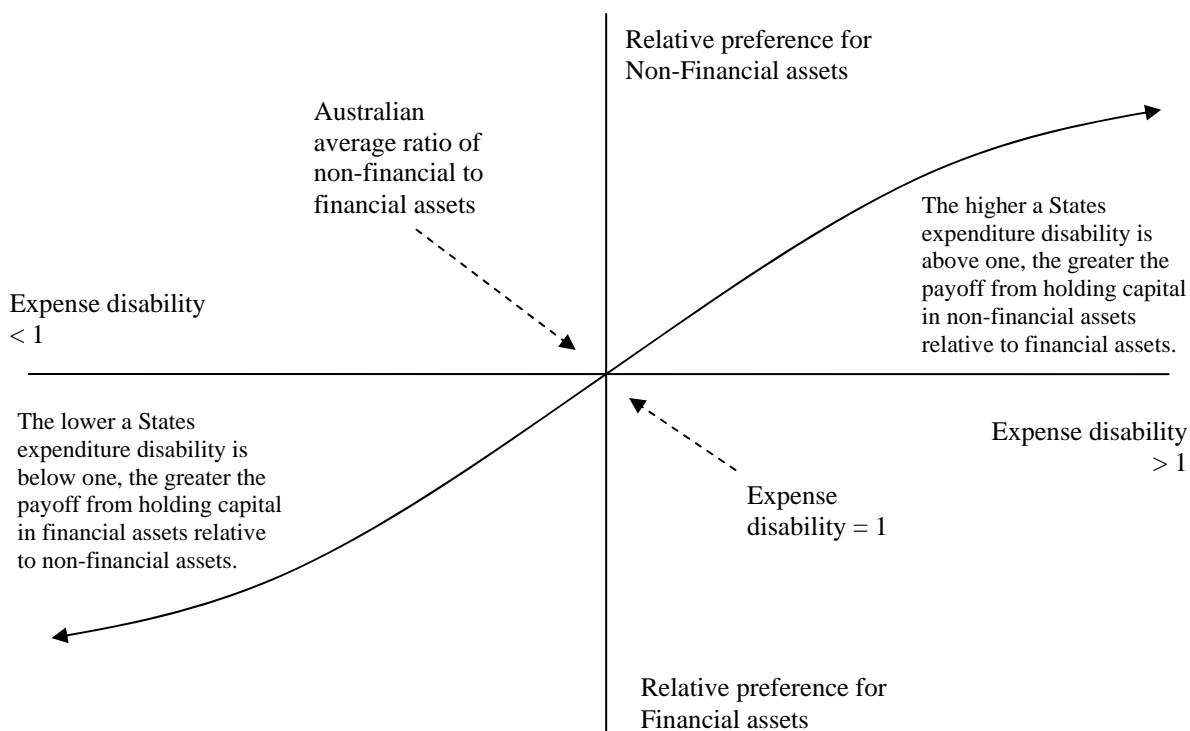
There is a number of ways in which a state can acquire infrastructure, including using accumulated savings, borrowing funds, leasing, PPPs, holding shares in government owned corporations and variations on these themes. The proposed assessment of capital will introduce the capacity for the following grant design effects with regards to the ratio of non-financial assets to financial assets held by States:

- States with expense disabilities above one will have an incentive to increase the ratio of non-financial assets to financial assets in order to increase the standard for non-financial assets. Under the proposed assessment, non-financial assets have an expense disability applied to them as well as a population growth disability. States could do this by:
 - o having a preference to hold capital as a non-financial asset rather than through PNFCs (accounted for as financial assets) and transfer the assets from PNFCs to the GG balance sheet;
 - o issue debt, thereby reducing net financial assets, to fund the acquisition of non-financial assets; and
 - o reduce the use of leasing or PPPs arrangements.

