Government of **Western Australia**
Western Australian Regional Development Trust

Our Ref: R227-10

16 May 2014

Mr Lyndon Rowe
Chair
Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

Dear Mr Rowe

INQUIRY INTO MICROECONOMIC REFORM

Thank you for the opportunity to provide a submission to the Economic Regulation Authority's (the ERA) on its Draft Report on the Inquiry into Microeconomic Reform.

The Western Australian Regional Development Trust (Trust) is established by the *Royalties for Regions Act 2009* (Act), as an independent advisory body to the Minister for Regional Development on the Royalties for Regions Fund. The Trust performs an oversight role and provides independent and impartial advice and recommendations on the allocation of funding from the Fund.

The income for Royalties for Regions is derived from 25 per cent of the mining and onshore petroleum royalties estimated in the annual State budget. The object of the Act is to promote and facilitate economic, business and social development in regional Western Australia through the operation of the Fund.

The Draft Report highlights matters on which the Trust has a view. General comments are set out below followed by comments on specific matters in Attachment A.

The Trust notes that the ERA's main focus in undertaking the inquiry is to identify areas of reform where they have the potential to improve the performance of the Western Australian economy.

The Royalties for Regions program has been putting in place enabling infrastructure to enhance growth and development in the regions. This has been critical investment. Four regions are now growing at or above the state average with the Peel, Pilbara and Wheatbelt regions realising considerably higher growth in the period since Royalties for Regions investment has commenced.

Royalties for Regions has sought to normalise key inputs to growth in regions, for example:

- Labour market supply
- Housing supply
- Cost of living

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- Amenity and liveability to allow permanent workforces to live sustainably in the regions
- Services such as health and education to improve the liveability of regions to attract permanent workforces.

Royalties for Regions has already made significant progress in achieving these goals. For example, the Pilbara Cities Initiative commenced in 2008-09 and is funded through to 2017-18 with proposed expenditure of some $1.7 billion. Specific initiatives include:

- The creation of new suburbs that house community members, industry, government and service workers.
- A new regional hospital that has been delivered in Port Hedland with planning well underway for the new $207 million Karratha Health Campus
- Hedland Senior High school has had a significant face lift and there is a new senior high school in Karratha
- The Pilbara Hinterland and Agricultural Development Initiative, a key economic diversification project.

By supporting economic growth in the regions, Royalties for Regions has the capacity to create new revenue streams for the State.

The Draft Report outlines the key growth industries have been mining, manufacturing and services and sales. The majority of this growth has occurred in the regions. The investment directed to regions through the Royalties for Regions program will further enhance prospects for growth in these established industries and a range of emerging industries. Improvements to regional amenities, services and infrastructure will attract people to regional locations to live, work and do business. There has been strong population growth in the regions in recent years.

Royalties for Regions has the capacity to support businesses to employ new people, which in part addresses the issue of labour supply that is a key constraint to regional growth. Royalties for Regions is also supporting regions to diversify economically through extensive planning processes such as the development of Regional Investment Blueprints (Blueprints) and Regional Planning and Infrastructure Frameworks.

Blueprints are regional growth and development plans and they highlight how to invest in regions to generate the greatest growth for the State. Draft Blueprints are being developed by the Regional Development Commissions for each of the State’s nine regions. Blueprints are intended to be evidence based documents with a goal to help transform regions to attain sustainable growth and development goals.

The focus for Royalties for Regions in moving forward in the current setting of fiscal constraint is on the quality and effectiveness of the ‘spend’. This is a critical policy imperative and a recognised position for the program going forward.

Major structural changes in the economy are occurring and Western Australia is moving beyond the mining investment boom. Many trade and investment links with Asia have been made during the boom. The Draft Report states that is a key vulnerability of the Royalties for Regions is its revenue source, that is, the volatility of markets, exchange rate and key dependence on key countries such as China. However, investment and trade links will lead to further investment opportunities following the boom period.

Research by the Organisation for Economic Cooperation and Development (OECD) emphasises the need to build from local capabilities, which is particularly true for geographically large countries. The regional imperative is to support regional specialisation based on competitive advantage and accountability for investment. This is an important policy framework as the regional growth in Western Australia is underpinning State growth.

The key areas of economic activity the ERA has outlined that have driven growth in the State are in the majority generated in the regions. It is critical that we provide the key levers for enabling that growth in the regions.

Western Australia's nine regional economies are on different growth trajectories. Aside from growth and potential, the key is for policy to support regional competitiveness – innovation, global engagement, competitive firms and investing in human capacity. We need more debate about how to grow and develop our regional economies, which in turn supports the growth of the State. The Trust therefore welcomes the ERA Draft Report and informed debate.

If you have any queries or wish to discuss this submission please contact me via Ms Lita Geros, Executive Officer on telephone or at Lita.Geros@drd.wa.gov.au.

Yours sincerely

Sue Middleton
Chair

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ATTACHMENT A

Western Australian Regional Development Trust submission to the Economic Regulation Authority's Draft Report on the Inquiry into Microeconomic Reform

Draft Report: Section 4.2.4 Infrastructure: Royalties for Regions

Recommendation 4: Repeal the Royalties for Regions legislation, or restrict regional funding to an amount determined annually as part of the Budget process and guided by appropriate cost benefit analysis on a project-by-project basis.

