



Queensland Government

Queensland Treasury Response to Commonwealth Grants Commission Draft Report Attachment 20

Capital

September 2009

Contact Officer:

Peter Johnson
Inter-Governmental Relations Branch
Queensland Treasury
(07) 3225 8261
peter.johnson@treasury.qld.gov.au

SUMMARY OF QUEENSLAND'S POSITION

The Commonwealth Grants Commission's recognition of the need for states to hold capital stocks of infrastructure and financial assets represents a significant improvement to Horizontal Fiscal Equalisation. A direct assessment of investment recognises population growth as the key driver of the need for new infrastructure, and delivers funding to states that is contemporaneous with the need to finance new assets. Generally, states require comparable levels of physical assets per capita in order to deliver comparable levels of services. Equally, states require comparable levels of net financial assets in order to have comparable capacity to earn interest and dividends. The financial and population data required by the model are available, comparable and reliable.

Alternative models, such as the South Australian methods of net worth and holding costs, or the 2004 Review debt charges model, rely on unsubstantiated assumptions and do not achieve the equalisation of stocks, which is the intended outcome of this assessment.

Queensland considers the revised treatment of expense disabilities reduces volatility to acceptable levels. Queensland supports the aggregation of expense disabilities using expenditure on non-financial assets by function, as this is more contemporaneous than depreciation.

Queensland believes depreciation should be assessed across functional categories, as proposed by the Commission in earlier discussion papers. If the Commission decides to pursue alternatives to this treatment, Queensland may provide further comments when an alternative approach is more fully developed.

The decision to not assess additional disabilities for Public Private Partnerships (PPP), natural hazard mitigation and the physical environment is supported by Queensland because reliable, comparable data are not available, and there is also little conceptual basis for a PPP disability. Queensland also supports the treatment of National Network Roads so that they do not have an impact on the relativities, and the proposal to not include a transitional assessment of unequalised debt charges.

Queensland considers that it is not appropriate to make any adjustment to the net lending assessment for land held by Public Trading Enterprises (PTE). These affect General Government returns on equity held in PTEs and should be recognised. The proportion of PTE equity in a state's financial assets is a policy choice, and the net lending assessment should not favour some types of state investment over others.

Queensland's Position on Key Issues

In finalising the Capital assessment Queensland supports the following:

- Investment and net lending to be assessed using relative shares of population growth;
- Expense disabilities applied to investment with a general discount, aggregated using investment in non-financial assets by function for both cost and capital stock factors;
- Depreciation to be assessed across functional categories as a service delivery expense;
- No assessment of PPP, natural hazard mitigation or physical environment disabilities;
- No transitional assessment of unequalised debt charges;
- National Network Roads to have no impact on the relativities; and
- No adjustment to the net lending assessment based on land held by PTEs.

PROPOSED METHODOLOGY

The Commission's proposal is to assess state capital expenditure in three parts:

- An investment category to assess new capital expenditure needs;
- A net lending category to assess state needs to accumulate financial assets; and
- An assessment of replacement capital expenditure using depreciation.

Investment and net lending are to be assessed directly using differential population growth, so that the assessed need of each state is the expenditure that would be required for a state to maintain the average per capita stock of produced and net financial assets. This is achieved by determining the Australian average per capita opening and closing stocks for each year, and the resulting total stocks for each state at the beginning and end of the year, based on their population growth. The difference in a state's stock between the beginning and end of the year represents the amount that a state needs to accumulate to maintain the national average per capita stock.

In addition, the investment component is adjusted for expense disabilities, to recognise factors affecting the different capacities of states to accumulate physical assets. These are the aggregated expense disabilities of other categories, split into capital stock factors, which recognise differences in the demand for infrastructure, and cost factors, which recognise differences in the cost of producing assets.

CONCEPTUAL ISSUES

Direct Assessment of Capital

Queensland believes that the Commission's decision to implement a direct assessment of capital significantly improves HFE. The assessment of operating revenues and expenses without recognition of capital does not recognise the total costs faced by states in delivering services, as infrastructure and financial assets are an integral part of providing services.

Infrastructure needs are assessed most appropriately in two parts – an assessment of depreciation to recognise the need for states to replace existing assets, and an assessment of new capital expenditure that recognises the need for states to increase their infrastructure base as their population grows.

In its Draft Report, the Commission reaffirmed its intention to assess new infrastructure directly using population growth, and this is strongly supported by Queensland. States require the average per capita stock of infrastructure, adjusted for disabilities, in order to have the capacity to deliver the average level of services. Population growth therefore creates an immediate and non-discretionary need to increase a state's infrastructure base. If infrastructure is not increased with population growth, a decline in service delivery must result.

It is also essential for new capital expenditure to be recognised contemporaneously with demand for new infrastructure. Equalisation must be implemented as close as possible to the period in which expenditure is incurred, and this is at the time assets are produced, not as assets are used. States generally fund new infrastructure upfront, using liquid assets or borrowings, and the choice of financing method is a policy decision, determined by the liquidity of states.

