7 Assessing mining revenue and expenditure

The relationship between States' mining revenues and their GST shares has been an important aspect of this Review. The Panel's first interim report explored how the system currently works.[1]

Mining, and the ability to generate royalty revenue, is highly concentrated in a few States. This fiscal advantage is a key driver of the GST distribution process — the major resource States (principally Western Australia and Queensland) receive lower GST shares than they would otherwise because of it, while those States with relatively little mining receive higher GST shares. Because State mining revenues have grown so strongly in recent years, so too has the scale of mining redistribution, which reached $4.7 billion in 2012-13. This is a far larger amount than is due to any other revenue factor, making it especially important to consider whether the current approach — of fully equalising mining royalties — remains the right one. Section 7.1 sets out the Panel's views on the threshold question of whether mining revenue should be treated differently to other revenue.

Separate to the question of *whether* mining revenue should be fully equalised, the Panel has identified several aspects of concern with *how* this equalisation is pursued. Our consideration of how to improve the mining revenue assessment and ensure that States' related costs are properly recognised is presented in Sections 7.2 and 7.3.

7.1 Should mining be treated differently to other revenue?

How mining revenue is currently treated

Mining revenue is one of the six categories of States' own source revenue that are considered by the CGC when determining GST shares. The CGC uses information on the value and type of mining production in each State and the associated royalty revenue to calculate two average royalty rates — one for low royalty rate minerals and another for high royalty rate minerals. These average rates, applied to the quantity of mining production occurring each year, produce an estimate of the amount of mining revenue that each State would raise, if it applied the average policy (Table 7.1).

Table 7.1: Assessed mining revenue ($per capita) 2008-09 to 2010-11

Year	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Average
2008-09	199	23	779	1,378	100	91	0	467	382
2009-10	142	11	474	1,342	110	86	0	467	297
2010-11	181	10	601	2,154	178	115	0	537	426

Source: Commonwealth Grants Commission, 2012 Update Report, Tables B-1, B-2, and B-3, pages 109-111.

Western Australia's assessed capacity to generate mining revenue is far in excess of the other States' (with Queensland and the Northern Territory also being above the

1 See GST Distribution Review, *Interim Report*, March 2012, Chapter 6.

average). In 2012-13, equalising this mining revenue advantage reduces Western Australia's GST share by around $3.4 billion (or around $1,400 per person).

Table 7.2: Redistribution of GST due to mining revenue differences, 2012 Update

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
$ pc	221	400	-279	-1,394	273	308	416	-130	204
$ m	1,640	2,300	-1,316	-3,364	458	159	155	-31	4,711

Source: Commonwealth Grants Commission, 2012 Update Report, Tables 5-4 and A-1, pages 65 and 106.

States have strongly opposing views on whether mining revenue ought to continue to be treated similarly to revenue from other State taxes, or whether it should be treated differently.[2] Perhaps unsurprisingly, the States with the largest mining sectors, Western Australia and Queensland, have argued for a fundamental change in approach. Meanwhile, States with a small share of mining activity (as compared to their population shares), including New South Wales and Victoria, are firmly opposed to the idea that mining revenue should be treated differently to revenue raised from other State taxes.

The Panel has considered the merits of three suggested reasons for treating mining revenue differently, namely:

- that the sheer scale of its effect on GST shares is, in itself, unreasonable
- that the outcomes under the current approach are influenced by individual State policies to a far greater degree than for other types of revenue
- that mining royalties are categorically different to other taxes, including because of the non-renewability of the underlying resource, and so should be thought of as akin to the sale of an asset and not bracketed with other State taxes.

These 'threshold' issues regarding *whether* mining revenue should be treated differently from other revenue have been considered separately to the important practical matters relating to *how* this part of the equalisation system should operate (see Section 7.2).

Is the sheer scale of mining's effect on GST shares unreasonable?

Differences between States' capacities to generate mining revenue are currently having a large effect on how the GST is distributed. This year, these mining differences are responsible for $4.7 billion, or 85 per cent of the total revenue-side redistribution ($5.5 billion), even though mining revenue only directly accounted for 8.4 per cent of States' own-source revenue during the relevant assessment years (2008-09 to 2010-11).

