SUBMISSION TO THE JCPAA INQUIRY ON COMMONWEALTH INFRASTRUCTURE SPENDING

Based on Auditor-General Report No.14 (2015-16) Approval and Administration of Commonwealth Funding for the East West Link Project, and

Auditor-General Report No.38 (2016-17) Approval and Administration of Commonwealth Funding for the WestConnex Project

Infrastructure Investment in Land Transport

To assist in considering the Auditor-General's reports regarding the East West Link Project and the WestConnex Project, it is important to understand the Australian Government's investment in land transport infrastructure in the context of the economic environment prevailing in 2014 when the Australian Government chose to make significant budget commitments to key projects around Australia.

As Budget Paper 1 from 2014 outlines, the Australian economy was in the midst of a major transformation, moving from growth led by investment in resource projects to broader-based drivers of activity in non-resources sectors. This was occurring at a time when the economy had generally been growing below its trend rate and the unemployment rate had been rising. Furthermore, the outlook for investment in engineering construction was forecast to decline by 13 per cent in 2014-15 and 20.5 per cent in 2015-16, as a result of declining investment in the resources sector.

The Australian Government committed an additional $11.6 billion in the Budget for the Infrastructure Growth Package including $1.5 billion for the East West Link project and a $1.5 billion National Partnership Payment for the WestConnex project in addition to a concessional loan of up to $2 billion. This commitment brought the Commonwealth's total investment in infrastructure to over $50 billion at that time.

This represented a record level of investment in infrastructure by an Australian Government and reflected the Government's decision to take action to increase economic activity, improve productivity and build a stronger, more prosperous economy. The infrastructure investments were directed at improving the quality, efficiency and adequacy of key transport links, reducing congestion, lowering business costs and increasing the liveability of our cities and regional areas. It was aimed at responding to the needs of the economy by building infrastructure that would drive economic growth, create jobs and improve productivity.

Significant demographic challenges have intensified the demand for infrastructure and have complicated the funding challenge, due to competing demands in other areas, such as health and social services. In recent years, Australia's population growth has been among the fastest in the developed world, with Sydney and Melbourne each projected to be home to almost eight million people by 2050. Our four biggest cities, on current projections, will continue to increase their overall share of the national population.

Australia's major cities and regional centres are a source of much of the country's economic activity; however, congestion is a major productivity constraint. The Bureau of Infrastructure, Transport and Regional Economics estimated the avoidable cost of congestion at over $16 billion in 2015-16, growing to as much as $37 billion by 2030. Major transformational projects such as East West Link and WestConnex, provide opportunities to use the Government's substantial investment to address these challenges.

The Australian Government recognises the limits of public funding for infrastructure, particularly with consideration of the growth pressures for investment. It also recognises the benefits of greater private sector involvement in public infrastructure investment, both through funding models that more equitably seek contributions from those who directly benefit from the infrastructure, and financing models that help drive greater discipline in project delivery.[1]

The Australian Government publicly committed to the wider use of innovative funding and financing and delivery options, beyond the traditional provision of capital grants as part of its response to the Productivity Commission's Public Infrastructure inquiry in 2014. It further articulated this commitment through the February 2016 release of its Principles of Innovative Financing. The principles highlight key values in project selection, including the selection of projects with the greatest economic benefits for the community and considering opportunities for innovative funding and financing beyond traditional grants such as through the use of concessional loans and similar financing mechanisms.

The Background Section of this submission contains more detailed information of these principles (refer Appendix A).

As outlined in 2014 Budget documents, the Government was prepared to use alternative financing to complement traditional grant funding and more effectively use its balance sheet to support Australia's infrastructure needs. These arrangements help mitigate investment risks and thereby generate significant additional state and private sector participation to build the infrastructure that Australia needs.

At the time of announcement, both projects were expected to achieve significant economic benefits to the state and the national economy by easing congestion, linking people to employment centres, and creating jobs throughout construction, assisting with the economic transition from the mining boom.

East West Link

At the time the Government committed funding to the East West Link, in the 2014 Budget, it was one of Victoria's core infrastructure priorities. It had been submitted to Infrastructure Australia (IA) as early as 2010.

The Government committed to funding the project because of its transformative benefits to the Victorian and Australian economies.

The project had the potential to address Melbourne's transport challenges, improve accessibility to economic and employment centres across the city, provide linkages to the Port of Melbourne and Melbourne Airport, and create an immediate boost to the economy by creating up to 6,700 jobs during construction.

The 18-kilometre cross-city road connection would have provided an alternative to the heavily congested Eastern, Monash and West Gate Freeways (the M1 corridor) and reduced reliance on the West Gate Bridge. The project would have reduced travel times by up to 20 minutes for commuters travelling from areas such as Geelong and Ballarat to the City.

