

Chapter 6

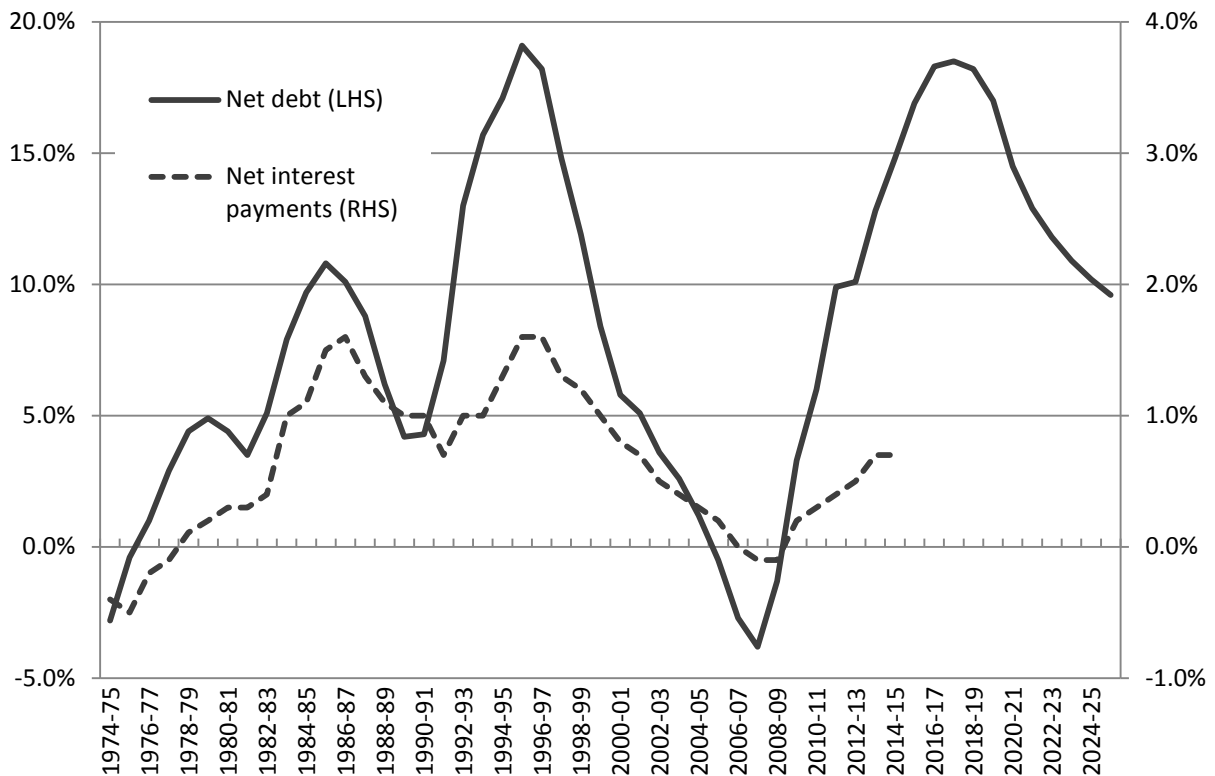
Infrastructure financing

6.1 This chapter covers the options at the federal level to raise money for infrastructure projects. The options covered in this chapter include: government debt; public private partnerships; and how this financing could be managed by the federal government.

Level of government debt

6.2 Figure 6.1 shows past and projected levels of net Commonwealth Government net debt over a fifty year period.

Figure 6.1: Commonwealth general government sector net debt and net interest payments as a percentage of GDP¹



Capacity for additional debt

6.3 Infrastructure Australia's (IA) plan noted that Australia's public debt is, by international standards, relatively low. IA suggested that the government may have borrowing capacity to finance economic infrastructure.

