31 January 2019

The Hon Josh Frydenberg MP
Treasurer
PO Box 6022
House of Representatives
Parliament House
Canberra ACT 2600

Treasurer,

RE: SUBMISSION TO THE 2019-20 FEDERAL BUDGET

Infrastructure Partnerships Australia is pleased to make this submission to your upcoming 2019-20 Federal Budget. Our submission focuses on funding and reform strategies for public infrastructure, the benefits of state asset recycling policies and the Federal Government's Asset Recycling Initiative (ARI).

With many asset recycling transactions now complete and the proceeds of these transactions having flown through to projects, it is appropriate timing for the Federal Government to revisit its role in promoting asset recycling and driving microeconomic reform. The effectiveness of asset recycling in generating additional funding capacity for new infrastructure projects has become clear over recent years. Multiple states and territories have benefited from asset recycling and have been able to accelerate investment across the infrastructure sector including in health, education and transport.

The overall weight of evidence points to the substantial success of asset recycling programs and particularly to increased investment in both social and economic infrastructure. Even so, there are a variety of lessons to be derived from the process of divesting or leasing and then reinvesting in infrastructure. Taking these lessons into account, specific improvements should be applied to future transactions to achieve even better outcomes.

This submission provides analysis of infrastructure funding levels in New South Wales and Victoria and explains the role of asset recycling in enabling substantial funding increases. Additionally, our analysis examines the role of the Federal Government's ARI in supporting successful state asset recycling programmes.

Recommendation

The 2019-20 Federal Budget should reinstitute the ARI to incentivise reform at the state and territory level. This should include reopening the Asset Recycling Fund to encourage

states and territories to pursue ownership reform and reinvest transaction proceeds into infrastructure. Furthermore, incentive payments should be extended to promote other reforms in the infrastructure sector including franchising or introducing contestability into public service provision.

Asset recycling as economic stimulus

Since the decline of the capital phase of the mining boom, public infrastructure funding has emerged as one of the key drivers of growth in the Australian economy. NSW and Victoria have significantly increased their infrastructure funding levels over the past five years. This increase in infrastructure funding has been necessary to accommodate Australia's growing population, particularly in Sydney and Melbourne, as well as to make up for underinvestment in infrastructure over previous decades.

To support increased infrastructure funding, both NSW and Victoria have embarked on programmes of asset recycling. Asset recycling consists of privatisation or long-term leasing of taxpayer owned assets, with the proceeds used to fund new or upgraded infrastructure. Examples include the long-term leases of electricity networks in NSW, and the Port of Melbourne in Victoria. Asset recycling positively impacts the economy in two key ways:

1. under performing public assets improve their operational efficiency under private ownership and management, and
2. reinvestment of the proceeds in new infrastructure stimulates the economy.

In this way, asset recycling has a dual benefit to the economy, whereby existing infrastructure assets become more efficient, while at the same time making funding available to pursue new projects. Infrastructure Australia recommended in its 2016 Australian Infrastructure Plan that the Federal Government 'should continue providing incentives for state and territory governments to improve the efficiency of their balance sheets by recycling appropriate publicly-owned assets to fund investments in productive infrastructure.'[1]

The Federal Government's Asset Recycling Initiative

The ARI was announced in the Federal Government's 2014-15 Budget, and consisted of $5 billion to incentivise states and territories to sell mature assets and reinvest the proceeds into infrastructure projects. Through the ARI, the Federal Government successfully leveraged a relatively small incentive funding pool to unlock tens of billions of dollars in new infrastructure funding across Australia.

In agreement with the Federal Government, states and territories could receive a bonus of up to 15 per cent of the assessed sale value, on the condition transaction proceeds were used to fund infrastructure. However, ARI payments would not be paid to states

[1] Infrastructure Australia, 2016, *Australian Infrastructure Plan,* p.91.

who sold assets to reduce state debt or to fund recurrent expenditure. In launching the ARI the Federal Government used asset recycling by divesting Medibank through an initial public offering and using the proceeds to fund ARI payments.

The ARI payments were important to incentivise states to recycle assets because it compensated them for lost tax equivalent payments. State-owned corporations are required to pay equivalent company tax (and dividends) to the relevant state government to ensure competitive neutrality across the public and private sectors. However, once state-owned corporations are privatised, they start paying company tax to the Federal Government instead.

