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Queensland Government

Queensland Treasury Response to Commonwealth Grants Commission 2015 Methodology Review

Response to:

Draft Report on State Revenue Sharing Relativities

September 2014

Contact Officer:

Robbie Meddick
Intergovernmental Relations Branch
Queensland Treasury
(07) 3035 1475
robbie.meddick@treasury.qld.gov.au

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INTRODUCTION

Queensland places immense value on the Commonwealth Grants Commission (Commission) process and accepts the difficult and complex task at hand for the Commission in addressing Horizontal Fiscal Equalisation (HFE) in Australia. The Commission's process has significant nation-wide impacts and influences, and is arguably one of the most important aspects of Commonwealth – State financial relations. This makes it vital that the process is underpinned by confidence, stability, credibility, and is robust.

Queensland welcomes the opportunity to respond to the Commission's Draft Report. Queensland's submission is focused on priority issues of concern, where major changes are proposed, and where there are concerns about strength of the concepts and logic behind proposed assessments. Queensland appreciates the opportunities for engagement through the 2015 Review process, and has made several submissions to date – a response to the Terms of Reference in July 2013, responses to Commission Staff proposals in February 2014, and responses to specific issues raised in additional Commission papers in 2013 and 2014.

Methodology should now be mature and robust

Queensland cautions the Commission against deciding on major changes to methodology that result in large revenue gains and losses for individual jurisdictions. The Commission's methodology should now be mature and robust. In general, changes should only be evolutionary or incremental, resulting in small gains or losses for jurisdictions.

Larger changes may sometimes be required where there have been significant changes in Federal Financial Relations, or in response to a Terms of Reference directive. However, the Draft Report makes major changes without a Terms of Reference directive or other compelling reason – for example, the expansion of scope to include some public non-financial corporations (PNFCs).

Fundamental changes to methodology with relatively large financial impacts bring into question the whole credibility of the Commission's process, and even more so at such a late stage in a process that is shorter than normal and does not lend itself to major changes in methodology.

There should be no doubt or uncertainty in the Commission's considerations when deliberating the use of major new methods or changes. If there is weakness in the methods, then they should not be used or their influences should be reduced until a better method can be developed.

Transparency - the 2015 Review is not the place to pilot trial proposed methodology

This is a major consideration for the Commission in this Review. If there are doubts and uncertainty about using new methods or data at this late stage, the Commission must surely err on the side of caution and be conservative in its decisions rather than risking large redistributive impacts where there may be problems or gaps in methodology. The Commission should avoid methods that are untested and unproved – the 2015 Review is not the place to pilot trial significant new methodology.

In the Draft Report, the Commission has decided to delay further consideration of major changes that were proposed for the Interstate Wages assessment. This is the correct decision in the circumstances – there has been insufficient time in the 2015 Review to fully explore the proposed changes, and the required data is not yet available.

This cautious approach should be applied in other areas where major changes are being considered but there is uncertainty over their reliability. Good examples of this are the transport assessments, where states[1] have not been given access to all data for analysis.

Short timeframes and flexibility for further evidence and views

An equally important matter is the short timeframe associated with this Review and the truncated opportunities for analysis and feedback to inform the Final Report. The 2010 Review Mining Revenue assessment is a stark reminder of the risk of unsatisfactory outcomes when significant last minute methodology changes are applied. The Commission must surely be cognisant of this if there is doubt or uncertainly about using major new methodology at such a late stage in the Review, particularly if significant redistributive impacts are at stake.

The Commission's Draft Report was initially expected to be released to states in June 2014. A delayed release has meant a truncated Review process. This has significantly shortened the opportunity afforded jurisdictions to respond, effectively only a matter of weeks rather than a matter of months. When large changes to methodology are proposed at this late stage, this is not ideal and has limited the ability for robust analysis and meaningful responses on many assessment categories, particularly priority issues of concern.

For several assessments and report attachments, Queensland simply cannot provide further comment at this stage, and will provide the Commission with responses on any significant outstanding issues at a later stage. The lack of adequate opportunity to interrogate the data and analysis behind some of the Commission's assessments is of grave concern to Queensland.

Given the short timeframe for this Review, Queensland's submission is only responding to priority issues. In the course of continuing to analyse the Draft Report assessments, Queensland will provide additional responses on significant matters and these will be provided to the Commission for consideration. In the circumstances, it is reasonable that the Commission's process be flexible in receiving further submissions.

[1] In this submission, "states" refers to states and territories.

Use of discounts

Queensland agrees with the Commission that discounting is an important tool in achieving the best estimate of HFE where there is uncertainty[2]. The Commission's use of discounts should not be limited to when there are 'reliability' issues with the assessment. Justification for using discounts must extend broader than this to include uncertainty, poor data, simplicity, transparency, common sense and what states do in practice, including excessive policy influence.

Queensland's major concerns

Queensland's priority issues and concerns will come as no surprise to the Commission. However, Queensland is concerned that the Commission does not seem to have given a balanced and necessary consideration of the detailed analysis and evidence which Queensland has provided in support of several of our priority arguments, for example the mining and transport assessments, and aspects of the Interstate Wages assessment.

Transport Services assessment – drivers of expenses are ignored and model has serious problems

There are fundamental problems with the transport assessments, in particular their reliance on a simplistic assumed relationship between costs and population, their reliance on too few data points, and unclear definition of population centres.

The assessment redistributes GST on the highly questionable premise it is more expensive per capita to provide public transport services in larger cities. Queensland is penalised because it doesn't have a city the size of Sydney or Melbourne. The Commission is proposing to make changes to the Transport Services assessment that will increase the GST redistributed through the assessment, despite strong evidence suggesting the assessment has serious problems.

Detailed analysis by the Queensland Government Statistician's Office (QGSO) has highlighted major problems in the current Transport Services assessment. However, the Commission has failed to address the problems we have identified, and indeed intend including state public enterprise expense data, increasing the GST redistributed by the assessment.

Transport Infrastructure assessment – complete rethink back to basics

The new Transport Infrastructure assessment is based on a similar methodology to Transport Services, on the unsubstantiated assumption that more assets are required per capita to provide public transport infrastructure in larger cities, and therefore increases the redistribution further. This assessment is based on simplistic assumptions that are not supported by evidence, and not endorsed by the Commission's consultants. The magnitude of redistributive impact brings into question the credibility of the assessment.

[2] Draft Report on State Revenue Sharing Relativities 2015 Review, paragraph 69.

Intuitively, this assessment directs GST the wrong way – away from growth states and towards states with high levels of existing infrastructure. In the Draft Report, a decision to assess the infrastructure assets of urban transport and housing PNFCs in the Infrastructure assessment rather than in the Net Lending assessment, negatively impacts states with higher than average population growth.

Queensland believes the Commission should consider going back to basics on this assessment, to rethink what is trying to be achieved and whether this assessment does that. Queensland believes it does not, and we have outlined alternative approaches for Commission consideration.

Mining – major policy neutrality concerns

The Terms of Reference require the Commission to develop a new assessment of mining revenue. This is in recognition of the serious problems with the current approach whereby a state's own policy decisions can have significant impacts on their GST outcomes. The Draft Report proposes to assess each mineral type individually, which exacerbates these problems. This could result in the GST distribution methodology distorting government decision-making related to the setting of royalty rates.

The proposed methodology will have an even more detrimental impact on states' ability to obtain an appropriate return for the state from its resources assets. Queensland argues for the aggregation of minerals, which would help address these policy neutrality concerns.

Despite evidence of additional expenditure incurred by mining states in support of their industries, the Commission has proposed a minimal adjustment (for regulation expenses). The expenditure incurred by states in support of their mining industries should be recognised, rather than just the royalties.

Interstate Wages Assessment – the influence of conceptual problems must be reduced

Queensland supports the Commission in delaying changes that were proposed for the Interstate Wages assessment in earlier discussion papers, for later consideration. However, problems still remain with the assessment, including an over-reliant focus on the weak relationship between public sector and private sector wages, and the use of old data going back to 2009.

The Commission is effectively retrofitting the methodology and theory underlying this assessment to something that states do not apply in practice. These problems have been made clear in Queensland submissions and detailed analysis by the QGSO.

The Interstate Wages assessment should be more heavily discounted to moderate the effects of applying a methodology with serious weaknesses and data deficiencies.

Definition of 'average policy'

The Draft Report's definition of average policy effectively allows a choice of average policy to suit particular methodology, rather than a single consistent approach that until this Review has stood the test of time. Queensland is not aware that any state had issues with the past approach. Taking this step could lead to greater misunderstanding of what the Commission does and further erosion of confidence in the Commission's methods, outcomes and HFE itself.

Closing remarks

The 2010 Review restructured and simplified many years development of the GST distribution assessment methodology. Significant changes to this methodology must be carefully considered, and be linked to strong justification and evidence.

In the short time remaining before release of the Commission's Final Report, it is crucial the Commission give robust consideration to Queensland's priority issues, and facilitate close engagement on methodology where any significant changes are proposed from the Draft Report. States must have adequate opportunity to analyse and respond.

In summary, Queensland reiterates its grave reservations about significant aspects of the methodological changes being contemplated by the Commission. In the limited time available for this Review, Queensland considers that the Commission should concentrate its attention on incremental refinements or revisions to methodology, rather than major changes which have significant redistributive effects as this may call into question the veracity of the current HFE review processes.

QUEENSLAND'S PRIORITY ISSUES

1. TRANSPORT SERVICES

Queensland's position

- The Draft Report has not addressed the substantial issues identified in the current transport model. The drivers of public transport expenses beyond policy choice are not fully understood. Factors that have been found to be significant drivers of public transport expenditure have been ignored by the Commission in the interest of simplicity and policy neutrality, such as the presence of rail and topography.
- While the Commission prefers to retain the current 'simple model', it is overly simplistic and reduces confidence in the model results. The current model has been shown by the Queensland Government Statistician's Office (QGSO) and the Commission's own consultants to not be policy neutral. This is worrying given this assessment redistributes a significant amount of GST.
- The use of urban centre localities to define urban centres results in inconsistent treatment of similar urban areas, as discussed further in Section 3 of this submission.
- The best way forward: A 50 per cent discount to the transport assessment is necessary until a more robust model that captures all significant drivers of public transport expenses can be developed, and the outlier effect of Sydney's data can be addressed. Such a discount will moderate the effects of applying a methodology with demonstrable deficiencies.

The current Transport Services category includes state operating and capital subsidies to providers of transport services. It also includes departmental expenses. The category is dominated by urban public passenger transport subsidies.

The Commission's assessment covers the expenses directly incurred by the General Government sector and subsidies to Public Non-Financial Corporations (PNFCs) and private providers.

The current assessment consists of 3 components:

- The urban subsidies assessment is based on the proportion of the population living in urban centres, the size of those centres and what on average states pay to subsidise centres of different sizes. The 2010 Review concluded that large cities, such as Sydney and Melbourne, received a significantly higher per capita subsidy than smaller cities;
- The non-urban operating subsidies assessment is based on the proportion of state populations that live outside capital cities; and
- Capital subsidies are assessed equal per capita (EPC).

1.1. Draft Report Proposal

For the 2015 Review, the Draft Report proposes leaving the structure of the Transport Services category largely unchanged, but to expand its scope to assess PNFC expenses directly rather than through General Government subsidies.

Significant issues with the current transport assessment have been raised by Queensland and other states that have not been addressed in the Draft Report. A more robust methodology must be developed to address the limitations of the current model. Given the limited timeframe remaining for the 2015 Review, it is not practical to investigate, test, consult on and implement an appropriate assessment at this time. The methodology should be thoroughly revisited in a future review. However, if the Commission persists with using an unproven model, a 50 per cent discount is necessary in the absence of a more robust assessment to address the unresolved conceptual, methodological and data-based issues with the assessment.

1.2. The simple model should not be retained

Queensland considers the transport assessment's current methodology only measures the drivers of public transport costs when other significant factors are ignored.

The Commission's own literature review, discussed in the October 2013 Proposed Assessments paper, found a wide range of factors aside from population influence public transport use and cost of service provision. The Commission then tested a multivariate model, including additional factors for:

- land area;
- presence of urban rail in capital cities;
- proportion of zero sloped land (topography measure); and
- length of rail and road waterway crossings.

The multivariate model found the presence of rail and topography in cities with rail to be more significant drivers of expenses than population. The Draft Report states the Commission plans to retain the 2010 Review model because it is simpler and more policy neutral. It argues that state policy for when rail is introduced has an influence. Queensland considers the 2010 Review model may be simpler because it includes fewer variables, but it is not policy neutral.

While simplicity is desirable, it should not be pursued at the cost of the reliability of the assessment, particularly when significant drivers of cost are not included. The exclusion of significant variables in the simple model means that the effects of the excluded variables are incorrectly attributed to population alone, and place undue emphasis on urban population shares.

While Queensland appreciates what the Commission is trying to achieve with the simple model, the observed relationship between population and transport expenses only tells part of the story regarding the drivers of state expenditure requirements, and Queensland considers the development of a more comprehensive transport assessment is necessary as soon as possible.

1.3. The simple model is not policy neutral

While a significant statistical relationship has been observed in the current transport model, its application in measuring the differences between state expenditure requirements is problematic because of its reliance on urban population only and the high degree of influence a small number of points have on the results.

As with other expense assessments, the transport assessment is intended to measure average policy and level of service provision across states. The 2009 Consultants Report on which the transport assessment is based refers to four general principles that guided their work, two of which were:

- '*The Commission's assessment of state needs is intended to be policy neutral. That is, the assessment is not intended to favour a particular approach adopted by a state*; and
- *Consistent with this, the current analysis is based on the concept of average policy and average technical efficiency. That is, a state may for example adopt especially low fares, provide relatively more public transport, provide higher quality services, or use less efficient delivery practices, but should not be compensated for doing so*.'

These principles would hold if the relationship between per capita spending and urban population were driven by many data points spread across cities with many different population levels. However, as discussed in the QGSO submission to the October 2013 Proposed Assessments paper, the relationship derived from the model is significantly influenced by the four largest population centres, and Sydney in particular has such a large effect on the outcome as to be considered an outlier.

The Draft Report states the Commission does '*not regard Sydney as an outlier as suggested by Queensland.* [The Commission] *have no reference point to say whether Sydney's per capita spending is unusual for a city in Australia of this size*'[3].

Queensland considers the 2009 Consultant's Report on which the assessment is based to be a reference point that Sydney is an outlier[4]. The Consultant's Report describes Sydney as an irregular datapoint. The report suggests Sydney's irregularity can be attributed to higher cost, with rail accounting for 66% of Sydney's public transport operating cost, at a cost 48% higher than Melbourne and 110% higher than Perth per train-kilometre. The consultant's analysis suggests two thirds of the higher operating cost in Sydney could be attributed to a more intensive travel task, and one third to technical inefficiency. As the model does not account for the intensity of the travel task, only population, Queensland considers it is likely the majority of the higher operating costs are due to Sydney's abnormally high costs.

[3] 2015 Review Draft Report Attachment 18, page 331
[4] 2010 Review of State Government Subsidised Urban Public Transport Services: Consultant Advice April 2009

Without factors for intensity of the travel task or technical inefficiency, all of this additional cost is attributed to population in the model.

As Sydney's datapoint has a large effect on the observed relationship between population and transport expenses, Sydney's above average spending on transport has a significant effect on the GST redistributed by the assessment, in favour of states with large urban populations such as New South Wales. This is not policy neutral, and not an acceptable outcome of the assessment. New South Wales has an incentive to increase transport spending or reduce cost recovery to increase its own GST share, while other states such as Queensland effectively lose GST when transport expenses in the state increase for reasons other than policy choice.

1.4. The geographic areas used in the assessment lead to inconsistent results

The use of ABS urban centre localities (UCLs) for defining geographic areas in the assessment is problematic. The information used to define separate urban centres in ABS' UCL methodology has not been updated since the 2006 census, and results in inconsistent treatment of similar urban areas. Analysis of this issue by QGSO is included in Section 3 of this submission.

1.5. Conclusion

As of the preparation of this submission, the Draft Report transport model and supporting data has not been shared with the states, despite state requests, as some states have concerns over the confidentiality of data. The comparability of the data between states is questionable and cannot be verified. There has been inadequate consultation and transparency, and states have not been given sufficient time to digest the details of the model. Coupled with concerns about the uncertainty and reliability of the current model, Queensland considers the case for a 50 per cent discount to the assessment is overwhelming. A new assessment methodology must be developed in a future review with sufficient time allowed to investigate, test and implement an appropriate model that does not rely on a simplistic correlation to redistribute large amounts of GST.

2. URBAN TRANSPORT INFRASTRUCTURE

Queensland's position

- The shorter timeframe for the 2015 Review has meant that the capacity to properly investigate, test and implement new assessments is limited.
- The Draft Report proposal for quantity of stock disabilities is too simplistic and underdeveloped. The regression model of urban population size and per capita infrastructure stock relies on unsubstantiated assumptions, places too much emphasis on the existing stock of assets, and does not represent average policy.
- The Commission's consultant did not endorse the proposed model and listed a number of concerns, similar to those expressed by Queensland. The Commission should be cautious of making major changes in these circumstances.
- If the Commission uses its quantity of stock model, a 50 per cent discount should be applied to the impact of the resulting factor on the redistribution.
- The best way forward is for the Commission to:
    - Implement a simpler, temporary alternative in the 2015 Review that does not require major changes or rely on an underdeveloped methodology. Some alternatives suggested by Queensland are based on the urban centre population, or assessing capital subsidies rather than the total stock of the General Government and PNFC sectors; and
    - As a priority following the 2015 Review, investigate alternatives for a model of Transport Infrastructure requirements that considers all relevant factors and is more fully developed.

In the 2010 Review, Transport Infrastructure was assessed in the general infrastructure category. As for other service delivery areas, the factors from the recurrent category were used to determine the quantity of stock required, and the assessment was based on population growth.

The 2015 Review Terms of Reference (clause 2c) instructs the Commission to develop a new Transport Infrastructure assessment.

2.1. Draft Report Proposal

The Draft Report proposes an assessment that would:

- Assess quantity of stock disabilities using the outcome of a linear regression of urban centre population size and the per capita value of infrastructure stock;
- Apply these quantity of stock disabilities to population growth to determine the quantity of investment required by states; and
- Apply the general infrastructure capital cost factors to derive states' investment requirements.

This methodology is to apply to assets held in the General Government and PNFC sectors.

2.2. Overview

The timeframe for the 2015 Review has been truncated compared to other reviews, which makes it difficult for completely new methodologies to be developed and tested or proved. It also creates risks for the Commission and scope for a loss of confidence in HFE outcomes. Where significant changes are proposed, comprehensive analysis and consultation are necessary to ensure that the changes will deliver what is being sought without unintended consequences.

The Commission's approach to developing a new Transport Infrastructure assessment has included two major elements:

- The inclusion of internal transactions and stocks from the PNFC sector; and
- The development of new quantity of stock disabilities.

The time allowed for the 2015 Review means that neither of these elements have received the consideration they warrant.

The inclusion of transport PNFCs extends the scope of HFE and represents a major change in the Commission's methodology. This is not a change that should be made without a Terms of Reference, and unless the Commission is confident that the methodology for assessing PNFCs is sound. Queensland's general concerns with the inclusion of PNFCs are discussed in Section 4 (Treatment of Public Non-Financial Corporations).

The Commission's general approach to developing the quantity of stock disabilities is to apply the same assumptions and methodology used in the Transport Subsidies assessment to capital requirements. This approach has been driven by the short timeframe of the 2015 Review and results in a model that is simplistic and underdeveloped.

In past Reviews, new assessments have been iteratively developed and improved over the course of the Review in consultation between the Commission and states. This has not occurred for the Transport Infrastructure assessment. There has not been sufficient time for the Commission to improve the assessment based on further analysis and state input. While the Commission engaged a consultant to examine its methodology, there has not been time to fully respond to the consultant's findings.

2.2.1. Data used in the Draft Report proposal is not yet available

One of the main issues in the Transport Infrastructure assessment is whether the model used to determine the quantity of stock disabilities is appropriate.

No state is able to properly assess this issue because the data used in the model has not been provided to states in time to incorporate our analysis in this submission. Queensland will provide a further submission on this issue if the data becomes available.

If the data is not made available to states, Queensland does not consider that the Commission can apply the model used in the Draft Report to calculate quantity of stock disabilities. While it may be acceptable to use confidential data in some circumstances, this is a new assessment that has a large redistributive impact. There are significant problems with the model that must be resolved. Under these circumstances, the Commission cannot apply a methodology if states have not had the opportunity to analyse the data, gain an understanding of the proposed approach and provide meaningful comments.

This is also a broader issue – where the Commission collects data from states, but that data cannot be shared due to confidentiality concerns, this affects the ability of states to fully understand the Commission's processes and contribute to the development of assessments. The use of confidential data is an issue that should be explored more fully in a future review.

2.3. Queensland's comments on the Draft Report approach to developing a new Transport Infrastructure assessment

Queensland has numerous concerns about the proposed approach, including:

- The quantity of stock model is simplistic and underdeveloped;
- There is no reliable evidence to support the assumptions on which the model is based;
- The quantity of stock required for various city sizes does not represent average policy;
- The Commission's consultant does not endorse the model and expressed a number of concerns;
- The model places too much emphasis on the existing stock held by states and PNFCs; and
- Assets held by PNFCs are assessed as though they are General Government assets (this is addressed in Section 4 of this submission).

2.3.1. Quantity of stock model

The conceptual case for the quantity of stock model in the Draft Report is not strong and is not supported by the available evidence. The model relies on the simplistic assumption that there is a linear relationship between the population of urban centres and the stock of assets required per capita, with higher asset stocks required for larger populations.

As noted above, Queensland does not yet have the data required to analyse whether the linear model is an acceptable approach in statistical terms and will provide further comments on this issue at a later stage. However, Queensland also has broader concerns:

- <u>The model is not fully developed</u>

  It considers only the influence of urban population size on asset requirements. Similar to Transport Services, this is particularly concerning given the Commission's own literature review found more evidence that numerous other factors (such as the presence of rail) affect state requirements than it found for urban population size. Although there is the evidence of the Commission's literature review, and a conceptual case that other influences such as different transport modes would affect states' requirements, the Commission do not appear to have seriously considered including any other influences in the model.

Constraining the model to a single factor is simpler than using a range of factors. However, other areas of the Commission's methodology rely on more complex models where this is deemed necessary. For example, the Commission is prepared to implement an extremely complex model in the assessment of Interstate Wages. While simplicity should be pursued wherever possible, this should be balanced against the likelihood that there are significant influences which have not been recognised.

