INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

24 February 2017

The Hon Scott Morrison MP
Treasurer
PO Box 6022
House of Representatives
Parliament House
Canberra ACT 2600

Treasurer,

RE: PRE-BUDGET SUBMISSION ON THE PROPOSED ESTABLISHMENT OF AN 'INFRASTRUCTURE FINANCING UNIT' (IFU)

I am writing to thank you for the various opportunities to consult with departmental officers from across Commonwealth central agencies, on your Government's proposed formation of an *'Infrastructure Financing Unit'* (IFU).

Further to those consultations, we are pleased to provide this first part of our pre-budget submission, which outlines a range of concerns about the form, function and risks posed by the IFU specifically – and of public structured finance vehicles generally.

1. OUR UNDERSTANDING OF THE FORM & FUNCTION OF THE PROPOSED IFU

From the above consultations and various government policy and media statements, we understand the following in regard to the IFU:

i. The IFU is intended to operate as a Federal Government investment '*advisor*' to '*broker*' investments in infrastructure: The Smart Cities policy states: "*The unit will create integrated project teams with the private sector and key agencies to broker investment in landmark projects through innovative financing solutions including private partnerships, balance sheet leveraging and value capture for major projects";*
ii. The IFU will direct or recommend the allocation of taxpayer funds to public infrastructure projects, such as roads, rail and airports;
iii. These funds will be structured as either debt or equity investments, not as traditional grant funding;
iv. The ability to structure Commonwealth infrastructure allocations as either equity or debt 'investments' appears to be the key driver for the IFU;
v. Structuring Federal infrastructure allocations as equity or debt allows similar accounting treatment to other 'off budget' investments (e.g. through the NAIF, the CEFC, the NBN, the WestConnex concessional loan, the National Water Infrastructure Loan Facility, etc.) – meaning these allocations have insignificant impact, or are not accounted for on the budget's bottom line;
vi. Unlike these other Commonwealth investment vehicles, the IFU will be a Unit within the Department of Prime Minister & Cabinet;

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vii. Achieving or sustaining the desired ‘off budget’ accounting treatment means that the IFU should only deploy or ‘invest’ funds where there is a reasonable prospect of debt or equity type financial return on these ‘investments’; and

viii. Irrespective of the Government’s accounting treatment, credit rating agencies will not put these allocations ‘off rating’ – they will still count against the AAA rating.

2. THE IFU DOES NOT SOLVE THE INFRASTRUCTURE PROBLEM – AND IT BRINGS MATERIAL RISKS TO TAXPAYERS

i. There is no evidence of any shortage of debt or equity finance for Australian infrastructure projects, indeed all indicators show that the appetite to invest is substantially higher than the number of investable projects; rather, there is a shortage of public and/or user funding to repay the costs of required projects;

ii. Infrastructure allocations ‘invested’ as either debt or equity require a cash flow or revenue source to repay the Commonwealth’s investment, plus a financial return;

iii. We cannot identify any currently proposed infrastructure projects which are commercially viable and not already attracting finance; therefore we cannot see how the IFU will increase the pace of infrastructure project delivery;

iv. The historically (very) high levels of traditional, private debt and equity seeking to invest in Australian infrastructure, means that the IFU’s investments - if directed to credit-worthy, commercial infrastructure projects, could only ‘crowd out’ efficient private investment;

v. If the IFU avoids ‘crowding out’, this will see it take equity or debt positions in (very) marginal and risky projects, where normal private investment is not willing to go;

vi. This would effectively see the Federal Government acting as a ‘lender of last resort’ and expose taxpayers to material risks;

vii. Commonwealth debt or equity investments provide an illusory benefit to the budget’s bottom line, but the Commonwealth is also taking equity or debt risk on complex projects – meaning that risky investments’ in marginal projects will likely never be repaid;

viii. Private equity and debt are used to allocate risk to those investors who are best placed to manage it, therefore protecting taxpayers from losses. Meanwhile, by investors having ‘skin in the game’, they are incentivised to manage risk, while also providing a basis for price and design competition;