This represents a large increase from previous years. The amount of GST redistributed due to mining has tripled over the past five years (from less than $1.6 billion in 2007-08)

2 This question would become moot if the preferred option of New South Wales, Victoria, Queensland and Western Australia, an equal per capita distribution of GST revenue, were adopted. However, given the Panel is not recommending that approach, we focus here on the 'fall-back' positions put by those States in their individual submissions to the Review.

and will almost certainly increase further over the next couple of years — whatever happens on commodity markets in the meantime — due to the lag in the HFE system.[3]

Under the current system this increase is the natural consequence of sharp increases in both the quantity of mining production and the price received for this output, and the fact that so much of Australia's mining production is located in Western Australia and Queensland. As mining royalties increase, both in absolute terms and as a share of States' budgets, the fiscal position of the main resource States relative to the other States is made stronger, so they are assessed as needing lower GST shares.

Queensland and Western Australia claim that this much redistribution is not fair — that the current outcome is too extreme. The other States say that it *is* fair — that this is the way the system is supposed to work.

The Panel agrees with the major resource States that the sheer scale of the effect that mining is having on GST shares warrants close scrutiny. We have attempted to provide that scrutiny later in this Chapter, particularly in examining whether some related costs are being insufficiently recognised. However, the mere fact that the mining part of the HFE system is currently driving a large amount of redistribution is not, in our view, a reason to treat mining differently from other revenue.

Mining is concentrated in a few States

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.

States have competing views as to how well overall the current system manages the inherent tension between these two principles. However, all States recognise that mining, with its highly skewed geographic distribution, poses the most difficult challenge in this regard.

As discussed in the second interim report, just three States — Western Australia, Queensland and New South Wales — collect more than 95 per cent of all State mining royalties.[4] The breakdown is even more pronounced for the two principal commodities, iron ore and black coal. Virtually all (around 97 per cent) iron ore production takes place in Western Australia, while black coal mining is dominated by Queensland (about two-thirds) and New South Wales (about one-third).

As shown by Figure 7.1, States' capacities to raise revenue from mining vary to a much greater degree than their capacities to raise revenue from other sources.

3 See Appendix D, which shows the possible effect on State relativities if mining royalties were not to grow as strongly as expected in the next few years.

4 By themselves, Western Australia and Queensland account for 80 per cent of total mining royalties.

Figure 7.1 Assessed revenue raising capacity ratios, 2010-11

Source: Commonwealth Grants Commission, 2012 Update, data downloads, Table S3-1.

This highly skewed distribution means that individual royalty policy decisions can have far greater impacts on GST shares than decisions to increase or decrease other taxes. For most taxes the indirect GST share effects are no more than two or three per cent of the size of the direct change in revenue. Western Australia, however, would currently lose more than forty cents in GST share for every additional royalty dollar it collected from a rate increase.[5] (As Western Australia has pointed out, the specific design of the mining revenue assessment means that in certain circumstances this GST share effect can be substantially higher).

It is clearly undesirable that individual policy decisions can have such large effects on GST shares. But it is far less obvious what the appropriate response should be. One option would be to no longer separately consider States' mining revenue raising capacities when deciding their GST shares (for example, by distributing the GST on an equal per capita basis or by using a global revenue indicator like household disposable income). This would address the policy neutrality problem, but would mean no longer recognising a very large driver of differences between the States' fiscal circumstances.

Ultimately, the fact that such a large source of revenue is so highly concentrated in a few States makes it particularly important to include mining within the HFE system, while at the same time making it practically difficult to do. Nevertheless, the Panel does not favour treating mining revenue differently on the basis that mining activity is geographically concentrated in a few States.

Should mining revenue be treated like an asset sale?

The two arguments discussed so far for treating mining revenue differently to other revenue relate to concerns with how the principles of HFE are given practical effect. A third possible reason that has been raised is that mining royalty revenue is categorically different to tax revenue, and so as a matter of principle should not be equalised (or perhaps only equalised over a much longer period).

5 See GST Distribution Review, *Second Interim Report*, June 2012, Table 3.1, page 30.

This argument (as put by Queensland and Western Australia) rests on the claim that royalties are essentially the price received by State governments for the sale of an asset owned by the people of that State (through the Crown). According to this view, rather than treating royalties like revenue from State taxes, they should be treated like the proceeds of other asset sales, such as of land, and not included in the HFE system.

Conceptually, there is some merit in the argument that looking only at royalty receipts without recognising the accompanying loss of the mineral assets provides an incomplete picture. Royalties are different from taxes. However, it does not necessarily follow that royalties should cease being treated like other State revenue for HFE purposes. The reality is that the longstanding practice of all Australian governments has been to treat royalties as recurrent revenue for accounting and budgeting purposes. Current royalty revenue is available to meet current expenditure needs, and in that sense is a close substitute for revenue from State taxes.

In any case, the corollary of treating royalties as an asset sale would be the recognition of the minerals themselves as assets on States' balance sheets. It is not clear that the combination of these changes would materially alter equalisation outcomes over time.

