Funding Australia's infrastructure -

Is it as simple as 'ABCD'?

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Infrastructure is a priority for both government and business. In fact the recent PwC CEO survey found 83% of Australia's CEOs said the Government should make infrastructure improvement its number one priority.

But while the increased public attention and debate on infrastructure is welcome, it is now time to take the debate forward and move into action around the real elephant in the room - funding.

There are various estimates of Australia's Infrastructure funding deficit with Infrastructure Partnerships Australia and Citibank putting it at $700 billion.

In our view the infrastructure deficit can be bridged with the following funding solutions:

A – Capital Recycling

B – Increased use of User Pays

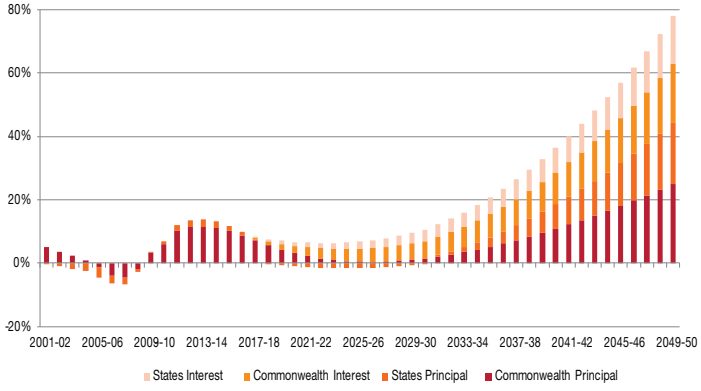
C – Other financing

D – Use of government debt financing

Public funding is not sustainable

The availability of public sources of capital to fund infrastructure will become increasingly constrained over the coming decades as Australian government's debt position is expected to worsen.

PwC's paper on *Tax Reform* shows that the combined annual deficits of Australian governments could rise from $27.4 bn in 2011-12 to an estimated $583 bn by 2049-50 – almost 6 per cent of GDP.



Net debt: Commonwealth and state/territory governments as a % of GDP

The onus therefore is on Governments to look for better and more effective ways to partner with the private sector to find sustainable sources of funding.

Capital Recycling can materially bridge the gap. It refers to the release of funds from the privatisation of existing brownfield assets with the funds being reinvested alongside the private sector in critical new greenfield projects.

Private funding is not enough

In order for institutions to step up and invest alongside Government there must be clearly identified cash flows to fund the infrastructure and provide a source of long term sustainable return.

Universal adoption of the User Pays principle to increase the returns of these projects is a critical element required to increase private funding to any significant degree.

But even then, funding gaps will remain given the long term nature of infrastructure projects, the extended timeframe for revenues to ramp up and the commercial constraints around pricing levels.

Key points:

- The infrastructure funding gap can be bridged materially by accelerating the process of Capital Recycling
- Capital Recycling requires three critical factors for success: community support, optimised User Pays and certainty for investors
- The new Federal Government can accelerate Capital Recycling by removing tax distortions and making funding to States conditional upon a program of Capital Recycling
- Governments need to engage more effectively with super funds to better understand their investment needs
- Governments need to be bolder and take on more risk in order to recycle scarce public capital – alongside the private sector – to get productive new infrastructure projects away

The Capital Recycling solution

In an environment where it is not feasible for Governments to increase borrowings and still retain AAA credit ratings, and the private sector can only accept limited risk, Capital Recycling is the only real alternative to funding infrastructure in a sustainable way.

'How can we accelerate the process of Capital Recycling?' is now the critical question facing both Governments and the private sector. The first steps in answering this question are being clear about the pre-conditions for Capital Recycling, understanding what the critical success factors are and commitments from Governments to implement policy changes that encourage the uptake of Capital Recycling programs.

Pre-conditions

Capital Recycling is only feasible for infrastructure projects that generate third party revenues and are not reliant on Government subsidy, such as social infrastructure like schools and hospitals.

Moreover, the revenue streams need to be sufficiently reliable so that the private sector can accept the demand risk associated with the usage of that infrastructure.

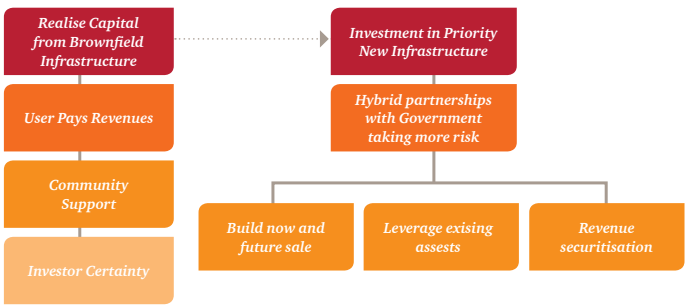
Notwithstanding the losses suffered on early tollroad investments arising from overly optimistic patronage forecasts, there is still pent up demand from super funds for infrastructure assets that offer stable, real long term returns linked to economic growth.

Critical success factors

There are two stages to Capital Recycling. The first involves freeing up capital from existing infrastructure assets, and the second involves clever and effective use of those funds to invest in critical new projects.

In order to successfully free up capital there needs to be community support, User Pays revenues and certainty for investors.

Two-stage model of Capital Recycling



1. Community support

Demonstrating how funds from brownfield asset privatisations will be redirected back into new infrastructure is an important step in gaining community support for Capital Recycling.