- Alternatively, States with expense disabilities below one would have an incentive to reduce the amount of non-financial assets held on the balance sheet relative to financial assets. This would reduce the standard for non-financial assets and thereby reduce the impact of redistributions away from them. States could achieve this by:
 - o using PNFCs to hold physical assets;
 - o realising future liabilities (such as future superannuation liabilities); and
 - o leasing infrastructure, rather than purchase non-financial assets, and hold the capital which would have been used to purchase the infrastructure as a financial asset.

The impact of the grant design effect on the preferred ratio of non-financial to financial assets is demonstrated graphically. The non-linear relationship recognises that States are more easily able to move some financial assets into non-financial (and *visa versa*) than others – effectively the ‘low lying fruit’ can be easily converted.

Impact on State incentives of applying expense disabilities to the assessment of Non-Financial assets on the ratio of Non-Financial to Financial assets held



Disabilities are not contemporaneous

Applying disability factors in the year of capital acquisition is not fit for purpose and misaligns the assessed disabilities with State needs. The direct method assumes that disability factors at the time of capital acquisition will be the same as at the time of capital consumption.

Under the proposed assessment, the assessed stock of capital will be subject to disabilities assessed for the current years under review, whereas the actual capital stock will be consumed on average over a 40 year plus period. However, this timeframe can differ as some capital investments will be depreciated over a shorter period of time, e.g. IT infrastructure is typically replaced every three to five years.

As the actual rate of consumption is influenced by the needs relating to the period of consumption rather than the period of acquisition, the direct method will fail to capture relative needs in an appropriate fashion and will reduce the contemporaneity of the assessment. For example, the circumstances of States disability factors applied to infrastructure which is consumed over 5 years would be different to that which is consumed over 50 years.

Double counting of net income and capital acquisition and the moral hazard of assessing financial assets

The equalisation of net financial assets introduces an element of double counting into the assessment. As net financial assets are an accumulation of past equalised revenues, this appears to constitute double counting.

The equalisation of net financial assets does not reflect the differing investment strategies of individual jurisdictions and is fraught with policy choice. As net income is equalised, each State has the same fiscal capacity to acquire assets. States have a policy choice to run positive operating balances and invest the surplus funds into financial assets. What assets States choose and have chosen in the past to invest in will have a large impact on the present value of financial assets.

Consideration needs to be made to changes to Intergovernmental arrangements surrounding the funding of capital

The ACT urges the Commission to take into consideration the future changes to infrastructure provision with the introduction of Infrastructure Australia and other associated intergovernmental agreements for the provision of capital.

A consumption approach to assessing capital

Whilst the Discussion Paper makes the point that States acquire non-replacement physical assets, and thus the direct approach satisfies the principle of internal validity ('what States do'), it fails to recognise that States account for these assets under a holding cost framework. That is, States incorporate holding costs into their operating statements with depreciation charges and interest charges (and other property income flows).

Ideally, a capital assessment should be based on the consumption of capital with disabilities applied at the time of consumption. This would be based on depreciation and opportunity cost. While depreciation is readily recognisable from government accounts, the value of the opportunity or holding cost is not. This does represent a problem with the consumption approach but not necessarily insurmountable.