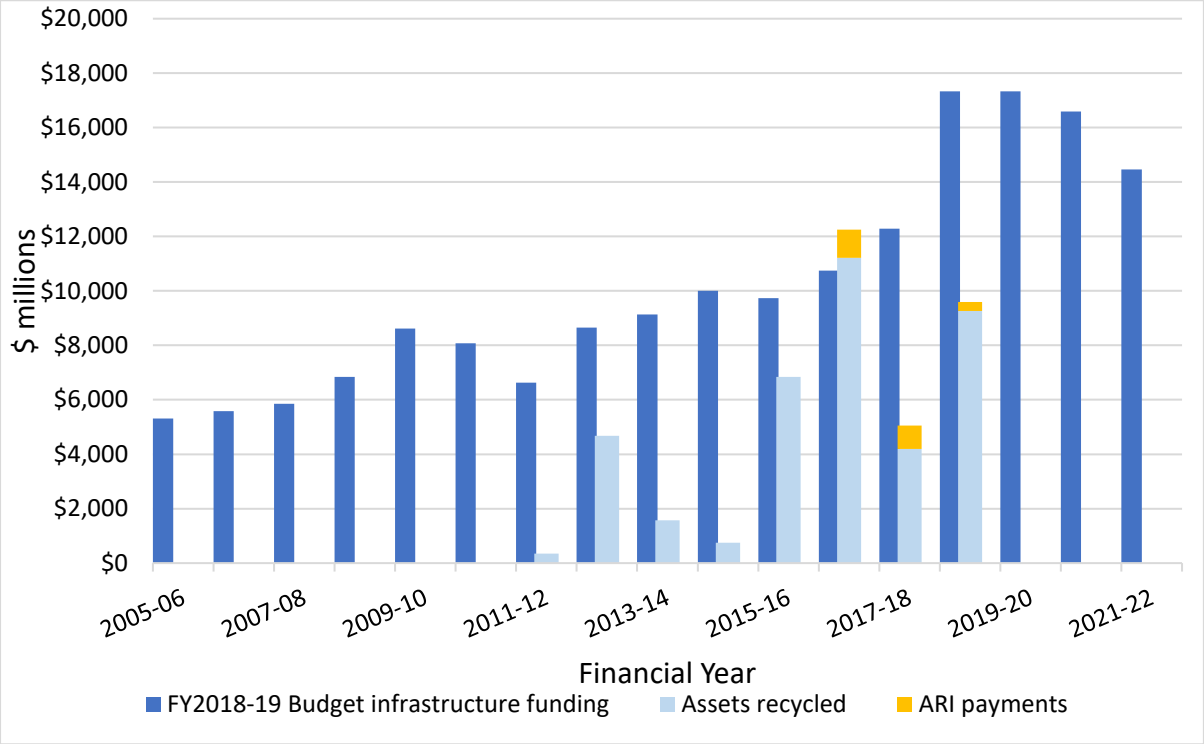
Despite the ARI's success, the Federal Government closed the fund after distributing only $3.6 billion of the initial $5 billion funding allocation to NSW, the Northern Territory and the ACT. NSW has been the biggest beneficiary of the scheme, having received ARI payments totalling $2.2 billion over the period FY2016-17 to FY2018-19. Subsequent to the closure of the ARI, the Victorian Government received $877.5 million from the Federal Government, which effectively brings the total amount of bonus payments made for asset recycling to $4.5 billion.

NSW's asset recycling programme

NSW has increased its infrastructure funding levels in recent years. Figure 1 shows infrastructure funding by the NSW Government since FY2005-06. While it is clear the absolute value of infrastructure funding has increased, we also note that the share of the budget dedicated to infrastructure has also increased substantially. This indicates that higher infrastructure funding is not just an outcome of a growing economy, but reflects an increase to the relative importance of infrastructure funding within the Government's expenditure strategy. In the 2005-06 NSW Budget, an average of nine per cent of expenditure was allocated to infrastructure over the four years, a stark contrast to the four year average of 17.65 per cent of expenditure allocated in the 2018-19 NSW Budget.

These increases in infrastructure funding have been underpinned by asset recycling. When the schedule of inflows from asset divestments is compared to NSW Government infrastructure funding, there is a clear correlation between asset divestments and an increase in infrastructure funding. Figure 1 shows NSW's infrastructure funding along with asset recycling net proceeds. In NSW, asset recycling proceeds are reflected in higher infrastructure funding in subsequent years.

Figure 1: NSW infrastructure funding 2018-19 Budget compared to asset recycling net proceeds, ($ millions, constant prices)*



Source: IPA Analysis

**excluding $408.6m of miscellaneous asset recycling proceeds*

Importantly, fiscal discipline in NSW has not been compromised as a result of increased infrastructure funding. In 2012, the Fiscal Responsibility Act (FRA) was legislated to protect the State's triple-A credit rating. This provides a framework and strategy for fiscal responsibility, including a target to ensure expense growth is below long-term revenue growth. The FRA makes NSW unique in Australia as the only jurisdiction required by legislation to maintain a triple-A credit rating. Since 2012, the NSW Government has met the FRA requirements, enabling the State to fund the infrastructure boom through continued fiscal discipline and its asset recycling programme.