Accordingly, the Panel is not convinced that royalty revenue should be treated as being akin to an asset sale for HFE purposes.

Conclusion on the HFE treatment of mining revenue

Differences between States' mining revenues are having large effects on the GST distribution process. However, the Panel is mindful that HFE outcomes change over time. The large redistributions due to mining are a fairly recent phenomenon. Future results could well differ markedly from current outcomes, for example if the resource sector becomes a much larger part of States such as the Northern Territory or South Australia, or if the recent 'mining boom' unwinds. By itself the fact that mining revenue currently accounts for a large share of the redistribution occurring through the HFE system does not demonstrate that mining revenue should be treated fundamentally differently to other State revenue.

While we agree with the major resource States that there are specific problems with *how* mining revenue is currently equalised (and we turn to those in the next section), we do not consider the case has been made that mining revenue should be treated differently to States' other own-source revenue.

> ***Finding 7.1***
>
> *States' mining revenue should continue to be equalised through the HFE system, on the same basis as other own-source revenue.*

7.2 Changes to the mining revenue assessment

The previous section explained why the Panel considers that the mining royalties collected by States should continue to be equalised. This section discusses some 'no regrets' improvements to how this part of the HFE system operates, which the Panel

believes should be made whether or not a broader deal on resource charging is struck between the two levels of government.

These suggested improvements fall into two groups. The Panel considers that there are problems with the current two-tier mining revenue assessment itself, so a new assessment should be developed to address these. Further, the Panel considers that some mining-related expense needs are not being fully taken into account under the current system, so we have recommended a way of recognising them.

Assessing States' capacities to raise mining revenue

As touched on above, the highly uneven distribution of mining activity between the States is difficult for the HFE system to deal with satisfactorily. For example, separately considering States' capacities to raise revenue from each individual commodity (as might be suggested by closely adhering to the principle of 'what States do') is not a realistic option. Iron ore provides the starkest example of the problems that would be caused by such an approach. Western Australia would have dominated a separate 'iron ore mining' category to the extent that there would have been a virtually one-to-one trade-off between its iron ore royalty revenue and its GST share. Totally removing that State's incentive to maximise the community's return from iron ore mining would clearly have not been in the national interest.

Another option would be to treat all minerals alike for HFE purposes and apply a single, undifferentiated mining assessment based on the average royalty rate across all commodities. This would have the virtue of simplicity, but at the cost of neglecting material differences between average profit levels of individual commodities.

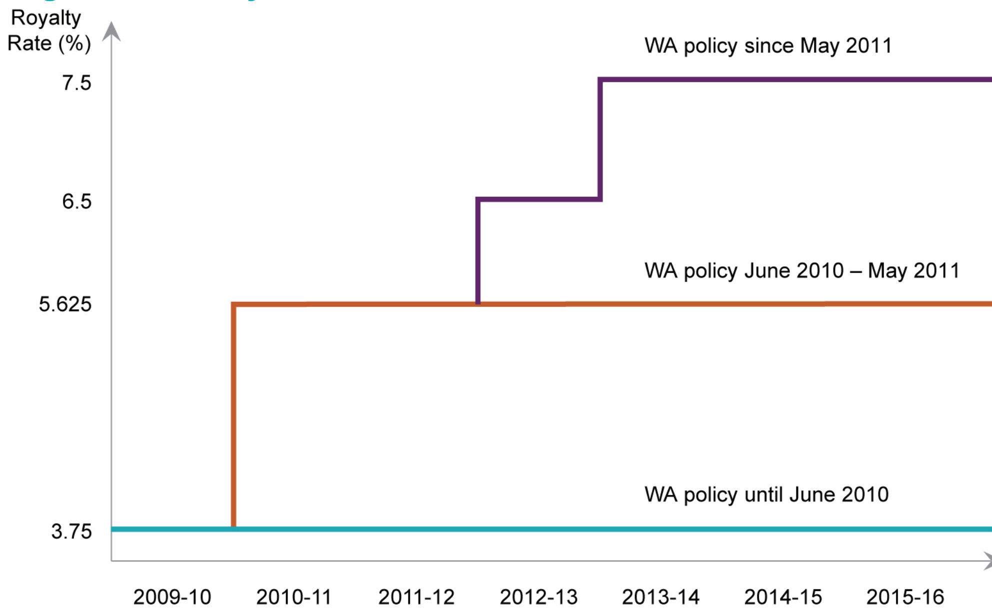
Instead, the CGC has attempted to strike a balance between these two extremes. The current mining assessment separates minerals into two groups based on whether their average royalty rate is above or below five per cent.[6] This division is based on the idea that differences in average royalty rates are broadly reflective of differences in profitability, and therefore 'capacity to pay' over the long-term. It also groups most iron ore and coal together, which serves to somewhat limit the effect that individual policy decisions of Western Australia, Queensland or New South Wales have on GST shares. This approach should work reasonably well in certain circumstances, but it is not well suited to handling the situation where a mineral might move between the low and high royalty rate groups.