ix. Public sector debt or equity investments – and government guarantees for private investment (balance sheet leveraging) only undermine or dull the very disciplines that see the public sector deploy (private) finance into public infrastructure in the first place;

x. As a Unit within the Department of Prime Minister & Cabinet, the IFU will also not enjoy the structural disciplines created by a fiduciary board, an investment committee or distinct financial accounts, such as exist for the NBN, CEFC, etc.; and

xi. In the event of any Government equity and debt infrastructure ‘investment’ failure, loss will accrue as future and unanticipated costs to the Commonwealth budget - with impacts on the AAA credit rating and overall fiscal position, in future years.

For these reasons we respectfully submit that:

1. The IFU should <u>not</u> be established.

We will be making a further pre-budget submission shortly, under separate cover, outlining the case for a return to Federal government policies that link enlarged funding grants to states to meaningful national reform priorities – such as the now de-funded Asset Recycling Initiative.

By your government's own estimates, the ARI unlocked circa $26 billion in state government infrastructure funding – for circa $4 billion in Commonwealth funding grants.

3. DOES THE IFU SOLVE THE INFRASTRUCTURE PROBLEM?

Australia's population growth, demographic change and economic development are placing obvious and growing pressures on infrastructure networks and systems across the country. While population growth and economic development are desirable and '*good problems to have*', the increased demand for transport, utilities and social services is not being met with corresponding infrastructure projects and reforms to cater for this growth.

In seeking to deploy Commonwealth equity or debt investments, it is important to understand the fundamental problem to be resolved.

There is no evidence whatsoever that there is a shortage of private equity or debt available for infrastructure investment.

Indeed, estimates of the available infrastructure investment not yet deployed are estimated at circa $320 billion[1] of 'dry powder'.

Indeed, the high levels of competition for greenfield projects, very low debt costs and the record prices for privatised brownfield infrastructure assets all evidence the high levels of equity and debt that are available – and the high levels of price and cost competition enjoyed by procuring governments.

Rather, it is funding for infrastructure that has been falling, in absolute and relative terms. Figure 1 below shows that only NSW has substantially lifted net investment – a direct result of that jurisdiction's major asset recycling and fiscal repair programme.

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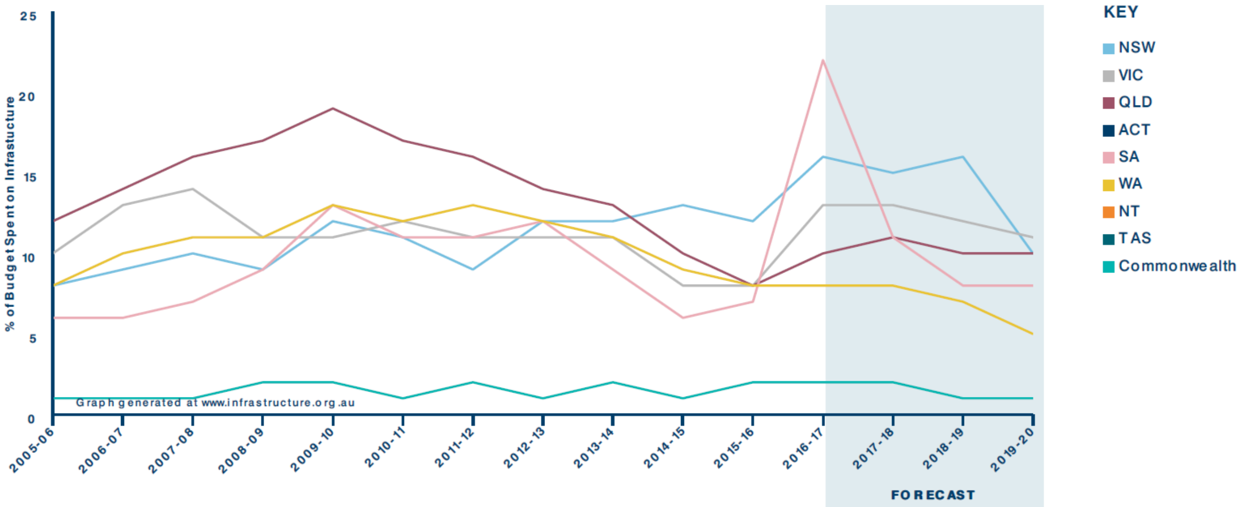
[1] Preqin Alternative Assets Data and Intelligence, Preqin Global Infrastructure Report, 2015 (assumes a gearing ratio of 60 per cent).