- The model relies on unsubstantiated assumptions

It is an assumption that larger cities require greater per capita stocks of assets. The Commission note that this conclusion is based on an observation of state data, but there are too few data points to support this assumption. While large cities, such as Sydney and Brisbane, appear to have higher asset levels than cities of much smaller populations (such as those close to 20,000), there is no evidence that the differences between large cities are not driven by policy choice. No state has more than one city of this size, so the impact of individual states' policies for large cities is impossible to determine.

By using the same assumptions as in the 2010 Review Transport Services assessment, the Commission is effectively relying on the view of the 2009 consultant that there is a positive relationship between population size and per capita transport services expenses. That consultant mainly examined services expenses, only briefly addressed capital costs and did not specifically consider asset stock requirements. However, in that consultant's capital costs analysis, it was concluded that the dominant factor driving differences between the capital costs of cities is whether they choose to implement a fixed rail track. The report also concluded that the current stock of assets was unlikely to reflect future investment requirements, which is the basis of the Draft Report model:

If actual future investment in capacity expansion was a similar proportion of current assets in all cities, current assets could be used as a proxy for any desired adjustment to take account of future investment. However, the available evidence suggests that this is unlikely to be the case[5]*.*

Taking these comments into account, Queensland does not believe that the Commission can reasonably use the 2009 consultant's advice to support the proposed methodology for Transport Infrastructure in this review.

[5] *2010 Review of State Government Subsidies Urban Public Transport Services: Consultant Advice*, April 2009, page 21

- <u>The outcome of the model does not represent average policy</u>

  The outcome of the model cannot be assumed to represent average policy. As discussed above, the model is based on too few data points. There is no way to ascertain from the data provided whether differences in the actual stock values of large cities represent an underlying need for different levels of stock, or other influences such as policy choice or differences in technical efficiency.

  Additionally, individual data points can have large impacts on the model outcomes, both in terms of functional form and estimates of model parameters. The Commission's 2014 consultant noted that "*given the size of the sample, the result may be determined by a couple of points*"[6]. Under these circumstances, the outcome of the model will not represent average policy.

  The Draft Report suggests that the addition of all urban centres with population over 20,000 addresses Queensland's concerns over the small number of data points. Queensland disagrees with this assertion because:

  - The issue mainly concerns the small number of data points in the large population centres. This problem is not alleviated by adding data points for much smaller population centres. The assessed per capita asset levels for large cities have the largest effect on the quantity of stock factors, as this is where the majority of the population resides. At the same time, it is at these higher population levels where differences in the needs of cities become far less certain due to the lack of data.

  - It appears that many of the population centres that have been added to the regression have no government owned assets. Table 7 in the Draft Report indicates that the regression includes 24 cities with state-owned assets and 43 with no state owned assets. Cities where states do not own any assets do not provide any information about the asset requirements for other cities and as such are not relevant to the regression analysis. For example, it is difficult to see how the fact that there are ten cities in Queensland with greater than 20,000 population with no state owned assets provides any information about the per capita assets that are required in Brisbane, or the difference between the requirements of Perth and Melbourne.

    The Draft Report states that the inclusion of cities with no state owned assets follows from the new definition of average policy for the 2015 Review (something is considered average policy if it is applied by at least one state and the impact is material). Queensland does not support the new definition, and most states have expressed concerns about implementation issues relating to the new definition. The Transport Infrastructure regression is an example of the new definition not being reasonable when applied in practise.

[6] *Report on econometric work conducted by the CGC*, Xiaodong Gong, IGPA, University of Canberra

- The model was not endorsed by the Commission's consultant

  The Commission engaged a consultant to review the quantity of stock model on a statistical basis. The consultant made a number of observations that are consistent with Queensland's issues with the model:

  - The size of the sample is small
  - The few largest cities have a large impact on the results
  - A number of the small urban centres have zero assets.

  Further, the consultant recommends that:

  Given the small number of cities, the regression results will always be sensitive to some observations. There is no quick statistical fix to this problem other than increasing the sample size. Judgement based upon additional information could be required in choosing the functional form and interpreting the results[7]*.*

  The implication of this recommendation is that the Commission cannot use the available data to support its choice of a linear regression model. A judgement could be made, but this would require additional information.

  Unless another source of information can be found that supports the Commission's choice of a linear regression model, such as supporting literature that suggests this kind of relationship is valid, the Commission cannot assume that this is the most suitable functional form. The advice of the 2009 consultant would be insufficient in this case, for reasons described above. The advice provided on 1 September (discussed in Section 2.3.2) is again based on unsubstantiated assumptions rather than additional evidence. If additional evidence is not found, the Commission should not rely on an assumption that the relationship is linear. This would be contrary to the consultant's advice.

- Too much emphasis is placed on existing quantities of stock

  In the assessment as a whole, quantity of stock factors are combined with population growth to derive the assessed investment requirement. In the overall outcome, the quantity of stock effects far outweigh the population growth effects, so that for most states the direction of redistribution is in the opposite direction to that indicated by population growth. Some states are assessed as having far greater than average need for new infrastructure construction despite low levels of population growth. This is a completely different result to the rest of the infrastructure assessment, where population growth drives the outcomes of the assessment. Queensland considers the Transport Infrastructure outcome to be an anomalous result because:

[7] *Report on econometric work conducted by the CGC*, Xiaodong Gong, IGPA, University of Canberra

- Population growth is the overarching reason that states need to construct new infrastructure. It is counterintuitive that the influence of population growth would be far outweighed by adjustments to quantity of stock factors.
- There does not appear to be a reason, conceptually, for differences in states' requirements for Transport Infrastructure to be far more widely spread than for infrastructure more generally. The Transport Services assessment does not give this kind of result compared to other expenditure categories, even though it is based on the same assumptions and uses the same basic methodology as the infrastructure component.

The factors arising from the regression model are also based on the values of existing stock held by states. As discussed more generally in Section 9 (Infrastructure) of this submission, the depreciated values of existing stock may not fully recognise the needs of growth states to construct infrastructure at new values.

2.3.2. Additional advice on the quantity of stock model

Commission Staff released additional advice on 1 September 2014, discussing the calculation of assessed assets in the quantity of stock model. This said that the assessment is very insensitive to the slope of the linear regression line, because the model is similar to a linear regression model that passes through the origin. In such a model, the gradient of the regression line would not matter because states would have the same share of assessed assets regardless of the gradient used. The paper also comments that:

Even with the limited data available and uncertainties about its quality, we observe that there is an upward sloping relationship between city size and assets per capita. Even if the asset values of a number of cities are overstated or understated by sizeable amounts, the relationship would still be upward sloping[8]*.*

The paper appears to be implying that because the relationship seems to be upward sloping, it doesn't matter whether the relationship has been estimated accurately.

This conclusion is invalid because the insensitivity of the line to the model outcomes is only true under very specific assumptions – that the model is linear and passes through the origin. The 1 September advice does not provide any insight into whether these assumptions are reasonable. Instead, it observes that under these assumptions about the model form and fit, the outcome is not dependent on the gradient, then concludes that the form and fit do not matter. This does not appear to be reasonable.

Without access to the underlying data, Queensland is unable to confirm whether the data is consistent with some kind of upward trend, or to assess the model fit or functional form chosen. However, these are important issues that must be resolved. The analysis in the 1 September advice is not a valid justification for not fully exploring these issues.

[8] *Urban Transport Infrastructure – calculation of assessed assets for each state in a year*, Commonwealth Grants Commission (provided to states on 1 September 2014).

2.3.3. Method of applying discount

The Draft Report discounts by 50 per cent the difference between the per capita asset values estimated from the regression outputs and the average per capita asset values for each city. If the Commission decides to proceed with the Draft Report approach, Queensland considers that the uncertainty in the model would be better recognised by discounting the impact of the factor on the redistribution. This would go some way to recognising that the model does not capture the most significant factors affecting states' infrastructure requirements, but would not be an ideal solution.

The 50 per cent discount was a placeholder in the Draft Report, with the level of discount to be reconsidered after the consultant's report on the model was received. Given that the consultant's report does not endorse the Commission's model, but rather highlights its problems, Queensland does not believe there is any justification for reducing the discount based on the consultant's findings. At the very least, 50 per cent of the impact of the quantity of stock factors should not be assessed due to considerable uncertainty over the method and data, and whether it actually leads to an improved HFE outcome.

2.4. Alternative approaches

Queensland suggests that a number of alternative approaches are available for the assessment of Transport Infrastructure that would satisfy the Terms of Reference:

1. **Retain the 2010 Review approach to assessing General Government transport investment, but differentially assess transport capital grants.**

   In this option, the Commission would assess only General Government investment and capital grants to PNFCs, rather than the full internal transactions of PNFCs. The Commission has not received a Terms of Reference directive to extend the scope of HFE, and there are conceptual issues with recognising the internal transactions of PNFCs rather than capturing their implications for General Government fiscal capacity.

   General Government investment could be assessed using the 2010 Review approach, which bases the assessment on recurrent needs factors and population growth. This approach to assessing infrastructure requirements is considered appropriate for most other service delivery areas. Likewise, capital grants could be assessed using recurrent factors. If equity held in PNFCs continued to be assessed in the Net Lending assessment, it would not be necessary to also assess population growth for capital grants.

2. **Base the quantity of stock factors on urban population size (over 20,000) only.**

   This option would recognise that, on average, states own assets in urban centres with populations greater than 20,000. As this is the service population for Transport Infrastructure, it would capture the main difference in the investment task faced by states.

   The main benefit of this option is that it would not require the Commission to make additional assumptions about the relationship between the stock of assets per capita and any other factors. As discussed above, the Draft Report proposal for such a model is underdeveloped and the impacts of a range of factors are not sufficiently understood.

The Draft Report notes that the ABS does not publish city population data for the last assessment year in time for inclusion in the assessments. Queensland does not consider this to be an issue for this option, as states' shares of urban populations are unlikely to change significantly from year to year.

3. **Develop a model for the quantity of stock factors that is based on a full examination of all potential influences on state infrastructure requirements.**

   This option would consider the influences (such as the presence of rail) that have necessarily been overlooked in the short timeframes for this Review. It would also include a full assessment of the model fit and its functional form.

2.5. Way forward

For the Commission to proceed with its proposal for the Transport Infrastructure assessment, it must be convinced that the approach produces the best HFE outcome. There are compelling indications that this is not the case, and that more work on the model is required. At the very least, 50 per cent of the impact of the quantity of stock factors should not be assessed due to considerable uncertainty over the method and data.

Queensland has suggested a number of alternative approaches for assessing Transport Infrastructure. The first two of these (assessing capital grants and basing the assessment on the urban population) would be relatively simple to implement in the time remaining for the 2015 Review. Unlike the Draft Report proposal, they do not require significant assumptions or major changes to the assessment methodology that have not been fully investigated.

The other alternative would require a full investigation of the factors that affect state infrastructure stock levels and the appropriate way of assessing PNFC functions. In the longer term, if the Commission is convinced that effects other than population growth should be recognised, and that stocks held by PNFCs should be assessed alongside General Government assets, Queensland considers that this would be the most appropriate way forward. The short timeframes for the 2015 Review have meant that this approach is not feasible. However, Queensland would encourage the Commission to investigate this alternative more fully after the 2015 Review or in a future review.

Queensland considers that, at this point in the Review, the best way forward is for the Commission to:

- Implement one (or a combination of) of the simple approaches Queensland has suggested for the release of the 2015 Review, instead of the Draft Report approach. This would satisfy the Terms of Reference without implementing an assessment that has not been fully investigated but has a large redistributive impact; and
- As a priority following the release of the 2015 Review, investigate the third alternative. Examine the potential for implementing a Transport Infrastructure

model that is more fully developed, and recognises that state requirements for Transport Infrastructure stock are affected by a range of complex factors. This would allow the Commission time to fully investigate, test and implement an appropriate assessment.

3. QUEENSLAND GOVERNMENT STATISTICIAN'S OFFICE ANALYSIS – CHOOSING AN APPROPRIATE BOUNDARY FOR THE TRANSPORT ASSESSMENTS

Queensland's position

- The use of urban centre localities (UCLs) to define urban centres results in inconsistent treatment of similar urban areas.
- The separation of adjacent urban centres is based on outdated data from the 2006 Census. Based on more recent data, outer areas of Brisbane that are currently treated as part of the Gold Coast have similar geographic and commute characteristics to areas of outer Sydney that are included in the Sydney UCL.

3.1. Introduction

The Commission's Draft Report assesses transport subsidies based on the assumption that the transport task increases with population size, resulting in governments spending more per capita in larger cities than in smaller cities. As a result, the Draft Report's choice of the appropriate urban geography is critical for the urban transport assessment.

3.2. Analysis of the choice of urban centre geography

The Draft Report's urban transport assessment uses the Australian Bureau of Statistics (ABS) UCL definitions as the basis of the geography and boundaries for the analysis. Under the ABS definition used to define urban centres, two abutting urban centres cannot be combined if they are in a separate "labour market". The ABS further defines a "labour market" as a Greater Capital City Statistical Area (GCCSA).

A GCCSA is a geography developed by the ABS to represent the socio-economic extent of each of the eight state and territory capital cities. The boundaries include people who regularly socialise, shop or work within the city, but live in the small towns and rural areas surrounding the city. They are aggregates of Statistical Area Level 4s (SA4s), which were designed to reflect labour markets using the 2006 Census travel to work data.

In assessing the suitability of the chosen geography, it is important to note that the 2011 Census data were not available at the time of creation of the 2011 GCCSA boundaries. These data therefore do not take into account significant upgrades and additional stations on the Gold Coast train line, which have had significant impact on those living within the Gold Coast and travelling by train to Brisbane to work. These upgrades include:

- September 2006 – Ormeau to Coomera duplication;
- August 2008 – Helensvale to Robina duplication; and
- December 2009 – rail extension from Robina to Varsity Lakes.

Therefore, any "labour market" boundaries derived using Census 2006 data are not reflective of current "labour market" flows and are not suitable to segregate urban centres (such as Brisbane and Gold Coast). Queensland considers any subsequent analysis around labour markets that are based on UCL or GCCSA are not fit for the purpose to which the Draft Report is applying this geography.

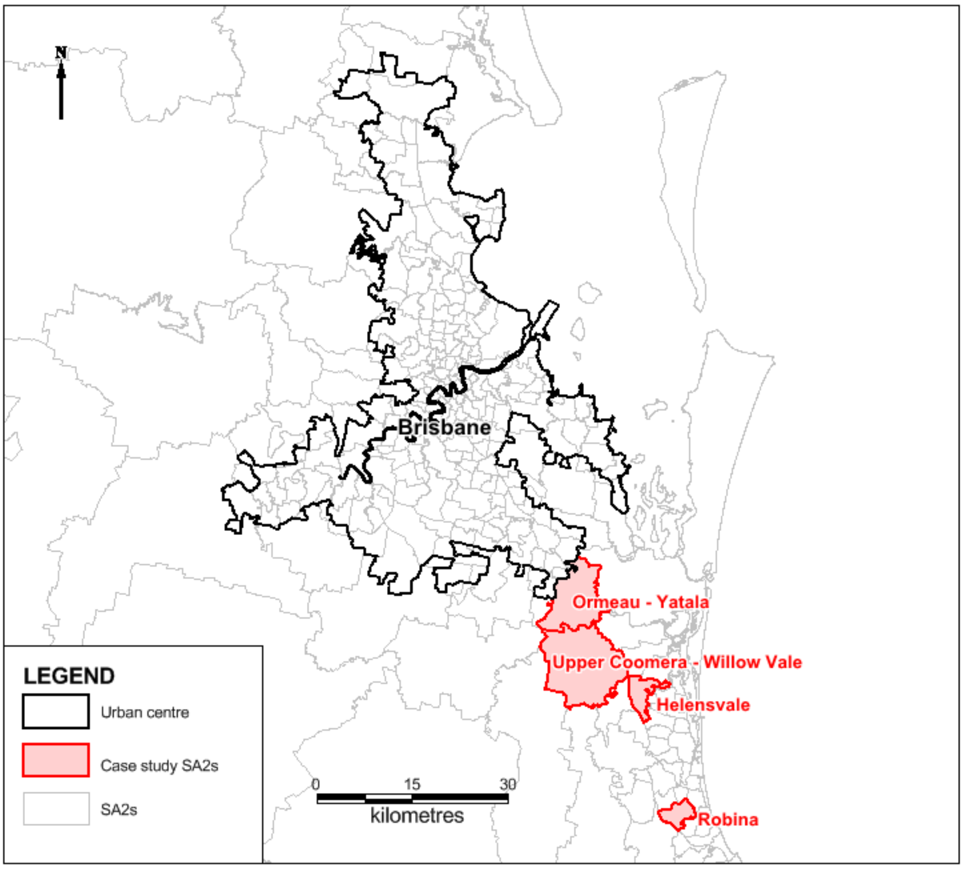
3.3. Case studies

The following analysis draws on four case studies from each of the Sydney and Brisbane UCLs to demonstrate why the Draft Report's use of a geography designed for a different purpose using outdated information, is inadequate for both the urban transport services and Urban Transport Infrastructure analyses.

According to 2011 Census data, there are over 5,400 usual residents living within the Gold Coast UCL who travel to the Brisbane CBD[9]. However, because they are not located within the Brisbane urban centre, they are excluded from the Commission's analysis of urban transport expenses and Urban Transport Infrastructure assessments.

Figure 1 shows the four case study SA2s within the Gold Coast UCL (that are not included in Brisbane UCL). Figure 2 shows the four case study SA2s within the Sydney UCL.

Figure 1: Queensland case study SA2s and the Brisbane urban centre, 2011



[9] The CBD has been defined as the "Brisbane Inner" SA3 of Queensland.

Figure 2: New South Wales case study SA2s and the Sydney urban centre, 2011

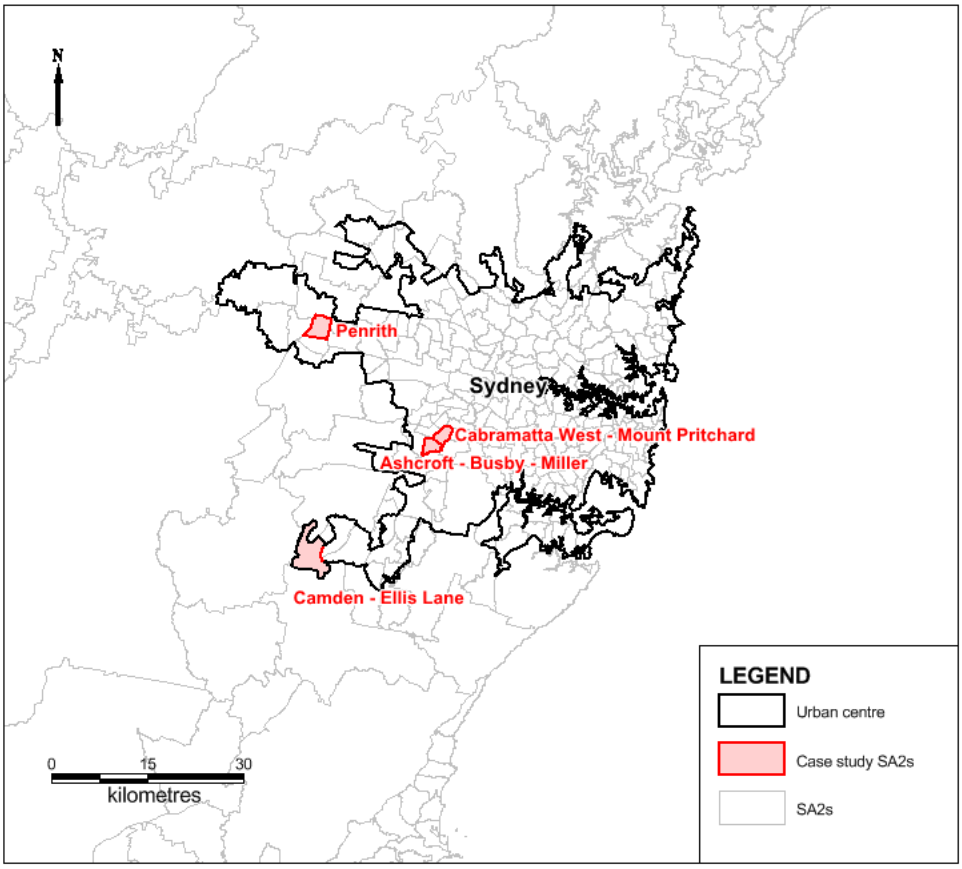


Table 1 describes the key statistics for each of the four case study SA2s within Queensland and New South Wales.

Table 1: Case study SA2s by key statistics, 2011

SA2	Distance to CBD (a)	Commuters to CBD	Usual resident population
	km	— persons —	
Within Sydney urban centre			
Ashcroft – Busby – Miller	28.9	192	16,647
Camden – Ellis Lane	51.5	275	12,135
Cabramatta West – Mount Pritchard	27.4	361	15,815
Penrith	49.6	362	11,814
Outside Brisbane urban centre			
Ormeau – Yatala	37.6	495	15,891
Upper Coomera – Willow Vale	48.2	437	23,920
Helensvale	56.8	250	15,988
Robina	75.6	243	20,522

(a) The CBD has been defined as the inner city SA3 for each state.
Source: Australian Bureau of Statistics, Census of Population and Housing, 2011, unpublished data

As shown in Table 1, the four NSW case studies combined generate 1,190 commuters to the Sydney inner city SA3. Given the average distance to the CBD for each SA2 this implies a total transport task of 47,558 passenger-km for the four NSW case studies.

Because these four NSW SA2 regions are within the Sydney UCL, the methodology used in the Draft Report applies the total population of the four regions in determining NSW's urban transport assessed expenses.

The four Queensland case studies combined generate 1,425 commuters to the Brisbane inner city SA3. Given the average distance to the CBD for each SA2 this implies a total transport task of 72,246 passenger-km for the four QLD case studies.

Because these four Queensland SA2 regions are outside the Brisbane UCL, the methodology used in the Draft Report excludes the population of the four regions in determining Brisbane UCL's urban transport and infrastructure assessments.

As shown in the Draft Report's chart of net urban operating expenses (Figure 1, p331) assessed operating expenses per capita rise as city size increases. Therefore, despite the fact the four Queensland SA2 regions have a demonstrated stronger link to the Brisbane CBD than the four NSW SA2 regions have to the Sydney CBD, the Draft Report methodology adversely impacts on Queensland's assessed operating expenses and Urban Transport Infrastructure.

3.4. Conclusion - the central premise is the use of wrong boundaries.

The Draft Report states the Gold Coast is treated as a separate city rather than amalgamating it with Brisbane because the demand for travel by public transport between this satellite area and the principal city was low relative to public transport travel within the satellite city.