The treatment of iron ore fines

The first interim report explored the dramatic effect on GST shares that could occur if the CGC were to move a mineral from the low royalty rate group to the high royalty rate group (or vice-versa). This is a live issue, given Western Australia's decision to increase, in stages, its effective royalty rate on this commodity from 3.75 per cent to 7.5 per cent from 2013-14 onwards.

6 There is a third component that comprises payments from the Commonwealth to the States in lieu of royalties pursuant to agreed revenue sharing arrangements.

Figure 7.2 Royalties on certain Western Australian iron ore fines



Source: Western Australia Government, Budget Paper No. 3, 2012-13, page 74.

Western Australia's first decision to remove the concessional 3.75 per cent royalty rate effectively increased the rate to 5.625 per cent. It expected to raise around $340 million a year from this decision.[7] However, it would have lost far more than this amount via a reduction in its GST share if the CGC had decided to move iron ore fines from the low rate into the high rate category. In any event, before the CGC was required to make its decision, the Commonwealth Treasurer instructed it to keep iron ore fines in the low rate group for the time being.

The potential for a State to lose more in GST revenue than it gains from an increase in its royalties does seem to be a perverse and inappropriate side-effect of the two-tier mining revenue assessment.[8] The Panel notes that the Commonwealth Treasurer has used the Terms of Reference for the 2011 Update and the 2012 Update to ensure this does not occur in this case. The Panel agrees that this was an appropriate response.

Finding 7.2

The current two-tier mining revenue assessment can produce excessively large GST share effects when a commodity moves between groups.

Finding 7.3

The Commonwealth Treasurer's previous directions to the CGC to keep iron ore fines in the low-rate group appropriately ensured Western Australia was not unfairly penalised for removing its concessional rate.

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7 Western Australia Department of State Development, *Agreement benefits Western Australia and iron ore producers*, http://www.dsd.wa.gov.au/4868_8006.aspx, accessed 17 October 2012.

8 As Western Australia has pointed out, this could also create the opposite incentive in relation to potential reductions in royalty rates. See Western Australian supplementary submission to the GST Distribution Review, March 2012, page 8.

Western Australia subsequently formally announced, in its 2011-12 Budget, its intention to bring its fines royalty rate up to the 7.5 per cent rate applying to iron ore lump. In its most recent budget, Western Australia estimated that, when fully phased-in, this change will generate around $1 billion a year in additional royalty revenue.

Table 7.3: Western Australian iron ore fines royalty rate changes

	2011-12	2012-13	2013-14	2014-15	2015-16	Total
Royalty rate — iron ore fines	5.625%	6.5%	7.5%	7.5%	7.5%	
Extra royalty income ($m)		399	939	966	975	3,280
GST impact ($m)				-86	-298	-384
Net revenue impact ($m)		399	939	880	677	2,896

Source: Western Australia Government, Budget Paper No. 3, 2011-12, page 89.

In contrast to its initial decision to increase the royalty rate to 5.625 per cent, the additional royalty revenue that Western Australia will receive from this decision will be considerably larger than the reduction in its GST share. This remains the case even though Table 7.3 significantly understates the ongoing GST share effect because of the HFE system's three-year averaging process. Looking forward, the additional $1 billion in royalty revenue could be expected to reduce Western Australia's GST share by around $400 million a year in the event that iron ore fines were kept in the low royalty rate group, or by around $500 million a year if fines were moved into the high rate group.

It would be untenable to keep iron ore fines in the low royalty rate group indefinitely when subject to the same royalty rate as iron ore lump (7.5 per cent). At some point, under the current approach iron ore fines must move into the high royalty rate group. The point when this occurs is important though, because of the large difference between assessing iron ore fines in the low royalty group (where the average rate is around 3.8 per cent) and in the high rate group (average rate around 7.4 per cent). Obviously, Western Australia would prefer fines be kept in the low rate group for as long as possible, while other States would prefer the switch occurs more quickly.