Figure 1: Committed Government infrastructure funding, as a percentage of General Government Expenditure



Source: Government infrastructure investment, infrastructure.org.au, accessed 23 February 2017.

4. IN INFRASTRUCTURE, PROJECT FUNDING AND PROJECT FINANCE ARE RELATED, BUT DIFFERENT CONCEPTS

The discussion about infrastructure often sees confusion between infrastructure funding, and project finance.

The Commonwealth's Infrastructure Finance Working Group report in 2012 examined these issues, finding:

> *"A major constraint on the delivery of social and economic infrastructure is the **funding** capacity of Australian governments. This is distinct from the capacity of the private sector to provide **financing** capital for infrastructure projects[2]. [my emphasis]*

And continued to note:

> *"…the IFWG sought to answer the key question: how to get the [infrastructure] market moving? …the primary issue preventing more projects coming to market was the lack of available funding.*

It is important to differentiate between **financing** and **funding**.

> *"…**funding**…refers to how infrastructure is paid for. Ultimately, there are only two sources of funding for infrastructure, government investment or direct user charges.*

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[2] Infrastructure Finance Working Group – Final Report, Infrastructure Funding and Finance Reform, 2012

> *"…**financing** refers to the way debt and/or equity is raised for the delivery and operation of an infrastructure project."* [3]

Financing refers to the supply of capital, such as debt and equity, used to pay for the upfront investment cost of an infrastructure project.

Funding is the cash flow then used to pay back the money raised through the initial financing.

As it stands, the most important dissimilarity between funding and financing is that there exists a shortage of funding, whereas financing remains abundant.

Therefore, we submit that a government financing policy solves the infrastructure problem we don't have – and ignores the one we do – a lack of capacity to repay the costs of the infrastructure we need.

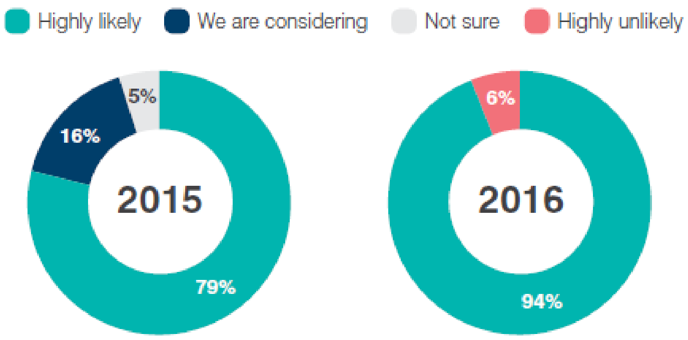
5. IF THE IFU SELECTS SOUND PROJECT INVESTMENTS, IT IS CROWDING OUT EFFICIENT PRIVATE INVESTMENT…

In an environment of capital market volatility and low interest rates, infrastructure continues to stand out as an attractive asset class to both domestic and international investors, as it offers comparatively stable returns in predominantly regulated, natural monopoly sectors.

In a global context, Australia stands out as a desirable destination to invest in infrastructure due to economic stability, mature market structures and successful track record in delivering projects.

Our 2016 *Australian Infrastructure Investment Report* surveyed major Australian and international infrastructure investors, finding 94 per cent of respondents were "highly likely" to invest in Australia, an increase from 79 per cent in the previous year, as seen in Figure 2 below.