The NSW Government has had a clear strategy in both its divestment of assets as well as protecting the proceeds. The proceeds have been ring-fenced using the Restart NSW Fund, which requires projects to demonstrate a net economic benefit to receive funding. The NSW Government also established the NSW Infrastructure Future Fund (NIFF) in December 2016 as an investment vehicle for Restart NSW proceeds. These proceeds are put into a range of financial assets with a higher earning potential than cash deposits and an investment horizon that matches the committed Restart NSW and Rebuilding NSW capital expenditure profiles. Earnings from the NIFF support the delivery of the Government's Restart NSW and Rebuilding NSW infrastructure programmes.

To date, the NSW Government has received $24 billion of net proceeds (in nominal prices) from asset recycling, not including the sale of 51 per cent of Sydney Motorway

Corporation or NSW's share in Snowy Hydro. In addition to this, NSW has received $2.2 billion in ARI payments from the Federal Government.

In total, $32.9 billion has been deposited into the Restart NSW Fund since its establishment in 2011 up until June 2018, of which asset recycling windfalls have made up the majority. Figure 2 summarises asset recycling contributions to Restart NSW.

Figure 2: Restart NSW Asset Recycling Inflows

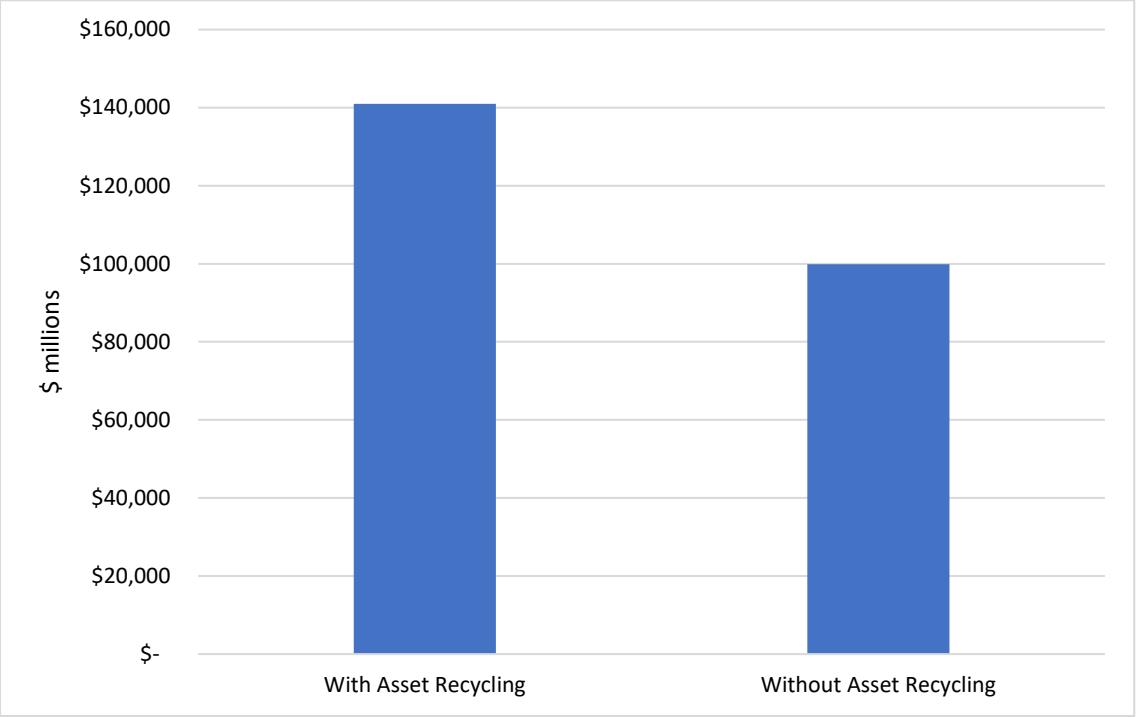
Asset	Net amount, $ million (nominal prices)	Financial Year
Transgrid	$6,578.6	FY2015-16
Ausgrid	$5,561.4	FY2016-17
Port Botany and Port Kembla	$4,252.9	FY2012-13
Endeavour Energy	$2,841.9	FY2016-17
Land and Property Information	$2,606.8	FY2016-17
Newcastle Port	$1,474.6	FY2013-14
Macquarie Generation	$713.6	FY2014-15
Sydney Desalination Plant	$312.0	FY2011-12
Other	$408.6	Various

