DEPARTMENT OF TRANSPORT AND REGIONAL SERVICES SUBMISSION TO THE HOUSE OF REPRESENTATIVES INQUIRY INTO INFRASTRUCTURE AND REGIONAL DEVELOPMENT

Contents:

Executive Summary

Investment in public infrastructure and the efficiency of its operation are significant influences on national economic and employment growth. The performance of infrastructure affects most economic activity and has a significant influence over quality of life, access to services and quality of the physical environment. Inadequate infrastructure impedes business performance and competitiveness.

Infrastructure is seen as a critical issue by many in regional Australia. This is based on a belief that much regional infrastructure is inadequate or non existent, hampering regional economic growth. However, in terms of regional economic development, infrastructure is only one element of a wide range of factors which affect economic performance. The provision and operation of infrastructure must be seen in the broader context of developing regional economies.

Infrastructure projects are by their nature very expensive, particularly in regional Australia. Traditionally, the public sector has been the key provider of infrastructure in Australia. This provision was based on a number of factors, including sheer geographical size, small population, lack of commercial viability and the maturity of our capital markets. As a result, the public sector was involved in building, owning and operating a wide range of infrastructure such as airports, electricity generation and surface transport networks. As new priorities for Government spending have emerged, Governments have spent proportionally less on infrastructure.

Governments are continually lobbied by project proponents and responding in a responsible and sensitive way is difficult. In handling this public pressure, Governments have to balance social and economic obligations, environmental concerns, unrealistic expectations and financial constraints. It is not surprising that regional project proponents continue to lobby Government to fund projects as there is a general desire for more and better infrastructure, especially if the costs of its provision are to be borne indirectly. The efficiency with which infrastructure is used is also critical. Inefficient use can exaggerate perceived needs.

As a result, new relationships between the public and private sector have emerged. These relationships involve a more accurate costing of infrastructure, more accurate risk assessment, increased use of cost recovery mechanisms and more creative equity and debt servicing provisions. Owing to budget priorities, Governments increasingly have a reduced ability to finance and undertake infrastructure projects directly and the scope for private sector involvement has grown. This growth is important, drawing as it does on the respective strengths of both the private and public sector. However, the principal problem with private sector funding of regional infrastructure proposals remains commercial viability. The underlying reality is that projects with limited commercial viability, including many in regional Australia, struggle to attract private investors. Given this situation, arguments can be made for closer public-private partnerships to ensure the provision of regional infrastructure. Our tax system currently makes such partnerships highly problematic.

The infrastructure and regional development relationship is very complex and there is no easy panacea. A number of questions surrounding public provision of regional infrastructure do need to be addressed. In particular, the issue of provision of long term capital to enable regional infrastructure projects to get off the ground is very important. At the moment there is a problem in attracting the necessary capital to regional infrastructure projects. Answers to a range of questions need to be found if much of regional Australia is going to develop economies which are sustainable and beneficial to their communities.

1. Introduction

Infrastructure is seen as a critical issue by many in regional Australia. This is based upon a belief that regional economic growth is often stifled due to a lack of key infrastructure. This infrastructure ranges from the traditional, physical infrastructure such as roads to "softer", service infrastructure such as higher education. With the ongoing technological revolution, these infrastructure requirements have grown to include, for example, access to optical fibre networks and Internet Service Providers (ISPs). Infrastructure demands are changing along with the way projects are financed and managed. This submission provides an overview of recent Commonwealth involvement in infrastructure and regional development, particularly the involvement of the Department of Transport and Regional Services (DTRS).

The transport portfolio has been actively involved in infrastructure at the Commonwealth level, playing a number of different roles over the years as public infrastructure builders, owners, operators, regulators and facilitators. This role has evolved with changes to both the general economic and financial environment and to the broader Commonwealth policy environment. In addition, DTRS has an active involvement in regional Australia, being responsible for coordinating the *Regional Australia Strategy* and a range of programmes aimed at assisting regional Australia with the economic, social and environmental infrastructure to create healthy communities. It is from the perspective of these two areas and their linkages that this submission has been prepared.

This submission comprises four main chapters with an Introduction and Conclusion. The second chapter, titled "*Regional Development and Regional Service Provision*," addresses the recent shift in focus for the Commonwealth's involvement in regional Australia. This change has a number of policy implications for notions of regional economic development and the provision of infrastructure. The third chapter, "*Infrastructure in the Broader Economic Environment*," contains a detailed exploration of Commonwealth involvement in infrastructure provision across a range of sectors and explores the changes in provision of infrastructure which are fundamental to future infrastructure projects. The fourth chapter, titled "*Regional Infrastructure Proposals*," addresses the issues involved in infrastructure provision in regional Australia and some of the specific problems facing regional infrastructure projects. The fifth chapter, titled "*Deficiencies in Infrastructure*," explores some of the infrastructure deficiencies that can be found in regional Australia and the issues that surround these deficiencies. The concluding chapter draws together the main themes that run through the submission.

2. Regional Development and Regional Service Provision

The Commonwealth's Role

The Commonwealth's role in regional Australia has undergone a marked shift over the last three years. This shift is based on moving away from one dedicated regional development programme toward a broader approach to regional Australia, with a specific focus on regional services. After the Federal election in October 1998, the Commonwealth Government made a conscious decision to address the issue of declining service provision in rural and regional Australia. The impact of the decline of basic services in rural and regional areas has been acute, with many communities facing the withdrawal of a number of different service providers. To address this decline, the Government has focussed on providing a basic level of service provision for all Australians. The portfolio of Transport and Regional Services was created to draw together a number of existing programmes with a rural and regional focus and adding administration of the new the Rural Transaction Centre initiative.

Underpinning this shift has been a broad focus on economic policy and the positive benefits that can be derived from this. The Commonwealth's primary economic responsibility is for the national economy, both macro- and micro- management and reform. Strong economic management is one lasting benefit the Commonwealth can bring to rural and regional Australia, creating the economic foundation upon which specific programmes, at Commonwealth, State/Territory and local levels, can build. Australia's strong economic performance over the past three years has had positive effects throughout urban, regional and rural Australia.