The political success of the Port Botany and Port Kembla long term leases, for example, is critically attributable to very clear messaging regarding dedicating the use of the proceeds to investment in new infrastructure through the NSW Restart Fund. In this case 30 per cent of the funds are specifically earmarked for regional projects.

By taking such an approach, the public and communities are better able to see the tangible benefits of Capital Recycling, as opposed to seeing funds flow through the general State budget as has historically been the case.

2. User Pays revenues

Generating understanding and acceptance of the User Pays principle is another critical success factor for Capital Recycling. Part of this challenge involves new technologies and systems that make it easier to optimise the ways consumers use and pay for infrastructure.

The recent changes in the Victorian electricity industry highlight the benefit of investing in 'Smart infrastructure' and the potential for 'Smart infrastructure' to change consumer behaviour. With the introduction of flexible pricing regimes consumers with smart meters in Victoria can now voluntarily switch to flexible electricity pricing, which means they will pay different rates depending on the time of day when they are using power (with lower pricing at times of low demand).

3. Certainty for investors

The third critical part of the success equation for Capital Recycling is to provide certainty and be responsive to investor requirements. We have identified four key elements that must be addressed in the transaction process:

Timetable	This involves a clear commitment by the State to a transaction process with a realistic programme achievable both for the State and bidders.
Cash flows	A robust assessment of future business to project sustainability and growth is critical.
Structure	A structure that maximises bidder flexibility is fundamental to maximising value.
Preparation	This includes a thorough due diligence process so bidders can focus on opportunities not just potential risks.

Investing the proceeds

The other major part of Capital Recycling involves investing the freed up capital in a strategic way in order to deliver critical, greenfield infrastructure. This necessarily involves newer forms of innovative hybrid partnerships to leverage private finance with Governments taking more risk.

Governments need to take more risk as the private sector is cautious after the experience of tollroad projects and is looking for more certainty regarding revenue projections. And for private financing to be off balance sheet, funding has to be raised on third party revenues requiring optimal application of user charges.

There are some great examples in the tollroad sector of new approaches to Capital Recycling. These hybrid models can be referred to as 'Build now and future sale', 'Leverage existing assets', and 'Revenue securitisation'.

1. Build now and future sale

Queensland has been the first State to apply the build first with intent of future sale as reflected in the sale of Queensland Motorways and the transactions involving the Go Between Bridge and Legacy Way. This approach is contained in the reference case for the WestConnex project in Sydney, where Government is in the process of setting up its own Special Purpose Vehicle, progressing the first stage of the M4 Widening and Extension itself, and subsequently looking to attract private finance when toll revenues have ramped up.

2. Leverage existing assets

Another approach is to minimise the need for Government funding through leveraging existing revenue streams on adjacent brownfield road concessions where the traffic patronage has already been firmed up, to support new road investment. This model is being developed for the F3M2 Interconnector.

3. Revenue securitisation

Capital Recycling can also be used where asset ownership and maintenance is treated separately from revenue streams. In the case of the East West Link, the State is going to assess the feasibility of securitising the toll revenue stream at a later stage after the initial project has been delivered under an availability payment PPP.

Other initiatives

While we strongly advocate the Capital Recycling approach to addressing the funding gap, it's important to develop solutions on a case-by-case basis, and to recognise the role other strategies may play.

One initiative worth pursuing under 'Other financing' includes creating a long term debt market around infrastructure. Excessive financial engineering pre-GFC has threatened the financial robustness of otherwise sound projects and complex financial models included multiple refinancings and regearings with overly optimistic margins. However with a robust and more transparent debt market there is more potential for institutions to invest more for the longer term.

And Governments will increasingly be looking at how they can deliver infrastructure more efficiently with greater use of service outsourcing, while retaining only a policy and regulatory role. States are fairly unified in seeking to create markets for the provision of services to the public sector and introduce contestability. Reforms in the health sector in NSW and Queensland are currently in the limelight with initiatives around logistics, procurement, pathology and radiology.

What can be done now?

There are two ground-breaking steps that a bold new Federal Government could take to support Capital Recycling.

The first is to remove distortions in the taxation of infrastructure so that investment is more attractive to a wider range of capital sources.

Such measures would include:

- allowing infrastructure investments to be treated as eligible investments for flow-through trust taxation
- allowing unit trusts who invest in infrastructure to utilise carry forward tax losses on the same basis as companies
- exempting interest and dividends from taxation for Australian superannuation funds in the same manner as foreign exempt pension funds.

The recent discussions between the State and Federal governments to allow the States to retain federal income tax payable by the privatised entities should also provide support for Capital Recycling.

The second step would be to expressly make the provision of funds to the States for investment in new infrastructure conditional upon commitment and progress with a programme of Capital Recycling and application of User Pays pricing.

In order to break the funding dilemma Governments must consider increasing brownfield asset privatisations. Whilst some level of community resistance is inevitable, a Capital Recycling approach – which sees the public benefit from privatisation – will help gain support.

Closer engagement between Governments and private sources of capital will also help clarify what each is looking for in terms of risk profiles, and help prepare and create new infrastructure investment opportunities with sustainable revenue streams.

In short, Governments need to be bolder and take on more risk to recycle scarce public capital – alongside an engaged private sector – in order to get productive new greenfield infrastructure projects away. We are committed to working with Government and industry to find solutions to help fund the gap.

For a deeper discussion, please contact:

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