Source: NSW Budget 2018-19

It must also be noted that recent sales of 51 per cent of Sydney Motorway Corporation (SMC) and NSW's share of Snowy Hydro are not included in Figure 2, although the NSW Government has announced that these funds will also be used for infrastructure. SMC proceeds will be used to fund WestConnex Stage 3 (M4-M5 Link) and other projects. Snowy Hydro sales proceeds will be managed separately to Restart NSW, with the NSW Government establishing the Snowy Hydro Legacy Fund for regional infrastructure, valued at $4.2 billion.

Looking forward, NSW has capacity to pursue further asset recycling through divestments of assets such as the remaining 49 per cent of SMC or the NSW Government's remaining stakes in electricity networks such as Ausgrid and Endeavour Energy.

Figure 3: Asset Recycling has boosted infrastructure funding in NSW FY2010-11 to FY2021-22 ($ millions, constant prices)



Source: IPA Analysis

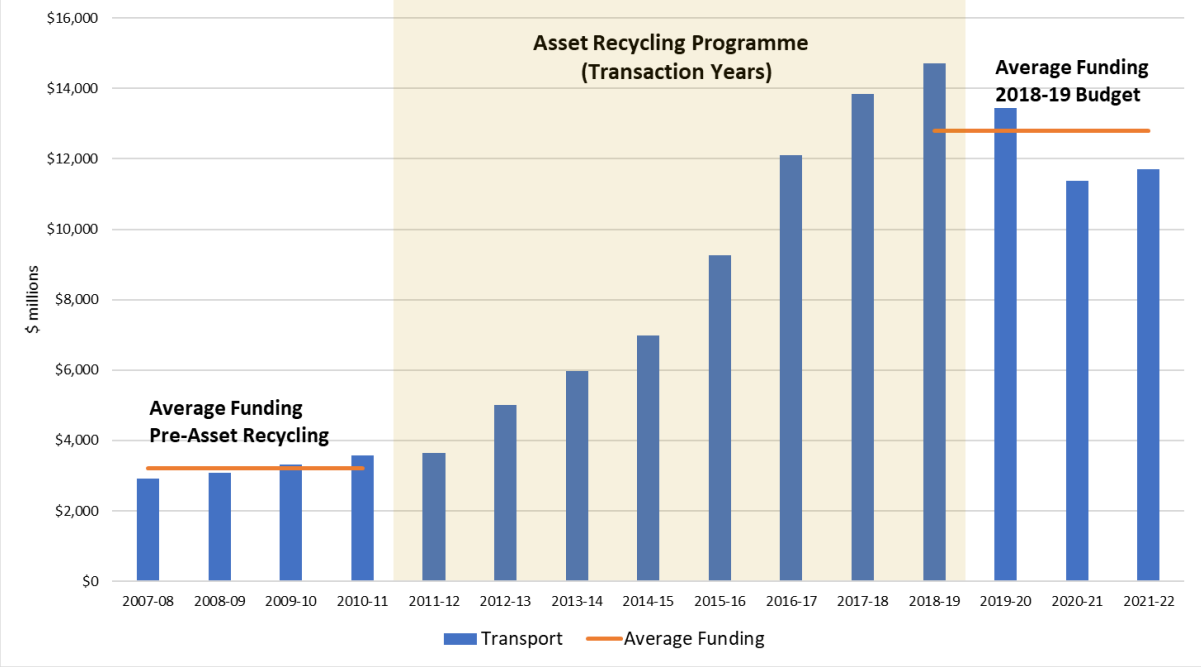
NSW taxpayers have benefited enormously from asset recycling, with the State's infrastructure funding increasing significantly as a result (see Figure 3). In total NSW has received $2.2 billion in bonus payments and circa $38 billion (nominal prices) in net proceeds as a result of its asset recycling programme. This amount is equivalent to the first two parts of the Sydney Metro, Northconnex and the next four years of health and education infrastructure spending. Perhaps most importantly, this additional infrastructure funding has not been the result of increases to taxation or government borrowings.

Although the ARI has been a valuable incentive for asset recycling in NSW, it is important to note that the State had already benefited from previous divestments, such as the leases of Port Botany and Port Kembla for $4.25 billion and $713.6 million for the sale of Macquarie Generation, in FY2012-13 and FY2014-15 respectively.