This is not a valid reason for excluding areas on the boundary between Brisbane and Gold Coast UCLs that have a stronger link to the principal UCL than areas near the boundary of the Sydney UCL. Fundamentally, the key limitation of the urban versus non-urban dichotomy applied in the Draft Report is the use of a geography that is not fit for purpose.

4. TREATMENT OF PUBLIC NON-FINANCIAL CORPORATIONS (PNFCs)

Queensland's position

- Queensland does not support treating urban transport and housing PNFCs as though they form part of the General Government sector.
- This change would extend the scope of HFE without a Terms of Reference directive. Queensland does not believe the Commission should decide what services are, by nature, General Government activities when this judgement contradicts decisions made by the majority of state governments.
- The 2010 Review framework better recognises the impact of PNFCs on state fiscal capacities than the 2015 Review proposal.
- The timeframes for the 2015 Review mean that methodological and data issues associated with extending the scope of HFE cannot be fully examined.

In the current and previous Commission methodologies, the scope of equalisation has been limited to the General Government sector. The Commission assessed the recurrent and capital subsidies provided to the PNFC sector, and the impact of the sector on states' financial worth through the Net Lending (Borrowing) assessment. It did not assess the internal transactions or assets of PNFCs.

4.1. Draft Report Proposal

The Draft Report proposes that in the 2015 Review, PNFCs for urban transport and housing services should be treated as though they formed part of the General Government sector. This means that:

- In the Transport Services and Housing assessments, PNFC expenses and revenue are combined with those of General Government and assessed collectively;
- In the Infrastructure assessment, PNFC asset stocks for urban transport and housing are combined with General Government assets and assessed collectively; and
- In the Net Lending assessment, states' holdings in urban transport and housing PNFCs are removed from Net Financial Worth.

4.2. Extension of HFE scope

Queensland is concerned that the Commission has decided to extend the scope of HFE to PNFC activities without a Terms of Reference directive to support this decision. In the Draft Report, the Commission indicates that it believes some PNFC activities can be considered to be part of General Government activities based on the Commission's assessment of the nature of these functions:

After giving careful consideration to the nature of these functions, we have concluded that, for our purposes, they are best considered as general government sector activities. The

States are responsible for delivering urban transport and public housing services, whether they are provided by government departments or through PNFCs[10]*.*

The Commission are proposing to apply their judgement to decide what should be considered a General Government activity. This is not appropriate. A large majority of state governments have chosen to deliver urban public transport services outside of the state General Government sector. The Commission should not use its judgement with respect to the nature of urban transport functions to contradict the general position of state governments.

The Commission do not have the prerogative to make this kind of change without a Terms of Reference instruction. The Terms of Reference make clear the Review priorities, and what the Commission is being asked to achieve in this Review. Extending the scope of HFE to PNFCs is a major change to HFE and Queensland does not believe it should be implemented when this is not what the Review is intended to achieve.

4.3. Choice of framework for assessing the impact of PNFCs

There are fundamental differences between the operations of Government Owned Corporations (GOCs) compared to the General Government sector. Importantly, while the General Government sector is primarily focussed on non-commercial criteria, such as the creation of economic and social infrastructure, the focus of the GOC sector is generally on commercial outcomes, such as efficiency, achieving commercial rates of return and competitive neutrality. The Queensland Commission of Audit discusses the greater commercial focus of GOCs and the structured corporatisation policy framework for GOCs in Queensland, which includes:

- *The separation of ownership of government business entities from their operation*
- *An annual financial return to government on its investment through dividends*
- *Achievement of competitive neutrality with the private sector*
- *An ownership structure that would facilitate divestment of the business unit at some future point in time*[11]*.*

Queensland is concerned that the Commission has attempted to simply combine General Government activities with those of GOCs, without allowing for differences in the aims and focuses of the sectors. For example, in the Transport Infrastructure assessment, the Commission takes the approach of attempting to determine what stock of assets is required to achieve the average level of services (the Commission's usual approach to assessing General Government functions). This general approach is less appropriate when applied to the activities of GOCs, where there is a greater focus on the rate of return associated with assets and less on the creation of infrastructure. The Commission's general approach may not be well suited to assessing the needs of commercial enterprises.

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[10] 2015 Review Draft Report, pg 15
[11] Queensland Commission of Audit Final Report Volume 2 (Part B, pg 42)

When it comes to a framework for recognising the impact of the PNFC sector on state fiscal capacities, the Commission has two broad options:

- The approach suggested for this review, where a specific assessment is made of the expenditure and infrastructure requirements of PNFCs in certain sectors, using internal transaction data; or
- The current (2010 Review) approach, which assesses the level of subsidy required for PNFCs and their impact on General Government net financial worth.

The 2010 Review framework better captures the impact of the PNFC sector on state fiscal capacities. This approach better reflects the financial consequences of the PNFC sector on states in practice, through the subsidies provided and holdings in the corporations as financial assets. The Queensland Commission of Audit also discussed the impact on the General Government sector of GOC operations:

While the financial operations of GOCs are reported separately from those of General Government, the General Government sector, as owner, must ultimately bear the financial cost of GOC operations. These costs include:

- *capital injections from the General Government sector, either for recapitalisation or for major capital investment*
- *losses incurred by GOCs, to the extent that these losses cannot be funded internally (or through borrowings)*
- *the cost of GOC borrowings, which are undertaken by the General Government sector through Queensland Treasury Corporation*
- *the cost to the Budget of (non-commercial) policy decisions which are delivered through GOCs, such as CSOs and concessional pricing arrangements*
- *the opportunity cost of a significant investment (in network assets) that might generate a higher economic or social return if invested elsewhere by government*[12]

These consequences are better reflected by the 2010 Review framework. Capital injections, losses not funded internally and the cost of non-commercial policy decisions are best captured by an assessment of General Government subsidies provided for these purposes rather than the full assessment of the internal transactions of GOCs. Other consequences appear to be better reflected by an assessment of states' General Government financial assets than an assessment of GOCs' needs for produced infrastructure stock.

4.4. Implementation issues

Queensland is also concerned that the short timeframe for the 2015 Review means that the Commission has not had time to properly consider the best methodology for assessing PNFC services and infrastructure. This is particularly an issue in the Transport assessments (Services and Infrastructure).

[12] Queensland Commission of Audit Final Report Volume 2 (Part B, pg 46)

For both Transport Services and Infrastructure, the Commission has not developed a new assessment, but used the same approach as the 2010 Review Transport Services assessment (the relationship between urban population and cost per capita). The proposed 2015 assessments do not improve on the 2010 Review approach or attempt to refine or build on the approach, but simply apply the 2010 Review methodology to a larger set of expenditure, and extend it to infrastructure, including PNFC infrastructure. There has not been time for a thorough examination of conceptual, methodological or data issues specific to PNFCs. These have simply been assumed to be the same as for the General Government sector.

4.4.1. Data Issues

Aside from the fundamental differences between General Government and PNFC operations described above, data issues are a particular concern. The quality or comparability of data available for the Commission's purposes from the PNFC sector is highly questionable. For example, there is significant uncertainty as to whether states have designated transport infrastructure by location and classified assets as urban or non-urban in a comparable way. Newly provided data from Transport PNFCs were only made available late in the Review process, as much of this data is commercial-in-confidence. Under these circumstances, the ability of the states and the Commission to ensure data comparability is doubtful. More broadly, where data cannot be shared, states do not have the opportunity to fully gain an understanding of the proposed approach or issues with state-provided data.

4.4.2. Excessive redistributive impacts

The large redistributive impact of the inclusion of PNFC transactions may also indicate that the assessments have not been implemented properly. Of itself, the decision to incorporate PNFC transactions directly into category assessments rather than assess their impact on state financial worth should not have a large impact on the redistribution. In practise, the Draft Report methodology results in large changes in the redistribution for Transport Services, Transport Infrastructure and Net Lending because of the decision to recognise PNFCs differently to previous methodologies. Conceptually, there does not appear to be a reason for the framework change to have large redistributive impacts, which may indicate there is a problem with the methodological implementation.

4.4.3. Changing the treatment of PNFCs requires a clean slate review

To avoid these implementation issues, the development of a methodology for including PNFC transactions in the Commission's process would need to be part of a full, clean-slate review. The truncated 2015 Review is not the place for a fundamental re-examining of the Commission's processes but is designed to address priority issues, where changes to the methodology are required (in response to the GST Distribution Review and recent changes in federal financial relations, such as arrangements for NDIS). The methodological impacts of changes to the framework and extensions of the scope of HFE cannot be fully examined. It is clear from the proposals for assessing Transport Services and Infrastructure that a clean slate approach has not been feasible in the time available.

4.5. Conclusion

The 2015 Review is intended to address priority issues, which have been designated in the Terms of Reference. It is not appropriate for the Review to also be used to extend the scope of HFE to the internal transactions of PNFCs where this is not in response to a Terms of Reference directive.

The current framework already recognises the General Government implications of state holdings in the PNFC sector through the assessment of recurrent and capital subsidies and the assessment of state net financial worth and should be retained.

There are also numerous implementation issues with assessing PNFC transactions which cannot be resolved in the short timeframes of the 2015 Review. There has not been an opportunity to develop clean slate assessments of Transport Services or Infrastructure, or to resolve the data confidentiality, reliability and comparability issues associated with bringing in PNFC transactions. It is also conceptually unclear why a framework change would, of itself, result in large changes to the redistribution of GST.

In light of these issues, Queensland does not support the Commission treating Urban Transport or Housing PNFCs as though they formed part of the General Government sector.

5. MINING RELATED EXPENDITURE

Queensland's position

- Mining would ideally be assessed on a net basis, taking both revenue and related expenditure into account. Mining development is also policy influenced, and not recognising this in the Commission's methodology creates a disincentive for states to facilitate industry development. Policy influence also means that there is uncertainty over whether states' production values represent their underlying revenue capacity.
- A discount of 50 per cent should be applied to mining revenues to account for these deficiencies.
- The Draft Report attempts to examine mining related expenditure on an individual category basis. However, assessments have not been successfully developed using this approach, due to methodological and data limitations. The Draft Report proposals do not reflect the expenditure requirements of mining states, as evidenced in Queensland's data. An alternative approach is warranted.
- If a discount is not applied, Queensland supports a collective assessment of expenditure related to mining in the Other Expenses category. If the Commission continues its individual category approach, materiality must be assessed collectively.

5.1. Draft Report Proposal

The Draft Report has approached the issue of mining related expenditure by examining the impact on individual assessment categories. The Report argues that in most areas, states with significant mining sectors face no higher expenses per capita than other states. It proposes making a separate assessment of mining regulation expenditure but has not made an assessment for any other kind of mining related expenditure at this stage.

The Draft Report notes that the Commission is still considering whether an assessment should be made for roads relating to economic activity. Regarding infrastructure more generally, it also notes that more consultation is required on whether the current infrastructure assessment fully recognises the costs of new infrastructure. This issue is addressed in Attachment 27 of the Draft Report and Section 9 of this submission (Infrastructure).

5.2. Approach to recognising mining related expenditure needs

5.2.1. The conceptual case for recognising mining related expenditure needs

Ideally, the Commission would assess mining revenue on a net basis. This would reduce the mining revenue of states, and their assessed capacity to raise revenue, by the expenses and other costs they had to incur to grow their revenue capacities. Currently, there is an asymmetry in the Commission's assessments, where the impact on fiscal capacities of mining revenue is recognised but the associated expenditure is not.

This ideal approach is not practical in the Commission's methodology, due to issues such as the lumpy nature of capital expenditure supporting the mining industry, and the difference in timing between expenses and the resulting revenues. Also, it is sometimes difficult to measure or quantify the impact on states of a large mining industry, particularly in areas such as opportunity cost and risk. Nevertheless, there is a conceptual case that these issues impact on mining states.

Previous submissions made by Queensland have discussed the unique attributes of the mining industry and the state revenue it generates, which should be recognised in the Commission's assessments. These arguments are summarised below.

- The mining industry is concentrated in a few states

  Where only a few states have significant expenditure arising from mining industry support, it is likely the impact on fiscal capacities will be material. This is similar to mining revenue, which is the largest source of revenue redistribution in the Commission's assessments, despite being a small proportion of state revenue.

- Mining development can be problematic

  Mining is subject to difficult and potentially controversial decisions by government. For example, the development of the coal seam gas (CSG) industry has been controversial in a number of states due to the potential environmental, agricultural and community impacts. In Queensland, there is particular concern over the impact of mining export activity on the Great Barrier Reef. The development of new coal or uranium mines is always controversial due to environmental concerns over the use of these minerals. Arguably, development of the CSG sector in New South Wales has been significantly constrained because of these issues.

  Mining industries can also have large social and community impacts, in part due to their reliance on the FIFO/DIDO workforce. In deciding to develop these industries, governments must make difficult trade-offs between environmental and social impacts and the economic benefits of a strong mining industry.

  This means that a state's mining production value (and thus its assessed revenue capacity) is more affected by policy choice than the revenue bases for state taxes. It follows that there is a degree of uncertainty around whether a states' revenue base as measured by its value of production accurately reflects its underlying revenue capacity.

- The incentive to develop the industry must be preserved

  The asymmetry of the current approach has the potential to affect states' incentives to make difficult policy choices to develop their mining industries.

  The mining industry creates economic benefits, particularly increases in employment and wages and increased government revenue, which are shared across the nation. The risk to the national interest is that HFE reduces the incentives for a state government to support the development of the mining industry to such a degree that the industry will not receive the support that it should be receiving, to the detriment of the nation.

On this issue, the Draft Report states that:

"*we are not asked to pursue objectives other than HFE. For this reason, our approach to the mining assessment is not designed to provide either an incentive or a disincentive for resource states to develop and expand their mining centres*[13]"

Queensland agrees that the Commission is not being asked to provide an incentive for mining states, but equally, it is of the utmost importance the Commission's process does not create a disincentive. Queensland considers that by not properly recognising mining relating expenditure, and by fully assessing mining revenue in a way that is not policy neutral, the Commission is creating a clear disincentive for industry development. Specific issues relating to the policy neutrality of the Mining Revenue assessment are discussed in Section 6.

- Redistribution of a state asset

  Royalties are payments for the extraction of an exhaustible state asset, which is fundamentally different from the rest of the revenue assessments, which deal predominantly with state taxes.

The unique attributes of the mining industry mean that the Commission's usual approach of simply measuring the base on which revenue is levied and the associated revenue is insufficient. It does not recognise that only mining states incur significant expenditure arising from mining industry support, or that the difficult policy choices associated with mining development mean that it is uncertain to what extent the value of mining production reflects states' underlying revenue capacities. It also creates a disincentive for states to encourage industry development and make difficult or controversial policy choices to support their economic growth.

Queensland considers that the 2015 Review must address this asymmetry in the mining assessment, and recognise that conceptually, mining should be assessed on a net basis.

5.2.2. Application of a discount

As Queensland argued in its previous submission, its first preference for addressing this issue is for a discount to be applied in the mining revenue assessment. This is a practical means of:

- Recognising that mining states incur expenditure and risks as well as derive revenue from their industries;
- Accounting for states' mining revenue capacities being more affected by policy choice than the revenue bases for other state revenues, and thus the true underlying revenue capacity being less certain; and
- Preserving the incentives for states to support mining industry development.

[13] Draft Report Review Attachment 7 Mining Revenue, paragraph 39.

The Draft Report explains that the Commission is not inclined to address these issues by means of a discount to the Mining Revenue assessment, for a number of reasons:

- Disentangling the impact of policy from other factors (such as the quality and grade of states' minerals) would be difficult;
- A discount would imply that States with relatively higher production are all pro-development states; and
- It is unclear whether there would be similar discounts required for the revenue derived from other industries.

Queensland agrees that it may be difficult to disentangle the impact of policy from other factors, however, that issue concerns the level of discount that would be required. Queensland considers that in this case it is appropriate for the Commission to make a judgement over the level of discount. This would be more reasonable than the full equalisation of revenue, which effectively assumes that mining industry development is not policy influenced at all. As described above, Queensland considers there is a strong conceptual case that mining industry development is policy influenced.

Queensland does not agree that the second two points are reason to not implement a discount. The Commission applies a range of discounts in its assessments and there is not usually any evidence required that the factor being discounted overstates the underlying effect being measured, just that it is applied with a degree of uncertainty. The impact of policy on states' revenue bases for mining creates sufficient uncertainty over the accuracy of value of production factors that it is reasonable to discount the revenue assessment.

The question of whether other industries have similar features or require similar expenditure to the mining industry is referred to a number of times in the Draft Report. Queensland's view is that a conceptual case has been made that specific characteristics of the mining industry – particularly that it is the subject of difficult policy choices and a disincentive should not be created for its development – mean a discount is required in the assessment of related revenue. A similar case has not been made for other industries, nor has any evidence been presented that other industries incur similar levels of expenditure. Queensland does not believe it is reasonable to assume that other industries require similar treatment, and does not consider such an assumption to be a valid reason to not recognise these issues in mining.

As discussed in Section 6 (Mining Revenue), an appropriate discount would also go some way towards reducing the grant design effects of the current assessment, which create a disincentive for governments to develop the mining industry and apply royalty rates that deliver the desired return for the state. A discount is the simplest and most objective way for the Commission to exercise judgement in this area.

A discount would also allow the recognition of factors for which the Commission has not been able to develop an assessment in the Draft Report. These include expenses such as those relating to business development and environmental protection, but also those that are less easily measured and do not fit easily into the current assessment framework. This includes opportunity cost and risk associated with mining related infrastructure and the impact of past investment on current revenue raising capacity.

5.2.3. The Draft Report approach to recognising mining related expenditure

The Draft Report further develops the approach to recognising mining related expenditure that was suggested in the Proposed Assessments paper. This was to investigate potential methodologies for assessing mining related expenditure in each individual category. In Queensland's response to the Proposed Assessments paper, Queensland was concerned that this would not produce a methodology that fully recognised the needs of states with large mining industries. There have also been specific issues with developing methodologies using this approach as described in the Draft Report:

- Data limitations – in some elements of the approach (for example, assessing the impact of FIFO/DIDO workers, the detailed datasets that would be required are not available to make an assessment. For other elements, not all states have provided the required data. For example, not all states have provided data for roads related to industry support or for total mining related expenditure. This makes it more difficult for the Commission to make an assessment, but should not be a reason to not recognise mining related expenditure where the mining states have provided data.
- Methodological limitations – in the Draft Report mining revenue attachment, the Commission recognises that there may be differences in state efforts and that there is a conceptual case that these differences should be removed. However, the Commission was unsure how these differences could be quantified so making an adjustment has proved impractical.
- Materiality issues – individually, assessments may not be material, for example in the assessment of regulatory costs associated with investment projects. However, the impact of mining is likely to be material if examined collectively.

In its Draft Report analysis, the Commission examines a range of expense areas which are affected by identified mining related expenses across Services to Industry, Roads, Services to Communities and the Infrastructure assessments. However, the Draft Report has only developed a methodology for specifically recognising mining related expenditure for the regulation component of Services to Industry (further consultation is pending on roads relating to economic activity and growth investment).

The limitations described above appear to be inherent to a category-by-category approach, and Queensland considers that the difficulties experienced by the Commission in measuring mining related expenditure in this way mean that a different approach is warranted.

Queensland is also concerned that materiality appears to have been considered at an individual level in at least some instances - for example, in the assessment of regulatory costs associated with investment projects and the consideration of environmental protection expenses. Queensland does not consider this to be an appropriate approach. Materiality of mining related expenditure must be considered across all categories collectively, as it is for other factors (such as Indigeneity) that affect multiple categories.

More broadly, Queensland is concerned that the approach as a whole does not recognise the drivers of additional expenditure faced by states with large mining industries, or the quantum of these expenditures:

- The Draft Report implies that mining related expenditures are not significant because they represent less than half a per cent of state expenditure. However, Queensland notes that in the state-provided expenditure data, Queensland's costs are easily materially larger than those of non-mining states, and that few disabilities in the Commission's methodology are significant enough to redistribute more than half a per cent of state expenditure. A substantial proportion of Queensland's additional expenditure is in areas where the Commission has not been successful at developing an assessment using the category-by-category approach.
- In Queensland's submission to the Proposed Assessments paper, it was suggested that the indicator that would best represent the drivers of need for mining related expenditure was private sector investment in the mining industry. This would recognise that state expenditure is likely to be concentrated in the investment phase of a mining development, in terms of regulation, administration and planning, business development, and supporting infrastructure. Queensland is concerned that the Commission is not proposing to recognise this important driver of state expenditure.

Queensland considers that the strength of the conceptual case and the asymmetry of fully assessing mining revenue but not related expenditure mean that the Commission needs to incorporate mining related expenditure more comprehensively into its methodology than suggested so far in the Draft Report. The difficulties inherent to a category-by-category approach have become more apparent following the analysis the Commission conducted for the Draft Report.

5.2.4. Queensland's preferred approach

Queensland's preferred approach, if a mining revenue discount is not applied, remains the aggregation of all relevant expenditure and making an assessment under a broad indicator in the Other Expenses category. This is the most practical way of overcoming the data and methodological limitations encountered in the Draft Report approach. As discussed above, Queensland's preferred indicator is private sector investment in the mining industry, which is a policy neutral option that is strongly related to mining states' expenditure needs. A collective assessment should include:

- Regulatory expenditure associated with mining;
- Business development expenditure;
- Environmental protection expenditure, including site rehabilitation costs;
- Community development expenses;
- Planning and project costs identified in state data returns;
- Royalties for regions expenditure; and
- Roads related to mining activity.

5.3. Individual components

While Queensland's preferred approach to assessing mining related expenditure is discussed above, specific comments on individual category assessments in the Draft Report are detailed below.

The issue of sufficiently allowing for the costs of growth investment is addressed in Section 9 (Infrastructure).

5.3.1. Services to Industry assessment

5.3.1.1. <u>Business development expenditure</u>

The Draft Report proposes to assess business development expenditure equal per capita (EPC). The Commission considers that all states support industries in a way that supports their economy, and that while states with more mineral resources may provide more support to the mining industry, states with other economic strengths support their industries. This assumption is not evidence based, and there are two main issues with the conclusion:

- Queensland has provided information detailing the business development support it provides to the mining industry and data on the costs. If other states are providing similar support to different industries, these states should be asked to provide evidence of this rather than the Commission assuming non-mining states undertake similar levels of business development activity; and
- The nature of the mining industry means that a higher level of expenditure may be required to support business development. Queensland's response to the Commission's data request detailed a range of business development expenditures that would not be required for other industries. For example, Queensland's Department of State Development has expenditure related to mining technologies and services, resources policy, the Gasfields Commission, mine water management and the Coal Infrastructure Coordination Taskforce. This issue does not appear to have been fully considered.