The Panel considers the Commonwealth Treasurer was correct to intervene to ensure that iron ore fines did not move into the high royalty group in either the 2010-11 or 2011-12 assessment years (while the rate was 5.625 per cent). Further intervention is no longer required. The Treasurer should direct the CGC to consider the appropriate treatment of iron ore fines from the 2012-13 assessment year.

Recommendation 7.1

That, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to:

- *continue to ensure that Western Australia's removal of iron ore fines royalty rate concessions in 2010 does not cause iron ore fines to move into the high royalty rate group in the 2010-11 or 2011-12 assessment years*
- *consider the appropriate treatment of iron ore fines for the 2012-13 assessment year and future years, in light of Western Australia's decision to bring the iron ore fines royalty rate to the same level as that for iron ore lump.*

The mining revenue assessment

The circumstances surrounding iron ore fines provide a specific example of the general problem that can be created by splitting the mining revenue assessment into discrete groups. In its first interim report the Panel encouraged the CGC and other stakeholders to review the mining revenue assessment method at the earliest opportunity. This remains our advice.

In the Panel's view, the mining assessment would be ideally based directly on profit levels, rather than using average royalty rates applied to the value of production as a proxy. However, the Panel recognises the difficulties that have existed in obtaining the necessary data to employ a single profit-based mining assessment.[9]

In Chapter 8 the Panel sets out its views on what the States and the Commonwealth should do to put the interaction between the State royalties and the Commonwealth's resource taxes on an improved, sustainable footing. Governments may choose not to adopt these suggestions, leaving the current tension between State royalties and the MRRT and PRRT in place. In that event, the CGC should recognise that the introduction of the MRRT and PRRT has altered the economics of States' iron ore, coal and petroleum royalties along with the incentives faced by the States when setting these royalties. The Panel sees a strong case for treating iron ore, coal and petroleum royalties differently to other royalties in such circumstances.

Recommendation 7.2

That the CGC and other stakeholders develop a new mining revenue assessment at the earliest opportunity. The new assessment should:

- *avoid excessively large GST share effects, such as when a commodity moves between groups under the current assessment*
- *treat iron ore, coal and petroleum differently to minerals that are not subject to Commonwealth resource rent taxes.*

7.3 Are all mining related expenditure needs recognised?

The Panel has examined concerns raised by Queensland and Western Australia about whether the system recognises all mining related expenditure needs.[10] Queensland and Western Australia say that, while mining revenue is fully equalised, their mining related expenditure needs are not fully recognised and this prevents them from attracting the labour and capital necessary to facilitate structural adjustment. Western Australia is particularly concerned that failure to recognise these needs forces a focus on cost recovery or private sector provision of mining infrastructure and that this has implications for smaller miners who would benefit from a greater public sector role.

9 Over time, this may change somewhat following the introduction of the MRRT on iron ore and coal projects and the PRRT on onshore petroleum projects. However, this would be of no assistance in relation to other minerals not subject to the MRRT or PRRT.

10 In an HFE context, expenditure 'needs' refer to factors outside a State's control that influence spending.

Queensland and Western Australia identified some unrecognised needs linked to direct mining related costs that they say are not sufficiently recognised in the current system. These include:

- costs linked to managing new and ongoing projects (including regulation costs)
- costs of providing services and related infrastructure in regional mining communities
- additional costs associated with fly-in fly-out workers
- very high service delivery and capital unit costs in remote mining communities
- mining related road construction costs.

In addition, Queensland and Western Australia say the equalisation system does not recognise the opportunity cost and risk associated with providing infrastructure to facilitate mining activity. Queensland and Western Australia say the 'gaps' in the current equalisation system could be recognised through appropriate expenditure assessments or a discount to the mining revenue assessment.

The Northern Territory[11] and some of the non-resource States say they support changes to ensure mining related expenditure needs are properly recognised, but their preference is to do this through appropriate expenditure assessments rather than a discount to the mining revenue assessment. Other non-resource States say that these needs are already recognised including through the capital assessments introduced in the last CGC methodology review, and that mining infrastructure should be provided by the private sector or government business enterprises (GBEs) on a cost recovery basis.

The Panel notes that while State governments have a major role in providing economic and social infrastructure in mining regions, the Commonwealth has indicated a willingness to play an increasing role. In the 2012-13 Budget, the Commonwealth confirmed its commitment to spend $6 billion over 11 years to 2020-21 on regional infrastructure investment to support Australia's economic development through investment in resource and export capacity, and address potential capacity constraints arising from export production and resource projects.[12] This support supplements past and ongoing programs for State road and social infrastructure services.