The shift toward a focus on regional services is based on the recognition that primary responsibility for regional economic development lies with the State and Territory Governments. In 1996, the National Commission of Audit found in relation to Commonwealth regional development initiatives that there was extensive overlap and duplication with other government programmes at the State and local levels. Since the Commonwealth's withdrawal from a specific regional development programme, there is evidence that State and Territory governments have improved their own regional development programmes. This point will be returned to below.

At the Commonwealth level, a "whole of government" approach to regional and rural Australia is being implemented through the *Regional Australia Strategy.* The *Regional Australia Strategy* is built on helping to provide the economic, environmental and social infrastructure that is tailored to the needs of each region. The Strategy recognises the role played by all portfolios in delivering programmes that improve the economic, social and environment conditions in rural and regional Australia. While individual portfolios have responsibility for their own policies and programmes, the *Regional Australia Strategy* has identified a number of key priorities including:

- improving services in rural Australia, including health services;

- initiatives for employment and business;
- facilitating infrastructure for regional Australia;

- rural initiatives; and

- environmental sustainability.

With the recent signing of Memoranda of Understanding (MOU) between a number of key portfolio Ministers, linkages between Commonwealth departments and agencies have strengthened. These MOUs will ensure improved communication between the Federal Government and regional Australia and improved service delivery.

A number of programmes at the Commonwealth level are addressing regional infrastructure issues. These programmes range from the Regional Telecommunications Infrastructure Fund (RTIF), which is working to provide regional Australia with the technology and expertise to take advantage of developments in the communications sector, to programmes such as the Natural Heritage Trust which is improving conservation and resource management practices.

Recent Thinking on Regional Development

Infrastructure is one of many elements in developing regional and rural Australia. Undoubtedly, infrastructure is a key enabling factor in development. It provides development capacity in a diverse range of areas, from the more traditional notion of transport and energy provision through to education and health services. In providing development capacity, infrastructure is crucial to business competitiveness. However, other factors can be very important in allowing regions to improve their economic performance and growth potential. In recent studies, creating and facilitating business growth is seen as vital to regional economic growth, a sentiment that is echoed by State government programmes[1].

A range of studies into regional development in Australia over the past decade have highlighted the importance of a number of factors such as:

- developing regional economic strengths via competitive advantage;

- business and regional leadership;

- creation of a learning environment;

- industry clustering;

- strategic planning; and

- commercial and financial skills.

[1] For a sample of current thinking on regional development see: Australian Local Government Association, 1998; Brown, 1996; Geno, 1997; Meredith, 1998; Porter, 1990.

The key theme running through much of the literature focuses on the need to foster business skills and improve existing capacity within regional communities to generate economic growth, building on a region's comparative economic advantage. Focussing on growing regional business, the regional development literature acknowledges that governments must look to the private sector for investment and business growth. The factors raised by the literature as critical to regional development have been picked up by many State governments in their regional policies and programmes.

Regional Development and the States

Most State and Territory governments around Australia have regional development programmes. Many of the principles underlying these programmes are similar, building upon regional economic strengths and creating economic growth. For example, both New South Wales and Victoria have developed integrated packages aimed at improving and supporting economic growth of their regional areas. Underlying these packages is a recognition that economic growth is sustained by investment in regional businesses and communities. In Victoria, the rural development programme is administered by Business Victoria. The Victorian programme is based on ensuring regional Victoria has access to all State government programmes with the addition of a targeted programmed called "*Partnerships for Growth*." In New South Wales, the Department of State and Regional Development is responsible for regional development programmes. Like Victoria, the focus for regional development activity is on business and investment growth. A number of common objectives can be seen running through both States' programmes:

- responding to the needs of regional communities;
- attracting new industry and investment;
- strengthening and expanding local business performance; and
- funding priority development projects and infrastructure.

Although only a sample of two State government programmes, they do provide an understanding of the approach being taken. At the State level, regional development programmes are better placed to address special needs of their regional communities. As a result, they are better able to prepare programmes tailored to these needs. In addition, improving partnerships with the private sector and promoting private sector growth enables State governments to use the expertise and skills of the private sector. Developing this notion of partnership has been an important development in public-private relations in recent years and is returned to in the following chapter.

Local Government and Regional Development

The role of Local Government in regional development is unique due to its proximity and accountability to local communities. Local Government has been the major ongoing contributor of funds to, and supporter of, the various regional structures that have emerged over recent years. In particular, Voluntary Regional Organisations of

Councils (VROCs) have often proven effective forums at the regional level for promoting economic development.

Local Government contributes to regional development through VROCs and other cooperative arrangements to fulfil its roles in advocacy, economic development and strategic planning and coordination. Approximately 50% of councils participate in a VROC. Local Government's role in regional development includes:

- Strategic planning;
- Statutory planning;
- Local leadership and coordination in development information, advice and technical assistance;
- Provision of infrastructure and essential community services;
- Commercial and industrial development, including business incubators;
- Involvement in training and job creation programmes; and
- Protection of amenity and environmental management.

Local Government also plays an important role in infrastructure provision. For example, Local Government is responsible for more than 80%, by length, of the nation's roads. Roads represent the major capital investment of most councils. Local Government spends around $2.3 billion a year on local roads (of which the Commonwealth provides $380m) but claims there is still a shortfall of $1 billion a year in local roads funding. The Australian Local Government Association (ALGA) is undertaking an extensive programme in conjunction with Austroads to ensure maximum efficiency in local roads expenditure. Local governments also play a critical role in the delivery of local community and health services, services that might be termed “soft infrastructure”. The actual range of services varies from State to State, but there is extensive involvement in areas such as immunisation, public and environmental health, childcare, and services and accommodation for the aged and other special needs groups.

3. Infrastructure in the Broader Economic Environment

Investment in public infrastructure and the efficiency of its operation are significant influences on national economic and employment growth. The performance of our infrastructure affects most economic activity and has a significant influence over our quality of life, access to services, and the quality of our physical environment. Inadequate infrastructure impedes business performance and competitiveness, impacting on both national and regional economic growth.