...this is an option that should be explored further. Provided new infrastructure assets are economically-viable, investments could unlock greater productivity across Australia and support current structural shifts to

1 Data derived from Commonwealth Budget Papers and Mid-Year Economic and Fiscal Outlook for 2015-16.

a greater focus on a competitive, service-based economy in the Asia-Pacific region.²

6.4 Mr Saul Eslake, Economist, believes that there is currently scope for the government to increase its borrowings to fund productive infrastructure. Mr Eslake referenced a recent statement by the International Monetary Fund (IMF):

For economies with clearly identified infrastructure needs and efficient public investment processes and where there is economic slack and monetary accommodation, there is a strong case for increasing public infrastructure investment. Moreover, evidence from advanced economies suggests that an increase in public investment that is debt financed could have larger output effects than one that is budget neutral...³

6.5 In continuation, Mr Eslake said:

The IMF goes on to emphasise that this conclusion is not 'a blanket recommendation for a debt financed public investment increase in all economies,' but the conditions which would prompt the IMF to counsel caution in particular cases—where debt-to-GDP ratios are already high or where returns to infrastructure investment are uncertain—do not seem to be pertinent in the Australian case.⁴

6.6 Mr Eslake looked to Australia's credit ratings to calculate a figure government could spend, noting that:

Australia's AAA credit rating is safe as long as government debt as a proportion of GDP remains below 30 per cent. There are different ways of measuring it, but, at the moment, public debt, including that of state and territory governments, is expected to peak somewhere around 22 per cent of GDP in a couple of years' time....

...A rough rule of thumb, allowing for the fact that on average during recessions Australia's public debt has increased by about 4½ percentage points of GDP, could be that Commonwealth government borrowing for infrastructure spending could increase by, say, three to 3½ percentage points of GDP without seriously putting at risk the Commonwealth's AAA rating.⁵

6.7 When considering an amount of debt a country can carry, Dr Paul McLeod, Research Program Leader, Planning and Transport Research Centre, University of Western Australia, commented that the question is really 'whether or not the

2 Infrastructure Australia, *Australian Infrastructure Plan – Priorities and reforms for our nation's future* (2016) – Report, p. 92.

3 International Monetary Fund, *World Economic Outlook, October 2014: Legacies, Clouds, Uncertainties*, (30 September 2015), p. 77.

4 *Committee Hansard*, 14 August 2015, p. 2.

5 *Committee Hansard*, 14 August 2015, p. 6.

underlying structure of the economy is such that it could sustain the debt currently and even more debt.⁶

6.8 Professor John Hewson challenged the basis for many concerns about government debt by drawing attention to the conflation of debt to fund the recurrent deficit and debt to fund capital (infrastructure) investment:

I think the way to start is to think in terms of jettisoning the very simplistic notions that have been peddled in parliaments around Australia that all debt is bad. If all debt were bad, none of us would buy a house or build a business. We should draw a distinction between recurrent expenditure and capital infrastructure expenditure in the budget and think about ways in which we can fund infrastructure separately to that.⁷

6.9 Professor, Steve Keen, Economics, History & Politics at Kingston University London, challenged the macroeconomic assumptions underpinning the policy of seeking to maintain a surplus:

Since a government should run a deficit of the order of the rate of growth of the economy in nominal terms, the fact that the government is running a far smaller deficit means that spending on infrastructure and essential welfare is well below what it could sustainably be. This generates waste. It is wasteful to give our children less education than we can afford, to maintain public infrastructure less well than we can afford, and to invest less in research than we can afford.⁸

6.10 IA highlighted that public sector borrowing for infrastructure is potentially more equitable as it distributes infrastructure costs across current and future taxpayers who will benefit from the infrastructure.⁹

Price of debt

6.11 Professor John Freebairn, Ritchie Chair of Economics, University of Melbourne, and Professor Max Cordon, Emeritus Professor of International Economics, Johns Hopkins University highlighted the opportunity provided by the historically low interest rates:

The context of Australia as an established net borrower from a large global capital market, together with current low borrowing rates, further supports a strategy of the use of government debt to fund infrastructure with a transparent and public positive benefit cost assessment. The issue of long term bonds to fund government infrastructure investment can be an important part of a strategy to lock in lower interest rates over the extended life of the productive investments.¹⁰

6 *Committee Hansard*, 9 October 2015, p. 32.

7 *Committee Hansard*, 14 August 2015, p. 25.

8 *Submission 64*, p. 24.

9 Infrastructure Australia, Australian Infrastructure Plan – Priorities and reforms for our nation's future (2016) – Report, p. 93.

10 *Submission 60*, p. 3.