The Panel has examined the scale and type of mining related expenditures identified by Queensland and Western Australia. The following sub-sections outline the Panel's findings and conclusions on the issues raised by Queensland and Western Australia.

Direct costs

Mining industry support costs

States with a large mining sector incur costs directly linked to the regulation and management of new and ongoing mining projects including environmental impact

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11 The Northern Territory has a relatively large mining sector. The Northern Territory, together with Queensland and Western Australia, is one of the main resource States in an HFE context.

12 Commonwealth Government, 2012-13 Budget Paper No.3, Support for State infrastructure services, page 100.

assessments, community consultation and infrastructure planning.[13] Since resource States are likely to incur higher per capita costs due to the larger scale of mining activity, the Panel agrees there is a conceptual case for recognising these higher costs.

The Panel understands that the CGC considered making an assessment in the 2010 Review, but concluded at that time that it would not be material. Given the recent growth in mining activity it is likely that mining industry support costs have increased. The Panel recommends that the CGC develop an assessment for mining industry support costs along similar lines to the assessment of regulation costs for the agricultural sector in the services to industry category. The CGC should also examine whether a similar assessment for other industries would be practical and material.

Social infrastructure and community amenities in regional mining towns

Western Australia and Queensland say there is growing demand for services in mining communities and that the high cost of providing social infrastructure in these communities is not fully recognised — particularly in the areas of health and education. Western Australia also identified support for local governments and general community amenities (for example, cultural, sporting and other recreational facilities) as areas where the CGC's assessments are inadequate. Western Australia estimates that the amount of its unrecognised needs in 2010-11 was $500 million.[14]

The Panel does not agree that there are significant unrecognised needs for social infrastructure including general community amenities. The current infrastructure assessments take account of population growth and where people live, and how this influences both the quantity and unit cost of infrastructure.[15]

The Panel notes some needs related to State government support for local government are recognised because State financial support for local government is included in the relevant expense categories and assessed in the same way as State expenses for similar functions.[16] The CGC does not equalise local government activities across the board because it does not consider that its Terms of Reference gives it a mandate to do so.[17]

The Panel accepts that local government areas experiencing rapid population growth will face higher costs related to the provision of community amenities, but without any information about the revenue capacity of local governments or the level of State financial support for local government, the Panel is unable to determine the extent of any unrecognised needs, if they exist.

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13 The Queensland Government says the total cost of administration for the mining sector was $100 million in 2008-09, rising to $120 million by 2011-12, see Queensland Government submission to the GST Distribution Review, August 2012, page 33. Western Australia did not provide an estimate of costs.

14 Western Australian submission to the GST Distribution Review, August 2012, page 16.

15 The latter is achieved by applying all expense use and cost disabilities in the depreciation and net investment assessments. See Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review, volume 2*, Canberra, 2010, pages 465 to 477 for a detailed explanation of how capital stock (or use) and cost disabilities are derived for the infrastructure assessments.

16 State support for local governments is provided across the full range of government functions but major areas are welfare, housing, water, sanitation, community amenities, natural disaster and roads.

17 Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review, volume 1, Main Report*, Canberra, 2010, page 32.

Fly-in-fly out (FIFO) and drive-in-drive out (DIDO) workers

A significant proportion of the mining workforce is employed on a FIFO or DIDO basis. The Panel understands that the ongoing presence of FIFO/DIDO workers creates additional demand for services in mining communities. The CGC's expenditure assessments use ABS estimated resident population (ERP) data to calculate service populations in different geographic regions. ERP data are based on place of usual residence and therefore are unlikely to pick up FIFO/DIDO workers. Western Australia estimates that the amount of its unrecognised needs in 2010-11 was $100 million.[18]

The Panel agrees that resource States' needs are likely to be somewhat understated because FIFO/DIDO workers are not included in ERP estimates, and the current assessments could be improved by including an adjustment for FIFO/DIDO workers.

Very high unit costs in remote mining communities

Western Australia says it faces very high costs in providing services in remote mining communities due to the high demand for labour and housing and that the equalisation system makes no distinction between equivalent areas of remoteness in different States. This means that Western Australia's very high costs are not recognised. Western Australia estimates that the amount of its unrecognised needs in 2010-11 was $315 million.[19] Western Australia says it spend substantial amounts on:

- district allowances and other benefits for regional public sector employees
- housing for government employees and non-government service workers in mining communities.