Over-investment and inappropriate investment in infrastructure, and poor use of it, deprive other areas of the economy of resources. Infrastructure can also become a severe financial and management burden for the local government authority and community responsible for its maintenance.

Achieving an optimal balance is difficult and perceptions of success in doing so are subjective. Strong recent improvements in our national productivity performance suggest that a reasonable balance is being achieved. We have greatly improved the efficiency with which we use our infrastructure over the last decade.

Infrastructure attracts a great deal of attention – positive and negative. It is seen as a source of progress, regional development, job and wealth creation, environmental damage and benefit, and a big drain on public finances. Governments and the community have to make judgements about priorities for investment and development, given the always limited resources available. Judgements also have to be made about the sometimes competing economic and social and development objectives.

Trends in the supply of infrastructure

Traditionally, the public sector has been the main provider of public infrastructure in Australia, owning around 90%[2] of the capital stock. Public ownership was necessary because of immature (domestic) private capital markets, the considerable commercial risk associated with such investments and the need to subsidise many such infrastructure projects. Public ownership was also a convenient means of delivering cross-subsidies. Policy objectives such as national development and establishing basic levels of service delivery were the rationale for public ownership and budget funded investment. This has not been the case in a number of other countries, including the United States which has a history of private infrastructure provision.

Since the 1960s the level of government investment in infrastructure has declined from about 9.2 per cent of Gross Domestic Product to 4.8 per cent of GDP in the 1990s. This was largely attributable to the decline in State and local government investment, which dropped from 7.5 per cent of GDP to 3.4 per cent over the same period. Commonwealth investment has remained relatively constant at between 1.6 and 1.4 per cent of GDP[3]. Data on recent investment levels and trends are available

[2] EPAC (1995) Private Infrastructure Task Force (1995)
[3] ibid

from a number of sources, including the Neville reports[4], "Tracking Australia" and "Planning Not Patching", published in July 1998 and October 1997 respectively.

This fall in public infrastructure investment does not necessarily indicate that the level of provision has become deficient. These figures do not include private investment which has increased greatly and displaced an increasing amount of public investment. Perhaps more importantly, our infrastructure industries and physical networks have become more mature (eg road maintenance rather than construction has become relatively more significant), and we have greatly increased the efficiency with which we use our infrastructure.

Involvement of the private sector

The dominant trend in the provision of infrastructure over the last two decades has been increased private involvement. Private sector interest and engagement in the provision and operation of infrastructure has taken some time to develop. The Australian finance sector lacked expertise in this type of investment. It was small by world standards and infrastructure projects are large, lumpy, and in some cases, risky investments. Our construction industry was more interested in construction projects rather than overall project development and equity commitment.

There was also a lack of experience with appropriate corporate structures and joint venture relationships to spread risk. High capital costs and long lead times before returns are received from infrastructure projects increased the risk to bankers in their private capital markets. Superannuation funds, although holding rapidly increasing portfolios, were similarly inexperienced in this form of investment. Superannuation funds are also limited by regulation of their investment practices. In short, the private sector was not ready for the opportunities and public policy was not receptive to its involvement in these industries.

The changing economic policy environment

A key catalyst for change has been financial sector reform stemming from the Campbell Report[5] and the movement of Australian banking and banks into the global banking industry. This reform has created a larger pool of funds and access to expertise in places where infrastructure lending had been commonplace for some time. Australians are becoming more conversant with the 'user pays' concept, and are gradually accepting tolls and other direct charges for services. This has given governments the ability to engage the private sector in infrastructure development that may otherwise have not taken place.

This change in the finance industry was part of a much larger economic reform in Australia, much of which focussed on infrastructure industries where our national productivity performance had been poor.

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[4] House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform (1997) *Tracking Australia: An inquiry into the Role of Rail in the National Transport Network* AGPS, Canberra and House of Representatives Standing Committee on Communications, Transport and Microeconomic Reform (1998) *Planning Not Patching*, AGPS Canberra.
[5] Committee of Inquiry into the Australian Financial System, (Chairman J.K. Campbell), (1981) *Australian Financial System: Final Report of the Committee of Inquiry*. AGPS, Canberra.

Productivity growth is the principal driver of economic growth - on both a national and regional basis. Efficient infrastructure investment and operation is critical to achieving this growth. Extensive micro-economic reform in Australia over the last 15 years has been instrumental in turning around Australia's disappointing productivity growth, achieving low inflation and increasing our international competitiveness. Much of this micro-economic reform has focussed on improving the efficiency with which we finance, construct, operate and use our infrastructure – especially in the transport, communications and energy sectors.

In competitive markets, which are essential to drive economic and employment growth, individual firms are at risk. Governments have judged that this risk should not be borne by taxpayers when private capital is willing to assume these risks of ownership. Comprehensive regulatory arrangements have been developed at a national and State level to deal with safety, environmental and operational matters in private markets, and with the potential for abuse of market power that exists in many infrastructure industries.

The Role of Government

As the public sector is gradually withdrawing from the ownership and provision of infrastructure its future role in this area is becoming increasingly well defined, especially at the Commonwealth level:

- establishing the optimal macro-economic conditions for economic and employment growth;

- facilitating private investment in infrastructure through the tax laws and effective planning, safety and environmental regimes;

- regulating competitive conduct through the Trade Practices Act, and promoting a thriving enterprise culture through appropriate industrial laws; and

- retaining a direct investment role where the level of infrastructure required by the community cannot be supplied on commercial terms or there are national interest reasons for continued public ownership (eg the ABC and Australia Post); and

- promoting infrastructure development (eg through the Institutional Investor Information Service and Invest Australia) and highlighting situations where for social or regional development policy reasons intervention is deemed necessary.