Infrastructure funding has increased across a range of sectors in NSW

Since first being elected in March 2011, the NSW Government has significantly increased transport infrastructure funding. Figure 4 shows the budget allocations for transport infrastructure as well as averages for selected periods. $14.7 billion in general government expenditure was allocated to transport infrastructure in FY2018-19. This is five times the funding (in real terms) that was committed to transport infrastructure in FY2007-08.

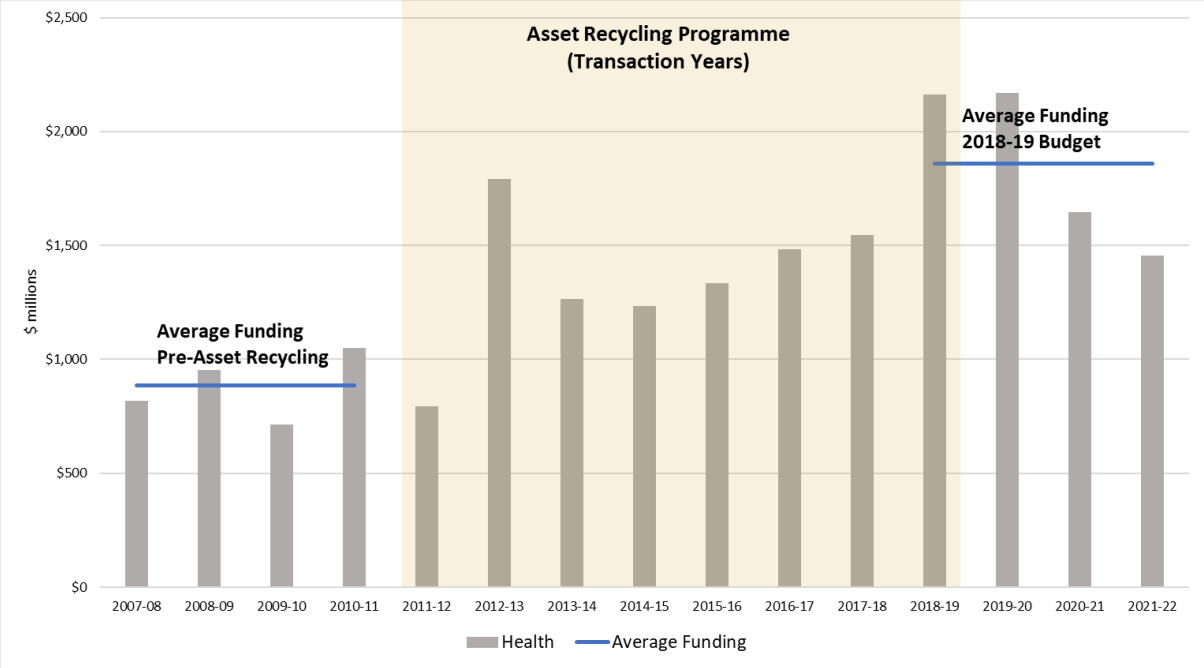
Figure 4: NSW Transport infrastructure budget allocations ($ millions, constant prices)



Source: IPA Analysis

The story is similar for other sectors such as health and education, which have also seen significant increases. Health has seen over 160 per cent (real terms) increase in infrastructure funding in FY2018-19 compared to FY2007-08 (see Figure 5).