The Panel notes that the equalisation system recognises that the cost of service provision increases with remoteness due to a number of factors, including higher wages paid to government employees working in more remote locations and high employee housing expenses. The Panel considers that some government employee costs in remote locations may not be fully recognised due to the discount applied by the CGC to the regional location assessment and recommends that the CGC re-examine this assessment in a future methodology review.[20]

Capital costs

Western Australia says that the CGC uses recurrent cost disabilities to approximate capital cost disabilities in its infrastructure assessments and that capital specific cost disabilities would be better — it says that approximating capital cost disabilities results in its capital costs being understated by $100 million each year.[21]

The Panel understands that the CGC considered using a direct measure of capital costs in the 2010 Review, but could not identify a suitable data source. Consequently, the CGC decided to use the recurrent cost disabilities, including regional location cost disabilities, to approximate capital cost disabilities. The Panel agrees that it would be

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18 Western Australian submission to the GST Distribution Review, August 2012, page 16.

19 Western Australian submission to the GST Distribution Review, October 2012.

20 The CGC applied a discount due to uncertainty surrounding the comparability of the data used. Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review, volume 2,* Canberra, 2010, page 520.

21 Western Australian submission to the GST Distribution Review, August 2012, page 16.

preferable to use capital specific cost disabilities if they were available and recommends that the CGC re-examine this issue in the next methodology review to determine if any new data sources or approaches are available for measuring capital costs.

Roads

Queensland and Western Australia identified a number of road projects directly linked to mining activity (including roads to meet the transport needs of the DIDO workforce) for which needs were not fully recognised. Most of the road projects identified in their submissions were road upgrades to accommodate increased traffic volumes and heavy vehicle use. Western Australia says it is planning to fund a $123 million access road to the Browse Liquefied Natural Gas (LNG) Precinct about 60 kilometres north of Broome.[22]

The infrastructure assessments seek to measure State road investment needs with the rural roads investment assessment picking up differences in needs due to road use and length. The use measure takes account of traffic volume and heavy vehicle use while the measure of road length focuses on State managed roads linking localities larger than 400 people by the fastest route.[23] In the Panel's view, needs for most of the mining related road projects identified in State submissions are therefore recognised. One area the Panel identified where needs may not be recognised are roads that link common-user facilities (for example, ports, regional airports) that do not coincide with population centres. The Panel recommends that the CGC examine this issue in the next methodology review to determine if the parameters for defining the length of State managed rural roads could be refined further. That said, the Panel observes that if States choose to fund roads to mining related sites that primarily benefit a single operator it is not appropriate for the HFE system to recognise these roads.

Other multi-user economic infrastructure

In addition to roads, the public sector provides other multi-user facilities such as ports, rail, electricity and water infrastructure to support development of the mining sector. Much of this infrastructure is provided through government business enterprises (GBEs). The resource States consider there is a risk that this infrastructure will be under-provided if left to the private sector and/or user pays funding and that this poses a problem for small- and medium-sized operators. The Panel examined a number of examples provided by Western Australia of multi-user infrastructure projects but concluded that, for the most part, these projects do not directly impact the State budget. The Panel agrees that upfront funding of these projects may place pressure on State debt levels and in turn limit the State's capacity to fund other investments. However, in the long-term these projects should be fully cost recovered and are likely to generate profits (and additional fiscal capacity) for the resource States.

Opportunity costs and risk

Western Australia (and Queensland in a different context) says the opportunity cost and risk of providing mining related infrastructure is not recognised in the equalisation system. Western Australia estimates the scale of its opportunity cost and risk was $870 million in 2010-11.[24] Western Australia says these intangible costs relate to

22 Western Australian submission to the GST Distribution Review, October 2011, page 22.

23 Commonwealth Grants Commission, *Report on GST revenue sharing relativities — 2010 Review, volume 2,* Canberra, 2010, page 346.

24 Western Australian submission to the GST Distribution Review, August 2012, page 16.

infrastructure that is initially not fully utilised and the risk of eventual under-utilisation.[25] Queensland says the opportunity cost arises because governments face budget constraints and spending on mining infrastructure means less spending in other areas and the timeframes for cost recovery are extremely long.[26]

The Panel has examined Western Australia's calculation of opportunity cost and risk, noting that it hinges on an assumption that Western Australia's population should be growing at 2 per cent a year above the national average. The estimate also assumes an opportunity cost applies to all public sector infrastructure, whether tax-funded or provided on a full cost recovery basis. While the Panel appreciates the conceptual argument put forward by Western Australia, the estimate of these costs is highly contestable, especially in the absence of any evidence to support the population target.

The Panel understands that changes to the assessment of capital in the 2010 Review were designed to ensure that the needs of States experiencing rapid population growth (such as Queensland and Western Australia) are recognised as population growth occurs. The Panel does not agree that further changes are required to create capacity for States in advance of actual population growth.