With the changing Commonwealth role, broader developments in Australia and the new federal financial arrangements scheduled to commence on 1 July 2000, State Government roles are also being refined. States will have the primary role in:

- the delivery, or commissioning the delivery, of community services;

- the provision of health services and regulation of private service providers;

- the provision of education services and regulation of private service providers;

- statutory and strategic planning and regulation, including anticipation of infrastructure requirements and their provision;

- the provision (through ownership and/or contract) of urban mass transport services; and

- planning and regulating the provision of infrastructure services to local communities, other than telecommunications, broadcasting and postal services (which are clearly Commonwealth responsibilities) but including water, transport and energy.

Governments have reduced their role as a direct provider of public infrastructure largely because it became possible through:

- the increasing depth and maturity of Australia’s capital markets, and with it an increased willingness to finance and accept the risks associated with ownership of these assets;

- an evolution in the commercial character of the actual infrastructure businesses (such as airports, electricity generators, etc) and the industries in which they operate;

- technological change and market development which has allowed (and forced in many cases) the introduction of competition in place of public monopoly market structures, and made efficient pricing instruments (eg electronic tolling) feasible;

- public policy reform which has reflected and encouraged this technological and market development;

- a reduced willingness by governments to accept ownership risk in competitive and commercial markets, accompanied by an increased focus on economic and public finance fundamentals (such as balanced budgets over time, reduced public debt, greater use of market disciplines in service delivery, etc); and

- a recognition that because of always limited public capacity to fund infrastructure, private investment has the potential to bring forward the economic benefits of infrastructure development.

<u>The DTRS Portfolio</u>

There have also been significant changes in the roles of the different levels of government over this time. In terms of the DTRS portfolio this includes:

- the Government is no longer involved in local road funding other than through the payment of untied grants (and these will be discontinued with the financial arrangements that will accompany the new income tax system). Commonwealth road funding has concentrated on a defined National Highway System, and a very limited number of urban linking roads and other roads of national importance. The States have responsibility for the rest of the arterial network;

- apart from the Sydney basin and Essendon airports, the Commonwealth has sold (through long term lease) or transferred its interests in all civil airports. The larger airports are now owned by private firms, most smaller and regional airports are owned by local government authorities;

- by the end of 1999 the Commonwealth's only equity involvement in the rail industry will be through the Australian Rail Track Corporation (which has a $250m investment programme) which provides access to interstate rail track and has no operational role in the industry; and

- the only involvement in the maritime industry will be policy, safety and environmental regulation and accident investigation. There will be no operational involvement:

    - all of Australian National Line Ltd's operating business divisions have been sold.

<u>Other Commonwealth Portfolios</u>

The Commonwealth has also retained a role in a number of areas including:

- continuing ownership of a corporatised Australia Post, enforcement of a standard charge for the delivery of letters anywhere in Australia (at a Government funded subsidy of $67m pa), and a contraction of the Australia Post legislated monopoly to the basic letter service;

- part ownership of Telstra, and enforcement of a legislated Universal Service Obligation at a cost of $250m pa, funded by the carriers (and therefore borne predominantly by the Commonwealth at this stage);

- ownership and principal funding responsibility for the ABC and SBS. Funded by parliamentary appropriation on a triennial basis, in 1998/99 the ABC will receive approximately $507m and SBS $87m; and

- significant Specific Purpose Payments for health and education.

Similar changes are occurring within State governments, although the rate of progress varies. All are moving in essentially the same direction. Local government authorities are also responding to funding pressures and demands for improved service delivery and aggregating services and contracting private service deliverers in some areas.

<u>Getting the policy and regulatory framework right</u>

These developments have focussed attention on the need for governments collectively to provide efficient 'facilitation' services to private investors. Governments have comprehensive and complex regulations in place to meet planning, safety, environmental and business conduct policies. Compliance with these regimes can be an onerous obligation for projects located in one State or Territory, and doubly so for projects which cross State borders. Taxation issues can also have a critical influence over project development.

Collectively these obligations, along with the normal processes of establishing appropriate corporate arrangements and securing finance, impose high transaction and setup costs on project development. These vary somewhat with the size of the project, but are a much greater cost in relative terms on smaller projects.

Environmental approvals are a key government responsibility, both at the State and Commonwealth levels for many projects. Infrastructure projects requiring significant Commonwealth decisions will normally trigger provisions of the *Environment Protection (Impact of Proposals) Act* (EPIP). This may necessitate a formal environment impact assessment.

The requirements of the EPIP Act may be in addition to obligations imposed by State law and Local Government by-laws. Despite the apparent complexity of these arrangements there is good cooperation between governments on most projects and approval requirements are usually managed so that they are no more difficult than they need to be. A Bill amending the EPIP Act is presently before the Senate. If passed this will simplify the Commonwealth requirements and refine the respective roles of the Commonwealth and States.

Planning approvals are a State and Local Government responsibility. State governments generally take an overview of land use planning and larger infrastructure developments that impact on networks such as power, water and transport. Local governments generally have prime responsibility for planning issues at the local level, including land use, local roads, waste-management, water, and sometimes airport infrastructure.

Tax issues are critical to many infrastructure projects, both in the general application of tax law and certainty of its interpretation for specific projects. The Commonwealth is addressing business tax reform through a review led by Mr John Ralph, AO. Reform proposals will be submitted to the Government in mid 1999, and the Government is planning to legislate for a new business tax regime to commence on 1 July 2000. The outcome of this reform process could have a profound influence over the future development of private infrastructure investment, and joint public/private arrangements for funding and operating projects which are not commercially viable on a stand alone basis. The reform process will be very important for regional infrastructure projects particularly if the new tax regime allows more flexible mechanisms for project financing.

The UK Government has developed a financing model known as the Private Financing Initiative which has been successfully implemented in several sectors in the UK, including roads. This model may be applicable to Australia as a partnership between the public and private sectors for financing and operating roads and road networks which are not commercially viable and will not be funded by the Commonwealth alone.

This Department is investigating the use of this model as a mechanism for extending the reach of Commonwealth road funding to increase the economic and social benefits of that investment. Achieving more and better road infrastructure for the limited available funding will necessarily involve greater private sector involvement.

The Commonwealth has a major projects facilitation process which provides proponents of certain major infrastructure projects with assistance in having their projects fast-tracked through governmental approval processes. This service is provided by Invest Australia in the Department of Industry, Science and Resources. Most States have similar arrangements for major infrastructure projects.