WestConnex

The WestConnex project was developed to accommodate the growing transport needs of greater Sydney. The Government committed $1.5 billion funding to the project in the 2014 Budget as the economic benefits were strong. The business case estimated the project would create more than

[1] Funding refers to the source of capital for a project, such as taxation revenue or user charges. Financing refers to how capital is provided upfront, such as through a concessional loan. Traditional capital grants involve provision of funding for the project without expectation of return. Innovative and alternative financing models, such as concessional loans, involve the Commonwealth financing projects, generally with an expectation of a return.

$20 billion in economic benefits for New South Wales and around 10,000 jobs, including many apprenticeships.

The project was to provide better connections between the growing population in Sydney's western suburbs and employment opportunities located further to the east. It was designed to support Sydney's productivity and economic growth by improving freight movements through improved connections to Kingsford Smith Airport and the port precinct. The business case predicted that WestConnex would save 40 minutes on a typical journey between Parramatta and Kingsford Smith Airport, bypassing up to 52 sets of traffic signals.

The commitment of a concessional loan was designed to build on the Australian Government's funding commitment to accelerate Stage 2 of the project and bring in greater investment from the private sector. Bringing projects forward releases the benefits for the economy and the community earlier. Building Stages 1 and 2 concurrently would also allow the NSW Government to plan for the sale of both stages to fund the final stage.

Comments on the Audit Findings from the Performance Audits

Protection of Australian Government Funds

Both the East West Link and WestConnex audit reports show that the payments by the Australian Government in 2013-14 were adequately protected by legal frameworks.

The East West Link project was cancelled by the Victorian Government. None of the Australian Government's $1.5 billion payment made to the East West Link in June 2014 was used on meeting costs associated with the project and all the funding has now been applied to replacement land transport projects.

The ANAO found that the Department had provided clear advice to Government in relation to the $1.5 billion payment for the East West Link project. The ANAO also found that the Department had provided timely advice when it became evident that there was an increased risk that the project would not proceed.

The same legal and administrative frameworks provided a safeguard for the initial payment made to the NSW Government for WestConnex, should the NSW Government not have proceeded with the project (which was already underway at the time of the initial payment).

The Australian Government attached a condition to its funding for WestConnex that, in the event that all three stages of the project were not delivered, the parties would discuss and agree the appropriate use of residual funds. This additional safeguard was a result of experience with the East West Link funding.

Milestone Payments

The ANAO found that the Department had provided well-considered advice on the advance payment for WestConnex. The Department does not agree with the ANAO's view that milestone payments were administered in a way that did not adequately protect the Australian Government's financial interests.

The WestConnex funding and financing strategy was that early stages of the project would be sold to fund later stages. This is why the Australian Government agreed with the NSW Government that the $1.5 billion grant funding would be provided in instalments over the early stages of the project. This structure of funding enabled the Australian Government to pay significantly less than it would have under a traditional matching funding arrangement with the state.

All WestConnex milestone payments were made in accordance with the Department's milestones practice direction. WestConnex milestones were based on agreed activities and reflected key deliverables associated with the project's critical path. Milestone changes from the initial Project Proposal Report (PPR) reflected design refinements as the project developed that were requested by the NSW Government as necessary to deliver the project in the most effective and efficient way.

The Department's advice to the then Assistant Minister for Infrastructure and Regional Development in 2015 clearly stated that these milestones were "subject to change based on project progress and will be assessed and possibly renegotiated between the Australian and NSW governments when separate PPRs are submitted for future phases".

Acceleration of WestConnex Stage 2

In relation to the provision of the WestConnex $2 billion concessional loan, the ANAO indicated that in their opinion the provision of the concessional loan did not achieve the Australian Government's objective of bringing Stage 2 of the project forward by approximately two years. However, the provision of the concessional loan enabled Stage 2 to be fully financed at contractual close, allowing Stages 1 and 2 to proceed in parallel resulting in significant time savings compared to if the two stages had progressed in sequence. The original timeline contained much uncertainty as it was developed prior to receiving planning approval, and prior to negotiations with constructors and financiers. It is not realistic to assume that the original timeline would not have changed as a result of the negotiations with financiers and constructors and the obtaining of required approvals.