6.12 Ms Marion Terrill, Transport Program Director, Grattan Institute, explained:

It is clear that the opportunity to borrow to build productive infrastructure is very good, with interest rates at historic lows. The 10-year government bond rate is about 2.6 per cent, and the states' 10-year bond rates are not much higher. Because governments can borrow cheaply, more cheaply than companies can, there is a real opportunity for governments to take advantage of such low interest rates, but spending is only worth doing for good projects.¹¹

6.13 One reason for the cautious approach to government debt is its potential to affect the Commonwealth's AAA credit rating.¹² Ms Terrill summed up why a AAA rating is important to government:

The AAA rating is part of what allows you to borrow cheaply, and borrowing cheaply is a very valuable thing for government.¹³

6.14 This was again recognised by Standard and Poor's Ratings Services who identified that the AAA credit rating was a government priority:

Although government budgets have capacity to absorb debt to fund infrastructure, the majority of the Australian governments (at both federal and state levels) have chosen to target 'AAA' credit ratings so that they can ensure strong access to markets, lower costs of debt, and, most importantly, deliver on their electoral promises to remain 'fiscally conservative'.¹⁴

6.15 Ms Fabienne Michaux, Head of Developed Markets Asia-Pacific, Standard & Poor's Rating Services, expressed the view that the Commonwealth does not have much scope to increase borrowings without risking their credit rating:

This is because, even though government debt is fairly low, we believe that the government's fiscal policy credibility increasingly hinges on it broadly achieving its current budget forecasts. This is after a number of years where planned improvements in budget outcomes have been derailed by sharp falls in commodity prices, and the earliest we may now see a Commonwealth budget surplus is 2020.¹⁵

6.16 Mr Craig Michaels, Sovereign Ratings, Standard & Poor's Ratings, re-iterated that although debt is part of the rating considerations, the current focus is on fiscal policy credibility:

...so yes, there is this debt threshold that is part of our framework, but increasingly we are saying it is not enough just to keep debt below 30 per

11 *Committee Hansard*, 5 November 2015, p. 1. See also Ms Marion Terrill, *Roads to riches, Better transport investment*, Grattan Institute, April 2016, p. 9.

12 For an explanation of what a credit rating is and how it is used please see Ms Fabienne Michaux, Head of Developed Markets Asia-Pacific, Standard & Poor's Ratings Services, *Committee Hansard*, 5 November 2015, p. 16.

13 *Committee Hansard*, 5 November 2015, p. 2.

14 *Submission 63*, p. 6.

15 *Committee Hansard*, 5 November 2015, p. 16.

cent, but a key part of the AAA has always been that we have thought governments are very much committed to getting budgets back in the black over a medium-term time frame.¹⁶

6.17 Mr Eslake explained that:

One of the principal reasons for the caution exhibited by successive governments of both political persuasions at both the Commonwealth and state levels regarding the funding through additional debt instruments of higher levels of infrastructure investment is the concern at the risk that this could trigger an adverse reaction from credit rating agencies, leading in turn to a downgrading of the Commonwealth's or a state-sovereign debt rating and thence to higher debt-servicing costs. There is no widely shared consensus among mainstream economists as to how seriously such concerns should be ranked as against other objectives and risks. The capacity to raise debt finance when needed or to refinance maturing debt at advantageous interest rates is not something to be dismissed lightly, yet nor should it, in my opinion, elevate it above all other fiscal and economic policy objectives.¹⁷

6.18 Mr Eslake also said that the Commonwealth has a strong desire to maintain its credit rating as the:

...credit rating underpins the AA rating of the four major Australian banks, which in turn allows them to raise wholesale finance in international capital markets at lower interest rates than would be the case if the Commonwealth's and hence the Australian banks' credit ratings were lower.¹⁸

State government

6.19 Mr Eslake also explained that Commonwealth and state debt are different.

However no such concerns apply to the credit rating of state governments. The only entities whose borrowing costs are affected by state governments' credit ratings are the individual state governments and their wholly-owned business enterprises. And even then the interest rates that state governments' borrowing agencies actually pay on their borrowings are influenced more by conditions in international sovereign debt markets, and by yields on Commonwealth government bonds, than they are by their own credit ratings. Thus, for example, Queensland has been able to borrow in recent years at much lower interest rates since it lost its AAA rating than it could while it had that rating, not because of the lower rating but because of the substantial decline in benchmark bond yields since the onset of the global financial crisis.