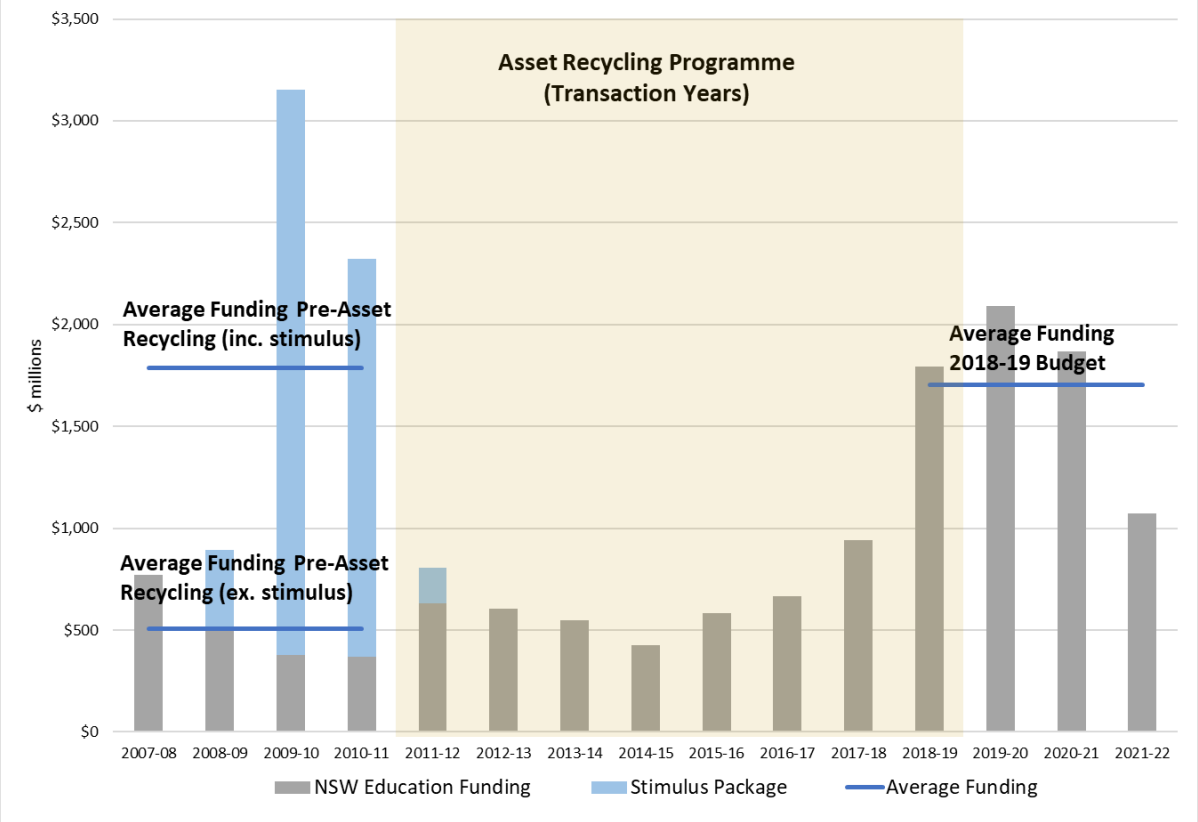
Figure 5: NSW health infrastructure budget allocations ($ millions, constant prices)



Source: IPA Analysis

Similarly funding for education infrastructure has increased 130 per cent (in real terms) from FY2007-08 to FY2018-19. In Figure 6, the average education funding from FY2007-08 to FY2010-11 is artificially high due to the Federal Government stimulus plan, which included $14.7 billion in school infrastructure funding under the Building the Education Revolution policy. Over FY2008-09 to FY2011-12, NSW was allocated over $4.5 billion ($5.2 billion in today's dollars) from the Federal Government. This year's Budget has matched the high bar set by the stimulus package.

Figure 6: NSW education infrastructure budget allocations ($ millions, constant prices)