<u>Where commercial supply of infrastructure doesn't work</u>

Some infrastructure will never be commercially viable in a conventional sense (for example much of the rural road network). However, it will continue to be provided by governments to meet fundamental social and development objectives which have a clear national commitment.

While construction, maintenance and even operation of this type of infrastructure may be undertaken by private firms there is no alternative to public funding for the foreseeable future. In most cases this will simply mean budget sourced funding, although the funding sources could diversify over time. The rural road example noted above could conceivably be funded through a cross subsidy provided by a corporatised road authority in future, although a formal budget funded Community Service Obligation would generally be a preferable funding mechanism.

Governments may also provide infrastructure, or contribute to its development, where there are economic benefits which cannot be captured by a service provider. Private developers are interested only in the financial viability of a project. With some projects the economic benefits are greater than the financial benefits because of positive 'externalities'. These benefits could include increased land values, improved traffic flows across a network generally with a central facility being constructed, and creation of tangible new business opportunities. In these cases a public contribution may be warranted to realise these broader economic benefits even when the facility may not be viable on a stand alone basis. Moreover, some of these benefits would be captured by governments over time through increased tax receipts.

A similar case can be made for a public contribution to projects which are not commercially viable on a stand alone basis but make a substantial contribution to achieving social, development and/or environmental outcomes. Examples are some water treatment and land degradation remediation works (dealing with the consequences of the negative externalities in the use of land and water).

However, all projects of this kind seeking a public contribution will be competing with other calls on public resources, and doing so in a state of responsible public expenditure. While they may be very attractive when considered in isolation they can only be assisted at the expense of some other government priority. A positive benefit-cost assessment in itself, for instance, is not sufficient grounds for government assistance. As well, many infrastructure proposals do not even pass this initial benefit-cost assessment.

Infrastructure Borrowing Tax Offset Scheme

The Infrastructure Borrowing Tax Offset Scheme (IBTOS) is the Commonwealth Government's principal mechanism at present for assisting private infrastructure development.

Developers of infrastructure projects experience high capital outlays in the development stages of a project but receive little or no return on their investment during this time and often for some years after completion of the facility. To ensure otherwise viable projects do not fail for this reason, and compensate for some of the deficiencies in the tax system (including the use of tax losses), the Government introduced IBTOS in 1998.

IBTOS provides a tax offset for lenders to infrastructure projects. In return, the borrower receives a reduction in finance costs in the form of lower interest rates or other benefits, and foregoes tax deductibility on interest payments associated with the loan. The outcome is that financial assistance is provided to infrastructure developers in the early part of project development, which is the time of greatest financial need. Almost all revenue initially lost is eventually clawed back through future tax paid on interest payments, and other tax on the use of outputs from the facility.

To date, there have been two rounds of IBTOS, which has a cost to revenue of $75m per annum. In the first round, 35 applicants bid for thirty projects valued in excess of $17 billion. Sixteen land transport projects were received, nine energy, four seaport and one airport project from all States/Territories except the ACT and Tasmania. Five projects have been offered the offset, subject to finalisation of Agreements between borrower, lender and the Commonwealth. Terms and conditions of the Agreements are being negotiated.

Sixteen projects valued in excess of $5 billion have been received in the second round of the Scheme and are now being assessed. The applicants that have agreed to have their proposals made public are:

- Chatswood to Parramatta Rail Link
- Brisbane Light Rail
- Gore Hill Tollway
- Basslink Project
- Maryvale Co-generation Project
- Franchise of Yarra Trams
- Franchise of Swanston Trams
- Hillside Trains
- Freight Victoria Limited acquisition of V/Line Freight

4. Regional Infrastructure Proposals

The principal consideration with private sector funding of most infrastructure proposals is commercial viability. As is obvious, projects which are not commercially viable will generally not be started. Other problems can be lack of investor knowledge, up-front costs, threshold levels and perception of risk. Investor perception of risk is critical. Higher risks require higher returns and reduce viability.

Each of these problems can be more severe in regional areas where the markets are thinner and the risk greater because the economic base of a region may be fragile (based on a narrow range of commodities for instance), and project size, and therefore investor interest will be more limited.

Potential investors may be concerned about their investment becoming “stranded”. Most regional areas have a limited range of business opportunities, often dominated by one major firm or industry. Any economic downturn can potentially put that company out of business or slow the activities of a particular sector. As a result there may be few, if any firms, able to use the infrastructure, leading to a decline in the worth of the infrastructure. In turn this affects the price the infrastructure can be sold at and the ability to recover the initial capital outlay. That original financial outlay then becomes stranded.

Governments are under constant pressure to assist developments proposed for regional areas which cannot be privately financed for these reasons. Responding in a responsible and sensitive way to these pressures is difficult and runs the risk of ad hoc assistance decisions. There are a limited number of Commonwealth programmes which can be used to assist regional projects, and one-off sources of assistance such as the Commonwealth Government’s Federation Fund which was established in the 1997-98 Budget, are irregular and often triggered by special and irregular events, in this case anniversary celebrations.

In the aviation sector, the Commonwealth has remained involved in a number of programmes that can be classified as providing infrastructure to regional Australia. The Commonwealth Government is contributing $13m over two years over 1998/1999 and 1999/2000 to subsidise the operation of a number of general aviation and regional airport control towers. This is ensuring tower charges can be maintained at acceptable levels until the provision of these services can be exposed to competition with anticipated reductions in the costs of tower services. The Government announced in the 1999/2000 Budget that this programme would be extended beyond the initial two year period.

The Australian Maritime Safety Authority (AMSA) has been installing Differential Global Positioning Systems (DGPS) broadcasting stations which broadcast correctional data over the maritime navigation band and have an effective range of over 200km. Eight stations have been established at Cape Schanck, Karratha, Horn Island, Sydney, Mackay, Cape Flattery, Brisbane and Gladstone. A final station at Ingham will complete coverage of the Queensland coast and principal Great Barrier Reef entrances. The relocation of the Lockhart River station to Weipa will enhance coverage in the Gulf of Carpentaria.