16 *Committee Hansard*, 5 November 2015, p. 18.

17 *Committee Hansard*, 14 August 2015, p. 2.

18 *Committee Hansard*, 14 August 2015, p. 2.

6.20 Ms Michaux contradicted this by suggesting that Commonwealth and state government ratings are closely intertwined which limits the scope for states to increase borrowing for infrastructure.¹⁹

6.21 Mr Eslake proposed that state and territory governments could fund infrastructure by borrowing from the Commonwealth. Mr Eslake suggested that the Commonwealth obtains debt and on-lends it to the states and territories at a small margin. If the Commonwealth on-lent to states, under the accounting conventions used in federal budget papers and other government financial reports, the loans made by the Commonwealth would be an offset to the increase in gross debt:

...so there would be no increase in the Commonwealth net debt, nor would there be any increase in the Commonwealth's underlying budget deficit, because the loans to the states would be classified under current accounting conventions as a 'net increase in financial assets for public policy purposes', which falls in the wedge between the underlying budget balance and the headline budget balance—like, for example, the Commonwealth's investments in the national broadcast network company...So there would be no net increase in the Commonwealth budget underlying deficit, there would be no net increase in the Commonwealth net debt and, therefore, no reason to expect the Commonwealth's credit rating would be affected.

The state governments' net debt would increase, and their credit ratings could be adversely affected, depending on the amount by which their borrowings increased. But since the state governments' credit ratings do not affect the borrowing costs of anyone other than themselves, and because the Commonwealth would, in effect, be carrying the additional gross debt issuance, there should not really be any serious consequences for anyone else as a result of that kind of transaction.²⁰

Raising government debt

Infrastructure bonds

6.22 The Productivity Commission (PC) found that in principle, using securitised borrowing via government infrastructure bonds, for an infrastructure fund could have advantages over general purpose borrowing. In particular, to the extent that the interest rate reflects the risks of the project, rather than the risks of default by the borrower. Bonds would make financing transparent and could instil greater discipline on project selection. However:

...if infrastructure bonds are used with the aim of bridging the financing gap otherwise not filled by the market, they would need to incorporate an incentive to investors to provide additional financing. To the extent that bonds are an alternative way of subsidising the project, the price of the bond (and, hence the interest rate) will no longer reflect the risk of the

19 *Committee Hansard* 5 November 2015, p. 16.

20 *Committee Hansard* 14 August 2015, p. 3.

project, and the above advantage of project-specific bond finance disappears.²¹

6.23 Government issued infrastructure bonds may have some positive perception value as the debt is being raised is for the overall public benefit. For example:

...Waratah bonds issued by the NSW Government are being promoted to investors 'who want to secure a better future and invest in their state'...The marketing of government debt as being for the purpose of infrastructure investment may also make it more politically acceptable and assist in overcoming the consequences of public misconceptions about government debt...

Ultimately, if government-issued infrastructure-specific bonds are to facilitate additional investment, they are likely to involve some form of subsidy. This is confirmed by past experience with such bonds in Australia...and is consistent with comments from some participants after the draft report...The subsidy can take various forms including tax advantages...or the underwriting by the government of the project's risks.²²

6.24 Dr McLeod cited examples from the United States (USA) where infrastructure bonds are used widely to fund public infrastructure:

Many US cities issue municipal bonds to fund local infrastructure and do so more or less successfully, according to the inherent economic strength of the city.²³

6.25 Mr Karl Fitzgerald, Project Director, Prosper Australia drew a relationship between the use of infrastructure bonds and value capture. Mr Fitzgerald said that infrastructure bonds were:

...a snazzy word for using the sovereign ability to sell securities and have that sovereign guarantee to repay them, which is underpinned by the value capture process.²⁴

6.26 However many witnesses supported the exploration of infrastructure bonds. Ms Debra Goostrey, Chief Executive Officer, Urban Development Institute of Australia (WA) indicated there would be advantages to this approach:

Remember that at certain times funding for infrastructure and urban development dries up, so by having a bonds approach you can level out the availability of finance. Yes, at various times it might be a little busy in that part of the market, but at other times it will be an essential source of funds.²⁵

21 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, pp 230-231.

22 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, pp 230-231.

23 *Committee Hansard*, 9 October 2015, p. 32.