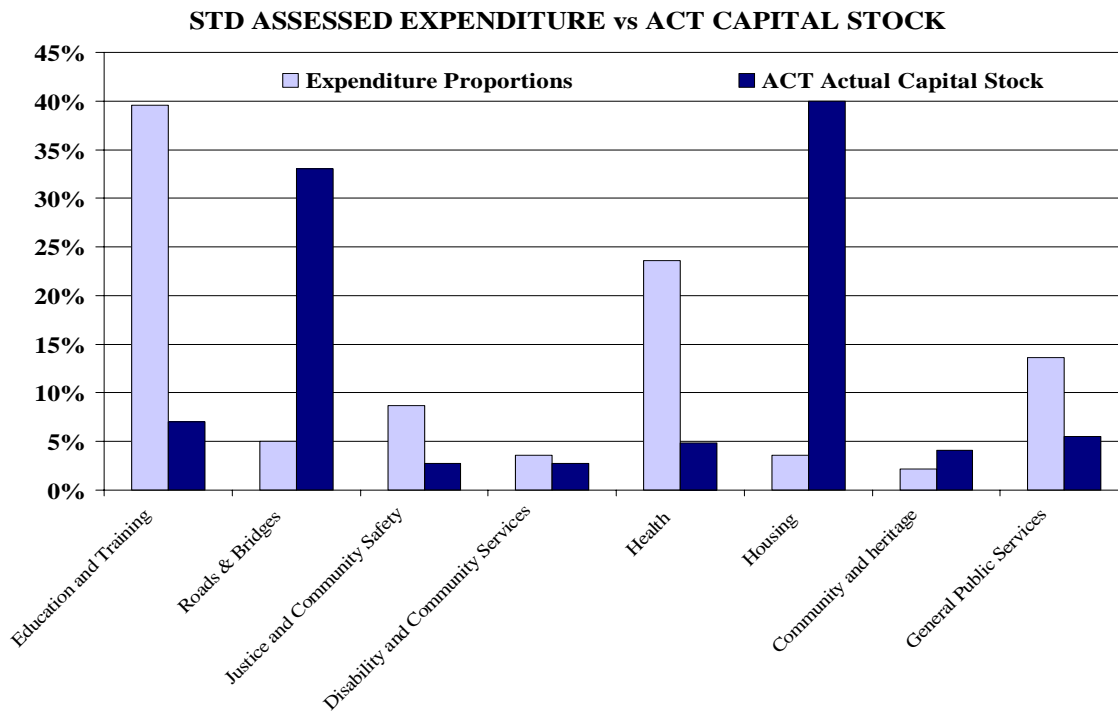
One approach would be to use the Australian average return on financial assets as a proxy for the opportunity cost of capital.

The benefits of a 'consumption' approach are that current assessments of capital align with the consumption of capital – that is, the assessed needs are more likely to reflect the use of capital and therefore its consumption. It also reduces the incentive for grant design as the assessment results are consistent regardless of how capital is acquired and accounted for.

In terms of capturing the additional costs the assessments would automatically pick up differences in population growth rates (through changes in population shares) and the accumulation of asset stocks (through a higher depreciation and holding cost standard). It follows that States and Territories would be given the capacity to fund depreciation and holding costs as if each State and Territory had a stock of assets implied by its population share and relevant assessed needs.

Application of disabilities

While not lending support for a direct approach to the capital assessment, the ACT notes that if it proceeds, assessed differences should be based on the standard distribution of asset types rather than weighted by the recurrent expenditure standards. The displayed chart compares the relative expenditure category standards with the ACT’s distribution of capital stock by category. It shows that for the ACT there is a significant difference in the distribution of capital stock and recurrent expenditures.



Additional disability factors

Under either assessment approach a number of disabilities are faced by States in the provision of infrastructure which have not been developed in the paper. Outlined is the conceptual case for those proposed by the ACT.

Public Private Partnerships

As an alternative method of procurement to deliver key state infrastructure and services PPPs are growing in popularity. The ACT has a procurement methodology policy on implementing private provision of public infrastructure projects, however, very few projects are undertaken that would be of sufficient size to justify the use of a PPP and the associated administrative overheads.

From the outset it should be noted that PPPs are typically arranged in one of two ways (or variations thereof):

- those where the revenue stream to the private partner is provided by the government (for example, hospitals); and
- those where the revenue stream is provided by users (for example, toll roads).

In terms of those PPPs where the revenue stream is provided by the government, the experience of the ACT has been that savings have not been obtainable due to the small scale of the infrastructure program. The ACT's infrastructure program compared to that of a more populous State is small in scale. This is not due to policy choice, rather it is a reflection of the infrastructure needs of a smaller population base. To put the ACT infrastructure program into the context of relative scale, the recently announced Women and Children's Centre is the ACT's largest ever health project at \$90 million, whereas Queensland is currently constructing a new Children's Hospital at a cost of \$1.04 billion. Furthermore, the volumes of infrastructure projects in larger jurisdictions are multiples of what is currently undertaken in the ACT.

