AUSTRALIAN CHAMBER OF COMMERCE AND INDUSTRY

Submission to Senate Economics References Committee: Infrastructure Provision and Financing

January 2015

EXECUTIVE SUMMARY AND LIST OF RECOMMENDATIONS

A growing population and the depreciation of existing assets over time mean that without adequate investment, the stock of infrastructure on a per capita basis will be diluted over time and this has serious implications for economic growth and living standards.

There are a number of challenges facing Australian governments in providing the infrastructure necessary to increase national productivity and living standards.

An ageing population and growing community expectations mean scarce government revenue will be applied to an ever-growing list of demands and a growing proportion of the population that is dependent on the budget for income and the provision of public services, while the capacity to raise taxation revenue will be diminished by a falling share of the population in the workforce. There is little choice but to increase private sector involvement in infrastructure provision, management and funding.

This submission outlines suggestions on how to increase the role of the private sector in financing infrastructure and relieve pressure on government budgets.

Recommendation 1: The role of the private sector
The private sector should be engaged to the maximum extent possible in the financing, construction, operation and maintenance of infrastructure assets.

Recommendation 2: The role for governments
Governments should:
- Facilitate private sector investment
- Ensure competition and contestability occur to the maximum extent possible at every stage of the process
- Establish sound regulatory pricing regimes where competition is not prevalent
- Ensure that public non-financial corporations do not compete unfairly against the private sector

Recommendation 3: User charging should be preferred funding option
The first option for governments should be to apply direct user-charges:
- Where competitive markets are already operating and functioning well, the most preferable option is for governments to apply user-charges as broadly as possible.
- Where there is currently no functioning market for a particular type of infrastructure, governments should act to establish a regulatory pricing and service regime so that user-charging can be applied.

Recommendation 4: Alternatives to user charging
If user-charging is not feasible, value capture options, such as hypothecated area levies or land-tax increases should be investigated as a second-best option.

If user-charging and value capture options are not feasible then governments should look at asset recycling in preference to general taxation or borrowing or to fund infrastructure.

Only once all other options have been exhausted should governments consider taxation or public debt funding.

Recommendation 5: National User-charging framework
Federal, State and Territory governments should seek agreement through the Council of Australian Governments (COAG) on a process to develop a national user-charging framework for large-scale road projects.

Recommendation 6: Infrastructure Australia to research a national framework for value capture
In addition to pursuing a national user-charging framework for large scale projects, the Federal government should:

- Issue a directive to Infrastructure Australia to set a research agenda on how best to apply value capture methods to various types of infrastructure projects and
- Work with State and Territory governments to develop a nationally coordinated framework for value capture initiatives.

Recommendation 7: Establish quarantined structured investment vehicles for infrastructure projects
To increase the attractiveness of infrastructure investment to the private sector, governments should consider establishing quarantined structured investment vehicles, with all borrowings hypothecated to particular projects.

The Federal government should:

- Offer different tranches of senior and subordinated debt instruments, hybrid securities and other options to cater for different risk appetites among different classes of investors and
- Investigate the use of tax rebates and limited credit guarantees to improve returns to investors for a given level of risk.

Recommendation 8: Ensure a formal role for Infrastructure Australia in project selection

The Federal government should ensure that Infrastructure Australia plays a formal, binding role in project selection as a condition of incentive payments made to States and Territories through the Asset Recycling Fund.

This should also be the case where Federal structured investment vehicles are utilised and investors benefit from 'credit enhancement' methods, such as tax rebates and government guarantees.

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1. INTRODUCTION

The Australian Chamber of Commerce and Industry (ACCI) welcome the opportunity to make a submission to the Senate Economics References Committee on privatisation of State and Territory assets and provision of new infrastructure.

There are a number of challenges facing Australian governments in providing the infrastructure necessary to increase national productivity and living standards.

The first fundamental issue is that the infrastructure deficit will naturally grow over time as population increases and existing assets depreciate, while the capacity for governments to fund infrastructure projects is waning.

An ageing population and growing community expectations mean scarce government revenue will be applied to an ever-growing list of demands and a growing proportion of the population that is dependent on the budget for income and the provision of public services, while the capacity to raise taxation revenue will be diminished by a falling share of the population in the workforce. There is little choice but to increase private sector involvement in infrastructure provision, management and funding. However, suitable mechanisms need to be in place to attract private sector funds. This has a number of dimensions including how infrastructure is funded, the suite of financing instruments available and the selection of the best projects. For the private sector to invest in an infrastructure project, the right balance between risk and return needs to be struck.