The direct assessment is policy neutral, in that it gives states the capacity to maintain an average per capita stock of infrastructure regardless of how they choose to finance the production of assets. This is not the case with any assessment that recognises capital expenses over the life of the asset, as this implies that states always incur capital expenses over time, which does not reflect what states do.

Capital expenditure has not been recognised appropriately in the past, because depreciation accounts only for the need to replace existing assets. At the same time, the debt charges assessment was highly unreliable, complex and did little, if anything, to achieve contemporaneity. Queensland supports the extension of the equalisation framework to include capital expenditure, assessed directly.

Similarly, the net lending assessment recognises that states require the average per capita stock of net financial assets to have a comparable capacity to earn revenue from interest and dividends. As a state experiences population growth, it will need to increase its stock of net financial assets, or its capacity to earn a per capita return on financial assets will decline. The direct assessment is underpinned by this simple logic and allows states to fund investment contemporaneously with population growth.

Both direct assessments are policy neutral, transparent and are based on reliable data. They recognise the demands of population growth and deliver funding to states when it is needed.

METHODOLOGICAL ISSUES

Investment

Queensland supports the Commission's proposed methodology for the investment assessment, which defines assessed investment as the amount a state would need to invest in infrastructure each year to maintain the average per capita stock of non-financial assets. This recognises the higher demands placed on infrastructure investment by rapid population growth, and the use of national stocks and investment levels to calculate national averages ensures the assessment is policy neutral. Expense disabilities are applied to recognise the influence capital stock factors have on infrastructure demand, and the impact of cost disabilities on the cost of new infrastructure. This is a simple and effective method of equalising stock per capita, giving states equal opportunity to provide a standard level of services. Opening stock is derived from closing stock and non replacement capital expenditure, which removes the impact of revaluations within a year and ensures that opening and closing stocks are in the same price levels.

Other approaches

Queensland does not support the net worth and holding costs approach(es) proposed by South Australia, primarily because the South Australian model relies heavily on assumptions and does not accurately represent what states do. South Australia's model combines the equalisation of a portion of net worth with the opportunity cost of holding assets. This requires assumptions of the holding cost rate, and a net worth discount rate which is designed to recognise revaluations and any variations in accounting standards. These rates have been arbitrarily set at 3% and 50% respectively.

There does not appear to be any evidence to support setting a net worth discount at 50%, and the model is heavily reliant on the choice of discount rate. In contrast, the Commission's model does not require an arbitrary discount rate. Instead, the Commission's model is conceptually valid, represents what states do, is policy neutral, transparent and is based on reliable and comparable data.

Another alternative suggested by some states is to adjust the 2004 Review debt charges model to reduce its complexity, and attempt to overcome its flaws. The 2004 Review debt charges model has significant problems, being highly dependent on assumptions such as the starting point for recognising capital differentials, discount rates and the length of asset lives. It also assumes that states fund infrastructure solely by using debt, and was not able to produce a conceptually valid outcome from 2003-04, when the Australian average per capita assessed borrowings became negative. The problems with the debt charges assessment are numerous, and the concentrated efforts of past reviews, along with more recent attempts by states, have been unsuccessful in resolving the assessment's flaws. Queensland does not consider a debt charges model to be a viable alternative to the proposed direct assessment of capital needs for the 2010 Review.

Some states have also suggested that it is sufficient to differentially assess holding costs and depreciation. Queensland does not support this approach because it depends on assumptions, such as the holding cost rate. Additionally, it is not contemporaneous, and does not achieve the equalisation of stocks that is fundamentally required if states are to have a comparable capacity to deliver an average level of services.

Treatment of expense disabilities

Queensland considers that the drivers of capital expenditure are more closely linked to those of recurrent expenditure for some categories than others. For example, the drivers of roads capital expenditure are likely to be similar to recurrent expenditure, while the link between socio-demographic composition disabilities and capital is less certain. For simplicity, Queensland supports the Commission using its judgement to apply a general discount to the combined expense factors that are applied to investment, to account for those weights that do not appear to have a direct link to capital expenditure. Queensland agrees with the Commission that this is preferable to making a judgement about each individual disability.

Prior to the Draft Report, the investment assessment applied total combined expense disabilities to the beginning and end of year populations. This resulted in a high degree of volatility, as the change in a state's total aggregated expense disabilities had a marked impact when applied to its population growth, and tended to amplify the assessed difference between states.

As well as accounting for less relevant disabilities, the general discount has the effect of dampening the yearly change in expense disabilities, thereby reducing volatility in the assessment when applied to beginning and end populations. Smoothing the aggregated expense use factors by averaging over three years appears to have reduced volatility also.

In a previous submission, Queensland proposed that the disabilities of expense assessments could be aggregated using expenditure on non-financial assets by function rather than depreciation. Combining disabilities using the split of expenditure on non-financial assets by function is more contemporaneous than depreciation by category, as it represents the actual split of state capital expenditure across expense areas in each year, rather than a long term measure of existing capital in each category.