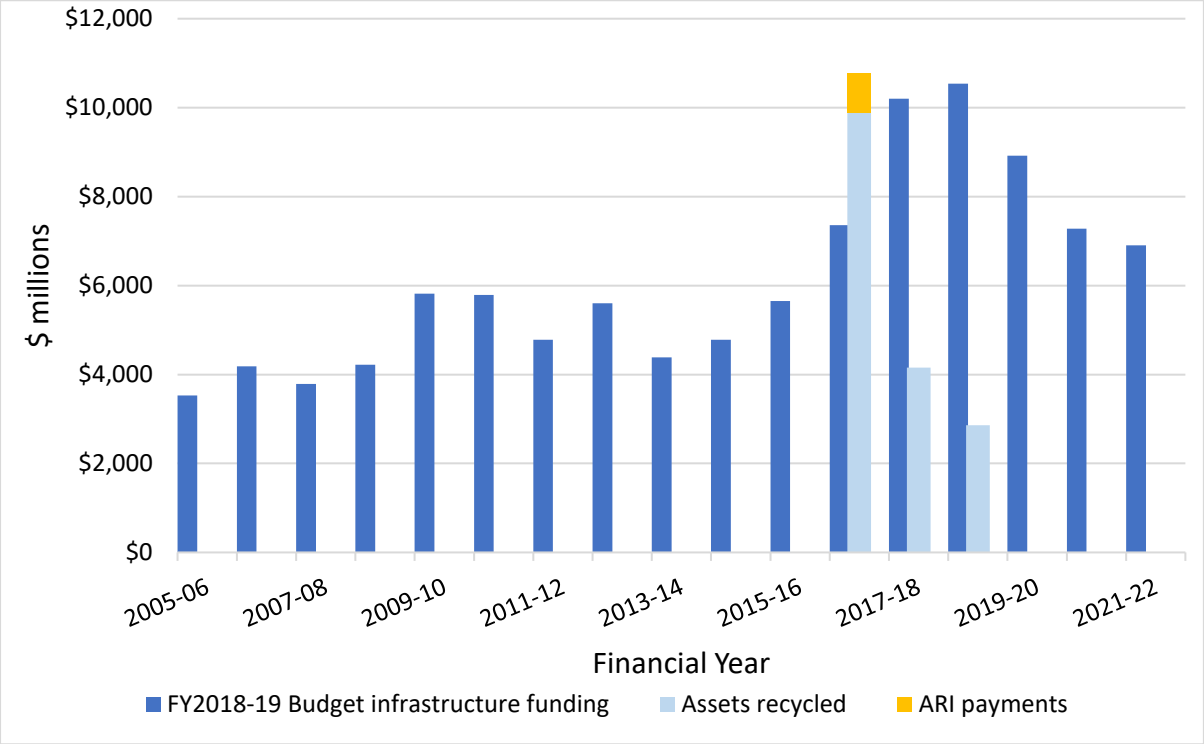


Source: IPA Analysis

Victoria's asset recycling programme

Victoria has also seen a noticeable increase in infrastructure funding in recent years (see Figure 8). In the 2005-06 Victorian Budget, a four year average of 8.5 per cent of general government expenditure was allocated towards infrastructure, compared to a four year average of 11.77 per cent in the 2018-19 Victorian Budget.

Figure 8: Victorian infrastructure funding 2018-19 Budget compared to asset recycling net proceeds, ($ millions, constant prices)



Source: IPA Analysis

Figure 8 also shows the timing of Victoria's asset recycling programme in relation to its infrastructure funding levels. Victoria has significantly increased its infrastructure funding, having received circa $14.6 billion (nominal prices) in proceeds from asset recycling (see Figure 9). In addition, the Federal Government provided $877.5 million in asset recycling bonus payments to Victoria. This bonus payment was not formally part of the ARI, due to delays resulting from the Federal and Victorian governments renegotiating which projects would be funded. In FY2018-19, $10.5 billion was allocated to general government infrastructure funding, compared to just $4.8 billion in FY2014-15.

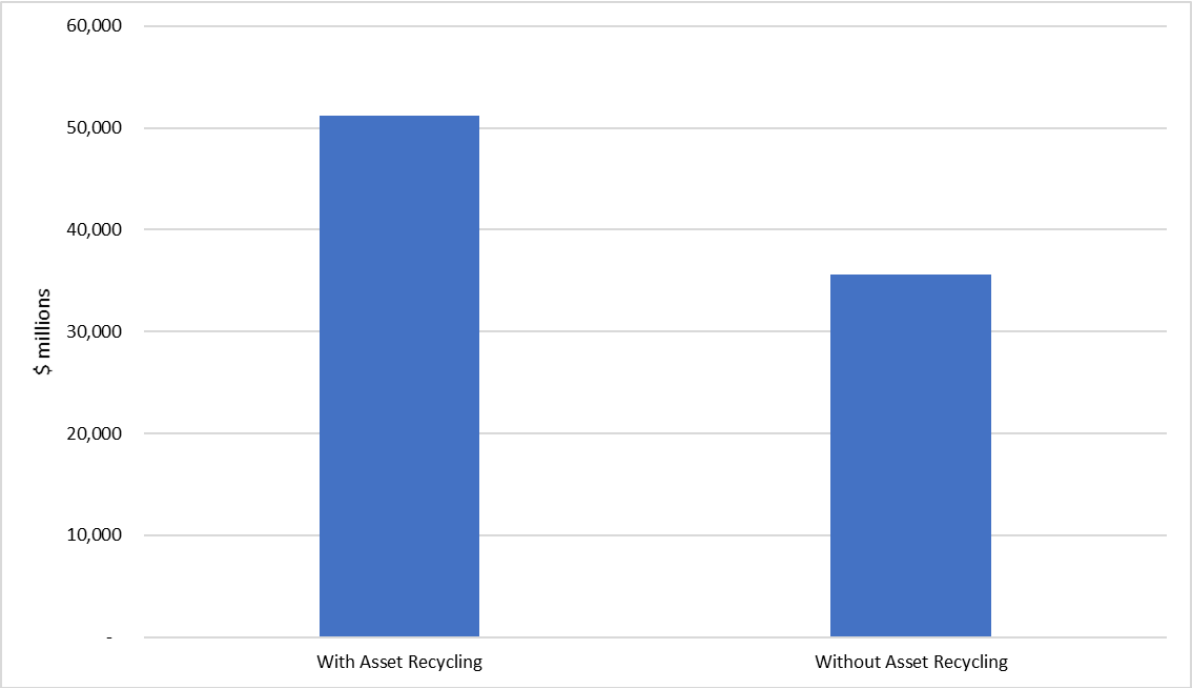
Figure 9: Victorian Asset Recycling

Asset	$ million, net proceeds (nominal prices)	Financial Year
Port of Melbourne	$9,700	FY2016-17
Snowy Hydro	$2,080	FY2017-18
Land Use Victoria	$2,860	FY2018-19