The next two challenges relate to Australia's Federal system of government. Firstly, States and territories are largely responsible for providing infrastructure, yet the Commonwealth has a far greater capacity to provide the necessary funding due to its more comprehensive revenue base and superior ability to issue debt.
The next challenge relates to the national coordination of infrastructure planning and project selection, which is also complicated by the fact that States and Territories are responsible for delivering infrastructure projects.

There is already considerable private sector involvement in the construction and operation of infrastructure assets. However, greater private sector involvement in financing and funding infrastructure is necessary to meet Australia's infrastructure needs into the future.

Asset recycling is a positive first step and ACCI strongly supports the Government's initiatives in this area. However, there is significant scope to increase the private sector contribution to infrastructure financing beyond that. This submission outlines suggestions on how to increase the role of the private sector in financing infrastructure and relieve pressure on government budgets.

2. THE CASE FOR PRIVATISING EXISTING ASSETS

Recommendation 1: The role of the private sector
The private sector should be engaged to the maximum extent possible in the financing, construction, operation and maintenance of infrastructure assets.

Recommendation 2: The role for governments
Governments should:

- Facilitate private sector investment
- Ensure competition and contestability occur to the maximum extent possible at every stage of the process
- Establish sound regulatory pricing regimes where competition is not prevalent
- Ensure that public non-financial corporations do not compete unfairly against the private sector.

In the face of constrained fiscal environments, Australian governments at all levels need to utilise their balance sheets to maximum effect to attract the financial capital necessary to provide the infrastructure Australians need to maintain and grow their living standards. Infrastructure Australia noted in 2012 that there was around $116 - $140 billion worth of equity in publicly-owned infrastructure assets held by State and Territory governments.[1]

Fiscal constraints will only get worse over time as demographic pressures build. State governments' credit ratings are already under pressure. As the recent experience of Queensland has shown, significant investment in publicly funded infrastructure can result in credit ratings downgrades which only added further pressure to their budget. Western Australia too has experienced a credit ratings downgrade in recent times.

In short, both Federal and State governments need to be open-minded when considering infrastructure funding and partnering with the private sector in a different way. Of course, risk must be appropriately priced and shared, but the alternative of doing nothing is a risk that the entire economy cannot bear in the long-run. A market based approach to infrastructure provision is mandatory. For the private sector to play an increased role in infrastructure financing, governments must investigate ways to facilitate construction of infrastructure, rather than directly provide it.

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[1] Infrastructure Australia, *Australia's Public Infrastructure: Part of the Answer to Removing the Infrastructure Deficit*, October 2012, http://www.infrastructureaustralia.gov.au/publications/files/Australias_Public_Infrastructure-Part_of_the_Answer_to_Removing_the_Infrastructure_deficit.pdf

Privatisation is likely to provide the greatest benefits when infrastructure operates in more competitive markets, or is not a monopoly. If a monopoly is privatised, regulation of pricing and service standards is needed to ensure that the private owner cannot abuse its market power.

Privatisation is especially crucial where governments have a conflict of interest between being an infrastructure owner and a regulator or public non-financial corporations may be competing unfairly with the private sector. In these cases, privatisation is likely to yield significant efficiency gains.

The decision to privatise should not be driven solely by the amount of money raised by privatisation, although the Government should ensure it receives a fair price. The aim should be achieving the most efficient level and type of investment and therefore the greatest net social benefit.

If the institutional framework is sound, none of these considerations require government *ownership* of infrastructure assets. The key principle is that governments' roles (at both State and Federal level) are to:

- Facilitate investment in infrastructure
- Allow and encourage competition and contestability
- Establish sound regulatory regimes to protect consumers and
- Ensure that public non-financial corporations remain competitively neutral.

3. FUNDING OPTIONS AND FINANCING MECHANISMS TO INCREASE PRIVATE SECTOR INVOLVEMENT

Recommendation 3: User charging should be preferred funding option
The first option for governments should be to apply direct user-charges:

- Where competitive markets are already operating and functioning well, the most preferable option is for governments to apply user-charges as broadly as possible.
- Where there is currently no functioning market for a particular type of infrastructure, governments should act to establish a regulatory pricing and service regime so that user-charging can be applied.