Queensland does not believe that the drivers of business development expenditure have been investigated sufficiently to assume that the expenditure of mining states is no higher than that of non-mining states. However, Queensland considers that the nature of the mining industry and the need to provide support that would not be required for other industries constitutes a conceptual case that mining states incur additional expenditures. Queensland has also provided data on the expenditure the state incurs.

It should also be taken into account that mining business development expenditure is directly related to the growth of revenue capacity through mining royalties. In terms of assessing mining on a net basis, it is important that the business development expenditure of states be recognised.

On this basis, Queensland considers that mining related business development expenditure should be included in a collective assessment of mining related expenditure in the Other Expenses assessment.

5.3.1.2. Mining regulation expenditure

Mining regulation expenditure is one of the few components of mining related expenditure that the Draft Report proposes to recognise. The Draft Report proposes to separate mining regulation expenditure from the "agricultural" and "other" regulation expense groupings and assess it using the existing methodology for assessing regulation expenditure, which uses a combination of industry size and the number of businesses.

Queensland is concerned that this approach is being driven by the short timeframes of the 2015 Review, and that other potential approaches may not have been fully explored. Similar to other mining related expenditure, Queensland's preference is for mining regulation expenditure to form part of the collective assessment in Other Expenses.

5.3.2. Services to Communities assessment

5.3.2.1. Environmental protection expenditure

The Draft Report proposes to not recognise the additional expenditure incurred by mining states for environmental protection. This is because the Commission is unsure that mining states have higher costs, as they have not been able to identify data that would allow them to discriminate between the environmental costs of different industries.

Queensland disagrees with this conclusion and considers that given the nature of mining operations, there is a strong conceptual case that mining states would have higher environmental protection expenditure than non-mining states. Based on state data returns (Table 22 of the Services to Communities attachment), there is good evidence that Queensland (as a mining state) has much higher environmental protection expenditure than the non-mining states that provided data:

- Queensland has provided data on the costs of environmental assessment functions and compliance activities specifically related to mining projects.
- Queensland's abandoned mines program incurs costs relating to rehabilitation and repair of mine sites.

The Draft Report notes that in the absence of data from Western Australia, an assessment is unlikely to be material. However, while data from Western Australia was not available in time for the Draft Report analysis, Queensland understands it is now available to the Commission and believes this issue should be reconsidered taking Western Australia's expenses into account.

While environmental protection expenditure related to mining may not be individually material, it should form part of a collective assessment of mining related expenditure.

5.3.2.2. Community development and planning

The Draft Report does not propose assessing additional expenditure for community development and amenities or planning expenditure, as these expenditures appear to be different across states and the Commission believes them to be highly policy influenced.

Queensland has provided data on additional expenditure for community development and planning that is directly related to the mining industry. This expenditure is driven by the presence of a large mining industry, rather than policy choice, and should be assessed collectively with other mining related expenditure.

5.3.3. Royalties for the Regions

Queensland's Royalties for the Regions program is an initiative designed to ensure that regional resource communities receive long-term benefits from the royalties generated by mining projects. As described in Queensland's program guidelines, $495 million is to be invested in regional communities over four years (2012-13 to 2015-16) for projects designed to build community capacity and economic sustainability through:

- *infrastructure that improves the liveability and amenity of regional communities*
- *making places more attractive for people to live and work*
- *economic development and resilience of regional communities*
- *development consistent with Queensland regional economic or planning priorities*
- *increased private sector investment in resource communities*[14]

Similar programs are in place in other states with major mining operations. Western Australia's Royalties for Regions program aims to reinvest 25 per cent of mining and onshore petroleum royalties into regions each year, and the New South Wales Resources for Regions initiative is designed to relieve infrastructure constraints and support communities affected by mining operations.

The reinvestment of mining royalties into regional communities is average policy for states with major mining operations. It is an expectation of regional communities that some of the benefits of the mining industry accruing to government will flow back to the regions. It is also necessary to ensure the long term economic sustainability of regions, as mining operations may not be ongoing.

The average policy of directing mining royalties to regional projects, rather than using them to meet general state expenditure requirements, should be recognised as a disability for mining states. This expenditure should be included in a collective assessment of mining related expenditure.

The data provided so far by Queensland has not included royalties for regions expenditure, but Queensland is able to provide further details of costs and projects if required.

[14] Queensland Royalties for the Regions program guidelines, round 3.

5.3.4. Roads relating to economic activity

The Commission has requested, and Queensland has provided data, on:

- The location and lengths of roads relating to economic activity that are not currently included in the synthetic roads network;
- The industry to which these roads mainly relate (mining, agriculture, tourism); and
- As part of a supplementary request, details of the purpose of each road and the areas it connects.

Further information was subsequently requested on the dollar value of output or quantity of output attributable to each road, in terms of the economic activity it serviced. The provision of this information would involve a large degree of estimation (for example, using output information for each industry combined with an estimate of the proportion transported on the road network). The contribution of individual roads would then need to be estimated in some way.

Even if this could be achieved, it may not provide an accurate picture of the economic contribution of roads. Queensland notes that roads relating to economic activity do not just service the transportation of outputs, but also service economic inputs. This may be important in cases where outputs are transported by another means (e.g. rail) but state roads provide access for inputs. Attempting to estimate the quantity of output attributable to a road would need to take this into account and is another reason that estimating the value of the contribution made by individual road sections to industries is difficult and approximate.

However, Queensland considers that the information already provided is sufficient for the Commission to make an assessment of roads relating to economic activity. It demonstrates that states build and maintain roads where the main purpose is the support of economic activities, and that these roads are not recognised in the currently assessed synthetic network. An assessment can be developed based on the road lengths provided.

Queensland understand that not all states have been able to identify roads relating to economic activity, and suggests that road lengths for these states be estimated. One method could be to estimate the length of roads in states not providing data as a proportion of the road lengths provided by other states, using:

- The relative size of relevant industries which may require additional roads (mining, agriculture, tourism); and
- A measure of the geographic spread of states to approximate the distance roads would need to cover. Although it is proposed to use ARIA as the general remoteness indicator, this may not be a good option here as the roads being estimated are state based (unlike ARIA), and are not necessarily related to the size of the remote population. The length of the synthetic network currently used in the roads assessment may be a better approximation because it is state based and is a measure of distance rather than the size of the remote population.

6. MINING REVENUE

Queensland's position

- Queensland continues to support a 50 per cent discount to recognise mining related expenditure needs. A 50 per cent discount will also 'avoid excessively large GST share effects' as recommended in the GST Distribution Review final report to which the Terms of Reference refer.[15]
- Queensland does not support a mineral by mineral revenue assessment as it is vulnerable to policy non-neutrality and grant design effects. Queensland supports an aggregated mining revenue assessment which would achieve all supporting principles of HFE as well as equalisation.
- Queensland does not support phasing in of the impact of iron ore fines over a three year period from 2015-16. The current terms of reference provides no such provision and therefore the 2015 final report should reflect the impact of the iron ore fines at the current royalty rate.

In the 2010 Review, the Commission adopted a three category mining assessment comprising high royalty rate minerals (oil and gas, lump iron ore, export coal and bauxite), low royalty rate minerals and grants in lieu of royalties. The first two categories are assessed on value of production and the third category is assessed on actual revenue received.

6.1. Draft Report Proposal

The Draft Report proposes a mineral by mineral assessment, as the Commission considers this approach achieves HFE more accurately. While acknowledging this approach has the potential to make the assessment less policy neutral (because changes in State policies may have a larger impact on their shares of GST), the Commission consider the goal of policy neutrality is subsidiary to the requirements to achieve HFE.

Under a mineral by mineral approach, the Commission will assess a mineral separately if it is material to do so. This means iron ore, coal, gold, on-shore oil and gas, copper, bauxite and nickel will be assessed separately with the remaining minerals assessed together in a group.

Lastly, the Commission proposes to phase in the impact of iron ore fines over a three year period from 2015-16.

6.2. Discounting Mining Revenue

The Draft Report considers discounting appropriate when it helps the Commission to achieve a better HFE outcome, for example, where there are data concerns. The Commission does not consider this is the case with the proposed mineral by mineral assessment and therefore does not propose applying a discount to the mining revenue assessment.

Queensland continues to support a 50 per cent discount to the mining revenue assessment to recognise mining related expenditure needs. There is conceptual merit in recognising the direct link between expenditure to support the mining industry development and the

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[15] GST Distribution Review Final Report, October 2012, Recommendation 7.2

increased fiscal capacity derived from the associated royalty revenues. Mining expenditure is currently not adequately recognised in any category.

A 50 per cent discount will also 'avoid excessively large GST share effects' as recommended in the GST Distribution Review final report to which the Terms of Reference refer[16] (as discussed later).

Discounting the Mining Revenue assessment is further discussed in Section 5 (Mining Related Expenditure).

6.3. Mineral grouping

The Commission advises its objective in developing a new mining revenue assessment is to achieve HFE and primacy should be given to achieving that objective. The supporting principles – what states do, policy neutrality, practicality and contemporaneity, while important, should be subsidiary to this objective. Therefore, the Commission has decided on an approach which best achieves HFE by separately assessing minerals where it is material to do so. The Commission proposes to separately assess the minerals that generate the most royalty revenue: iron ore, coal, gold, onshore oil and gas, copper, bauxite and nickel and the remaining minerals in one group. The Commission's intention is to keep this structure until the next review. However, if there is a major change in circumstances, such that another mineral becomes material or one of the material minerals becomes immaterial, the Commission will exercise judgement on whether HFE would be improved by changing the structure of the assessment.

Queensland does not support the Commissions' approach to developing a new mining revenue assessment or the proposed mineral by mineral assessment as it does not apply equal regard to each of the principles of HFE. A disadvantage to such an approach is a mining revenue assessment that is vulnerable to policy non-neutrality, grant design and an assessment that does not avoid excessively large GST share effects (as was the intention in developing a new mining revenue assessment discussed under 'Terms of Reference' below).

6.3.1. HFE and its supporting principles

In the 2010 Methodology Review, the Commission developed four key principles on which to develop their assessments. The principles indicate that equalisation should be implemented through methods that:

- reflect what states collectively do
- are policy neutral
- are practical
- are contemporaneous[17]

[16] GST Distribution Review Final Report, October 2012, Recommendation 7.2
[17] Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities*, 2010 Review, Vol 1, pages 35-37

In determining the best mining revenue assessment in the Draft Report, the Commission considered "the main issue is finding an appropriate balance between fiscal capacity, what states collectively do and policy neutrality[18]".

The term HFE can be used to refer to both an objective and the mechanism used to achieve it; where the mechanism is the process through which revenue is distributed to the states and the objective is that of securing particular outcomes captured by the term 'equalisation'.[19]

The GST Distribution Review provides a good view:

> "Two pillars of the current HFE system are that equalisation should be implemented through methods that reflect what states collectively do, and are 'policy neutral'. Essentially, this means that the policies of the states, looked at collectively, *should* be used to determine their GST shares but that the specific policy choices of any individual State *should not* significantly influence its GST share*."*[20]

6.3.1.1. Terms of Reference

The Terms of Reference for the 2015 Review states:

> "2. In undertaking its assessments, the Commission should have regard to the recommendations of the final report of the *GST Distribution Review final report* (October 2012) to:
>
> g) develop a new mining assessment (Recommendations 7.1 and 7.2)"[21]

The GST Distribution Review final report concluded that State mining revenue should continue to be equalised, but recommends that the Commission develop a new mining revenue assessment at the earliest opportunity to address policy neutrality concerns. The review also recommends a new mining revenue assessment that should avoid excessively large GST share effects.

Queensland supports continuation of the current approach to developing a mining revenue assessment and does not support the Commission's newly adopted view that primacy should be given to equalisation above the supporting principles of HFE. Queensland views that each principle of HFE is equally important, provides a framework for how HFE is implemented and cannot be considered subsidiary to equalisation (as discussed later). All other states support a form of grouping to equally address all principles of HFE.

6.3.2. Policy neutrality

The Commission acknowledges that a mining assessment which achieves HFE and which is also policy neutral is made more difficult by the dominance of the revenue base by two states.

[18] 2015 Review Draft Report, Attachment 7, page 125
[19] *The GST Distribution Review final report* (October 2012).
[20] *GST Distribution Review final report* (October 2012), page 107.
[21] Terms of Reference, Commonwealth Grants Commission 2015 Methodology Review, page 1.

Ultimately any mining revenue assessment would be open to issues such as policy neutrality therefore it is a matter of which mining assessment is most policy neutral and provides the least incentive for grant design.

The current mining revenue assessment seeks to strike a balance between ‘what states do’ and treating all minerals alike. The assessment separates minerals into two groups based on whether their average royalty rate is above or below five per cent.

When Western Australia decided to increase its royalty rate on iron ore fines from 3.75 per cent to 7.5 per sent from 2013-14 onwards, the two tier mining assessment was found to be subject to policy neutrality issues where a significant enough change to the royalty rate of iron ore fines would exit it from the low royalty rate group into the high rate royalty group therefore having a great impact on GST redistribution.

This was further complicated by the incremental increase of the iron ore fines royalty rate where the two tier assessment redistributed more revenue than was gained from the rate increase as a commodity can enter the high royalty rate at the a lower royalty rate than the average rate applied to the high royalty rate group.

The Commission advises a mineral by mineral assessment will eliminate this problem however this problem will simply be replaced by a new problem. Where the old assessment redistributed more revenue than was gained from a rate increase and/or creates excessively large GST share effects, the new assessment redistributes a proportion of revenue every time a rate is changed, rather than just when a commodity moves between groups. This is even more detrimental to achieving good policy outcomes (in terms of an appropriate return to governments for the mining of mineral resources) than the old assessment, as it creates a disincentive for states to ever increase royalty rates.

Queensland has undertaken modelling to demonstrate the extreme redistribution problem clearly evident in a mineral by mineral assessment.

Queensland and Western Australia are chosen for modelling as they are the dominate states in coal and iron ore respectively.

The model shows the impact of Queensland making a policy choice that increases its royalty revenue for coal by $100 million under a grouped approach and then under a mineral by mineral assessment. The model also shows the impact of Western Australia making the same policy choice but for iron ore.

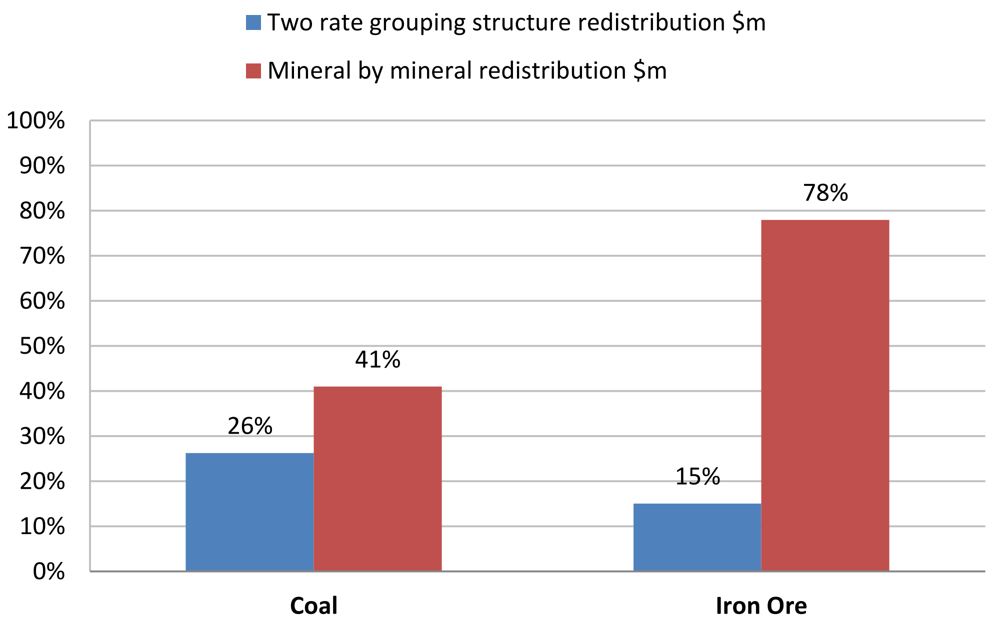
<u>Queensland (Coal)</u>

Figure 1 shows that under the current two rate grouping structure, the redistribution is 26% of the additional royalty raised, whereas under a mineral by mineral assessment redistribution is almost doubled at 41% of the additional royalty raised.

Western Australia (Iron ore)

Figure 1 shows that under the current two rate grouping structure, the redistribution is 15% of the additional royalty raised, whereas under a mineral by mineral assessment the redistribution is an extreme 79%.

Figure 1: Share of revenue redistributed from State policy choice to increase revenue, 2011-12



Data source: 2011-12 High royalty rate mineral group Commission calculations.
2011-12 ABS VoP figures for Coal and Iron Ore assuming an average royalty rate of 7.5% on the base case.

The above figure demonstrates how extreme redistribution under a mineral by mineral assessment can be in comparison to the current two rate grouping structure. It specifically demonstrates how vulnerable to policy change a mineral by mineral assessment is as there is no mechanism to minimalise the impact of policy change. In contrast, the current two rate grouping structure has the mechanism to avoid excessively large GST share effects in most cases. Enhancing the current two rate grouping structure would provide a mechanism to avoid excessively large GST share effects in almost all cases. The more aggregated a mining revenue assessment approach is, the less vulnerable it is to policy change. A single aggregated mineral grouping would be the most policy neutral assessment structure and would not produce large GST share effects when states policies change.

Based on lessons learnt subsequent to the gradual increase of royalty rate of iron ore fines, the intent of the Terms of Reference for mining revenue, based on recommendations 7.1 and 7.2 of the final report of the GST Distribution Review (October 2012), in addition to HFE, was to avoid excessively large GST share effects. In other words, a Mining Revenue assessment that achieves HFE based on its supporting principles including policy neutrality and what states do.

A mineral by mineral assessment is extremely vulnerable to policy non-neutrality, more so than a grouping assessment, as it would allow a state's policy to directly influence the GST distribution. Such an outcome is in contravention of the principle of policy neutrality, a principle of HFE.

6.3.3. Grant design

The Commission believes while it is theoretically possible for State policies to affect GST distributions in this area, there is no strong evidence that this happens. Queensland's view is that it is not necessary to prove state royalties policies are designed to affect the GST distribution. The existence of an incentive for states to alter their policies is sufficient and must be avoided by the Commission. The Commission cannot guarantee that policy design will not affect the GST distribution.

With the change to the royalty rate of iron ore fines, it has been proven that while the implications for the mining assessment may not be the primary consideration, ultimately, there are ongoing changes in the mining industry that are not always foreseeable at the time of any one review or update that will impact on the GST distribution.

A mineral by mineral assessment has no measure to guard against policy change, which means there is a higher risk that the assessments could influence state policy. It cannot be assumed because states may not have acted on incentives created by the methodology for assessing mining revenue in the past that there will be no impact on state policies if the Commission moves to a mineral by mineral assessment.

6.3.4. Data

A mineral by mineral assessment poses practical data concerns. Queensland understands there will be a level of estimation where specific data is not available. For example, some of Queensland's royalties data for individual minerals is confidential. Queensland requests high levels of consultation in this regard.

6.4. Phasing in of iron ore fines

Since the 2010 Review, Western Australia has incrementally increased the royalty rate applied to iron ore fines from 3.75% to 7.5%.

From the 2011 Update to the 2014 Update, Terms of Reference dictated that the Commission should ensure that, with regard to the removal of iron ore fines royalty rate concessions in 2010, the classification of iron ore fines should not move between mineral royalty rate groups in between methodology reviews.

The Commission recognises in this review that there is no similar direction in the terms of reference and that a mineral by mineral assessment provides no special treatment for iron ore fines and on introduction would lead to a significant reduction in Western Australia's GST revenue. The Commission indicates appreciation that where "*previous updates have not taken full account of Western Australia's higher revenue capacity, when judged over a* *span of years, a one-off adjustment in 2015-16 could be considered an appropriate correction*".

The Commission then advises having given "*careful consideration to this issue because we believe it raises significant high level questions going to the practical application of fiscal equalisation … we have formed the view that there should be a phased introduction of the impact of higher effective royalty rates on iron ore fines on the GST distribution over three years starting in 2015-16*" [22].

6.4.1. Terms of Reference

The 2011 to 2014 Update Terms of Reference directive was implemented as an interim measure in between reviews to retain the classification of iron ore fines in the low royalty rate group. This ensured that the removal of iron ore fines royalty rate concessions in 2010 did not have a significant GST redistribution impact where redistribution of GST away from Western Australia was greater than the mining revenue earned with initial incremental increases.

No such terms of reference has been made in this review. The Commission now considers this an issue which raises "*significant high level questions going to the practical application of fiscal equalisation*"[23]. Queensland is not aware of compelling reasons as to why this is an issue and why or what significant high level questions this raises. The Commission, for reasons not adequately explained, feels bound to maintain and be guided by the previous Terms of Reference. These are clearly not repeated in this Review and were only ever intended as a placeholder until a new methodology could be developed in a review process. If the royalty rate for iron ore fines had been assessed as the rate increased and not retained in the low rate group by a Terms of Reference, then today, they would simply be assessed at their current rate and would not warrant this level of consideration. The treatment of iron ore fines would effectively be a non-issue.

Queensland considers further discretionary intervention by the Commission is not required and lacks transparency. The Commission should not feel bound by or compelled to continue with a Terms of Reference directive that is not part of the 2015 Review, which provides a special treatment for iron ore fines.

6.4.2. Queensland's position on options for the treatment of iron ore fines

1. One-off adjustment

Queensland is of the view that a 'one-off adjustment' option simply implements the methodology that will be developed for the 2015 Review and Queensland supports this option as it is the only reasonable way forward.

[22] 2015 Review Draft Report, pages 126-127
[23] 2015 Review Draft Report page 127

2. Phasing in

The Commission states in the normal course of events the averaging process would have 'phased in' the impact of the change in royalty rate of iron ore fines *anyway*. Accordingly, the Commission has formed the view that there should be a phased introduction of the impact of iron ore fines in future years.

The averaging process and phasing in in future years are distinctly very different but are used interchangeably by the Commission.

The averaging process is applied across all categories and assessments and is a fundamental smoothing mechanism adopted by the Commission as part of its usual calculations. Phasing in is an ad hoc implementation tool designed to counteract a large GST redistribution impact over a period of time.

The Commission states HFE is the primary objective for adopting a mineral by mineral assessment. Phasing in the treatment of iron ore fines is fundamentally at odds with that objective. The Commission has recognised that Western Australia has significantly increased the revenue it obtains from the increased royalty rates applied to iron ore fines. It is therefore difficult to understand why the Commission would propose to phase in the impact of higher effective royalty rates without being directed to do so in the Terms of Reference, as this will clearly not achieve HFE.

Queensland does not support phasing in of the impact of iron ore fines over a three year period from 2015-16. Any special treatment would be a contradiction of HFE and its supporting principles and should not be made.