Figure 2: Likelihood to invest in Australian infrastructure

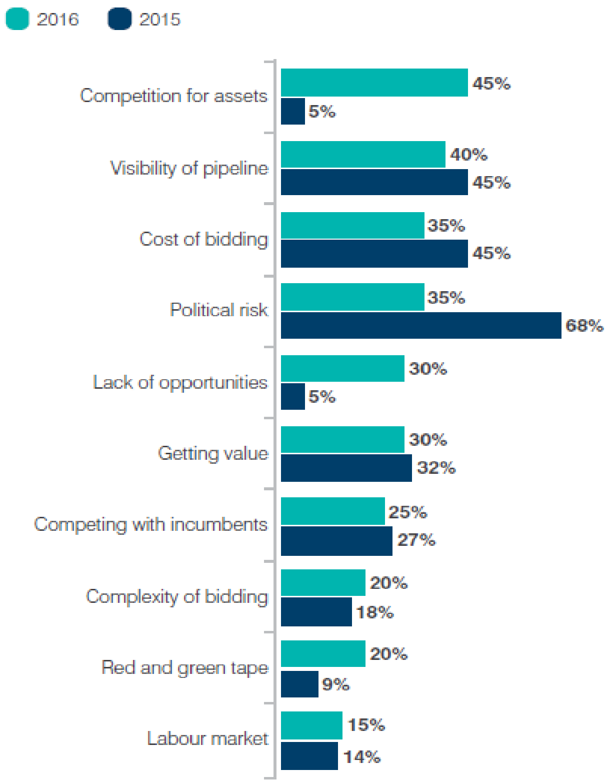


Source: Australian Infrastructure Investment Report, 2016

[3] Infrastructure Finance Working Group – Final Report, Infrastructure Funding and Finance Reform, 2012

Because Australia is an increasingly attractive investment destination relative to other markets, the leading barrier for investing in Australian infrastructure in 2016 was "competition for assets" (45 per cent), which was ahead of "lack of opportunities" and "cost of bidding", as seen in Figure 3 below:

Figure 3: Challenges to investing in Australian infrastructure



Source: Australian Infrastructure Investment Report, 2016

This high level of observed appetite – and broad investor concerns about high levels of investment competition versus too few infrastructure investment opportunities and projects – demonstrates again that there is no shortage of existing, traditional debt and equity finance.

Case Study: WestConnex

The recently released Australian National Audit Office (ANAO) report on WestConnex found that Stage 2 of the project, costing an estimated $4.5 billion, did not require the $2 billion Commonwealth concessional loan. The report found that *"financing could have been obtained from private sector lenders and through the privatisation of Stage 1."*[4]

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[4] Australian National Audit Office, The Approval and Administration of Commonwealth Funding for the WestConnex Project, Page 43, 2017, Barton

The Audit Office found that the concessional loan was motivated by the better net final *presentation* of the Federal Budget[5], with project outcomes secondary to the appearance of an improved budget bottom line.

The loan made even after WestConnex's own financing strategy for the project advised that: *"no further State (or Commonwealth Government) financing is required to deliver WestConnex"*[6].

The Audit Office found that Commonwealth Government financing did crowd out private finance, did not benefit the project and did not deliver value for money.

6. IF THE IFU AVOIDS CROWDING OUT PRIVATE CAPITAL, IT WILL BE ACTING AS THE LENDER OF LAST RESORT ON (VERY) MARGINAL PROJECTS…

To structure its allocations as equity or debt, the Commonwealth must have a prospect of a commercial return – in other words, in commercially viable projects. A project is commercially viable if it can generate sufficient revenue to sustain the costs associated with the construction, finance, operation and maintenance of the asset, plus a reasonable rate of return.

The high availability and appetite for private investment in public infrastructure means that viable projects will already command high levels of interest. If the Commonwealth seeks to avoid 'crowding out' this existing private finance, it will naturally see taxpayer finance flow to projects that are so commercially risky or marginal (even if the economic benefit is high) that private investors will not touch them.

Such remaining projects available for investment would see a mixture of very low rates of return (or negative returns) and inappropriate risk profiles.