Recommendation 4: Alternatives to user charging
If user-charging is not feasible, value capture options, such as hypothecated area levies or land-tax increases should be investigated as a second-best option.

If user-charging and value capture options are not feasible then governments should look at asset recycling in preference to general taxation or borrowing or to fund infrastructure.

Only once all other options have been exhausted should governments consider taxation or public debt funding.

It is important to distinguish between infrastructure *funding* and *financing*. Funding refers to who pays for the cost of construction, operation and maintenance of an asset. Financing refers to the method of investment in the infrastructure, whether it is through direct ownership (equity) or lending (debt). Equity investors will demand a return on their investment, while lenders require interest as compensation for risk of default by the borrower and for sacrificing alternative uses of their capital. Both debt and equity finance can be sourced through the public sector or the private sector.

Irrespective of whether the Federal government borrows to directly *finance* infrastructure provision or not, infrastructure *funding* ultimately comes from two sources. These are either taxpayers or the end-users of infrastructure. Government borrowing merely shifts the burden from current to future generations of taxpayers.

A common argument is that public provision and funding of infrastructure is a way to avoid having to provide a return to the private sector through user-charging. However when the costs of taxation are taken into account, it is likely that these outweigh the costs associated with direct user-charging. The use of tax finance or public debt often involves a cross-subsidy.

This is not to say that taxpayers, through governments, should never invest in infrastructure. Taxpayer investment can and should occur when there is a clear and demonstrable market failure that outweighs any potential government failure and after a thorough cost benefit analysis has been undertaken. Even in this case, partnerships with the private sector should be used to reduce development and operating costs. Also, an intergenerational transfer (achieved through government borrowing) may be entirely reasonable, given that infrastructure assets typically deliver a flow of benefits for decades or more.

The key point is that funding (both for construction and operation) should come from those who are most likely to benefit from the infrastructure directly. This can be achieved in various ways, depending on the type of asset involved.

The mix of funding options will affect how projects are financed. Governments should endeavour to use a mix of funding options to ensure that the beneficiaries of infrastructure provision all make a contribution that reflects their flow of benefits. That is, when there are likely to be substantial spillover benefits (positive externalities) governments can borrow to provide 'matched funds' with the private sector to construct infrastructure.

In some cases, infrastructure may be under-provided because of public good characteristics (non-rivalry and non-excludability). In that case, governments can provide a partial operating subsidy (community service obligation or CSO) to supplement user-charges to ensure the private sector receives an adequate rate of return on funds invested for the services they are required to deliver.

Governments can accept some of the early 'demand' risk for so-called 'green fields' projects as these are more risky than existing 'brown fields' assets. Private sector investors tend to find the latter category more attractive. The strategy of privatising 'brown fields' assets to enable the construction of new 'green fields' infrastructure is entirely sensible, and indeed, necessary given fiscal constraints.

There are a number of ways to attract private sector finance into infrastructure projects and each has different virtues and drawbacks. Some methods that have been used in Australia and elsewhere include user-charging and value capture. The Federal government also needs to consider providing a portfolio of finance options with different risk/return profiles to attract private sector investment.

3.1 User-charging

Recommendation 5: National User-charging framework
Federal, State and Territory governments should seek agreement through the Council of Australian Governments (COAG) on a process to develop a national user-charging framework for large-scale road projects.

User charging is suitable for assets where end-users can easily be excluded from using them – essentially these are services that resemble private goods as opposed to so-called 'public goods'. User charges are commonly used for transport, water and electricity services. There currently exist well-functioning markets in these sectors and these market-based approaches should be utilised wherever possible.

User-charging is used extensively overseas. However, it remains underutilised in Australia, particularly for road transport projects. Assets are likely to be used more efficiently if users are required to pay at least a portion of the costs and so user-charging helps to promote efficient levels of investment.

User-charging is also equitable. Funding returns on investment, operating costs and depreciation from consolidated revenue involves a degree of cross-subsidy from taxpayers that will not use the assets to those that do. Unless there are significant spillover benefits from a particular project, it is inequitable for one group of taxpayers to fund infrastructure that they are unlikely to use.

Despite the benefits of road user charging, there remains considerable resistance to its application in some jurisdictions and the development of a national framework could be one way to overcome this.