Budget flexibility

ERA comment

In its Draft Report, the ERA notes that royalties has increased strongly and that the State Government expects royalties to continue to rise in the coming years. The ERA's view is that the rise in royalties together with the offsetting decrease in GST from the Commonwealth in response to the royalties increase has magnified the impact on the State's budget flexibility.

In the view of the ERA, hypothecation of substantial revenues for regional projects is reducing budget flexibility, precluding proper capital prioritisation. The ERA notes that hypothecation is not inherently good or bad and that there are examples of successful application of this policy.

In its argument, the ERA has referenced the *Inquiry into Royalties for Regions Policy* by the Standing Committee on Estimates and Financial Operations (Report 20).

- On 1 December 2008, the Committee resolved to undertake the inquiry and report to the Legislative Council by 14 May 2009.
- The Royalties for Regions Policy was endorsed by Cabinet on 13 October 2008 and the *Royalties for Regions Act 2009* proclaimed on 27 March 2010.

Page 65 of the Draft Report, refers to the Committee noting the added challenge to the State Budget recreated by the increase in expenditure associated with RFR" and "supported advice from Government that the amount allocated to RfR will be adjusted if the State's AAA credit rating is at risk".

The Draft Report also refers to the Committee noting there was "no cost benefit-analysis was undertaken and is of the view that the initiatives, programs and funding allocation to be implemented as part of the RFR program require cost benefit analysis".

The ERA is of the view that the policy has not been adjusted in response to the downgrading of the State's credit rating nor has key regional financial data been collected. The ERA considers ex-post cost benefit evaluation of the policy does not appear to have been undertaken as also recommended by the Committee.

Trust response

The Trust's view is that Royalties for Regions demonstrates a successful application of hypothecation. With regard to the budget flexibility, the Trust maintains the principle of 'hypothecation' is critical to the State's development. The hypothecation of royalties to develop the regions has arguably resulted in much higher growth rates across the majority of Western Australian's regions.

The Trust acknowledges that in some ways it reduces budget flexibility, but the Trust notes that the Act provides that "the Minister, with the Treasurers concurrence" may authorise expenditure. Accordingly, each budget with relevant proposals is a negotiation and takes place as part of normal budgetary processes.

The *Royalties for Regions Act 2009* allows for flexibility and negotiation between the Treasurer and the Minister for Regional Development. The Trust has also in its advice, noted that there may be exceptional financial circumstances in which Royalties for Regions may need to make more of a contribution to the State budget.

The Trust's view is that this is entirely appropriate and represents how Royalties for Region can contribute to fiscally responsible State budget. However, the Trust notes that as conditions improve, there should be a return to normal programming for Royalties for Regions.

The 2013-14 State budget and the coming 2014-15 State budget reflect these realities and Royalties for Region's contribution to the State budget.

In relation to ERA's call for ex-post cost benefit evaluation of the Royalties for Regions program, the Trust strongly concurs with this view. Such an evaluation is a priority for the Trust in its coming term. The Royalties for Regions program is now mature enough and been around long enough for this evaluation to take place.

The Royalties for Regions process does not reduce the State Government's ability to select projects in line with good practice principles. It does introduce another layer of decision making from the regions, but the OECD literature indicates that this is a key leveraging process and leads to higher productivity and innovation in regions.

Practical limitations on project analysis

ERA comments

The ERA has highlighted the average size of a Royalties for Regions project is approximately $1.2 million and notes that projects of this size reduce the capacity to develop quality cost benefit analysis processes.

Trust response

As the ERA has highlighted the average size of a Royalties for Regions project is approximately $1.2 million and notes that projects of this size reduce the capacity to develop quality cost benefit analysis processes.

Nevertheless, DRD has a strong accountability and governance framework that oversees the project development and assessment process.

The current business case and assessment process would be described as assessing the proposed benefits and ensuring they align with identified State and regional priorities. Proponents for Royalties for Regions funding are required to submit a detailed business case that undergoes a due diligence assessment before being submitted to Cabinet for approval. In addition, business cases are subject to consultation with the Department of Treasury, relevant Ministers and Directors General. This would exceed in scope and diligence all other processes within government to assess projects of similar sizes

The ERA has further noted that they anticipate the quality of projects will fall as the 'easy' projects will have been achieved. The opposite is occurring.

What is now evident is that projects that have been developed through planning and assessment processes, have undergone detailed business cases and due diligence deeply contextualised in future growth plans for the regions that outline growth expectations to exceed the State growth average.

Through the Blueprint process the regions have also carefully referenced the draft State Planning Strategy and have answered key challenges in the draft State Planning Strategy around urban expansion. They have identified how the regions can become competitive in taking the pressure off urban growth and provide alternatives for living in the regions.

Draft Report: Section 4.2.9 Infrastructure: Public Private Partnerships

Recommendation 8: Expand the use and scope of PPP's to procure public infrastructure, particularly in cases that will result in core services being delivered for better value for money.

ERA comment

The ERA considers that strategic planning that facilitates contestability in service delivery has the potential to not only lower infrastructure procurement costs but can also result in a lower cost of recurrent or operating costs associated with use of that infrastructure. It notes that benefits from government services are evident from widening the use and scope of PPP procurement methods.

Trust response

The Trust concurs with Recommendation 8 and notes the regions have strongly supported this in their draft Blueprints. The Trust supports encouraging input from the private sector to provide innovative solutions to infrastructure needs and emphasises that regional Blueprints are designed to achieve this goal.