6.5. Queensland's position on the assessment of mining revenue

Queensland continues to support a 50 per cent discount to recognise mining related expenditure needs to recognise the direct link between expenditure to support the mining industry development and the increased fiscal capacity derived from the associated royalty revenues. A discount would also achieve to avoid excessively large GST share effects.

Queensland reiterates its belief that a mining assessment based on a single aggregated minerals structure would strike a more appropriate balance of HFE and its principles. This approach would greatly enhance the policy neutrality of the assessment and reduce the potential for grant design effects while still assessing each state's relative capacity to raise revenue through mining royalties. It would also remove the potential for minerals to move between groups or redistribute a proportion of revenue when a commodities' royalty rate is changed.

If an aggregated mining revenue assessment is rejected, it may be preferable to retain the current two-rate structure (with iron ore fines appropriately in the higher rate group) but address its shortcomings in dealing with cases where there are significant changes to royalty rates. At least the methodological shortcomings of a two rate mining assessment are well understood and the grouping has some relationship to 'what states do'.

If the two rate structure were to be retained, a remedial arrangement would be required to ensure the assessment structure addresses potential mobility of minerals between mineral groups rather than a reliance on Terms of Reference directives. It is conceivable that provisions in the methodology could be established to adequately address changing royalty rates between reviews and guarantee an outcome consistent with the overarching principles of equalisation.

7. INTERSTATE WAGES

Queensland's position

- Substantial issues with the current Interstate Wages assessment have been consistently raised by Queensland and other states and these issues have not been addressed in the Draft Report. The statistical relationship between private and public sector wages is no longer significant and the results of the model are unreliable. There is now little confidence in the outcome of the wages assessment, and Queensland questions whether the assessment should continue. If the assessment is to be continued, it must be discounted by at least 50 per cent.
- The Commission has investigated an alternative Interstate Wages model based on capital city rather than whole of state wage differences. Relative capital city wages are not an appropriate measure of the drivers of Interstate Wages and a convincing conceptual case has not been made. Comparing only wages in capital cities reduces the sample size of the statistical model, reducing the reliability of the assessment further. Queensland supports the Draft Report proposal to not introduce a new version of the Interstate Wages model based on capital city wages.
- Queensland does not support revisiting the capital city wages model if a new Characteristics of Employees dataset becomes available as proposed in the Draft Report. The problems with the conceptual case and reduced sample size are not resolved with the availability of a new dataset.

The current Interstate Wages assessment uses relative private sector wages as a measure of interstate differences in public sector wage levels. The Commission's assumption is based on '*the theory that private sector wage levels are freely determined by market driven influences and that public sector wages face these same pressures*[24]'. Private sector employers pay different wages for comparable employees in different states due to differences in cost of living, the attractiveness or otherwise of the location, or competition for labour. It is suggested that, as private sector wages are largely beyond the control of state governments, differences in private sector wage levels can be used as a policy neutral measure of public sector wage differences.

7.1. Draft Report Proposal

The Draft Report proposed to keep the Interstate Wages assessment unchanged from the 2010 Review methodology. Though a new model based on capital city wages, rather than whole of state, was proposed in the October 2013 Proposed Assessments paper, the Commission decided to refrain from moving to a new model in the 2015 Review. The capital city wages model may be examined further in the 2016 Update to test the model with the Characteristics of Employees data set when it is available in 2015.

The 2015 Review describes the Interstate Wages model as capturing the 'pressures' on wage setting that are faced by both the private and public sectors. This description of the Interstate Wages assessment represents a departure from previous reviews. The 2010 Review states the assessment seeks to capture the differences in wages paid to comparable private and public sector employees in different states. Private sector wages are used in the

[24] 2015 Review Draft Report, page 404

model because they are not directly affected by state policy. The move away from a more definitive description of the Interstate Wages assessment in past reviews to one that discusses an attempt to capture wage pressures that are shared by the private and public sectors has allowed the Commission to relax their modelling assumptions and ignore the statistical validity of the wages model. Rather than loosening the objective of the assessment, the underlying issues with the methodology must be addressed.

7.2. Conceptual case

The Draft Report states Queensland and Victoria dispute the existence of wage cost disabilities. Rather, Queensland disputes the reliability of the current assessment and considers there is no longer evidence indicating the assessment actually measures wage cost disabilities.

There may be a case that there are differences in the wages states pay that are beyond their control, likely driven by factors such as differences in cost of living and attractiveness of location. However, there is little reason to believe the current Interstate Wages model reliably captures these pressures. Evidence presented in the Draft Report attempting to support the use of the model in the absence of a statistical relationship is problematic.

Given the significant issues with the methodology and data outlined below, Queensland considers no assessment of Interstate Wages to be a better HFE outcome than the current assessment until a more robust and reliable assessment can be developed. If the current assessment is to continue, a discount of at least 50 per cent is necessary to compensate for the lack of confidence in the regression results.

7.3. Methodological and data issues

7.3.1. Statistical relationship

Queensland's submission to the Proposed Assessments paper argued the statistical relationship on which the Interstate Wages model relies has deteriorated through consecutive data sets, and is non-existent in the currently used 2009 Survey of Employment and Training (SET) data. The Draft Report acknowledges the correlation has weakened, but considers that over time the link between private and public sector wages holds.

The Commission assertion that the relationship between private and public sector wages will hold over time is supported by Figure 1 in the Draft Report, showing relative public sector wage levels measured by SET over several data sets. The Commission considers the variance between states shown in Figure 1 persists over time and that some of the variance is beyond the control of state governments, despite the degree of policy influence inherent in public sector wage levels.

Assuming the variance is due to factors other than state policy, differences in private sector wage levels across states may reflect the non-policy factors if correlation can be shown between private and public sector wage levels. If there is no correlation, there is no reason to believe private sector wages have any influence on the public sector, or that they have any relation to the 'pressures' affecting public sector wages. The relationship measured in the current Interstate Wages model is not statistically significant, and thus there is no correlation in the 2009 SET data. The Commission proposes a current correlation is not necessary because it may one day return. Queensland considers the Interstate Wages assessment should not use a statistical relationship to measure interstate wage differences if the statistical indicators of the validity of the model are ignored.

7.3.2. Trends in other data

The October 2013 Proposed Assessments paper points to trends in Average Weekly Earnings data for New South Wales and Western Australia to suggest private and public sector wages are still correlated in the long run. While Figure 8 in the Draft Report shows New South Wales' public sector wages moving in the same direction as private sector wages in recent years (following a period of divergence from around 1998 to 2004), Figure 9 shows Western Australia's private sector wages moving from a point below the public sector (around 0.96 relative to the national average respectively) to around 1.16 in 2013. Western Australia's public sector wages also rose from around 0.98 to 1.04 relative to the national average in 2009, but have not increased further between 2009 and 2013.

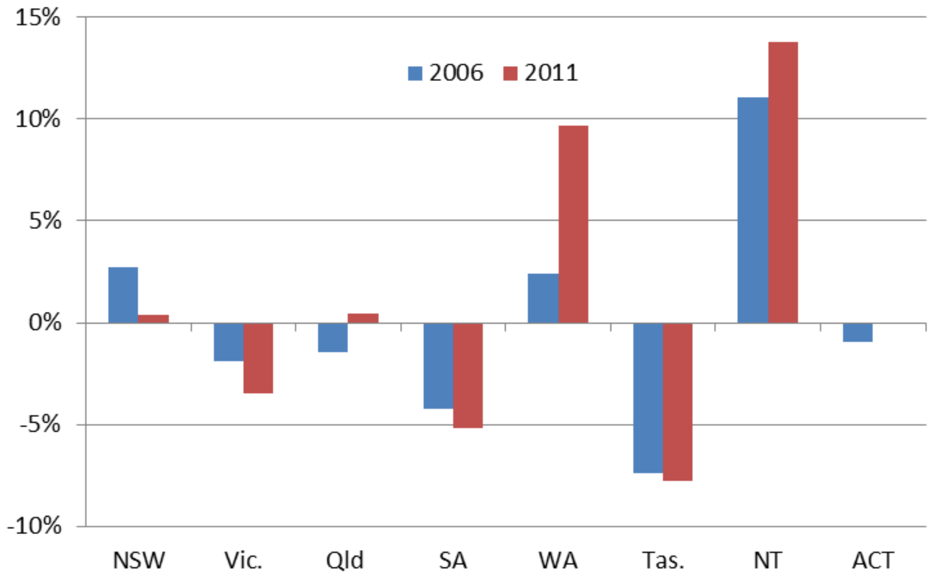
Examining the wage relationships of the other states in Appendix B reveals little evidence of a long term link between private sector and public sector wages. In particular, Victoria's Average weekly earnings show a large divergence emerging from 2007 onwards, with no indication this represents a lag in public sector wages that will readjust over time as suggested for Western Australia's divergence. Similarly, South Australia, Tasmania and Northern Territory show some level of divergence in the late 2000's.

The charts for all states in Appendix B show considerable divergence in relative private and public sector wages using SET data for New South Wales, Western Australia, South Australia and Tasmania in the later data sets. Examining the ABS Average Weekly Earnings (AWE) data from 2009 to 2012, South Australia and Tasmania show no evidence that this is due to a lag in public sector wage setting as the Commission have suggested is the case in Western Australia. Across all states' charts shown in Appendix B, there appears to be little evidence to suggest that this divergence is only temporary or a lag in public sector wages rather than a fundamental weakening in the relationship between private sector and public sector wages.

The comparison of SET and AWE data in itself is problematic. AWE data cannot be adjusted for characteristics such as occupation as is done with SET data, so they are comparing different measures of relative wages. As can be seen in Appendix B, apparent trends in AWE data do not reflect trends in SET data, and the wage relativities are significantly different.

This highlights a significant problem in the current methodology; the choice of data used to determine relative wages could change the results substantially. AWE data shows Northern Territory as having below average private sector wages in 2009, which would have resulted in GST distributed away from the state, a reverse result. The Queensland Government Statistician's Office demonstrated in their submission to the October 2013 Proposed Assessments paper that 2011 Census income data adjusted by occupation structure also gives significantly different wage relativities, with a reversed result for Queensland and ACT (Figure 1).

Figure 1: Standardised[(a)] private sector wage relativities compared to Australia, by state and territory, 2006 and 2011



(a) Standardised to the Australian 2-digit private sector occupation structure.

Source: ABS Census 2011

7.3.3. Conclusion

Based on the available evidence there is no indication that the current Interstate Wages model reflects the differences in the cost of wages between states. While a statistical relationship between private sector and public sector wages using SET data was observed at a point in time, the wage relativities produced by the model are now not significantly different from zero. The breakdown in this relationship cannot be explained at this time, and an examination of all states' AWE data shows as much evidence of a general divergence in wages as it does for lags in the responsiveness of public sector wages.

Queensland considers the results of the current Interstate Wages assessment cannot be considered as closer to achieving HFE than not assessing Interstate Wages until a more reliable model can be developed. Failing this, the assessment must be discounted by at least 50 per cent. Queensland understands the Commission may wish to reassess this discount when the new Characteristics of Employees data is available, but until that time the significant issues with the assessment have not been addressed and a discount is necessary.

7.4. Capital City model

The Commission is attracted to the use of capital city wages because it believes it is more consistent with what states do. However, as outlined in Queensland's submission to the October 2013 Proposed Assessments paper, this assertion relies on a series of assumptions about how states actually set wages.

Queensland's Public Service Commission (PSC) was consulted and prepared a paper on their views on public sector wage setting, which has been provided to the Commission alongside this submission. In their view 'the ease or difficulty of filling roles in Brisbane does not determine the level at which wages policy is struck, which will ultimately be applied state wide'. The Commission has yet to provide compelling evidence that governments do not consider the state-wide factors when setting wage levels.

Box 1: Exert from Report on econometric work conducted by CGC

General comments:
The model is a standard wage equation which has a sound base in the literature. The sample size is also large by any standard. Compared to previous practices, it uses data from capital cities only.

Capital city or whole of State model

1. There is a trade-off between the conceptual validity of moving from a national model to a capital city only model, and the increased standard errors associated with the smaller sample. Are there techniques for measuring and informing us on this trade-off?
Answer: As mentioned above, the larger is the sample, the more efficient (accurate) are the estimates, although the difference between the capital and non-capital city workers may need to be controlled for (e.g., by including dummies). If it is believed that the non-capital city workers are from a different population from those in the capital cities, then the best way is always to estimate them separately. To some extent, this is a question for judgment.

2. Does the simpler model produce estimates that are acceptable for the Commission's use? They are not statistically different from those produced by the current model, and the R2 has declined only marginally. Is there a standard measure of whether the simplified model is superior to our original model?
Answer: The R^2s using two samples are not comparable, although the similarity of the two, together with that of the estimated coefficients, indicates that the results are similar. Strictly speaking, if the observations are from the same population, the larger the sample, the more accurate are the estimates. But the sample of capital cities is large enough, thus the benefit of including more observations is marginal.

Recommendation:
In principle, estimation results using larger samples are more precise. Thus, if feasible, regression results using larger samples are always preferred.

The *Report on Econometric Work Conducted by the CGC* (Box 1) includes a discussion of the effect of using a model based on capital city rather than whole of state wages. The report recommends that estimation results using larger samples as in the whole of state model are more precise and regression results using larger samples are always preferred. The econometrician avoids commenting on the validity and reliability of the Commission's use of the model other than to say the larger sample size of the whole of state model is preferable. Queensland considers there is not a trade-off between the conceptual validity of a capital city model and the decreased reliability of the reduced sample size, as the conceptual case for capital cities has not been shown to be any more valid than the whole of state model. Additionally, neither model produces a statistically significant relationship.

Similarly, the Draft Report discusses an approach that compares the wage differences between comparable employees rather than all employees, and notes '*The effect of reducing the utilised SET sample under such an approach, as argued by South Australia, would increase the sampling errors, and potentially introduce policy concerns in certain segments of the labour force*[25]'.

Moving to a capital city wages model reduces that sample size significantly. A strong conceptual case would be required to justify a move to a less robust statistical model. Whether 'what states do' is better reflected by the wage levels in the capital city or whole of state appears to be primarily a judgement call, and Queensland does not consider judgement sufficient reason to further weaken a model that has been shown to have significant statistical issues even with a larger sample size.

[25] 2015 Review Draft Report pages 410-411

OTHER ISSUES

8. DEFINITION OF AVERGE POLICY

Queensland's position

- Queensland supports the Commission retaining the 2010 Review methodology approach to determining average policy. This approach can be implemented simply and consistently.
- The alternative approach is applied inconsistently in the Draft Report, and may not function sensibly in all cases. If the Commission proceeds with the alternative approach, the Final Report should clarify the situations in which the new definition applies. Otherwise, its use will be vulnerable to selective use and judgement.

Under the current approach to determining average policy, a revenue or service provision is considered average policy if it is implemented by a majority of states and affects a majority of the revenue base or service population.

8.1. Draft Report Proposal

The Draft Report proposes that an alternative approach be used to determine average policy:

"*In this review, the Commission has adopted a new approach to deciding what States do and how assessments will be made. It will consider any tax imposed or service provided by any State to be part of what States do collectively. These will be differentially assessed if doing so has a material impact on at least one States' fiscal capacity*.[26]"

8.2. Applying the new definition of "what states do"

8.2.1. Inconsistency in the application of "what states do"

There are a number of examples in the Draft Report where the definition of average policy is applied inconsistently, with the new definition used in some situations and the old definition in others. Queensland considers that these inconsistencies have slipped into the Draft Report because the new definition doesn't make sense in many situations and is highly susceptible to judgement. Also, the situations where it does or not apply have not been clearly defined.

It is clear from the Draft Report that both definitions of 'what states do' will continue to be applied if the new definition is adopted. For example, in the revenue assessments, the new definition is to be applied in the land tax assessment, so that metropolitan levies are differentially assessed, even though they are raised by less than a majority of states. However, the new definition is not being applied or investigated in other cases:

- Tax-free thresholds are still applied using the average tax free threshold. This reflects the old definition of average policy. To be consistent with the new definition

[26] 2015 Review Draft Report page 16

of average policy, the Commission should be using the minimum tax-free threshold. This would recognise that at least one state taxed that segment of the revenue base.

- Adjustments that are made to improve the comparability of state revenue bases also implicitly use the old definition of average policy. For example, in Stamp Duty on Conveyances, the bases of states that tax a wider range of unit trusts are decreased because the majority of states do not tax these bases. However, under the new definition the bases of all states should be increased to include the full range of transactions on which Stamp Duty is imposed by any state.

Queensland does not support making adjustments in this way, as it would be complicated and would not best reflect HFE. However, Queensland does not believe the Commission should adopt a new definition of average policy then apply the definition selectively. The old definition can be applied sensibly and consistently and should be retained.

8.2.2. The new definition may not always function reasonably

In the Transport Infrastructure assessment, the Draft Report also demonstrates that the new definition does not always function sensibly in practise. In the quantity of stock disabilities model, all urban centres with greater than 20,000 populations are included in the regression, even though most states do not own assets in a large number of these centres. These population centres should not be included because they do not provide any information about the asset requirements of the larger cities where states own assets, which is the purpose of the regression model. However, they are included in the regression analysis in the Draft Report because of the revised definition of average policy.

If the new definition requires the Commission to continually make judgements about whether it is practical or sensible to use a particular approach to determining average policy, this will be detrimental to HFE.

8.2.3. Application of the definition to how states deliver services

In some cases, the new definition appears to be applied to how states are delivering services, not what services are being delivered. For example, the Commission is proposing to treat urban transport PNFCs as though they were part of General Government, even though a majority of states deliver urban transport services outside of the General Government sector. This is not a case where an important service is delivered by less than a majority of states, but where a majority of states have chosen to deliver services by different means than directly through the General Government. All states provide urban public transport services, and they are already assessed in the 2010 Review framework through the assessment of subsidies and Net Lending. This recognises that the majority method of service delivery is not to deliver services directly through General Government.

If the Commission’s determination of average policy does not reflect how the majority of states choose to deliver services, it is difficult to see how sensible judgements could be made about which states’ policy is chosen as the average. The choice to assess urban transport as though General Government service delivery was average policy is similar to, for instance, choosing to assess mining revenue using profitability rather than value of production, because at least one state uses this method. The outcome from such a decision would be unlikely to reflect HFE.

Queensland does not consider there to be a sensible way of determining the average service delivery approach than by what the majority of states do. Even if the Commission decide to adopt the new definition in some circumstances, it should not be applied to determine how the average state delivers services.

8.3. Implementation issues

In their responses to the Proposed Assessments paper, states raised a number of concerns relating to the implementation of the new definition:

- It will often not be practical to collect data from states that do not levy a particular tax or provide a particular service, or to reliably estimate tax bases and service delivery requirements;
- The assessment methodology will become more complex, as additional assessments will need to be made;
- More materiality tests will be required to determine whether revenues or expenses should be assessed
- Policy neutrality will be difficult to achieve because a small number of states (or possibly one) will set the average; and
- It may lead to a greater risk that states' individual policy choices will impact on the GST distribution – for example, if states have an incentive to keep revenue raised from a particular tax below the materiality threshold.

The Draft Report does not satisfactorily address these concerns. For issues such as the treatment of tax-free thresholds, the Commission has not attempted to collect data or conduct a materiality test, but such investigations would be necessary for the new definition to be applied reliably. Queensland considers that these implementation issues mean that the new definition will not be applied reliably.

8.4. Queensland's position

At a conceptual level, Queensland considers that HFE is best achieved by developing a methodology that is based on the common practices of states. Queensland supports the Commission retaining the 2010 Review methodology definition of "what states do". This definition does not have the implementation issues inherent to the new proposed approach, and can be applied simply and consistently. If issues with the new definition cannot be resolved, this has great potential to erode confidence in the Commission's methods and outcomes.

If the Commission decides to implement its new definition, the Final Report must clearly define the situations in which the new definition applies and where it does not apply. In the Draft Report, the explanation of the new definition is somewhat loose and broad, leaving its application too open to judgement. For example, if the new definition is not intended to apply to tax free thresholds or the scope of tax bases, but only to discrete taxes and services, this should be explicitly stated. Similarly, the average service delivery approach should still be determined by what the majority of states do, and this should be stated in the Final Report.

Clarity around the application of the new definition may also assist in minimalising implementation issues, such as increased materiality testing.

9. INFRASTRUCTURE

Queensland's position

- There is a compelling conceptual case that the current investment component does not adequately allow for the cost of new infrastructure. This issue should be examined carefully in the remainder of the Review.
- Queensland supports the Draft Report proposal to exclude recurrent use factors that are not related to the quantity of infrastructure stock from the infrastructure assessment and to remove the 12.5 per cent discount currently applied to quantity of stock disabilities.
- Commonwealth payments for National Network Roads should continue to be treated so that 50 per cent of the payment impacts on the relativities.
- Queensland does not support using the Rawlinsons cost index to measure capital cost disabilities. This index is policy influenced and will not reliably measure cost influences for the construction of state government type assets. Other similar indexes produce completely different results, so it is difficult to see how the Commission can choose a capital cost index without understanding the reasons for these differences.
- If the Rawlinsons index is used, it should not be applied to Roads and Transport Infrastructure. For other service delivery areas, a higher level of discount (50 per cent) should be applied.
- Queensland's preference is for capital cost factors to continue to be assessed using the general location factors. If a physical environment factor can be developed from the consultant's report in the time remaining for the Review, this should also be included in the capital cost factor.

The infrastructure assessments allow for the impact on state fiscal capacities of the infrastructure (buildings, equipment) states need to provide services. The infrastructure assessment is made up of:

- the investment component, which allows for the impact on fiscal capacities of the need to acquire extra infrastructure each year; and
- the depreciation component, which allows for the impact on state fiscal capacities of the existing infrastructure used each year.

In the investment component, a state's assessed investment is the amount it would need to spend if it is to finish the year with the average per capita stock of infrastructure, adjusted for its disabilities, assuming it started the year in a similar position.

The investment component allows for the effects of:

- the state's population growth on the quantity of infrastructure it requires to provide the average services;
- changes over the year in demographic and other factors affecting the per capita quantity of infrastructure a state requires to provide average services; and
- interstate differences in the costs per unit of infrastructure.

The depreciation component recognises the impact of differences in the quantity of infrastructure needed to provide services, and differences in the cost of infrastructure.

This section of Queensland's submission addresses issues raised around the investment component in the Draft Report, excluding the assessment of Urban Transport Infrastructure, which is addressed in Section 2, under Queensland's Priority Issues. The assessment of urban transport and housing PNFC assets are also addressed in Queensland's priority issues.

Queensland has no further comments on the depreciation component at this stage.