The ANAO also claims that the Stage 2 project could have proceeded to construction as planned without the concessional loan and that the concessional loan was used as a replacement for the financing that could have been obtained from private sector lenders and through the privatisation of Stage 1 in 2019-20. The ANAO takes this view from a single Macquarie Capital Report produced in 2013, despite the fact that the scope of the project and the amount of Australian Government funding has changed since the time that report was produced. In addition, the strategy in the 2013 report required Stage 2 construction contracts to be executed before sale proceeds from Stage 1 had been secured. The Department did not share the view that a construction firm would be willing to enter into a construction contract prior to all funding being secured given the uncertainty in the value of Stage 1 at the time Stage 2 was proposed to be contracted.

Governance Framework

The ANAO suggests that the Northern Australia Infrastructure Facility criteria should have been considered when offering the WestConnex loan. The Department does not believe the framework for the NAIF is relevant to this audit as the NAIF was developed well after the concessional loan. Holding the Department to the NAIF framework is considered setting a standard after the event. The purpose of the NAIF framework is to enable an independent board to assess proposals for up to $5 billion over 5 years in concessional finance to encourage and complement private sector investment in infrastructure. The WestConnex concessional loan was a one-off, tailored loan.

Interest

The ANAO considers that value for money is adversely affected as the interest rate is set below a comparable market rate with no margin to cover the Australian Government's loan administration costs or risks. In this context it needs to be noted that the Government policy intent was to provide a *concessional* loan. Additionally, the interest rate was based on the yield of the Australian Government bond series that most closely matched the maturity of the loan. The yield on the selected bond series has been below the rate of the loan since the first drawdown. The ANAO acknowledges that the Department has adequately addressed the risk that the loan will not be repaid.

The ANAO is of the view that the interest capitalisation period reduces the liquidity risk on the project and results in income to the Australian Government being delayed. The modelling provided to the Department by the NSW Government indicated that the debt service coverage ratio required by Senior Debt would not be achieved without the interest capitalisation period on the concessional loan. The Department accepted this view on the basis of advice from its commercial advisers.

Response to the recommendation on the WestConnex Concessional Loan

In relation to recommendation from the ANAO audit report, the lessons learned from the WestConnex concessional loan have already been taken into consideration for the development of future concessional loans by the Department which includes changes to its approach in seeking legal advice, and in the creation of the term sheets for a concessional loan to strengthen due diligence processes and considerations.

In addition, the Department has commenced several activities to continue to improve its processes and procedures for the administration of the Infrastructure Investment Programme. For example, as part of its response to the ANAO audit, the Department has established a small taskforce to review the capacity of its systems to support current and future IIP business requirements through greater automation of processes.

There were no recommendations directed at the Department from the East West Link audit. The only recommendation was directed at the Treasury.

Appendix A

Background

The Government's Investment Agenda

A key focus of the Government's investment in land transport infrastructure is supporting projects which deliver clear economic and social benefits, and which address nationally significant infrastructure deficiencies.

Informed Investment

Over the last decade, successive Governments have undertaken a process of continuous improvement to their land transport investment arrangements, with a focus on being an informed investor and achieving value for money for Australian taxpayers. The Department has led this process through reforms to the delivery of the Infrastructure Investment Programme, particularly through improved project assessment and selection processes.

- Key reform initiatives that are embedded within the Government's Infrastructure Investment Programme are detailed below: Improvements to the Government's project assessment processes, including development of independent network analysis by the Department and working with state and territory governments to update the standardised tools for economic analysis within the Australian Transport Assessment and Planning Guidelines;
- Establishment of improved Project Costing guidelines for all proposals for major projects, including requiring all projects with an out turned capital cost of $25 million or more to provide cost estimates using the Government's best practice probabilistic cost estimation methodology. This allows greater scrutiny of individual proposals as well as stronger comparisons between proposals;
- Grant funding for projects is approved at the P50[2] outturn cost estimate of the funding for each phase. Access to additional funds beyond P50 up to P90 is only be provided on a demonstrated needs basis, noting that the Department may review and/or seek independent verification of the proponent's requirement for additional funds beyond P50;
- Establishment of a more robust Investment Assurance Framework to review the Department's implementation of the Programme, to ensure that these reforms are delivering value for money. This includes an internal Assurance and Compliance Programme, Cost-Estimation Reviews of projects and Engineering Solutions Assessments; and
- Greater investment by the Commonwealth in planning and business case development works, to ensure that projects are robustly developed prior to consideration of Australian taxpayer funded investment.

These reforms have been developed by the Department and are being delivered through continued consultation with stakeholders, particularly other levels of government. They also reflect the package of reforms outlined in the Australian Government's response to the Productivity Commission's 2014 *Inquiry into Public Infrastructure*. The departmental initiatives reflect and support the Australian Government's programme of reforms.