Proceeds from Victoria's asset recycling programme have been earmarked for infrastructure funding. Port of Melbourne proceeds are funding transport infrastructure across Victoria, including 10 per cent dedicated to regional infrastructure. Similarly, over half of the Snowy Hydro transaction proceeds will be allocated to regional infrastructure, with the remainder going towards school infrastructure.

Figure 10 below shows the difference asset recycling has made to the infrastructure funding budget for Victoria.

Figure 10: Asset Recycling has boosted infrastructure funding in Victoria FY2016-17 to FY2021-22 ($ millions, constant prices)



Source: IPA Analysis

Victoria's asset recycling programme has not been as large as the NSW programme, which is partly due to Victoria having fewer assets available to divest. Victoria is already benefiting from reforms undertaken in the 1990s and 2000s, which included the privatisation of the electricity industry in 1995. Since then, studies have consistently shown that Victoria's electricity network is more efficient[2], with less excess investment in the regulated asset base (poles and wires), and more investment in innovations such as smart meters and flexible pricing.[3]

Victoria also benefits from franchising of public transport services, including trams and trains. The private operators of the transport services continue to meet contracted performance targets, such as punctuality, unlike publicly operated buses and regional and intercity trains in NSW[4].

[2] Infrastructrue Australia, *Australian Infrastructure Plan, p.103.*
[3] Grattan Institute, 2018, *Down to the wire: A sustainable electricity network for Australia,* pp.10, 38.
[4] Audit Office of NSW, 2017, *Report on Transport 2017,* pp.19, 21.

Asset recycling could help other states

The current infrastructure boom is not evenly spread across Australian states and territories. Queensland and Western Australia have struggled to maintain current levels of infrastructure funding growth over the past few years, and have in fact seen decreases over the past decade. Both states have been heavily constrained fiscally, with relatively elevated levels of state debt. Critically, Queensland has ruled out asset recycling as a method to fund infrastructure.

Although the proceeds are not earmarked to fund public infrastructure projects, Western Australia is progressing with some small transactions such as WA TAB and Landgate. The proceeds from the Landgate transaction will be used to fund the National Redress Scheme and the State Government's decision to remove limitation periods for all child sexual abuse actions. Proceeds from the WA TAB will see 35 per cent allocated towards racing infrastructure, with the rest yet to be allocated to specific expenditure items.

An asset recycling programme in these states would considerably improve infrastructure funding capacity. Leasing state-owned assets to the private sector would also result in more efficient operation of those assets, which would benefit end-users. Additionally, the proceeds that the state governments would receive from the transactions, if used appropriately to fund infrastructure, would stimulate the economy. This stimulus would be immediate through construction, as well as longer term through new infrastructure capacity and improved efficiency.

For more detailed information on infrastructure funding across the state and territories, please see our Infrastructure Budget Monitor.

Conclusion

Funding infrastructure is crucial for the economic growth and continued prosperity of Australia. Historic underinvestment coupled with high population growth have resulted in an urgent need to build and improve our infrastructure. Given this large task, it is vital to explore available options to fund infrastructure in a sustainable way.

Asset recycling has played a critical role in facilitating large increases in infrastructure funding across NSW and Victoria. Recycling assets raises funding capacity, while also improving operations of underperforming assets, through efficient private ownership and management. Transaction proceeds are reinvested as infrastructure funding providing immediate stimulus as well as improved long-term economic outcomes. Infrastructure Australia notes that 'recycling capital represents a valuable reform and funding tool as it can help complete efficient regulated markets and release substantial capital to be reinvested in productive infrastructure.'[5]

Despite the benefits of asset recycling, many states and territories have been slow to pursue the policy as part of their infrastructure funding mix. In this context, the Federal

[5] Infrastructure Australia, 2016, *Australian Infrastructure Plan,* p.91.

Government can play a leadership role by reintroducing incentive-based programmes similar to the Asset Recycling Initiative to advance reforms in infrastructure across the states and territories. This should include reopening the ARI, as well as other programmes to encourage broader reforms such as franchising or introducing contestability into public service provision.

Yours sincerely,

Adrian Dwyer

Chief Executive Officer