9.1. Draft Report Proposal

The Draft Report proposes to assess investment using the same general approach used in the 2010 Review methodology, based on population growth and factors affecting the quantity of stock required and the cost of infrastructure. The Draft Report proposes that:

- The quantity of infrastructure stock disabilities are calculated by combining the factors affecting the use of each service using the average proportion of infrastructure devoted to that service;
- Factors affecting recurrent service use but which do not affect infrastructure requirements are explicitly excluded from the infrastructure calculations and the 12.5 per cent discount removed;
- Commonwealth payments for national network roads are assessed on the basis that the national needs are measured by reference to the interstate distribution of half the NNR payments (unchanged from the 2010 Review); and
- Capital cost disabilities are measured by reference to construction cost indices, discounted by 50 per cent for roads and urban transport and 25 per cent for other services.

Attachment 27 of the Draft Report (Impact of Population Growth on Fiscal Capacities) also discusses whether the current infrastructure assessment provides adequately for the cost of new infrastructure. This issue is addressed in this section of Queensland's submission.

9.2. Providing adequately for new infrastructure

Attachment 27 of the Draft Report discusses an argument presented by Western Australia that the current infrastructure assessment only gives states the capacity to fund new infrastructure at depreciated values. This arises because the infrastructure assessment is based on the average value of stock, which will be more depreciated than the new infrastructure required to service an increasing population. As states need to fund infrastructure at new, rather than depreciated values, the infrastructure assessment may be underestimating the financial burden of providing new infrastructure. Queensland considers this to be a compelling conceptual case and believes that related conceptual and analytical issues should be examined carefully in the remainder of the Review.

The Draft Report notes that the recognition of the cost of providing new (rather than depreciated) assets would require consideration of whether there are offsetting benefits:

- Newer infrastructure requires lower than average repair and maintenance costs;
- Faster growing states may be able to capture scale economies in infrastructure not available in other states; and
- Modern infrastructure may provide greater functionality or efficiency than older infrastructure, reducing the required quantum needed for average service delivery capacity.

Queensland considers that this issue relates to the financial consequences of acquiring new infrastructure, compared to utilising existing infrastructure. It is reasonable that if the Commission proceeds with recognising the need to fund infrastructure at new values, the Commission should also investigate the potential for differences in maintenance costs.

However, there does not appear to be evidence of higher maintenance costs in some states attributable to an older average age of assets. It is expected that existing state assets require continual maintenance, and once assets have reached an age at which they require maintenance, it is not clear that the maintenance cost would continue to increase as the asset's age increased. Similarly, depreciation expenses are apportioned over the life of an asset and would not be expected to increase as an asset ages.

It is also not clear that this would have an offsetting effect on the recognition of the cost of new assets. The newly constructed assets assessed in the infrastructure assessment represent a small proportion of the overall stock of assets, and it is not clear that faster growing states have significantly newer assets on average, or that they have lower maintenance costs for their existing assets.

Conceptually, the second two points appear to be more related to the question of whether there is a difference in the quantity of stock needed in a fast growing state compared to a slower growing state. This question has been considered separately in Attachment 27, which considers whether the assessment understates the needs of growth states by not recognising the demands of future growth. The Draft Report considers the conceptual case for this to be unclear, despite the evidence presented by Western Australia. There does not appear to be evidence or a clear conceptual case that faster growing states would instead require less quantity of stock due to scale economies or greater functionality. Queensland does not believe these issues should be taken into account in considering the costs of new infrastructure. Additionally, it is unclear how these effects could be measured.

9.3. Quantity of infrastructure stock disabilities (other than urban transport)

Queensland supports the removal of recurrent disabilities from the infrastructure assessment where these are not clearly linked to infrastructure requirements. These are mainly cost of service factors that are less likely to affect the amount of infrastructure required.

The revised infrastructure cost disabilities, with less relevant factors removed, are likely to be more reliable than other assessments where a low level discount (12.5 per cent) is applied. On this basis, Queensland supports the Draft Report proposal to remove the low level discount for the quantity of stock disabilities.

Queensland also supports combining the factors affecting the use of each service using the average proportion of infrastructure devoted to that service. This approach will reflect the infrastructure needs of states in different service delivery areas in a policy neutral way.

9.4. Roads National Needs

In the 2010 Review, the Commission decided to assess Commonwealth payments for National Network Roads (NNR) so that they have a 50 per cent impact on the relativities because the roads investment assessment does not fully recognise needs for these kinds of roads.

The assessment of roads investment is driven by state-based factors. These include road length and use factors, but state population growth is the major driver of the assessment of roads construction needs. Conceptually, the population growth of individual states is not linked to the need to provide a national road network. The Draft Report confirms that there is no relationship between state shares of the NNR payments and any of the state-based factors used in the assessment of roads infrastructure needs.

The concessional treatment also recognises that NNR construction payments are driven by Commonwealth Government considerations which the Commission does not assess, including the need to develop an efficient national transport network to facilitate national economic growth and productivity gains in the long term. It is difficult to see how a Commission assessment, which would use state-based factors, could capture these national considerations. As the size and distribution of NNR payments are based on the Commonwealth Government's judgement of the national benefits, the actual distribution of NNR funding provides the best means of measuring these considerations.

A National Network Road has a dual national/state purpose – while there may be some "spill over" benefit to the state where a road is built, it is also part of a Commonwealth-defined national network. The proportion of a payment attributable to each of these purposes cannot be estimated. A 50 per cent treatment strikes the most appropriate balance between recognising the national purpose of the roads and the benefits for states.

9.5. Capital Cost disabilities

Queensland's response to Discussion Paper 2014-02S outlined a number of issues with the use of Rawlinsons to develop a capital cost factor, and some of these concerns were discussed in the Draft Report. These are detailed below.

9.5.1. Previous use of Rawlinsons index

A construction cost disability based on the Rawlinsons index was applied to the Depreciation assessment in the 1999 Review, but removed in the 2004 Review due to concerns about policy contamination, volatility of the index values and the potential for double counting with other disabilities. Even when Rawlinsons was used in the 1999 Review methodology, it was discounted by 50 per cent due to these concerns.

Queensland disagrees with the Draft Report view that the circumstances surrounding this decision no longer apply. The Draft Report discusses the impact of state taxes and charges on the indexes, but there are other policy neutrality concerns with this index, including the impact of different building codes and standards. Queensland considers that these may have increased since Rawlinsons was last applied in the Commission's assessments due to different state responses to environmental issues such as climate change.

Incorporating short-term volatility in the building cycle into the capital cost factor remains as undesirable as it was when the index was last removed from the Commission methodology. The 2010 Review approach is comparatively stable but there is no reason to think it is less effective at measuring the changing circumstances of states.

While double counting concerns may have been alleviated with other changes to methodology, policy neutrality and volatility concerns from the 1999 Review, together with other issues such as fitness for purpose of the Rawlinsons index mean that it is still unsuitable for equalisation purposes.

9.5.2. Reliability of Rawlinsons index

Queensland remains concerned that the Rawlinsons index is not fit for purpose or reliable as it does not measure the relative costs of the infrastructure built by states. The index is an amalgamation of the costs of building a range of different kinds of infrastructure, including some state government type infrastructure, but also including a range of assets that are not built by state governments (such as banks, hotels, industrial, residential and retail buildings). The overall index is likely to be heavily influenced by assets that are not similar to those built by state governments.

The Draft Report discussion does not alleviate Queensland's concerns. It states that while the indices do not specifically cover the types of buildings states construct, the Commission considers the breadth of their coverage means they provide a good guide to the underlying differences in construction costs.

Queensland disagrees with this conclusion because:

- There are large discrepancies between the overall capital city index and the relative costs of producing state-type buildings (as shown in Table 1); and
- Use of the overall capital city index would assume that these discrepancies are due to state policies for the construction of their assets. Otherwise, the construction cost disability would not be measuring the non-policy influences affecting the construction of state-type assets and would not be a reliable measure of the relative costs incurred by states under average policy.

This is unlikely to be a reasonable assumption, given the other potential non-policy sources of difference, such as differences in building materials and labour costs for different kinds of asset. A high degree of variability in the relative costs of producing non-state type assets is also observed – this supports the case that discrepancies in factors are affected by non-policy factors. The Draft Report does not appear to include evidence to support this assumption.

If the assumption is not valid, the error in the capital cost index could be significant given the variation in cost indices, and in some cases could be adjusting capital costs in the wrong direction.

Table 1 – Rawlinsons costs of construction per square metre relative to Sydney – state type assets

	Sydney	Melbourne	Brisbane	Perth	Adelaide	Hobart	Canberra	Darwin
Administration office (2-3 storey)	1.00	0.98	0.96	1.04	0.98	1.03	1.05	1.13
Primary School	1.00	1.01	0.95	0.93	1.07	1.11	1.38	1.37
Secondary School	1.00	0.98	0.89	0.87	0.99	1.08	1.09	1.24
District Hospital	1.00	0.93	0.93	0.99	0.96	0.96	0.99	1.15
Private Hospital	1.00	0.96	0.94	0.99	0.96	0.96	0.98	1.23
Aged person single storey home	1.00	0.87	0.94	1.02	0.84	1.13	0.99	1.19
Law courts, capital city	1.00	0.79	0.75	0.96	0.83	na	na	na
Overall capital city index	**1.00**	**0.97**	**0.94**	**1.04**	**0.99**	**1.01**	**1.03**	**1.22**

Source: Rawlinsons Australian Construction Handbook 2014

1. Figures highlighted in orange vary from the overall capital city index by 0.05 or more. Figures highlighted in red vary from the overall capital city index by 0.1 or more.

9.5.3. Policy neutrality

There is significant scope for states' policy differences to affect the general costs of construction through differences in building standards. While the Building Code of Australia (BCA) provides a nationally consistent set of provisions for the design and construction of buildings, its provisions are the minimum necessary standards, and:

- States' building codes are applied in addition to the BCA. In Queensland, the Queensland Development Code (QDC) overrides the BCA if the two are in conflict. The QDC covers a range of aspects of construction that have the potential to significantly impact costs, such as design and siting standards, fire safety, building sustainability (such as energy and water efficiency and buildings in transport noise corridors), general health and safety and maintenance standards.
- Local governments are responsible for local planning instruments, which are overseen by state governments. The extent to which states allow local governments to implement regulations that diverge from state and national codes is another source of policy difference. In Queensland, a high degree of control is exerted over the ability of local governments to diverge from state and national development codes. States where local government divergence from state and national codes is more strictly limited could be expected to have reduced construction costs, and this will affect the relative construction costs as measured by the Rawlinsons index.

The Draft Report concludes that differences in building codes appear to be heavily influenced by technical requirements and that these would be broadly similar in similar circumstances. Queensland is not aware of evidence that has been put forward in this review to support this assumption. As well as state differences in the degree of divergence permitted in local government regulation, there are a range of areas where differences in state regulations are likely to be driven by policy, such as requirements to construct new buildings so that they conform to a particular energy efficiency standard or fire safety standards.

Since the Commission last considered Rawlinsons indices in the 2004 Review, states have developed policies in response to issues such as climate change and natural disasters, including floods, drought, bushfires and cyclones. The degree and manner in which governments responded to these issues have varied widely. It is likely that differences in states policies have increased due to these issues since the Rawlinsons indices were last considered.

9.5.4. Comparison to other indexes

Discussion paper 2014-02S compared the results of the Rawlinsons index to the Riders Digest index, noting that they produce very different results and noting that further investigation was required to explain the differences. The Draft Report does not appear to provide an explanation for the differences in the two indexes.

For example, if attempting to use the various indexes to determine the relative cost of a hospital in Queensland, alternatives range from 0.82 (the Riders Digest tender price index), to 0.93 (Rawlinsons district hospital), to 1.47 (Riders Digest private hospital). This is such a wide range of alternatives it is difficult to see how the Commission could reasonably choose one over the other, particularly when the differences cannot be explained. This is not an isolated example – many of the relative costs in Rawlinsons and Riders Digest are significantly divergent. The choice of index would impact not only on the size of the redistribution, but could easily adjust capital costs in the wrong direction.

A third index is published in *The Building Economist* (the journal of the Australian Institute of Quantity Surveyors). Again, this produces a result that is entirely different from the Rawlinsons or Riders Digest surveys.

Table 2 – Comparison of different building cost indices

	Sydney	Melbourne	Brisbane	Perth	Adelaide	Canberra	Darwin
Rawlinsons capital city index[1]	1.00	0.97	0.94	1.04	0.99	1.03	1.22
Riders digest tender price index[2]	1.00	0.97	0.82	1.00	0.95	0.98	1.04
AIQS Building Cost Index[3]	1.00	1.02	1.08	1.13	1.08	1.23	na

1. Rawlinsons Australian Construction Handbook 2014
2. Riders Digest 2014
3. Journal of the Australian Institute of Quantity Surveyors (June 2014). Index is for October 2013.

As the discrepancies between the relative costs calculated by these indexes cannot be explained, it is difficult to see how the Commission could reasonably choose one over the other. The difficulty in explaining the differences suggests that the issue is not well understood, and the Commission should be cautious about implementing methodological changes in these circumstances.

9.5.5. The effects of the physical environment

Earlier in the 2015 Review, the Commission engaged a consultant to examine the impacts of physical environment on the cost of state infrastructure. The consultant provided a report that examined the impact of a range of environmental factors including topography, rainfall, temperature, wind and soil factors on infrastructure costs.

The Commission has decided to not develop a physical environment disability based on the consultant's findings because this may double count factors measured in the Rawlinsons index, and because some potential environmental factors could not be examined due to unavailability of data.

As discussed in previous submissions, Queensland considers that the effects of the physical environment are best captured by the consultant's report, which was developed specifically for the Commission's purposes, and captures most of the environmental features the consultant considered likely to have a material impact. An indirect measure of physical environment influences through a broad indicator such as Rawlinsons is less likely to properly capture the impact on the costs of state assets.

9.5.6. Conclusion

Queensland remains concerned that the Rawlinsons capital city indexes are unsuitable for use in the infrastructure assessment as:

- It is not desirable to reintroduce an approach that was discarded in past review; Queensland does not agree that the circumstances surrounding this decision no longer apply;
- The capital city indexes are policy influenced and are not suitable for the Commission's purposes as they does not capture the cost influences on the kinds of assets built by states; and
- There are large unexplained differences between the Rawlinsons outcomes and the outcomes of other similar indices. The Commission cannot be confident about choosing the Rawlinsons index over the others if it cannot explain these differences.

As outlined in Queensland's previous submissions, Queensland's preference is to continue to assess differences in the cost in infrastructure using the recurrent location factors. Ideally, this would be combined with a physical environment disability based on the consultant's report, if this can be developed in the time remaining for the 2015 Review.

The Draft Report already suggests applying a 50 per cent discount to the Rawlinsons cost factors when applied to roads and transport, and the 25 per cent discount when applied to other areas. If the Commission decides to use Rawlinsons as its capital cost factor, Queensland considers that:

- The index should not be applied to roads or transport at all– these types of assets are not included in the Rawlinsons index. Roads and transport assets are also dissimilar to the kinds of assets that are included (for example, they have different input requirements in terms of materials and labour). There is no reason to believe that applying the Rawlinsons index is an improvement over not applying a capital cost factor.
- A higher discount of 50 per cent should be applied to other assessments, in recognition of the reliability and policy neutrality issues outlined in this submission.

10. SCHOOLS EDUCATION

Queensland's position

- Queensland supports the assessment of state funded schools expenditure using actual enrolments with a pre-year 1 adjustment, and the calculation of cost weights using a regression based on ACARA data. Further comments on the regression will be provided in Queensland's response to *2014-03-S Update and Supplementary Issues*.
- The Terms of Reference relating to the National Education Reform Agreement (NERA) arrangements can no longer be applied reasonably in light of Commonwealth Budget changes to schools funding.
- Queensland supports the Commission's conclusion that the "no windfall gain" element of the Terms of Reference is no longer relevant.
- If the Commission decides to use the Schools Resourcing Standard (SRS) in its assessment of Commonwealth funded schools expenses, this should be weighted to reflect the degree to which Commonwealth funding has transitioned to the SRS. Post Commonwealth Budget, it is clear that the majority of the transition will not occur.
- If backcasting is applied to the Commonwealth contribution, this should account for different growth rates in states' enrolments.

In the 2010 Review methodology, the Schools Education assessment was based on the actual enrolments of schools, with adjustments for the pre and post compulsory years of schooling, and cost and use disabilities for the socio-demographic characteristics of students. State funded expenses for non-government students were assessed as a fixed proportion of the cost of government students.

Commonwealth funding for non-government schools was treated so it had no impact on the relativities, and a separate assessment was made of student transport services.

10.1. Draft Report Proposal

The Draft Report proposes assessing schools expenditure in four components:

- State funded schools expenses (government and non-government);
- Commonwealth funded government schools expenses;
- Commonwealth funded non-government schools expenses; and
- Student transport services.

State funded schools expenses are to be assessed as follows:

- Using actual enrolments as the broad measure for use in all age groups, with an adjustment to the distribution of pre-year 1 students; and
- Estimating cost weights for Indigeneity, socio-economic status (SES), service delivery scale (SDS) and remoteness using ACARA data, and applying these cost weights to government and non-government students.

It is proposed to assess Commonwealth funded government schools expenses using the Schools Resourcing Standard (SRS) developed in 2013 for the NERA. Commonwealth payments for government schools are to be treated so that they impact on the relativities.

Commonwealth funding for non-government schools is treated so it has no impact on the relativities.

The student transport assessment is based on the number of rural students and the average distance travelled by rural students. Queensland has no further comments on the assessment of student transport services at this stage.

10.2. State funded schools expenditure

10.2.1. Enrolments

Queensland supports the Draft Report proposal to base the Schools Education assessment on actual enrolments, and to discontinue the post-compulsory adjustment that was applied in the 2010 Review methodology. This reflects the increased standardisation of state policies. The revised approach to pre-compulsory enrolments, which makes an adjustment for the impact of South Australia's previous gradual intake policy for pre-year 1 (which applied prior to 2014) is also appropriate, as removing the impact of this policy difference is material.

10.2.2. High cost students

The Draft Report proposes using a regression model to develop weightings for higher cost students in government and non-government schools, based on detailed school expenditure data from the Australian Curriculum and Reporting Authority (ACARA).

Queensland considers the ACARA dataset to be fit for purpose, as it supports the calculation of average state expenditure on identified high cost groups such as Indigenous, remote and low SES students. It is also likely to be more reliable and comparable than alternatives (such as a state data collection), as it is collected and compiled by a central education authority. Some states raised concerns that data from some schools may not be included in the dataset (for example, Tasmania noted financial information for four of its secondary colleges was not reported in 2010). This appears to affect a small number of schools overall, and would be unlikely to affect the average cost weights in the regression model.

The paper *2014-03-S Update and Supplementary Issues* details changes to the ACARA regression model used in the Draft Report, based on the advice of the Commission's consultant. This paper also asks for information from states as to whether high costs for Indigenous remote students are attributable to Indigeneity or remoteness. Queensland will provide further comments on changes to the regression and the drivers of costs for remote Indigenous students in its response to the supplementary paper.

10.2.3. State expenses for non-government schools

The treatment of state expenses for non-government schools is determined by the average policy of states regarding the funding of non-government schools. In the 2010 Review, it was determined that states on average calculated total funding levels for non-government schools as a proportion of the funding provided to government schools, and this policy was reflected in the assessment. The Draft Report suggests that average policy has changed, and that since the negotiation of NERA arrangements, states fund non-government schools through a bottom-up approach, using school and student characteristics. Accordingly, the Draft Report proposes to assess state expenditure for non-government schools using a regression model to calculate weightings for high cost students.

Queensland's process for determining funding for non-government schools has not changed since this issue was examined in the 2010 Review. Total funding for non-government schools is determined as a proportion of funding to government schools, and funding is allocated between non-government schools based on need.

Queensland understands that the original intention of the NERA agreements signed by some states was to provide funding to non-government schools using a bottom-up approach based on need. However, it is possible that subsequent developments in school funding arrangements may affect whether this occurs in practise, particularly changes to schools funding that were announced in the 2014-15 Commonwealth Budget. Queensland suggests that changes to state policies for the funding of non-government schools be reconfirmed before the release of the Final Report, in light of Commonwealth Budget developments.

10.3. Commonwealth funding for government schools

10.3.1. Terms of Reference relating to the NERA and implications of the Commonwealth Budget

Clause 6 of the 2015 Review Terms of Reference states that:

> *The Commission will ensure that the GST distribution process will not have the effect of unwinding the recognition of educational disadvantage embedded in the National Education Reform Agreement (NERA) funding arrangements. The Commission will also ensure that no State or Territory receives a windfall gain from non-participation in NERA funding arrangements.*

The original purpose of the Terms of Reference for the NERA was to ensure that the intentions of the agreement were not overridden by the Commission methodology. If such an instruction had not been implemented, the risk that states' responsibilities under the agreement would not be recognised as average policy, and the additional Commonwealth funding redistributed to non-signatory states, could also have been a disincentive for states to participate. However, this original purpose is no longer relevant in light of subsequent developments in school funding arrangements.

The Draft Report notes that following the December 2013 announcements of agreements between the Commonwealth Government and the remaining non-signatory states, there is no longer any potential for states to receive a windfall gain from non-participation. Queensland supports the Commission's conclusion that this element of the Terms of Reference is therefore no longer relevant.

In Queensland's submission to the October 2013 Proposed Assessments paper, it was argued that developments in schools funding arrangements meant that the Terms of Reference was less applicable to the current terms of the agreements. Since then, the Commonwealth

Budget has made further changes to schools funding arrangements that mean the NERA arrangements have been effectively discontinued. The revised arrangements are as follows:

- The Commonwealth will provide recurrent funding to the end of the 2017 school year in accordance with the Students First arrangements; and
- From the 2018 school year, total funding will be indexed by the Consumer Price Index, with allowances for changes to enrolments. States will receive equal per student base funding and even proportions of existing loadings for disadvantage.

Commonwealth Budget changes mean that the effective impact of the NERA/Students First agreements on Commonwealth funding for government schools will be an increase in overall Commonwealth funding that is:

- Relatively small compared to the increase that was anticipated (and agreed for signatory states) for 2018 onwards;
- Only weakly related to the method of calculating the SRS as outlined in the *Australian Education Act 2013*, as the transition to SRS funding was scheduled to occur slowly in the initial years of the agreement and more rapidly after 2018. Changes to arrangements outlined in the 2014-15 Commonwealth Budget mean that the majority of the transition will never occur.