[2] P50 represents the project cost with sufficient contingency included so that there is 50 per cent likelihood that this project cost will not be exceeded. Similarly, P90 represents the project cost with sufficient contingency included so that there is 90 per cent likelihood that this project cost will not be exceeded.

2016 Principles for Innovative Financing

The Principles articulate how projects should be selected, including that proposals should:

- address identified national priorities and deliver the greatest economic benefits to the community;
- be integrated with transport and land use planning, including urban renewal and housing supply;
- have given due consideration of all solutions to address the identified deficiency, including other modes, technological solutions and innovative delivery mechanisms;
- where appropriate and efficient, involve shared funding contributions from beneficiaries; and
- have considered opportunities for Commonwealth funding and financing support beyond traditional grants. This includes the use of concessional loans and similar financing mechanisms.

Infrastructure Australia's Plan

The Government's infrastructure investment reform agenda delivered by the Department complements the 2014 reforms to Infrastructure Australia (IA), the Government's independent infrastructure advisory body. These reforms represented a major shift in the assessment of Commonwealth investment opportunities, by making IA's assessment of project business cases and potential investment reforms more independent and robust.

Under its revised role, IA is providing a stronger evidence base to help inform the Government's future investment and investment policy decisions, including through the 2015 Australian Infrastructure Audit and the 2016 15-Year Australian Infrastructure Plan. In addition, IA continues to provide independent expert project assessment advice to Government, through its review of the Business Cases for all infrastructure projects seeking $100 million or more in Commonwealth funding.

East West Link Project

Melbourne's East West Link was proposed to be constructed in two main sections: the six-kilometre Eastern Section that would connect the Eastern Freeway with CityLink; and the 12-kilometre Western Section that would extend the link to the Western Ring Road. The East West Link was expected to provide the following travel time savings:

- 15-20 minutes for people travelling from Geelong, Werribee, Altona and Laverton to the city and other key destinations including the Royal Melbourne and Children's hospitals;
- 10-15 minutes for travellers from Ballarat, Melton and Caroline Springs to the city and other key destinations including the Royal Melbourne and Children's hospitals; and
- 15-20 minutes off a typical trip from the freight and logistics precinct in Truganina in Melbourne's west to the Port of Melbourne.

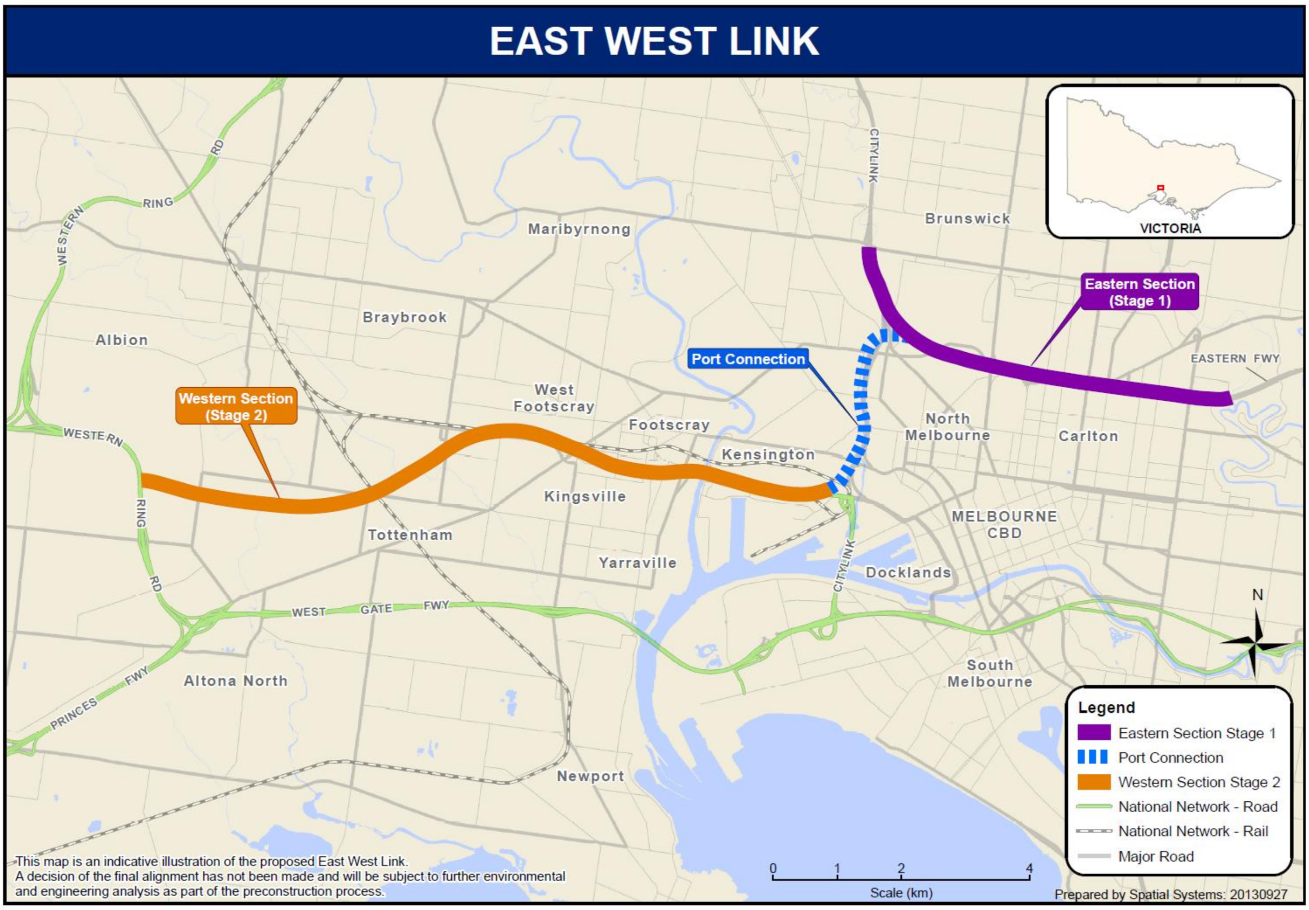
In addition, residents of suburbs such as Tottenham, West Footscray and Sunshine would benefit from being only 10-15 minutes from the city by car.