3.2 Value Capture

Recommendation 6: Infrastructure Australia to research a national framework for value capture

In addition to pursuing a national user-charging framework for large scale projects, the Federal government should:

- Issue a directive to Infrastructure Australia to set a research agenda on how best to apply value capture methods to various types of infrastructure projects and
- Work with State and Territory governments to develop a nationally coordinated framework for value capture initiatives.

Where user-charging is not feasible or the cost is prohibitive, value capture methods provide an alternative to ensure the beneficiaries directly contribute to the provision of infrastructure.

Consult Australia defines value capture as follows:

> *...value capture refers to funding methods that are closely tied to increases in public tax revenues from private property. The method relies on establishing a revenue benchmark prior to program commencement that can be monitored against specific planned investments in transport infrastructure and urban renewal. Revenues above the benchmark are then sequestered into dedicated accounts and used to repay bonds or loans which fund projects and programs, while revenues below the baseline continue to flow to taxing authorities.*[2]

[2] Consult Australia, *Capturing Value*, October 2013, http://www.consultaustralia.com.au/docs/default-source/cities-urban-development/Capturing_Value.pdf

Value capture methods are only suited to projects that will have a direct impact on land prices. These can include urban public transport projects or local infrastructure for new housing developments, for example.

Ultimately, State and Local governments will be responsible for implementing these types of funding mechanisms but the Federal government could seek to reach an agreement with States and Territories on a national framework for value capture initiatives. The Federal government could also play a role in Federal and State governments could also play a facilitative role in hypothecating revenues derived from value capture models to build community support for this approach.

3.3 Statutory Investment Vehicles

Recommendation 7: Establish quarantined structured investment vehicles for infrastructure projects
To increase the attractiveness of infrastructure investment to the private sector, governments should consider establishing quarantined structured investment vehicles, with all borrowings hypothecated to particular projects.

The Federal government should:

- Offer different tranches of senior and subordinated debt instruments, hybrid securities and other options to cater for different risk appetites among different classes of investors and
- Investigate the use of tax rebates and limited credit guarantees to improve returns to investors for a given level of risk.

The Federal government has undertaken a key first step in attempting to establish the Asset Recycling Fund (although the legislation is still currently before the Parliament). The effectiveness of the Fund in attracting private sector could be dramatically improved if the Federal government would consider diversifying the financial instruments available to the private investors to cater for different risk/return profiles.

Private sector financing of infrastructure is already taking place through hedge funds and the Federal, State and Territory governments should investigate how these attract investors.[3] Self-managed superannuation funds (SMSFs) made up around 30 per cent of all superannuation assets in 2014.[4] Facilitating contributions to the Asset Recycling Fund from these investors should be a priority for the Federal government. The Federal government should also look at other special purpose structured investment vehicles more generally as a means to unlock more private sector investment in infrastructure.

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3 See http://www.blueskyfunds.com.au/blue-sky-funds/real-assets/our-approach/
Blue Sky recently provided financing for the recycled water infrastructure in the Lightsview development in South Australia http://waterutilitiesgroup.com.au/lightsview_rewater.html

4 ATO, *Self-managed superannuation funds: A statistical overview 2012-13*, https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2012-2013/

SMSF investors are content to receive quite modest returns, yet they place a premium on security. Institutional equity investors may be willing to accept greater risks but would require a higher return as compensation. SMSF investors are more likely to be attracted to infrastructure projects that have local relevance to them and if they can see other larger, more sophisticated investors involved with significant 'skin in the game'. Only utilising traditional government bonds to finance infrastructure is unlikely to achieve these multiple objectives. In turn, this is likely to attract less private sector investment as opposed to a diversified suite of instruments.

In addition to diversifying the types of debt and equity instruments available, the Federal government should examine 'credit enhancement' options, such as tax rebates and (limited) government guarantees to improve the returns available for a given level of risk.

4. IMPORTANCE OF A WELL-DESIGNED PIPELINE OF INFRASTRUCTURE PROJECTS

Recommendation 8: Ensure a formal role for Infrastructure Australia in project selection
The Federal government should ensure that Infrastructure Australia plays a formal, binding role in project selection as a condition of incentive payments made to States and Territories through the Asset Recycling Fund.

This should also be the case where Federal structured investment vehicles are utilised and investors benefit from 'credit enhancement' methods, such as tax rebates and government guarantees.