The possibility of unwinding the recognition of disadvantage in the SRS model would have been a concern if states were required to allocate Commonwealth schools funding as determined by the SRS, or if the arrangements required states to allocate their funding to schools in a way that did not reflect average policy as determined by the Commission. However, this has not occurred. Queensland observes that:

- Changes in the Commonwealth Budget mean that the NERA arrangements will not continue to be implemented in terms of the Commonwealth contribution; it can hardly be expected that signatory states will still be required to make changes to their own funding levels or their allocation models. This is supported by discussion of Students First in the 2014-15 Commonwealth Budget, which says that the Commonwealth will work with the states to focus on teacher quality, school autonomy, engaging parents and strengthening the curriculum[27], rather than the allocation of funding to schools. Various commitments made by states under the original agreement are now irrelevant, and Queensland considers that if states choose to implement changes to their schools funding models despite the withdrawal of Commonwealth commitments this should be considered a state policy choice.
- Changes to states' methods of allocating funding to schools, if based on various NERA Heads of Agreement, would have been consistent with the Commission's determination of average policy in any case. States' Heads of Agreement only required that states implement some kind of needs based model, using factors such as Indigeneity, remoteness and low SES (where relative needs are measured by the Commission). Signatory state retained the flexibility to develop their own models,

[27] 2014-15 Commonwealth Budget Paper 3

provided such factors were taken into account, and in terms of the allocation of funding had the same capacity to implement average policy as a non-signatory state. The Terms of Reference specified that the recognition of disadvantage was not to be unwound, so concerned the allocation of funding to schools rather than the overall level of funding that states were required to provide.

Queensland understands that the Commission is restrained by the need to satisfy its Terms of Reference instruction, but considers that developments in this area since the Terms of Reference was issued mean that it cannot be implemented reasonably to the schools funding arrangements as they now stand. Attempting to do so will create an assessment that does not reflect what states do and is inconsistent with HFE.

10.3.2. Draft Report Proposal

The Draft Report proposes to assess Commonwealth funding for government schools by:

- Assessing the expenditure of Commonwealth NERA payments based on the average funding per student in each state, as calculated using the Commonwealth Department of Education SRS model; and
- Backcasting the expenditure of Commonwealth payments in the application year into the assessment years.

This treatment is designed to satisfy the Terms of Reference instruction that no unwinding should occur of the recognition of educational disadvantaged embedded in the NERA arrangements.

Queensland considers that "the recognition of disadvantage embedded in the NERA" should be interpreted as the recognition embedded in the actual Commonwealth payments provided for schools education, not the full SRS as calculated in the *Education Act 2013*. As discussed above, Commonwealth payments will only ever partially transition to the SRS under the revised funding model. Using the SRS calculations as the measure of expenditure requirements for Commonwealth funding overstates the recognition of disadvantage embedded in the arrangements.

Queensland also recognises that the Commission is attempting to avoid a situation where the assessment is affected by the degree to which individual states' payments have transitioned to the SRS. This may have been affected by different starting points as well as different transition rates.

As an alternative, Queensland suggests weighting the assessment of Commonwealth expenditure by the average state transition level. For example, if in a particular year, states on average had transitioned to SRS by 10 per cent of the difference between original payment levels and the SRS, the Commission could weight SRS per student amounts by 10 per cent, and assess the remainder of expenditure using the Commission calculation of state expenditure needs.

To some degree, this would be an approximation of the degree to which the SRS is embedded in Commonwealth payments, but it would be a more accurate reflection of current arrangements than using the full SRS, would better reflect what states do and be more consistent with HFE. Queensland considers that it would satisfy the Terms of Reference instruction without overstating the recognition of disadvantage embedded in the arrangements.

10.4. Commonwealth funding for non-government schools

Queensland supports the Draft Report proposal to treat Commonwealth funding of non-government schools so that it has no impact on the relativities, as states have no flexibility in how this funding is used.

10.5. Backcasting

10.5.1. State Expenditure

Queensland supports the Draft Report proposal to not backcast any changes to states' own funding of schools that may have resulted from the introduction of the NERA arrangements. Changes to school funding arrangements in the 2014-15 Commonwealth Budget, including the effective discontinuation of NERA arrangements, mean that changes to states' own funding of schools cannot be assumed to have resulted from NERA arrangements rather than their own policy choice. Although a number of states made agreements at the time of signing the NERA to work towards needs based allocation of funding to schools, it cannot be expected that signatory states would be held to this aspect of the agreement when the Commonwealth is no longer providing the additional funding agreed from 2018.

For this reason, backcasting of state expenditure would not be conceptually valid as the Commission could not be sure that the changes being backcast had resulted from a major change in federal financial relations. As discussed in the Draft Report, there is also no means of backcasting states' policies reliably.

10.5.2. Commonwealth funding for government schools

The Draft Report proposes to backcast both the assessed expenditure of Commonwealth NERA payments and state shares of the Students First (and combined NPs) revenue that is received by states in the application year. Queensland's comments on the proposal for assessing Commonwealth expenditure are above, but there are also specific backcasting issues to be considered.

In the 2014 Update, Queensland raised concerns that the backcasting process used the actual shares of school payments in the application year (which are based on application year enrolments). As states' school enrolments had grown at different rates between the assessment years and the application year, the actual shares of payments did not reflect the shares states would have received if the 2014-15 policy had applied in the assessment year.

If the suggested backcasting treatment is applied, it will be important to ensure that school enrolment numbers from the same year from are used in both the revenue and expenditure backcasting process. Either:

1. The revenue side would reflect the actual shares of payments from the application year, and the SRS per student applied to the application year enrolments on the expenditure side; or
2. The revenue side would be adjusted to reflect the shares states would have received for their assessment year enrolments, and the SRS per student applied to the assessment year enrolments on the expenditure side.

If a consistent treatment is not applied, the assessment will not properly recognise the impact of enrolment growth on revenue and expenditure, and the “no unwinding” directive may not be correctly implemented.

11. REGIONAL COSTS

Queensland's position

- Queensland supports retaining the State Accessibility/ Remoteness Index of Australia (SARIA) as the Commission's standard measure of remoteness. Queensland considers ARIA does not capture as adequately the fiscal consequences of more remote communities.
- Queensland supports, in principle, that Staff recommend the Commission update the economic model used in the schools regression to include changes specified as we understand further information is requested whether the high costs for remote Indigenous students are allocated to Indigeneity or remoteness which is sensitive to the exact specification of the model.
- Queensland supports, in principle, the ACARA gradient being extrapolated to other categories, with the exception of Justice Services, where a regional cost disability exists. Queensland will provide further comments on changes to the regression and the drivers of costs for remote Indigenous students in its response to the *2014-03-S Update and Supplementary Issues* paper.

In the 2010 Review, the Commission sought data from the states on their total costs and number of employees by region for schools and police services. The data were used to calculate national average costs per full time equivalent employee for each region of the State-based Accessibility/Remoteness Index of Australia (SARIA) region. Each region's total average cost was compared with the total average cost for highly accessible areas to derive a relative weight. These weights were applied to the populations in each region in each State to calculate weighted populations from which disability factors were derived.

The Commission calculates a schools gradient, police gradient (applying to the Justice Services category) and a general gradient. The general gradient was the simple average of the schools and police gradient. This general gradient was applied to:

- Community and other health services;
- Welfare and housing;
- some elements of Other expenses; and
- rural roads expenses within the Roads assessment.

11.1. Draft Report Proposal

Remoteness is now assessed on the basis of the ABS Accessibility/Remoteness Index of Australia (ARIA) rather than SARIA. For categories, other than Justice, where a regional cost disability is assessed, the gradient has been based on the output from the regression analysis of ACARA data.

11.2. Staff discussion paper CGC 2014-03-S

Since the release of the Draft Report, the Commission has received the report from the consultant engaged to examine the econometric modelling used to estimate differences in spending on students with different characteristics using Australian Curriculum and

Reporting Authority (ACARA) data. The Commission has also received the updated 2012 ACARA data.

A number of changes were made to the models. The new regression has produced higher relative costs in remote areas than the regression used in the Draft Report. The paper proposes to update the economic model used in the schools regression to include changes specified.

11.3. Changing the remoteness classification

The Commission seeks to consult with states on how well ARIA captures the fiscal consequences of more remote communities.

The Commission has already identified one shortcoming of ARIA in that it changes the distribution of populations by remoteness for some states, in part as a consequence of the truncation aspects of ARIA. The Commission provides as an example, where compared with the SARIA distribution, Western Australia's proportion of population classified as very remote under ARIA declines substantially and could have a material impact on the GST distribution, that is a reduction of around $60 million. It is likely those states with similar remote characteristics will similarly be negatively impacted relative to remoteness scale.

Permeable of State borders and truncation aspects of ARIA does not address that states are primarily responsible for the costs of delivering services to regions within their borders. The true fiscal consequences of remote communities are therefore shortened relative to the truncated distance.

It is inconsistent for the remoteness measure to recognise that residents of states may access services in other states (the assumption that state borders are permeable) and for a cross border disability to only be recognised for Canberra and the surrounding areas of New South Wales.

The SARIA/ARIA methodology is designed to measure the distance residents must travel to access certain types of services; it is assumed that city size is a proxy for the kinds of services that may be accessed. Treating smaller capital cities as Category B services centres therefore implies that some aspects of service delivery (distinct from administrative scale expenses) are not provided in states that do not contain a Category A city. This does not seem likely, as a capital city has a general standard of services it delivers.

For example, under ARIA, Darwin is reclassified as a Category B service centre. Toowoomba is also classified as a Category B service centre as both cities have near equivalent population. However it cannot be said that Toowoomba has the same function as Darwin where Darwin functions as a capital city and has all the provisions of any other capital city in Australia whereas Toowoomba does not. If city size is a proxy for the kinds of services that may be accessed, this would need to be addressed in the Commission's methodology.

Queensland maintains that SARIA is a better index of remoteness for comparing states and that there is no compelling reason to alter the SARIA methodology.

Queensland refers the Commission to its response to Staff Discussion Paper CGC 2013-01 which provided comprehensive comments on issues raised by Staff on remoteness classification.

11.3.1. ACARA data and extrapolating to other services

The Commission advises the ACARA gradient, rather than the general gradient will be extrapolated to other categories, not because these constitute different methods of service delivery but because the ACARA gradient is a more reliable measure of Regional costs. The police cost gradient remains extrapolated to the Justice Services category.

In principle Queensland supports the ACARA data and extrapolating of the ACARA gradient to other categories to which regional costs applies with the exception of Justice Services. However we understand there is uncertainty as to whether the high costs for remote Indigenous students are allocated to Indigeneity or remoteness which is sensitive to the exact specification of the model.

The paper *2014-03-S Update and Supplementary Issues* details changes to the ACARA regression model used in the Draft Report, based on the advice of the Commission's consultant. This paper also asks for information from states as to whether high costs for Indigenous remote students are attributable to Indigeneity or remoteness. Queensland will provide further comments on changes to the regression and the drivers of costs for remote Indigenous students in its response to the supplementary paper.

12. SERVICE DELIVERY SCALE

Queensland's position

- Queensland supports retaining the definition of Service Deliver Scale (SDS) as 50km from a town of 5,000 people as a reasonable definition by which to calculate service user populations affected by SDS.
- Queensland does not support the narrowing of the application of SDS without supporting evidence for the proposed change.
- Queensland supports not applying a discount to the SDS disability in Schools Education.

The Service Delivery Scale (SDS) disability assessment recognises that states experience diseconomies in the provision of certain services to small isolated communities. It reflects the higher costs incurred due to relatively higher staffing levels in those communities because of the indivisibility of labour and unproductive travel time.

In the 2010 Review, the Commission considered that in small isolated communities, services were provided but inputs per user could not be fully utilised and were not used as productively as in other areas. These areas were defined and measured using an analysis of school and policing staff. The Commission concluded that service delivery scale (SDS) affected costs in areas which were 50km from centres of 5,000 people.

The increase in costs in SDS areas was measured using school and police data and an extrapolation was made from these services to the Community and other health services and Welfare and Housing categories.

12.1. Draft Report Proposal

In the Draft Report, output from the regression analysis of the ACARA data has been used to assess SDS disabilities in Schools education. The assessment of SDS for housing and community health expenses, as well as for welfare services, with the exception of family and child expenses, has ceased. The assessment of SDS remains in Schools education, police and magistrate expenses within the Justice category and family and child expenses within the Welfare category assessments.

12.2. Staff discussion paper CGC 2014-03-S

The approach to SDS has changed however Staff advise this change has very little GST impact. The ACARA regression based SDS weight is only applied in the Schools Education assessment. The police factor will still be applied to Justice (police and magistrates courts) and Welfare (family and child).

Staff intend to recommend the Commission update the econometric model used in the schools regression to include the changes specified in the discussion paper.

12.3. Measuring service delivery scale

The availability of ACARA data has changed the way in which the Commission can measure higher costs due to SDS.

The Commission has noted, from the analysis of the ACARA data, the level of the SDS effect has been found to be smaller at 10 per cent in this review than at 40 per cent in the 2010 review. The Supplementary Issues Paper intends to allow the data to determine the fixed cost per school which the Commission advises represents a SDS weight of 10 per cent, approximately the same weight calculated when including SDS as a variable in the regression model.

States are advised this method allows for a more reliable regression model as fixed school costs are not incorporated in the results of other variables. This method means the approach to SDS has changed since the Draft Report however this change has very little GST impact.

The Commission notes in contrast that the analysis of ACARA data suggests that regional loadings should be higher in this review. The combined SDS and regional costs results suggest that some portion of costs that were considered to reflect SDS effects in the 2010 review are now being allocated to regional cost effects.

Queensland observes these changes where weight loadings previously associated with SDS have been identified as regional cost effects. The paper *2014-03-S Update and Supplementary Issues* details changes to the ACARA regression model used in the Draft Report, based on the advice of the Commission's consultant. This paper also asks for information from states as to whether high costs for Indigenous remote students are attributable to Indigeneity or remoteness. As discussed in other categories, Queensland will provide further comments on changes to the regression and the drivers of costs for remote Indigenous students in its response to the supplementary paper.

12.4. Application of SDS

The Commission has applied the SDS cost weight to Schools education, Justice (police and magistrate courts) and Welfare (family and child). The Commission advises while there is a strong conceptual case for the application of SDS to afore mentioned categories, they are not convinced that similar disabilities are experienced in the areas of Housing, general Welfare and disability expenses on the basis that services in such categories are available or provided locally or the service provider must travel anyway because of the nature of the service.

The Commission says, in relation to Health, the assessment is not yet finalised and a lot of uncertainty remains. The SDS disability has not been applied to Health in the Draft Report because the Commission considers that the alternative Health methodology may already incorporate SDS influences. Until such time that the assessment is finalised a decision to exclude the SDS disability should not be made. If the Commission retains the 2010 model then the SDS disability should also be retained.

Queensland does not support the narrowing of the application of SDS as there is no evidence provided to support the assumptions made and the examples given. For example, in relation to Housing, while services can be provided in SDS affected areas, the Commission considers that it is generally undertaken by local groups so that no additional travel is involved.

However, evidence of this has not been presented, and Queensland considers that indivisibility of labour effects can affect housing services in a similar manner to other services, such as schools. Where changes are proposed to the existing application, the onus is on provision of evidence and/or a strong conceptual case to support this change. Neither of the two has been provided.

12.5. Discounting

Queensland supports that a discount will not be applied to the SDS disability in Schools Education where the Commission advises the ACARA data is more detailed and comparable than other data previously available.

13. INDIGENEITY

Queensland's position

- While there is evidence that separate indicators of Indigenous and non-Indigenous disadvantage may better reflect what states do in some cases, the additional complexity is not warranted.

The 2010 Review methodology uses the ABS Socio-Economic Index for Areas (SEIFA) to distribute state populations into socio-economic groups, for both the Indigenous and the non-Indigenous populations. SEIFA scores are applied in a range of categories where a geographical measure of socio-economic status (SES) is required.

13.1. Draft Report Proposal

The 2015 Review Terms of Reference asks the Commission to "develop methods to appropriately capture the changing characteristics of the Indigenous population". In response to this section of the Terms of Reference, the Commission have investigated whether differences in the level of disadvantage of Indigenous populations are fully recognised by the general SEIFA, or whether a separate measure of Indigenous disadvantage is justified. Where the SEIFA score of an area is driven by the majority non-Indigenous population, it is possible that this is not completely representative of the SES of the Indigenous population.

The Draft Report proposes that when a geographic measure of socio-economic status is applied, the index of Indigenous Relative Socio-Economic Outcomes (IRSEO) is used to measure the relative disadvantage of the Indigenous population, and a non-Indigenous Socio-economic Index for Areas (NISEIFA) is used to measure the relative disadvantage of the non-Indigenous population. This would affect a number of categories:

- Health;
- Welfare Services (family and child component);
- Post-Secondary Education;
- Justice Services (discussed in *2014-03-S Update and Supplementary Issues*); and
- Schools education (also discussed in *2014-03-S Update and Supplementary Issues*).

Other categories that apply a measure of SES will use a range of other (non-geographic) measures.

13.2. Use of specific Indigenous SES indicator

Queensland has supported the investigation of an Indigenous specific measure of disadvantage as a general approach to addressing the Terms of Reference directive. Where the SEIFA score of an area is driven by the majority non-Indigenous population, it is possible that this is not completely representative of the SES of the Indigenous population, which in most areas is likely to be a minority. However, the use of separate indexes of Indigenous and non-Indigenous SES has the potential to add significant complexity to the assessment methodology.

As outlined in Queensland's response to the Proposed Assessments paper, Queensland considers that separate indexes should only be applied if there are clear advantages over a single index, which would justify the additional complexity. In the response to the Proposed Assessments paper, Queensland had a number of concerns about the use of IRSEO:

- IRSEO is based on a much larger geography than SEIFA (Indigenous Areas compared to SA1s), and Indigenous Areas may not be sufficiently homogenous to appropriately recognise the disadvantage of populations;
- More work was needed on whether it is average state policy to have materially higher per capita expenditure on more disadvantaged than less disadvantaged areas, as measured by IRSEO; and
- There are risks associated with IRSEO – for example, that there is insufficient time in the review to ensure that IRSEO can be implemented reliably.

Queensland remains concerned that the large geography on which IRSEO is based could cancel out the advantages of specifically measuring the relative disadvantage of the Indigenous population. It remains unclear whether IRSEO is offering a clear improvement over SEIFA in terms of how well it is measuring the proportion of states' population at different levels of disadvantage.

The Draft Report analyses state expenses on the Indigenous population for a number of state service areas to determine whether the IRSEO and NISEIFA outcomes are well aligned with differences in state expenditure on groups at different levels of disadvantage. This analysis finds that IRSEO and NISEIFA appear to better explain differences in state expenditure than SEIFA for hospital inpatients services, Post-secondary education, and Welfare (family and child) services. The Update and Supplementary Issues for the 2015 Review paper also suggests applying IRSEIO and NISEIFA to Justice Services and Schools Education.

While the Draft Report analysis provides some evidence that IRSEO and NISEIFA may better reflect what states do than a SEIFA based approach, Queensland is unsure whether the evidence is sufficient to justify the additional complexity. One issue is that, while IRSEO and SEIFA appear to better explain differences in state spending within non-remote areas, they do not explain differences within remote areas. For this reason, the cross-classifications proposed in the Draft Report do not subdivide remote areas by SES.

On balance, Queensland's preference is to retain SEIFA as the geographic measure of disadvantage, because the additional complexity does not appear to be warranted. However, if the Commission decides to apply IRSEO and NISEIFA in these assessments, Queensland supports the cross-classifications suggested in the Draft Report. These only subdivide remoteness areas by SES in cases where the subdivision appears to better reflect average state expenditure for the relevant populations. Queensland considers this to be a prudent approach to applying the new disadvantage measures.

14. HEALTH

> **Queensland's position**
>
> - Given the shortened timeframes for both the 2015 Review as a whole and state consultation, Queensland does not support the move to a completely revamped health assessment in the 2015 Review.
> - While Queensland supports the development of a new assessment in principle, the design of the assessment and the recently introduced Independent Hospital Pricing Authority data required to support the assessment are still in early stages. Queensland considers there is insufficient time remaining to complete a fully realised assessment with sufficient consultation before the release of the Final Report in early 2015.
> - In addition, Queensland considers the uncertainty around the availability and comprehensiveness of the IHPA data beyond 2017-18 when Health and Hospital Reform funding is intended to move to an indexed basis is further reason to avoid a rushed implementation of a new assessment.

Health services are currently assessed in the Admitted Patients and Community and Other Health Services assessment categories.

The drivers of the assessment are derived using Australian Institute of Health and Welfare (AIHW) data on admitted patient services, calculating national average costs for population groups cross-classified by:

- age;
- Indigenous status;
- socio-economic status (SES); and
- location of patient residence.

Assessed costs are derived by applying these national average costs to the number of people in the corresponding population groups in each state. The costs for each population group are added to derive total hospital-based costs for each state.

14.1. Draft Report Proposal

14.1.1. New Public Hospitals assessment and structure

In August 2011, the Council of Australian Governments (COAG) agreed to the implementation of the National Health Reform Agreement, which will deliver reforms to the organisation, funding and delivery of health care services. The most relevant changes for the Commission's assessment are the move to a nationally consistent approach to activity based funding (ABF), also referred to as 'casemix' funding. Under the ABF approach, each activity/service within the hospital will be classified and costed, with the establishment of the IHPA to determine the nationally efficient price. Each episode of care in every hospital would be allocated a National Weighted Activity Unit. These data, along with the patient's personal details, would be used to calculate national average costs for population groups cross-classified by age, Indigenous status, SES and location of patient residence. Assessed hospital-based costs would then be derived by applying these national average costs to the number of people in the corresponding population groups in each state.

The proposed Health category comprises recurrent expenses on:

- Public hospitals
  - Admitted patient services – acute and non-acute medical care and treatment for public patients admitted in public hospitals and public patients treated in private hospitals.
  - Non-admitted patient services – all emergency care delivered to presentations at public hospitals and all outpatient type services such as obstetrics, gynaecology, cardiology, pathology, radiology and imaging services etc.
  - Non-hospital patient transport – aero-medical ambulance services and the reimbursement of costs through Patient Assisted Travel Schemes (PATS).
- Other health services
  - Community health centre services – a wide range of health services provided in a community setting including domiciliary nursing services, well baby clinics, mental health services, home nursing services, family planning, alcohol and drug rehabilitation etc.
  - Public health services – activities for the protection and promotion of health and the prevention of disease, illness or injury. These include organised immunisation, health promotion, screening programs, communicable disease control, and prevention of hazardous and harmful drug use.

14.1.1.1. Category structure

The assessment of the Health category is undertaken separately for each of the following components:

- admitted patients;
- emergency departments;
- outpatients;
- non-hospital patient transport; and
- community health.