The Remote Air Service Subsidy Scheme (RASS) subsidises five air operators to service approximately 200 specified remote ports, with a population of almost 9,000 people, located predominantly in Queensland and the Northern Territory, with some in SA and WA. These include cattle stations and remote indigenous communities. The services primarily provide regular deliveries of mail and educational needs, as well as carriage of general freight and passengers. The 1998/99 funding for RASS is $1.258m.

Apart from funding National Highways, the Commonwealth provides funding to the States/Territories on a cost-sharing basis for Roads of National Importance (RoNIs). Funding is generally provided for construction only. RoNIs serve regional and national development by:

- encouraging inter-regional and international trade in goods and services;
- improving national competitiveness by maximising transport efficiency and reliability; and
- allowing for quick adjustments to the pattern and nature of trade in response to emerging national and international economic opportunities.

Recently, the Federal Government broadened the criteria under which roads qualify for Commonwealth road funding, to encompass RoNIs. To be included in this category, candidate roads must generate economic benefits for the nation as a whole and, therefore, be considered an important part of Australia's economic infrastructure. Funding will be concentrated on those parts of the road network where deficiencies have an adverse impact in inter-regional and international trade and commerce. The criteria therefore have been developed for RoNI funding in the context of strategies that emphasise network performance and concentrate on arterial roads contributing to attainment of national goals: that is, roads that link major roads of economic activity or major transport facilities.

The Federal Road Safety Black Spot Programme aims to reduce the social and economic costs of road trauma by the cost effective treatment of locations with casualty crashes. Since the introduction of the Programme in 1996-97 1,122 projects have been approved across Australia with an estimated value of more than $116m. Similar funding will be delivered over the next three years of the Programme. Just over half of funds allocated have been for cost-effective safety-oriented projects in non-metropolitan and rural areas of Australia. This reflects an objective of the Programme to recognise the high level of road trauma in rural areas by directing approximately 50 per cent of funds to such areas.

Flood can have major impacts on the often fragile economic base of rural and regional communities. Business unaffected by the initial flooding can be severely affected by the resultant loss of infrastructure and services. The objectives of the Regional Flood Mitigation Programme are to assist in the implementation of high priority, cost-effective flood mitigation works and measures in rural towns and regional centres, to promote safety, protect the economic base, and, where possible, promote environmental sustainability. The Commonwealth will contribute $20m over the three years to 2001-2002 to fund one third of approved projects. The States and Territories and local government will settle the funding of the other two thirds between them. The first projects will be approved for funding in August 1999.

As noted on page thirteen, a high proportion of resources are allocated to service delivery in regional areas (eg postal, broadcasting and telecommunications services), and the States, Territories and Local Government authorities receive very large untied grants from the Commonwealth to fund their responsibilities. This will soon become an even larger stream of revenue from a growing indirect tax base.

Funding responsibilities for Local Government are being transferred from the Commonwealth to the States and Northern Territory as part of the Tax Reform Package. The Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations was signed at the Premiers' Conference on 9 April 1999. The Agreement contains the conditions agreed by the States, Northern Territory and the Commonwealth for the transfer of the payment of local government financial assistance grants and guarantees maintenance of funding. States and the Northern Territory have agreed to enact legislation to support the Agreement.

<u>The Key Questions for Regional Infrastructure Projects</u>

In considering infrastructure proposals being sought by regional communities or proposed to governments by private proponents a number of difficult questions must be asked:

- Is the infrastructure being sought the best way to provide the benefit being sought?

- Can the project be commercially viable in the form proposed or in some other form?

- Are there economic returns which cannot be captured by the project proponent which might warrant public financial assistance on economic grounds?

- Is there a social, development or environmental policy outcome which might warrant public assistance where there is not an economic case for the investment? and

- Will the assistance lead to a sustainable asset investment without a need for ongoing assistance?

If the answer to these is in the affirmative, there are two remaining critical questions to be asked:

- Who bears the risk of commercial failure? and

- If government assistance is being considered for a project, is that the best use of taxpayers funds on economic and/or social policy grounds?

Given the number of such projects being proposed to governments and the extent of available funds, a decision to grant assistance to a project is always at the same time a decision to deny assistance to other projects. Exercising judgements and choices about resource allocation are a fundamental responsibility of government of course, but even a cursory analysis of these questions indicates why there will always be some dissatisfaction with governments' handling of these decisions.

The problem of setup and transaction costs

Turning an imaginative concept into a funded project specification is an extremely expensive and complex process. There is evidence that the private sector is reluctant to provide a facility costing less than $50m. Even then, the project may incur a premium interest rate because of perceived risk.

One way of dealing with the high setup, due diligence and transaction costs that has been proposed is to 'bundle' similar projects and create scale economies. This is more difficult than it sounds – not all contiguous areas want similar infrastructure at the same time, there are difficulties in sharing risks, responsibilities, and renewal as areas grow at different rates to their neighbours, creating different needs. There may be several places where the 'bundling' of a similar type of project would provide a 'critical' mass to allow for private sector investment. It remains to be seen if this bundling of projects is a workable approach in practice.

The Former Regional Economic Development Programme

From 1994 until 1996, the Commonwealth was involved in a specific programme aimed at increasing the economic capacity of Australia's regions, the Regional Development Programme (RDP). Based on work undertaken by the Taskforce on Regional Development (1993) and the consultants McKinsey and Co (1994), the RDP created more than 44 Regional Economic Development Organisations (REDO) around the country. The total budget allocation for the RDP was $150m over 4 years. In addition, $70m over four years was allocated for regional infrastructure projects. Following the change of Government in 1996, these totals were not fully committed. Examples of some of the types of regional infrastructure projects completed under this programme include:

- building a gas pipeline;
- enlarging an existing weir;
- establishing an export development unit;
- upgrading tourism facilities; and
- completing feasibility studies and business plans.