24 *Committee Hansard*, 5 November 2015, p. 43.

25 *Committee Hansard*, 9 October 2015, p. 23.

6.27 Mr Jeremy Cordina, Chair, Infrastructure Committee, Urban Development Institute of Australia (WA) also saw merit in this approach:

In many ways the finance industry is as cyclical as any other, so if you had another mechanism that fills the gap that would be fantastic.²⁶

6.28 Professor Hewson, suggested that there was scope for the Commonwealth to investigate financing infrastructure through a fund which issued government securitised infrastructure bonds, which could be issued at a low rate of interest.²⁷

6.29 Professor Hewson told the committee that banks, superannuation funds and sovereign wealth funds would welcome infrastructure bonds as they cannot really find a similar funding stream anywhere else:

We do see quite a lot of money flowing from, say, Canadian pension funds into the Australian finance markets, some in shares and some in fixed interest. A lot of central banks want the equivalent of fixed interest, even though it has not been a great investment in terms of the returns they make on it- it is a basic security fixed interest number.²⁸

6.30 The committee heard that a key challenge for infrastructure bonds is the expectations about the rates of return. Ms Goostrey emphasised that this would come down to the level of risk and that lower returns can be useful in a diversified portfolio:

If you invest directly into a development, you are wearing the entire risk of any delays or problems with that project. If you are investing in a diversified pool with returns, particularly with infrastructure, if you have long-term contractual agreements with a government entity or others, that de-risks and therefore the returns do not need to be as high. In a diversified portfolio, they become useful. So it is all about risk. If you can de-risk it through those long-term contracts or other arrangements, it will be a valuable part of people's portfolios.²⁹

6.31 Dr Phillip O'Neill, Director, Centre for Western Sydney, University of Sydney commented that investors committing to an infrastructure project need to get a rate of return competitive with what it can get globally:

So you will not accept a lower rate risk adjusted in one country than another. They manage, in part, their risk by having a diversified portfolio of products.³⁰

6.32 Professor O'Neill was more cautious about the potential for infrastructure bonds and told the committee that the options for government were somewhat limited:

The only thing that governments can do by way of issuing bonds or securities for the infrastructure sector in Australia - it is different in other

26 *Committee Hansard*, 9 October 2015, p. 23.

27 *Committee Hansard*, 14 August 2015, p. 25.

28 *Committee Hansard*, 14 August 2015, p. 27.

29 *Committee Hansard*, 9 October 2015, p. 23.

30 *Committee Hansard*, 9 October 2015, p. 33.

parts of the world - given the strength of the Australian fiscal scene, is offer a slightly lower cost for borrowing and a risk-sharing process.³¹

Pooling projects

6.33 The committee heard that one option to overcome difficulties in the provision of public infrastructure is packaging or pooling smaller projects together to diversify risks for investors over a longer time period using vehicles such as municipal bonds.

6.34 Mr Cordina also suggested that packaging infrastructure bonds to form a portfolio of projects, rather than a single project would be a sensible approach for risk management diversification.³²

6.35 Dr Ian Martinus, Economic Development, City of Wanneroo indicated that this option has not been sufficiently explored.³³ Dr Martinus emphasised that investors would be interested in transparent low risk packaged opportunities:

This is even for Australian investment funds and offshore sovereign funds. It really does not matter to some people what is in the basket. It matters on the level of risk. If it is backed by assets or Australian AAA bond rating or whatever this thing is, this debt guarantee, we would get our outcomes and the people considering the investment would get the opportunity.³⁴

6.36 Ms Jane McGill, Senior Policy Adviser Infrastructure, Industry Super Australia, showed that pooling projects has been tried in the UK around schools where they have the aggregator model:

They aggregate the finance and then they run multiple projects in multiple districts. But the interesting thing about it, which makes it very similar to the inverted bid model, is that the government first secures the finance—they first find the financial and investment partners—and once the money is in place, then they tender for the construction and operation of the schools. There is another similar model that does something similar in Scotland called, I think, the SPD. The inverted bid model would be very suitable to bundling a large number of projects that have similar characteristics.³⁵

6.37 Dr Martinus indicated that to make the investment instrument attractive, the competitive advantage of a region could be emphasised.³⁶ Dr Martinus spoke about the ways in which this could occur:

...a discount or zero-coupon bond, mum and pop investors could look at it as part of their superannuation or WA Super could look at. There would be great opportunity. The cocktail component derisks a lot of the elements for any one player and provides something at LIBOR plus three or whatever it

31 *Committee Hansard*, 14 August 2015, p. 15.