14.1.1.2. Summary of changes since the 2010 Review

- There is a single Health category and a direct method of assessment is used for all components, instead of the previous subtraction method. The impact of the private sector is assessed using economic environment factors.
- Category expenses are assessed net of user charges, because we have data on the net expenditure on different socio-demographic groups.
- Data on the use and cost of health services are sourced from IHPA instead of the AIHW.

14.2. Status of assessment and IHPA data issues

The proposed Health assessment is far from complete, and uses placeholders for some of the key parameters, for example, degrees of substitutability for non-inpatient services. The Commission considers the current approach in general to be a placeholder, and seeks state views on whether the new approach should be adopted in the 2015 Review or if the 2010 Review methodology is more appropriate at this time.

The availability and reliability of the IHPA data to be used in the new assessment is of particular concern. IHPA was established to work with states to classify all services delivered by public hospitals into National Weighted Activity Units (NWAUs), which are then translated into costs.

The IHPA admitted patients database uses a detailed and comprehensive allocation of the actual services and costs for each patient. It also makes adjustments for paediatrics, Indigenous, remoteness, etc. Some states said that these adjustments could distort the Commission's unit costs. The Commission considers these adjustments should improve, rather than distort the assessment, as they reflect the actual costs incurred by states in treating different demographic groups.

14.2.1. Potential impact of the 2014-15 Commonwealth Budget

From 2014-15 to 2016-17, National health reform funding will be directly linked to the growth in public hospital activity provided in each jurisdiction. From 2017-18, the Commonwealth will index its contribution for public hospitals funding by the CPI and population growth. State funding entitlements in 2017-18 are reported in Commonwealth Budget Paper No. 3 on an equal per capita basis. This may have implications on the data that are available from IHPA.

In Queensland's submission to the October 2013 Proposed Assessments paper, Queensland supported the move to IHPA data on the basis that the reliability of the data should improve as it matures. This assumed the health funding reforms would continue in to the out-years. With the Commonwealth Government now intending to move away from funding based on public hospital activity, it can no longer be assumed that the data will improve or even continue beyond 2017-18.

In light of the uncertainty with the future of the IHPA data, and the large sections of the new health assessment that are still under development as of the Draft Report, Queensland no longer supports substantial changes to the health assessments in the 2015 Review.

Queensland continues to support the development of a new health assessment in the future when there is sufficient time to introduce a fully formed methodology, greater opportunity for state consultation, and the uncertainty around the IHPA data has been resolved. In the 2010 Review, the rushed development of the mining assessment has led to significant problems in the following years, and Queensland considers retaining the current methodology to be preferable given the shortened timeframe of the 2015 review.

15. ROADS

Queensland's position

- Queensland supports the proposed change from the use of Significant Urban Areas to Urban Centres and Localities for defining geographical areas in the roads assessment, as expenses for roads in the surrounding hinterlands of urban areas are likely to be similar to those of rural roads.
- The information provided by states for roads relating to economic activity thus far should be sufficient for the Commission to make an assessment. Road lengths for states that have not provided data should be estimated.

The Roads category assesses recurrent expenses on:

- the maintenance and rehabilitation of roads, bridges and tunnels
- road safety, traffic management and other transport activities (such as driver licensing, motor vehicle registration, heavy vehicle regulation and road transport planning administration).

Roads construction expenses are not included as they are assessed in the Infrastructure category. All revenues generated from user charges are assessed in the Other revenue category.

The Commission divides total road maintenance expenditure into the five components and their sub-components based on State spending provided by the National Transport Commission (NTC).

Each component and sub-component is weighted by the proportion of the service delivery expenses it affects. The weights applied to each component are derived from work done by the NTC in estimating heavy vehicle road use charges.

The NTC makes determinations of heavy vehicle registration charges, designed to offset the damage done to roads by these vehicles. To do this, it gathers data from states on what they spend on roads and decides what proportion relates to heavy vehicles and the volume of traffic. The residual are assigned to length by assumption. These data are also split by urban and rural roads. The Commission splits the NTC expense data into State spending on local roads, bridges and other services.

15.1. Draft Report Proposal

The Commission proposes to use the ABS's Urban Centres and Localities (UCLs), rather than the ABS's Significant Urban Areas, to define geographical areas in the roads category. It is argued they capture less of the surrounding hinterland of urban areas, which is more appropriate for determining urban boundaries for the urban and rural road length factors. It means that the rural road length algorithm and the urban population used in these factors would be recalculated using UCLs.

15.1.1. Queensland's position

Queensland considers expenses for roads in the surrounding hinterlands of urban areas are likely to be similar to those of rural roads, and supports the use of geographic areas that define them as such in the assessment.

15.2. Roads relating to economic activity

The Roads assessment also considers whether additional roads relating to economic activity should be included in the synthetic roads network. Queensland's position on this issue is also described in Section 5.3.4.

The Commission has requested, and Queensland has provided data, on:

- The location and lengths of roads relating to economic activity that are not currently included in the synthetic roads network;
- The industry to which these roads mainly relate (mining, agriculture, tourism); and
- As part of a supplementary request, details of the purpose of each road and the areas it connects.

Further information was subsequently requested on the dollar value of output or quantity of output attributable to each road, in terms of the economic activity it serviced. The provision of this information would involve a large degree of estimation (for example, using output information for each industry combined with an estimate of the proportion transported on the road network). The contribution of individual roads would then need to be estimated in some way.

Even if this could be achieved, it may not provide an accurate picture of the economic contribution of roads. Queensland notes that roads relating to economic activity do not just service the transportation of outputs, but also service economic inputs. This may be important in cases where outputs are transported by another means (e.g. rail) but state roads provide access for inputs. Attempting to estimate the quantity of output attributable to a road would need to take this into account and is another reason that estimating the value of the contribution made by individual road sections to industries is difficult and approximate.

However, Queensland considers that the information already provided is sufficient for the Commission to make an assessment of roads relating to economic activity. It demonstrates that states build and maintain roads where the main purpose is the support of economic activities, and that these roads are not recognised in the currently assessed synthetic network. An assessment can be developed based on the road lengths provided.

Queensland understands that not all states have been able to identify roads relating to economic activity, and suggests that road lengths for these states be estimated. One method could be to estimate the length of roads in states not providing data as a proportion of the road lengths provided by other states, using:

- The relative size of relevant industries which may require additional roads (mining, agriculture, tourism); and
- A measure of the geographic spread of states to approximate the distance roads would need to cover. Although it is proposed to use ARIA as the general remoteness indicator, this may not be a good option here as the roads being estimated are state based (unlike ARIA), and are not necessarily related to the size of the remote population. The length of the synthetic network currently used in the roads assessment may be a better approximation because it is state based and is a measure of distance rather than the size of the remote population.

16. HOUSING

Queensland's position

- Queensland supports treating the Remote Indigenous Housing National Partnership Agreement payments so that it does not impact the relativities. Indigenous Community Housing Organisations (ICHOs) remain the major deliverer of housing for Indigenous people in remote areas of Queensland. Such services therefore remain a purchase of service by the Commonwealth Government and should retain its no impact status. Should the Commission retain its position, Queensland supports a discount of 50 per cent to reflect that Queensland is not the major deliverer of housing for Indigenous people in remote areas of Australia. Queensland otherwise supports the phase-in treatment of the payment.
- Queensland maintains some concerns regarding the data used in the analysis of factors affecting rental payment but otherwise supports making no adjustment for difference in rent collection rates.
- Queensland does not support the inclusion of PNFCs.

In the 2010 Review, Housing was assessed within the category of Welfare and Housing based on the Commission's view that welfare and housing services are affected by the same drivers. The net housing expenses assessment recognised differential state needs relating to Indigeneity and the social-economic status (SES) of their populations. FHOS grants were assessed actual per capita as they were considered common policy. The Commission decided that the Remote Indigenous National Partnership Payment should not impact relativities as these payments were deemed to fund improvements to assets not owned by the state.

16.1. Draft Report Proposal

The 2015 Draft Report proposes the following methodology changes:

- The category covers PNFC and general government expenses and revenue.
- Gross expenses are assessed using Census data on households in social housing cross-classified by income, Indigeneity and location instead of Commonwealth pensioner numbers classified by Indigenous status.
- Assessed rents are calculated by applying average rents paid by the different household groups to assessed households.
- First home buyer grants, bonuses and stamp duty concessions are consolidated in the Housing category and are assessed EPC.
- As a placeholder, the Remote Indigenous Housing NPP will impact on the relativities from 2013-14.

In this submission Queensland will address the components of this category it considers are currently of priority. As the consultation process progresses, we may find it necessary to make further comment and will do so at the appropriate time.

16.2. PNFCs

Queensland does not support the inclusion of PNFC data and this is addressed under Queensland's priority issues.

16.3. Treatment of the Remote Indigenous Housing National Partnership Agreement payment

The Draft Report proposes that the Remote Indigenous Housing National Partnership Agreement payment should impact on the relativities because service delivery in this area has changed and states now have greater responsibility over the funded services. The Commission states the payments are for services usually provided by states, and also that needs and housing infrastructure are also assessed in this category.

In the 2010 Review, the Commission decided that the NPP should not impact on the relativities because these payments funded improvements to assets not owned by state governments.

The Commission advises the National Partnership Agreement on Remote Indigenous Housing (NPARIH) expects State housing authorities to become the major deliverer of housing for Indigenous people in remote areas of Australia, a process that requires the transfer of responsibility for ICHOs to State Governments.

Referencing the National Partnership on Remote Indigenous Housing – Progress Review (2008-2013) (NPARIH review) completed by the Department of Social Services, the Commission advises that most jurisdictions have chosen to bring their ICHOs into their State frameworks through a process of accreditation and registration, thereby ensuring that they are meeting appropriate performance standards and implementing rent reforms.

The Commission notes that the changes since the 2010 Review mean that states now have greater control over the management of ICHO dwellings and it is clear they are a substitute for public housing. The Commission is however, not certain when this change in responsibility occurred in each State and that their assessment recognises the full use made of public housing by different types of households. The Commission seeks states' views on this change and information on when the changes in responsibility occurred and how it has affected State spending on housing, housing investment and state holdings of assets would also be helpful.

16.3.1. ICHOs

16.3.1.1. <u>National Partnership on Remote Indigenous Housing – Progress Review (2008-2013)</u>

Table 1 provides an overview of the number of ICHOs and dwellings per state with those that have transitioned into the relevant government framework as at the time of the NPARIH progress review.

Table 1 - Number of transitioned ICHOs and dwellings based on the NPARIH progress review (2008-2013)

	Queensland	New South Wales	Western Australia	South Australia	Victoria
ICHOs	80	206	12	5	21
Properties	2000	4400	400	192	
Transitioned ICHOs	33	58	2	2	16
Transitioned Properties	(a)	(a)	(a)	105	(a)
Percentage of properties transitioned (%)	40	(b)	(b)	55 (c)	(b)

Note: (a) The number of transitioned properties is not specified
(b) The percentage of stock transitioned is not specified or unable to be derived from the available figures.
(c) The percentage of stock transitioned is derived from the available figures

16.3.1.2. Queensland's ICHOs

Queensland currently still has 80 ICHOs with a combined property portfolio of approximately 2000 dwellings. Of the 80 ICHOs, 33 ICHOs with 667 dwellings agreed to join the Queensland Government social housing system. As at 30 June 2014, six ICHOs with 136 dwellings have decided to withdraw from the social housing system. As at 25 August 2014, there are 27 ICHOs with a combined portfolio of 531 dwellings[28] in the State housing system.

Queensland's recent figures show that only 27% of ICHO managed dwellings have been incorporated into the Queensland Government social housing system and that an overwhelming 73% still remain outside of the reform.

16.3.2. Treatment of the NPARIH payment

The NPARIH payment currently does not impact on the relativities because it is deemed a purchase of services by Commonwealth Government.

The criteria to determine treatment of the NPARIH payment in the 2015 Draft Report is based on who is the major deliverer of housing for Indigenous people in remote areas of Australia. This is based on ICHOs that have transitioned into states' frameworks through a process of accreditation and registration, therefore the states become the major deliverer of housing services for Indigenous people in remote areas of Australia.

16.3.2.1. Queensland's position

Queensland does not support that the Remote Indigenous NPA payment should impact on the relativities.

[28] This figure includes assets that are in the process of being disposed.

Based on current figures, it is demonstrated that Queensland is not the major deliverer of housing for Indigenous people in remote areas of Australia and that ICHOs overwhelmingly still hold this responsibility.

The NPARIH review shows that most states similarly are not the major deliverer of housing for Indigenous people in remote areas of Australia as they remain with ICHOs.

Queensland supports continuing the current no impact treatment of the NPARIH payment in the 2015 Review as the reason for this treatment has not changed.

Should the Commission proceed with its decision that the Remote Indigenous Housing NPP should impact the relativity, Queensland supports a discount of 50 per cent to reflect that Queensland and potentially other states are not the major deliverer of housing for Indigenous people in remote areas of Australia.

Queensland otherwise supports the phase in treatment of the NPARIH payment.

16.4. Housing Revenue assessment

Queensland maintains some concerns regarding the data used in the analysis of factors affecting rental payment. We note it remains the data shows Indigenous households in non-remote regions paid more rent than non-indigenous households, although on average Indigenous households paid slightly less rent than non-Indigenous households.

The Commission has addressed this concern which was also raised by Western Australia and the Northern Territory. The Commission cites the Productivity Commission's report on Government Services 2014 and a report from the Australian Housing and Urban Research Institute to support the Census data.

No adjustment for differences in rent collection rates has been made because Productivity Commission data show that rent collection rates are similar for Indigenous and non-Indigenous housing. In any case, it is expected that the small gaps should decrease as State Governments take over responsibility for Indigenous community housing with ICHO rent reforms leading to fair rent setting in line with that applying to public housing.

16.4.1. Queensland's position

While noting concerns regarding the data, Queensland otherwise supports making no adjustment for difference in rent collection rates.

17. SERVICES TO COMMUNITIES

> **Queensland's position**
>
> - Queensland notes the proposed methodology for a combined Utilities subsidies assessment on a two part basis and maintains a watching brief as the proposed methodology develops.
> - Queensland supports small communities' definition to be extended to those with a population between 50 and 1,000 instead of between 200 and 1,000.

The Services to Communities category includes expenses on essential and support services that states provide to their communities.

In the 2010 review, the assessment recognised 6 different types of expenses.

- **Water and wastewater subsidies.** The assessment recognised that states on average provide subsidies to water providers in small communities and in areas of poor water availability and/ or quality. The share of a State's population residing in urban centres – localities (UCLs) with populations between 200 and 1000 people in areas of poor water availability and/or quality was used as an indicator of differential needs across states.
- **Electricity subsidies.** The assessment recognised that states with larger shares of the population living in remote and very remote areas had greater subsidy requirements because this was where states tend to subsidise providers.
- **Water and electricity concessions.** The assessment recognised that states with larger shares of Commonwealth pensioner concession card or health care concession card holders had to spend more on concessions.
- **Community development expenses.** This assessment recognised that states spend more on community development if they have a larger share of the population living in discrete Indigenous communities. These communities require more administrative and essential service support.
- **Community amenities expenses.** These were assessed on an equal per capita basis because there was no common policy across states.
- **Protection of the environment expenses.** These were assessed so that each state receives its population share of the expenses. The range of expenses included was particularly diverse and no drivers other than population could be established.

17.1. Draft Report Proposal

In the 2015 Review Draft Report, the Commission proposed the following changes:

- A utilities subsidies assessment has been introduced, distinguishing between water and electricity subsidies for uneconomic services in remote small communities and for uniform tariffs and special projects. The former is assessed using the proportion of population living in small remote and very remote communities. The latter is assessed equal per capita (EPC).
- Small communities now cover those with populations between 50 and 1 000 instead of 200 to 1 000.

- Needs associated with water availability and quality are no longer assessed.
- A new definition of discrete Indigenous communities has been adopted.

In this submission Queensland will address the components of this category it considers are currently of priority. As the consultation process progresses we may find it necessary to make further comment, such as when the treatment of Water for the Future payments is considered, and will do so at the appropriate time.

17.2. Utilities

The Commission has decided to combine subsidies to water and electricity providers into one utilities assessment and assess them on the same basis in two parts. Firstly, the operation of uniform tariff policies which provide a subsidy even in metropolitan areas or for specific projects in these areas will be assessed on an EPC basis. Secondly, residents in smaller and isolated communities receive additional subsidies to meet the higher costs of water and electricity provisions and this part will be assessed on the basis of a state's share of the population living in these communities.

Using data provided by states, the Commission estimates some 40 per cent of total utilities spending are provided as subsidies for smaller more remote communities.

Queensland is of the view that:

- The operation of uniform tariff policies should be assessed as average policy and not EPC; and
- The estimated spending of total utilities provided as subsidies for uneconomic service provision should be higher than the 40 per cent estimated in the Draft Report.

17.2.1. Uniform tariff policies

The Commission has determined a new definition for average policy where "*if even one State does something (raises a revenue or provides a service), that is part of what states do collectively and the materiality of its impact on State fiscal capacities will be tested. If the impact is material, the tax or service will be regarded as average policy and it will have an impact on the GST distribution*.[29]"

For electricity in Queensland, uniform tariffs are set at the full cost recovery price of south-east Queensland. In contrast, subsidies for uniform tariffs cover all providers in Western Australia and the Northern Territory because prices are set below full cost recovery. In other states, tariffs vary according to location. Similar uniform tariff policies are in place for water and sanitation services. Queensland considers that under the new definition, uniform tariffs should be considered average policy.

Queensland considers that the only component of uniform tariff expenses that should be assessed EPC are those that are provided to all residents of a state, regardless of where they

[29] 2015 Review Draft Report page 25

live. This would occur where prices for all residents are set below full cost recovery. As this component would provide an equal subsidy to all state residents, states would not have different needs, and an EPC assessment is appropriate. The remainder of subsidies reflect the higher costs incurred outside of the capital city (the lowest cost region) and should be assessed differentially.

It is likely that the proportion of subsidies relating to higher cost regions is higher than the 40 per cent estimated by the Commission as being provided for uneconomic services.

17.2.2. Definition of small communities

Queensland supports small communities to be defined as those with a population between 50 and 1,000 as it adequately captures where the additional subsidies in relation to smaller and isolated communities exists. This extends the previous definition of small communities as a population between 200 and 1,000.

18. OTHER EXPENSES

Queensland's position

- Unless further evidence is found to clarify the direction of the effect, Queensland supports no longer assessing the impact of cultural and linguistic diversity (CALD) on State expenses.
- Queensland notes administration scale, native title and land rights and some national capital assessments have been relocated from other categories.

In the 2010 Review, the Other Expenses category comprised those services and transactions not separately examined and assessed. It included:

- General public services;
- Other services not assessed elsewhere;
- Sundry purposes and transactions; and
- Superannuation for state government employees engaged in providing these services

18.1. Draft Report Proposal

The 2015 Review Draft Report proposes:

- The impact of cultural and linguistic diversity (CALD) on state expenses is no longer assessed; and
- Administrative scale, native title and land rights and some national capital assessments have been relocated to Other Expenses from other categories.

Queensland will not be addressing the relocation of expenses to this category from other categories.

18.2. Cultural and linguistic diversity (CALD)

In the 2010 Review, the Commission accepted the conceptual case for inclusion of a disability reflecting the additional expenses incurred by states in providing services to migrants with low English fluency.

Queensland understands that the CALD assessment was implemented in the 2010 Review as the Commission believed there to be a clear conceptual case for CALD disabilities, and some supporting evidence from a study of the costs of treating patient groups in Victorian hospitals. As reliable data was not available to make an assessment in each individual category where a CALD disability was expected to apply, a single aggregate allowance was assessed in the Other Expenses category.

In the Draft Report the Commission advises there is a strong conceptual case that people with poor English skills impose a higher cost in using State services than those with English as a first language. However, in attempting to find strong evidence for a CALD disability, the Commission had identified there is also have a strong conceptual case that people with poor English skills use services less than people with English as a first language.

The Commission now considers CALD may have an impact but it is not clear whether having a large CALD population increases or decreases the overall cost of delivering state services and no longer make an assessment of CALD populations in any category nor use language spoken at home in the post-secondary category.

Queensland supports that the impact of cultural and linguistic diversity (CALD) on state expenses is no longer assessed unless further evidence is found to clarify the direction of the effect.

19. LAND TAX

Queensland's position

- While Queensland does not support the Commission's revised framework for determining average policy, an assessment of metropolitan levies and fire and emergency services levies is consistent with the new framework.
- Queensland supports combining metropolitan levies and fire and emergency services levies under an all property component and assessed separately from the land tax component of the category.

In the 2010 Review, the Commission concluded that revenue raised through metropolitan levies was different from other land taxes and not average policy. On this basis, metropolitan levies were excluded from a differential assessment and assessed equal per capita (EPC).

In addition, revenues collected through fire and emergency services levies were assessed in the Other Revenue category on an EPC basis.

19.1. Draft Report Proposal

The Land Tax category in the Draft Report comprises two components:

- an all property component, which includes metropolitan levies and the property part of fire and emergency services levies. This is assessed using the value of properties; and
- the income producing property component, which is assessed using the taxable value of property aggregated by the landholder.

The inclusion of metropolitan levies and fire and emergency services levies in the Land Tax Category is based on the Commission's framework that, where a tax is sufficiently similar to another state tax, they be assessed in a combined category. On this basis, the Commission considers these levies to be similar in nature to land taxes and as such, are considered to be average policy and differentially assessed.

19.2. Inclusion of metropolitan levies and fire and emergency services levies

Queensland does not support the Commission's revised framework in determining average policy (as discussed in Section 8 – Definition of Average Policy). If the Commission decides to implement the revised framework, Queensland considers the proposed treatment of metropolitan levies and fire and emergency services levies in the land tax category is consistent with the revised framework.

Queensland supports the proposal to combine metropolitan levies and fire and emergency services levies under an all property component (separate from the land tax component); and to assess this component using Valuer General (VG) data on value of properties. Metropolitan levies are closer to a flat charge per property than land tax. Similarly, fire and emergency services levies are property based levies, generally comprising of a fixed and variable component, with the variable component based on a mix of property value, property size, land use and property location. Given these levies are imposed on a per property basis, it is appropriate that they be grouped together, but assessed separately from land taxes, which are levied at an aggregated landholder basis.

The nature of metropolitan levies and fire and emergency services levies are different to land tax. These levies do not have exemptions from the base as land tax (e.g. there is no principal place of residence exemption for these levies); do not have a tax free threshold; and do not have a progressive rate structure as land tax. Given these differences, it would be inappropriate to use the same revenue base as that used for the land tax component of the assessment, which sources data from State Revenue Offices (SRO) and adjusted for the progressivity of tax rates.

The Draft Report's proposal to use data on the value of properties from the VG is considered more suitable in assessing the all property component of the land tax category.