Following the findings of the Commission of Audit's report in 1996, the RDP was abolished by the Government on 17 July 1996. Funding to a total of $80m was allocated for a range of contracted commitments entered into prior to 17 July 1996. A number of projects funded using this $80m are due to be finalised this financial year.

The Institutional Investor Information Service

Established in January 1997, the Institutional Investor Information Service (IIIS) is a partnership arrangement between Federal and State government and industry in the Australian Capital Territory, Queensland, New South Wales, Tasmania, Victoria and Western Australia. The IIIS was established by the Commonwealth with the specific aim of enhancing economic growth in regional Australia by facilitating greater private investment in economic and social infrastructure. The IIIS aims to expand private sector investment in infrastructure in regional Australia by bridging the information gap between institutional investors and regional project proponents. The IIIS is managed for the Commonwealth by the Australian Council for Infrastructure Development (AusCID).

There are three core elements of the IIIS scheme:

- a marketing/information awareness campaign to explain to project proponents how the institutional investor market works;

- an education campaign aimed at the institutional investor market about the benefits of holding a more diversified investment portfolio and the investment opportunities that exist at the regional level; and

- a national register of "Investor Ready Projects" to be placed on the Internet.

The primary activity of the IIIS has been to undertake eighteen workshops throughout regional Australia. Undertaken in conjunction with the participating State and Territory governments, the workshops provide an opportunity for regional project proponents and representatives from major financial institutions to meet and discuss projects. Through these workshops, sixty eight projects have been presented for appraisal. The appraisal process has served as an educational tool for regional project proponents, increasing their awareness of the financial aspects of project development. Other activities undertaken through IIIS include developing a website and undertaking a pilot infrastructure stocktake.

Two important elements of the IIIS were not able to be undertaken, the Concept Review and the Assessment Service. The Concept Review was designed to offer project proponents access to limited expert assessment of their projects at an early stage of development. The Assessment Service was designed to offer a formal assessment of projects against assessment guidelines and market criteria. This Service was designed to determine whether projects have enough merit to warrant a full feasibility analysis and further due diligence work by the investor. In their final report on IIIS, AusCID noted that there seemed to be a reluctance to use these services based on assumptions by the proponents that it is the responsibility of government to fund the development of infrastructure projects rather than the proponents themselves. However, the IIIS project has been a positive educational tool for regional Australia, clearly addressing the information gap between regional proponents and institutional investors. The project has identified a number of deficiencies and shortcomings in the regional infrastructure sector and these will be discussed in Chapter Five.

Transitional effects of new investments and reform

More efficient infrastructure can have local impacts as labour needs are reduced or production locations change. The regional transition to these changes can be severe. Improved network infrastructure, such as roads and railways, can also have negative local effects as towns are bypassed and lose sales from passing traffic, fewer stops are required, local maintenance services are no longer needed, and access to major regional centres (for shopping etc) is improved at the expense of smaller centres. Internet shopping and banking services will accelerate this trend as rural dwellers gain access to international sources of consumer goods with which local suppliers cannot hope to compete.

There are also transitional effects from better use of infrastructure, and some losers as well as overall economic and social benefits. These effects are often ameliorated through assistance measures such as:

- $5.3 billion in payments to the States and Territories over the nine years to 2005-2006 for assistance in addressing any adverse impacts of competition policy reform;

- the use of Telstra sale proceeds for programmes such as the Rural Telecommunications Infrastructure Fund for $253m, which is designed to provide support for projects offering service quality above the universal service obligation (which assumes all Australians have reasonable access to the standard telephone service);

- $20m in assistance for South Australian and Tasmanian communities affected by the sale of Australian National businesses; and

- $10m for the Commonwealth's Newcastle Structural Adjustment Fund, which is being provided for key initiatives leading to sustainable, private sector employment and which utilise the natural and competitive advantage of the Hunter region.

There is a widely held view that construction activity leads to significant job creation and there may well be some positive short term impacts in terms of employment. However, because construction activity is a highly capital intensive business using largely imported equipment and often imported labour, the impacts on regions may be minimal in the longer term.

5. Deficiencies in Infrastructure

The Committee has been asked to examine deficiencies in Australia's infrastructure. It will find widespread views that there are such deficiencies. This is not surprising as there is a general desire for more and better infrastructure, especially if the costs of its provision are not to be borne directly. The efficiency with which infrastructure is used is also critical to whether infrastructure in itself is adequate. For example, sound infrastructure used inefficiently may appear inadequate at first glance such as a water storage facility with inadequate water pricing arrangements.

Some of our key infrastructure sectors such as roads and water do not have adequate pricing mechanisms in place. In many cases it is not possible to say whether more or different infrastructure is warranted without pricing reform. Private urban road developments are achieving this, but more needs to be done on a system or network basis. Some progress has been made on water pricing, but jurisdictional problems have impeded progress.

It is well established that the demand for (unpriced) urban arterial road space in major cities is almost unlimited, and that users will tolerate very high levels of congestion before changing their behaviour. The same is almost certainly the case with unpriced or underpriced water for agricultural and horticultural production. In both cases the cost of the externalities borne by others and by the environment is significant.

Identification of deficiencies

Private developers can usually be relied upon to identify commercial opportunities and realise them where the returns are adequate.

State governments in their role of network and land use planners should be anticipating needs and initiating processes to ensure they are met. They are also well placed to understand the calls of local communities for improved services and how they relate to developments in the broader region.

Local Government authorities are especially well placed to understand the service needs and development opportunities of local and regional communities. They are infrastructure funders and providers (eg roads, water facilities), and should be in a position to cooperate with adjacent LGAs to bring larger projects to fruition through 'bundling' where this is practical.

Local communities generally have sufficient access to local, State and Federal representatives to have proposals of genuine merit taken seriously, although there is clearly a significant lack of available project development skills in regional Australia.

There have been many attempts to establish national infrastructure and investment advisory committees of various kinds to identify and advise government of infrastructure needs, including regional needs, and on network planning and priorities generally. The typical problem is that there is no shortage of advice to governments on infrastructure needs/deficiencies but little serious work on development prospects and the gap (if there is any) between the project's commercial prospects and viability.