Queensland notes that the Commission intends to combine cost factors using weights derived from expenditure on non-financial assets by function, but capital stock factors using weights derived from depreciation. As the investment assessment measures new capital expenditure, Queensland still considers expense disabilities should be weighted as contemporaneously as possible, and supports the use of expenditure on non-financial assets by function to derive weights for both cost and capital stock factors. This would also be simpler than the Draft Report method as it would not require the calculation of different weights for cost and use aggregations.

Additional disabilities

Queensland supports the Commission's proposal to not include additional disabilities relating to Public Private Partnerships (PPPs), natural hazard mitigation and the physical environment. There is no conceptual basis for a PPP disability, as the use of PPPs is an infrastructure delivery policy choice of states that does not necessarily generate greater efficiency or financial savings. Also, the assessment would rely heavily on judgement as there is no reliable way of measuring any savings attributable to the use of PPPs. In any case, PPP expenses will be assessed within individual expense categories, so it would not be appropriate to assess a PPP disability in the capital category.

As there are no comparable, reliable data available to assess natural hazard mitigation or physical environment disabilities, Queensland supports the Commission's proposal to not assess these disabilities. All states have different climactic conditions, and it is unclear how any assessment would compare the impact of these on states – for example, whether bushfires are worse than flooding, or whether strong winds are worse than heavy rainfall.

National Network Roads

Queensland supports the Commission's proposal to treat National Network Roads (NNR) so that they have no impact on the relativities, and understands that this requires an Actual Per Capita (APC) assessment of these expenses in the capital assessment, to offset the assessment of revenue received for NNR.

Clarity in the final report would be improved if the Commission included an explanation of the link between the assessment of NNR revenue and the treatment of NNR in the capital assessment.

Depreciation

Queensland supports the assessment of depreciation expenses in each functional category, in the same way as other service delivery expenses. This was proposed by the Commission in Discussion Paper 2006-06 *Disaggregating Expenses*, and Queensland believes it greatly simplifies the Commission's assessment while still recognising depreciation expenses in an appropriate way.

The Draft Report suggested that the Commission's treatment of depreciation may change, but did not provide detail of how an alternative assessment would work. Queensland was satisfied with the depreciation assessment proposed in previous discussion papers and does not believe there is a need to make further changes. If the Commission develops an alternative to assessing depreciation in functional categories before the final report, and advises states of the proposed assessment, Queensland may provide further comments.

Net Lending

In order to have the same capacity to earn revenue from financial assets, states require the average net financial worth per capita. The Commission's model is therefore based on the population dilution effect – the recognition that as state populations grow, their net financial assets per capita must decline unless they accumulate financial assets commensurately with population growth. Queensland supports the Commission's proposed assessment of net lending, which uses population growth to assess state net lending requirements in each year. The derivation of opening stock from closing stock and net lending ensures that net financial assets are in the same price levels, and effectively removes the impact of revaluations within a year.

It is appropriate in this part of the assessment to not assess any additional disabilities. There does not appear to be any evidence that levels of borrowing for the Northern Territory are the result of special circumstances rather than policy choices. Even if a conceptual case could be demonstrated, Commission analysis has shown that the disability would be immaterial, and it should not be assessed.

PTE Land

The stock of net financial assets in the assessment of net lending includes equity held in PTEs. This may be influenced by the value of land held by PTEs, and since land held by the General Government sector has been excluded from the investment assessment, some states have suggested that land held by PTEs should be excluded from the net lending assessment.

Queensland does not support the exclusion of any portion of PTE equity based on land held by PTEs from the stock of net financial assets. The intention of the net lending assessment is to give states an equal capacity to hold the average net financial assets per capita, so that states have the capacity to earn average returns. It is appropriate for any land or assets held by PTEs to be recognised in the assessment as they affect General Government sector returns on equity. States hold financial assets in a variety of different forms, and the proportion of a state's financial assets that are held in the form of equity in PTEs is a policy choice. In practise, the proportion of net financial assets held as equity in PTEs varies markedly across states and over time. The partial exclusion of one type of state financial investment would lead to an assessment that is highly policy influenced. It could also lead to grant design effects, as it may become beneficial for some states to hold a greater proportion of financial assets in PTEs rather than in forms that are fully differentially assessed.

Other Issues

Queensland considers that an Equal Per Capita (EPC) treatment of interest earnings, dividends and gross debt charges is appropriate, as each state is assessed as having the same capacity to accrue interest and dividends through the net lending assessment.

Data Reliability

Queensland considers that the GFS data used in the assessment is of sufficient reliability, as it is audited and must comply with accounting standards. Queensland also considers Estimated Resident Population at 30 June each year data to be reliable and supports the use of this data in the assessment.

Transitional Issues

Queensland supports the proposal not to include a transitional assessment of unequalised debt charges, as this would rely on estimates of disabilities and average debt charges that were demonstrably unreliable in the debt charges assessment.