Case Study: State Bank of South Australia & Tricontinental Merchant Bank (Victoria)

The 1980s saw the South Australian and Victorian governments experiment with government debt and equity investments.

The State Bank of South Australia was created in 1984 and owned by the South Australian Government. The bank financed projects such as[7]:

- the renovation of London's Wembley Stadium;
- the (Rundle Mall) Myer complex;
- apartment constructions in New York, Sydney and Melbourne (mezzanine financing); and
- holiday resorts on the Gold Coast.

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[5] Australian National Audit Office, The Approval and Administration of Commonwealth Funding for the WestConnex Project, Page 38, 2017, Barton ACT

[6] Australian National Audit Office, The Approval and Administration of Commonwealth Funding for the WestConnex Project, Page 43, 2017, Barton ACT

[7] McCarthy, G., Things Fall Apart: A History of the State Bank of South Australia, 2002, Adelaide.

In 1991 the bank collapsed under a weight of failed investments, which exceeded 30 per cent of the bank's loan book. The South Australian Auditor-General found that "*a contributing cause of the institution's financial failure*" was the failure by government sector to manage the complex investment risks including debt, capital, interest rate and liquidity risk to the Government bank[8].

In 1991 the findings of a Royal Commission into the collapse found that the bank had lost $3.15 billion in government-guaranteed funds[9].

Victoria's Cain Government also experimented with Government investment mechanisms when faced with challenging fiscal realities; a policy which saw TriContinental, the State Banks's investment banking division, also collapse under bad loans.

The Victorian Auditor-General found that the losses cost Victorian taxpayers some $3.1 billion[10].

Each of these examples provide cautionary examples for the Commonwealth in pursuing structured investment vehicles.

Case Study: The Northern Australia Infrastructure Facility (NAIF)

The Northern Australia Infrastructure Facility (NAIF) is yet to issue a single loan – showing that Commonwealth equity or debt does not answer a gap in capital markets.

The NAIF provides for some $5 billion (in aggregate) in concessional finance for economic infrastructure projects in Northern Australia. Sensibly, the NAIF Investment Mandate does not seek to crowd out private sector investment – but seeks to achieve the impossible – by investing in commercially responsible projects, but only where private finance is not available or complete.

The mandate limits the NAIF to only lend where:
"The project is unlikely to proceed, or only at a much later date, or with a limited scope without NAIF financial assistance[11].

But this criterion is balanced against other criteria which seek to protect taxpayers from loss, by requiring that any NAIF finance:

"…will be able to be repaid, or refinanced[12].

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[8] South Australia Auditor-General's Department, Report of the Auditor-General on an investigation into the State Bank of South Australia (The MacPherson Report), 1993, Adelaide.
[9] South Australian Government, Royal Commission into the State Bank of South Australia, 1993, Adelaide.
[10] Victorian Auditor-General's Department, Report of the Auditor-General on the Finance Statement (year ending 30 June 1991), 1991, Melbourne.
[11] Northern Australia Infrastructure Facility Investment Mandate Direction 2016 (criterion 3).
[12] Northern Australia Infrastructure Facility Investment Mandate Direction 2016 (criteria 5 and 6).

The mandate also requires that at least 50 per cent of the debt for any project must be sourced from traditional debt lenders – ensuring commercial due diligence for the debt alongside the NAIF finance.

Significantly, this criterion means that the project must be commercially viable. However, in the context of the previously mentioned criteria, the project cannot be commercially viable to the extent it will be progressed without a concessional loan.

At best, this leaves a very narrow set of circumstances within which a project will attract NAIF financing – or benefit from it.

The NAIF has yet to make a single loan. Indeed, it is hard to envisage many or any appearing, before the NAIF winds up in June 2021.

This evidences the reality – public sector finance solves problems we do not have - and exposes taxpayers to risks they do not need.

Where projects exist in Northern Australia – or anywhere else – which are not commercially viable but serve important economic or social needs, it is funding, not finance, that is needed to fill the gap.