Although PPPs have been shown to generate savings to government (detailed below), fixed costs are incurred in the design and monitoring stages due to the complex nature of negotiations and contractual arrangements. These administrative costs comprise a large proportion of the overall cost to governments and are undertaken by employees with a diverse range of specific skill sets and subject matter expertise. In order to maintain a sufficiently qualified unit of administrators, and to be cost effective, a minimum number of projects is required. In this way the ACT experiences a 'barrier to entry' due to the high fixed costs.

Given the fixed costs of initiating a PPP most States have a monetary threshold specifying the minimum project size. In 2006 the Victorian Public Accounts and Estimates Committee recommended in their Report *Private investment in public infrastructure*, that the threshold for Victorian PPPs should be increased from \$20 million to \$100 million. The current threshold for PPPs in New South Wales and Queensland is also \$100 million. A threshold at this level would mean that very few ACT major projects would actually qualify to even be considered for a PPP arrangement. The ACT's strategic functional review report recommended a threshold of \$80 million for ACT projects.

The estimated cost of the current prison project – the Alexander Machonachie Centre is \$125 million and the estimated cost of the largest road works project undertaken by the ACT Government to date, the Gungahlin Drive Extension (GDE) is \$120 million. In jurisdictions with dedicated PPP administrative units these projects would qualify to be implemented within a PPP arrangement because they would likely be able to be bundled with a number of other similar projects or would be part of a series of annual PPP offerings. The mentioned projects for the ACT are unlikely to be replicated in the next few years.

However, even when projects, such as schools, are bundled together, the ACT would find it difficult not only to reach the desired threshold, due to the small number and size of projects, but also to sustain a program of projects for any length of time, as is possible in more populous States, which have large numbers of projects suitable for PPP delivery each year and going forward.

In terms of the user pay model of PPPs the ACT would have great difficulty attracting private investment for projects such as a toll road. If a PPP was used to deliver the GDE, due to the lower levels of overall congestion in the ACT there'd be an insufficient volume of traffic using

the road for a private investor to extract a reasonable return. For example, the Sydney M7 has an average of 130,000 trips per day, while the GDE has an average of 25,000.

The potential savings generated by PPPs can be substantial, and when applied to the total infrastructure spend of the States are likely to be material. As the ACT has not been in a position to use PPPs in the delivery of infrastructure it is unable to substantiate the potential for budget savings. However, the larger jurisdictions where the use of PPPs is well established (such as NSW and Victoria), have independently undertaken studies to determine the potential cost savings and both, individually, found that they amount to around 7% of the total project costs. (More details on these and other reports are outlined in the ACT State Visit briefing notes. The NSW and Victorian reports were provided to the Commissioners and Commission staff in Session 6 of the ACT State Visit).

Interstate non-employee costs

A key cost driver for the development of infrastructure is the capacity of the private sector to deliver large projects and the associated interstate costs differentials of providing infrastructure. In jurisdictions of small size which lack a large volume of major construction projects there is a lack of competition between project developers due to the low number of firms with the capacity to deliver such projects. This leads to increased construction costs in small jurisdictions. Furthermore, in jurisdictions without access to raw building materials additional costs are incurred due to higher freight requirements.

As such, an administrative scale disability and some form of interstate non-employee cost disability should be applied to the capital assessment.

Cross-Border

The ACT also notes that any capital assessment should provide for cross border influences for non-financial and financial assets given the material impact that non-residents place on the ACT's infrastructure requirements. The assessment needs to recognise that both non-financial and financial assets are used to provide infrastructure and that changes in the size of the ACT's cross border population impacts on the need to provide infrastructure through PNFCs in a similar fashion as through non-financial assets held on the GG balance sheet.

In line with the proposed general method for cross border, the ACT's population should be adjusted to reflect the high growth rate of the cross border population.