The Australian Government provided a national partnership payment of $1.5 billion towards the project.

Construction on the Eastern Section was expected to commence in late 2014 and be complete in late 2019. Early works on the Western Section were expected to commence in late 2015, with a view to the overall project being complete in 2023.

The East West Link project was cancelled by the Victorian Government.

In December 2016, the Australian and Victorian governments reached formal agreement on a $3 billion package of projects to be funded, utilising the full $1.5 billion previously paid to the Victorian Government for the East West Link. The Victorian Government is also contributing $1.5 billion to the package. The projects to which these funds have been applied are being administered under the National Partnership Agreement on Land Transport Infrastructure, whose legal framework is the *National Land Transport Act 2014*.


EAST WEST LINK
VICTORIA
Eastern Section (Stage 1)
Port Connection
Western Section (Stage 2)
Maribyrnong
Brunswick
Braybrook
Albion
West Footscray
Footscray
Kensington
North Melbourne
Carlton
Kingsville
Tottenham
Yarraville
MELBOURNE CBD
Docklands
South Melbourne
Altona North
Newport
WESTERN RING RD
CITYLINK
EASTERN FWY
WEST GATE FWY
PRINCES FWY
N
Legend
Eastern Section Stage 1
Port Connection
Western Section Stage 2
National Network - Road
National Network - Rail
Major Road
This map is an indicative illustration of the proposed East West Link.
A decision of the final alignment has not been made and will be subject to further environmental and engineering analysis as part of the preconstruction process.
0 1 2 4
Scale (km)
Prepared by Spatial Systems: 20130927

WestConnex Project

The $16.8 billion WestConnex project, adopted as a priority for New South Wales in its State Infrastructure Strategy 2012, provides the missing link in Sydney's Orbital Network. The project will deliver 33 kilometres of new and upgraded motorways linking western and south-western Sydney with the Central Business District, Kingsford Smith Airport and Port Botany precincts. It will largely be constructed in the existing M4 and M5 corridors and involve approximately 14 kilometres of road above ground and 19 kilometres of tunnels, including a new tunnel connecting the two corridors.

The key benefits of WestConnex are:

- Relieving congestion on the existing M4/Parramatta Road and M5 East.
- Supporting freight movements between Port Botany and the logistics hubs in Western and South Western Sydney.
- Supporting people and freight movements to Sydney Airport.
- Acting as a catalyst for urban regeneration along key corridors, particularly Parramatta Road.
- Enhancing connectivity with the southern part of Sydney's CBD, and enabling improved orbital connectivity.
- Facilitating improvements in public transport in inner Sydney.

The project is being delivered in stages through to 2023 as follows:

- Stage 1a - M4 Widening - major works commenced in May 2015 (82 per cent complete);
- Stage 1b - M4 East tunnelling – works commenced in July 2016 (28 per cent complete);
- Stage 2 - King Georges Road Interchange Upgrade - opened to traffic in December 2016;
- Stage 2 - New M5 - tunnelling commenced in November 2016 (18 per cent complete); and
- Stage 3 – M4-M5 Link – currently in planning.