The Panel recognises that there is a risk that State funded social and economic infrastructure related to mining activity may not be fully utilised in the future if the level of mining activity declines. However, this type of risk exists for all States undergoing structural change, and the Panel has no basis for concluding that the resource States face relatively greater risk, or for assigning a value to this risk.

Summary on mining related expenditure needs

The Panel has thoroughly examined the scale and type of mining related expenditures identified by Queensland and Western Australia and concludes that, while most of their direct mining related needs are recognised, some small gaps exist including:

- Mining industry support costs are not fully recognised. For Western Australia the Panel considers the potential size of unrecognised needs may be $30 to $60 million. This estimate is based on an estimate of needs derived from our own indicative assessment for mining support costs along similar lines to the one for agriculture.

- Costs related to FIFO/DIDO workers. For Western Australia the potential size of unrecognised needs may be $20 to $40 million. This amount is less than Western Australia's estimate because only a proportion of the total number of FIFO/DIDO workers are present at any one time and no supporting information has been provided on the additional cost of each FIFO/DIDO worker.

- Very high government employee costs in remote locations. For Western Australia the potential size of unrecognised needs may be $10 to $20 million. This amount assumes that Western Australia's regional location needs may be 5 to 10 per cent higher than currently recognised.

25 Western Australian submission to the GST Distribution Review, August 2012, page 15.
26 Queensland submission to the GST Distribution Review, August 2012, page 33.

In a number of other areas, the Panel concludes that there are no significant unrecognised needs related to:

- the provision of services and social infrastructure in mining communities (except those for FIFO/DIDO workers)
- State financial support for local government for the provision of community amenities
- how capital specific cost disabilities are estimated
- mining related road projects.

Finally, the Panel considers that the equalisation system should not recognise opportunity cost and risk associated with mining related infrastructure.

These findings are summarised in Table 7.4. The table includes estimates of the potential scale of Western Australia's unrecognised needs in 2010-11. They amount to about $60 to $120 million. This amount for Western Australia is equivalent to around a 3 per cent discount to the mining revenue assessment.

Table 7.4: Summary of potential gaps in the assessment of mining related costs[27]

Description of unrecognised needs	WA's estimate of additional unrecognised needs in 2010-11	Panel's conclusion on the size of WA's unrecognised needs
Mining industry support costs	No estimate provided	Additional $30 to 60 million
State provided services, social infrastructure and other community amenities in mining regions	Additional $500 million	Needs are already fully recognised in the CGC's assessments.
Financial support for local government for the provision of community amenities	Part of the additional $500 million estimate provided above.	Unable to quantify any additional unrecognised needs
Services and infrastructure for FIFO and DIDO workers	Additional $100 million	Additional $20 to $40 million
Very high costs in Western Australia's remote mining communities	Additional $315 million	Additional $10 to $20 million
Capital costs approximated using recurrent costs	Additional $100 million	Unable to quantify any additional unrecognised needs
Roads in mining regions	No estimate provided	Needs are already fully recognised in the CGC's assessments.
Opportunity cost and risk (or cost of in-advance provision of infrastructure)	Additional $870 million	The equalisation system should not recognise opportunity cost and risk as needs.

27 Queensland provided information on total spending over the last 4 years on roads and social infrastructure in mining regions and areas that have linkages to the mining region. The amounts are equivalent to an average annual spend of $370 million. This was in addition to mining industry support costs. Queensland did not include an estimate of the size of unrecognised needs. See Queensland submission to the GST Distribution Review, August 2012, page 32.

The issues and circumstances referred to above can be re-examined in detail by the CGC at its next methodology review. As this may take several years to occur, the Panel has felt the need to recommend interim action. The Panel therefore recommends that the CGC add an amount to its expenditure assessments equivalent to a 3 per cent discount to the mining revenue assessment. In this way the scale of the unmeasured needs for each State will be linked to the scale of the mining revenue assessment.

In recommending this approach the Panel acknowledges that the scale of unrecognised needs for Queensland is based on information for Western Australia. Nevertheless, the types of costs identified by Queensland were similar to those identified by Western Australia. This interim assessment should remain in place until the next methodology review is completed.

Recommendation 7.3

The Panel recommends that, in the Terms of Reference for the 2013 Update, the Commonwealth Treasurer direct the CGC to add an amount to its expenditure assessments equivalent to a 3 per cent discount of the mining revenue assessment in order to compensate for the fact that some mining related needs of the resource States are not fully recognised. This interim assessment should remain in place until the next methodology review is completed.