A key challenge in the provision of infrastructure in Australia comes from the fact that State and Territory governments are largely responsible for providing infrastructure while the Commonwealth has a superior ability to fund it. This creates the potential for conflict between governments about particular projects and increases risk and uncertainty, which dissuades private investors. It also raises the chances that governments will be liable to pay compensation for projects that do not proceed due to changes of government. This is a waste of scarce capital resources.

A crucial element of the risk versus return equation for the private sector is the selection of, and long-term commitment to, high-quality projects. As infrastructure assets are long-lived and tie up a lot of physical and financial capital, the issue of good project selection does not end once the construction phase is over.

If governments are going to reduce the pressure on their budgets in the long-run by utilising an asset recycling strategy, selection of good quality projects is essential. If governments do not pay serious attention to selecting the best projects, then private investors will likely require greater inducements to invest in 'brown fields' assets in future.

It is crucial to note that poor quality projects will negatively impact on government finances irrespective of whether they are owned publicly or privately. However, the benefits of an asset recycling strategy will be squandered if poor quality projects are allowed to go ahead. This is because the quality of the project has a bearing on the income stream available from the asset and therefore the price a government will receive for it when it is privatised. It will also mean a government will have to provide greater subsidies to the operator (whether public or private) to meet any shortfall in operating costs and provide an adequate return on investment.

The fundamental question is 'how best to achieve high-quality project selection?'
It is encouraging that the National Partnership Agreement on Asset Recycling specifies eligible infrastructure projects must demonstrate the following:
- a clear net positive benefit
- enhance the long-term productive capacity of the economy and

- where possible, provide for enhanced private sector involvement in funding and financing.

Nevertheless there is room to strengthen these requirements by explicitly granting a greater and more formal role for Infrastructure Australia and similar bodies in some State jurisdictions in the selection of projects more broadly.

It is vital to build an apolitical consensus around a pipeline of high-quality projects to get the best outcomes for the nation. The national infrastructure priority list should be enshrined in the relevant legislation. Inclusion of an infrastructure project on the national infrastructure priority list should be a key criterion for incentive payments to be made to States from the Asset Recycling Fund. It should also be a key criterion for the establishment of a dedicated structured investment vehicle that may be entitled to government incentives or credit enhancement initiatives, as suggested in section 3.3.

Formalising the independence of Infrastructure Australia and giving it the pre-eminent role in selection of nationally significant infrastructure projects will enhance investor confidence by removing political uncertainty that can dissuade private investors.

5. ABOUT ACCI

5.1 Who We Are

The Australian Chamber of Commerce and Industry (ACCI) speaks on behalf of Australian business at a national and international level.

Australia's largest and most representative business advocate, ACCI develops and advocates policies that are in the best interests of Australian business, economy and community.

We achieve this through the collaborative action of our national member network which comprises:

- All eight State and Territory chambers of commerce
- 29 national industry associations
- Bilateral and multilateral business organisations.

In this way, ACCI provides leadership for more than 300,000 businesses which:

- Operate in all industry sectors
- Includes small, medium and large businesses
- Are located throughout metropolitan and regional Australia.

5.2 What We Do

ACCI takes a leading role in advocating the views of Australian business to public policy decision makers and influencers including:

- Federal Government Ministers & Shadow Ministers
- Federal Parliamentarians
- Policy Advisors
- Commonwealth Public Servants
- Regulatory Authorities
- Federal Government Agencies.

Our objective is to ensure that the voice of Australian businesses is heard, whether they are one of the top 100 Australian companies or a small sole trader.

Our specific activities include:

- Representation and advocacy to Governments, parliaments, tribunals and policy makers both domestically and internationally;
- Business representation on a range of statutory and business boards and committees;
- Representing business in national forums including the Fair Work Commission, Safe Work Australia and many other bodies associated with economics, taxation, sustainability, small business, superannuation, employment, education and training, migration, trade, workplace relations and occupational health and safety;
- Representing business in international and global forums including the International Labour Organisation, International Organisation of Employers, International Chamber of Commerce, Business and Industry Advisory Committee to the Organisation for Economic Co-operation and Development, Confederation of Asia-Pacific Chambers of Commerce and Industry and Confederation of Asia-Pacific Employers;
- Research and policy development on issues concerning Australian business;
- The publication of leading business surveys and other information products; and
- Providing forums for collective discussion amongst businesses on matters of law and policy.

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