IIIS and Problems with Regional Infrastructure Development

A recent report by AusCID[6] on the final stage of the IIIS project provided some discussion of the problems facing regional infrastructure projects. The report highlights a number of generic issues relating to investment in regional infrastructure development. They include:

- market imperfection;
- critical mass;
- dependence culture; and
- 'orphan' syndrome.

Market imperfection refers to a lack of understanding on the part of project proponents of the amount of detail and analysis needed in the preparation and presentation of projects. Lack of knowledge and suitable experience and expertise in preparing project proposals have led to a re-focussing of the workshop programme to take account of the need to develop these skills. Skill development is an important aspect of equipping regional Australia to prepare more attractive project proposals, particularly from the viewpoint of institutional investors.

Many regional infrastructure markets and sectors lack the critical mass necessary to make projects financially viable due to high initial costs and insufficient initial demand to underpin the invested amounts in order to meet minimal returns. Investors are also wary of regional infrastructure given that investment returns are affected by the often very large "public good" aspect of many of the projects.

"Dependence culture" refers to the ongoing belief among many regional infrastructure proponents that government has an obligation to provide the assistance necessary to develop and fund projects. As noted above, the role of government is changing and many of the traditional assumptions are no longer valid. This is particularly true of government's role in developing project concepts. IIIS and the work of AusCID is addressing this issue.

The concept of "orphan projects" refers to projects that are not financially viable due to inadequate returns. These projects, often on a small scale and with total costs of under $20m, are usually ignored by investors who are deterred by the high initial project costs and length of time before an adequate return is delivered. There has been some debate about the need for a source of long term equity to provide the financial resources necessary for regional projects. Superannuation funds have been mentioned as a possible source of long term equity, however, there has been insufficient work undertaken to determine the viability of such a proposal. The nature of long term capital requirements would generally indicate the need for public sector involvement. With such long time frames involved before any investment provides a

[6] Unpublished report prepared by the Australian Council for Infrastructure Development on the Institutional Investor Information Service in 1999. The Report is part of the management process for the IIIS project. A copy of the IIIS Final Report can be provided to the Committee if required.

return, it is easy to understand the unwillingness of private investors to become involved in projects requiring this type of capital investment. Provision of this long term capital for regional infrastructure proposals is a difficult question and it may be the case that the public sector is the only potential source of this type of capital.

Can infrastructure save a region?

Proponents of particular projects often argue that the construction of a certain piece of infrastructure will lead to major regional economic development. The reality for most regions is that infrastructure alone cannot provide the secure future they are seeking. The reason the infrastructure being sought may note be viable as a private sector project is closely related to the economic insecurity the community is wanting to address.

Experience with the IIIS has shown that many regional infrastructure proposals lack detailed analysis and are not well costed. It is common for large direct and indirect economic and social benefits to be attributed at the proposal stage. It is difficult to verify these assertions as benefits are rarely measured post hoc.

There has been no evaluation of the generally small scale infrastructure projects funded under the previous Regional Development Programme (RDP). Some have just been completed or are still under construction. In an interim evaluation of the RDP by McKinsey and Co., commissioned in 1996 by the then Department of Housing and Regional Development, the emphasis on funding of “infrastructure projects versus regional leadership” was one of the main criticisms[7]. The emphasis on infrastructure projects was seen as undermining the long term objectives of the programme, in this case supporting regional leaders and fostering a self-help approach to regional economic growth.

Major infrastructure developments have a mixed record in achieving sustainable regional development. The provision of cheap hydro-electricity has not secured a strong economy for regional Tasmania. The Ord River Scheme had a chequered history with unanticipated ecological problems and difficulties in accessing markets, before more recent success. The decentralisation and growth centre policies of the 1970s saw activity in only 3 of the planned 36 growth centres ie Albury-Wodonga, Bathurst-Orange and Monarto. Of these, only Albury-Wodonga achieved any of the original objectives of the policy. More recently the ambitious Multi-Function Polis (MFP) concept was abandoned, with its final Adelaide site now only a suburban residential development. Although benefits of each have been patchy at best, the costs, and opportunity costs, have been massive.

[7] McKinsey and Co (1996) *Supporting Regional Leadership: Unfinished Business*. pp15. This report was prepared for the then Department of Transport and Regional Development.

5. Conclusion

Infrastructure provision in regional Australia is a complex issue, involving a range of issues and interested parties. Many of these parties are seeking different outcomes and benefits from a single infrastructure project. Undoubtedly, projects do have a range of benefits beyond their immediate aim, but infrastructure is not the "single cure" for the problems of regional Australia.

Successful development of a region is dependent on the interplay of many factors, of which infrastructure is one, along with regional skills and leadership, business and market development, industry linkages and clustering and importantly the inherent and potential competitive advantage/s of the region. Australia's regions are very diverse and not all are equally endowed in terms of population and skill base, climate, soils and natural resources or proximity to markets.

That said, the lack of specific infrastructure can inhibit regional growth. However, many regional infrastructure projects struggle to meet the rigorous financial criteria imposed by the financial sector. This being the case, these projects can not be undertaken without part or full government funding.

Reform of the financial sector and changes to the relationship between government and private sector providers have led to the creation of a new framework for funding infrastructure proposals. This has enabled much greater private sector involvement in infrastructure, filling some of the gap created by governments' withdrawal. A number of projects, particularly in the development of urban road infrastructure, have shown the wider community is becoming more accepting of private sector provision. Direct pricing mechanisms such as tolls are being used with increasing frequency, indicating increasing public preparedness to accept "user pays". However, these mechanisms have limited application in much of regional Australia where the population densities and potential revenue streams are very thin.

Government involvement in infrastructure will continue to be required in a number of instances, particularly to meet fundamental social and development objectives in regional Australia. The IIIS project has shown an obvious deficiency in availability of the long term capital necessary to get regional infrastructure projects off the ground. Mechanisms to enable governments to work with the private sector to provide the capital necessary to fund worthwhile and appropriate regional projects deserve further investigation.

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