7. THE IFU COULD UNDERMINE THE VERY DISCIPLINES AND BENEFITS THAT SEE GOVERNMENTS USE PRIVATE FINANCE IN THE FIRST PLACE

Private finance is (slightly) more expensive than public sector borrowings, but private investment in public infrastructure routinely sees substantially lower construction and operating costs than traditional government delivery models, because of the disciplines and risk allocations created when infrastructure developers have ‘skin in the game’ – in the form of equity and debt risk.

Project financing models such as Public Private Partnerships (PPPs) are a risk allocation model, and not usually a funding model.

Infrastructure projects are by nature highly complex and exposed to a great deal of risk across the life of an asset, particularly during the greenfield construction phase. One of the objectives of capital structures like PPPs is to transfer these risks away from taxpayers.

In simple terms, PPP procurements see multiple consortia that include equity from project developers and debt provided by banks. The drive by equity to ‘win’ the tender creates a very powerful incentive for excellent design and service outcomes – at best cost; while the debt lenders in each consortia provide discipline on equity, through due diligence on operational and construction risks.

This threat of extinction or financial loss has proved a powerful mechanism to align private value to the public good needed from infrastructure projects.

It is unlikely, for example, that the IFU could house the depth of experience in major Australian and international construction and equity investment – or replace the detailed due diligence of major bank lenders.

It is hard then to understand the benefit of Federal Government equity and debt investments, which would serve to blunt or remove the incentives and disciplines created by private investment.

Indeed, even sophisticated and experienced investors make errors – and the Commonwealth should reflect on the large scale project failures that have happened even without government finance. Examples include:

- The Lane Cove Tunnel;
- The Cross City Tunnel;
- Clem7 Brisbane; and
- Brisbane Airport Link Tunnel.

However, at its core, project finance models such as PPPs have been successful because they set clear goals and clear roles and responsibilities between the government and private sector – with money at risk for the private sector if they get it wrong.

It is hard to see the benefits of Federal equity and debt investment into project vehicles – but it is very easy to see the risks.

8. CONCLUSION

The realities of a complex fiscal, economic, demographic and political environment see substantial pressures on governments to 'fix' infrastructure – but a high degree of resistance to the structural and market reforms needed to achieve this aim.

The pressure on the AAA, ongoing deficits and various budget policy commitments see a very strong focus on the budget's bottom line position – making the prospect of infrastructure 'investment' attractive in terms of budget reporting.

However, as noted throughout this submission we can see little by way of actual economic or social benefit – but much in terms of potential risks to the taxpayer.

Commonwealth Government funding support *is* needed for infrastructure – Commonwealth *financing* is not.

If the budget seeks to materially increase the pace, quality and scale of national infrastructure investment we respectfully submit that Government policy needs to return to real options, which include grant funding and should also include national government incentives linked to state government asset recycling, fiscal repair strategies, or through the development of well structured, well-articulated infrastructure markets.

Thank you for your consideration of this submission – I hope that it informs this issue for the Cabinet and your Government – and I will seek meetings to discuss this issue with you as soon as practicable.

Yours sincerely,

BRENDAN LYON
Chief Executive Officer

cc: The Hon Malcolm Turnbull MP, Prime Minister
The Hon Barnaby Joyce MP, Deputy Prime Minister, Leader of the National Party
The Hon Julie Bishop, Deputy Leader of the Liberal Party
Senator Fiona Nash, Deputy Leader of the Nationals
The Hon Darren Chester MP, Minister for Infrastructure and Transport
Senator The Hon Mathias Cormann, Minister for Finance
The Hon Paul Fletcher MP, Minister for Urban Infrastructure
Dr Martin Parkinson AC PSM, Secretary, Department of Prime Minister and Cabinet
Mr John Fraser, Secretary, the Treasury
Mr Mike Mrdak AO, Secretary, Department of Infrastructure & Regional Development
Ms Rosemary Huxtable PSM, Secretary, Department of Finance