32 *Committee Hansard*, 9 October 2015, p. 33.

33 *Committee Hansard*, 9 October 2015, p. 4.

34 *Committee Hansard*, 9 October 2015, pp 7-8.

35 *Committee Hansard*, 5 November 2015, p. 10.

36 *Committee Hansard*, 9 October 2015, p. 8.

is. Even I as a private investor am interested in the future of this state and, obviously, Australia. The competitiveness for me and my children—being selfish—is my wanting to see them finish their further studies and work and live in reasonable proximity of where they recreate and do things with their families.³⁷

6.38 However, Mr Anthony Schinck, Chief Executive Officer, City of Ballarat, cautioned that local councils may find this impractical as local councils have difficulty in packaging small parcels of debt together.³⁸

6.39 The PC report noted the potential benefits of aggregating or bundling of smaller projects that have a higher benefit-cost ratio:

The preference for iconic projects can also come at the expense of smaller-scale projects that address particular bottlenecks or lead to more efficient use of existing infrastructure.³⁹

6.40 Further the PC report noted that smaller projects tend to have a higher benefit-cost ratios:

...The Office of the Infrastructure Coordinator...indicated that this trend reflects that smaller projects are more likely to be targeted at addressing problems that are preventing better use of the wider network.⁴⁰

Municipal bonds

6.41 The committee also heard from several witnesses that municipal bonds could be an option to finance local government infrastructure. Citi in its submission articulated that developing a municipal bond market is 'a natural extension of the infrastructure debate at the local government level'.⁴¹

6.42 Citi outlined the many ancillary benefits for issuers and investors:

Firstly, it allows the cost to be spread to future generations who will also benefit of the assets. Secondly, it prevents the need to divert funds from internally generated renewal and maintenance budgets to capital expenditure. Thirdly, debt finance promotes rules-based and market-based discipline for municipals as the ability to borrow responsibly and to meet future debt servicing obligation is normally dependent on rigorous and robust financial governance politics and long-term planning. Fourthly, it can facilitate institutional investment as local governments enjoy steady and

37 *Committee Hansard*, 9 October 2015, pp 4-5.

38 *Committee Hansard*, 5 November 2015, p. 27.

39 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 271.

40 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 272.

41 *Submission 76*, p. 2.

secure income streams like rates which can be used to meet debt servicing obligations and secure debt facilities.⁴²

6.43 Dr Joseph Drew, Research Fellow, Centre for Local Government, University of New England, discussed encouraging local or municipal bond markets with a municipal bank:

[with a] protected monopoly position, and the idea is that they use municipal funds from councils who do have the funds to spare and bank, and then lend out to councils who need funds to achieve something...They can also put small parcels of debt together, and if they were to be backed by the federal government or the state government then they would have a high bond rating and they could secure funds at a sensible interest rate.⁴³

6.44 However, Dr Drew conceded that an Australian municipal bond market may not be sufficiently large to address infrastructure needs, even if it was backed by governments. He believed that there was significant capacity for private sector involvement:

The problem there is that the estimates of the infrastructure backlog would suggest that we actually need private funds to come in, that municipal funds in themselves are not going to be enough to do the job.⁴⁴

6.45 Ernst and Young recommended that the Commonwealth investigate establishing a 'national financing authority for local government' to encourage private investment in local government infrastructure programs.⁴⁵ It suggested that this authority could:

...bundle approved council borrowings into a limited number of bond issues, which could be underwritten by the Australian Government.⁴⁶

6.46 Ernst and Young argued that low-risk and competitive municipal bonds would be an attractive investment for many private investors, including Australian superannuation companies.⁴⁷

6.47 Mr Sean Cameron, Manager for Economic Development, City of Ballarat, emphasised that when packaging projects a central organisation is needed help pull the project together. Mr Cameron suggested a revamped IA for the role:

That may be some form of Infrastructure Australia that can actually look at that and start delivering the expertise to identify back to the regions. We

42 *Submission 76*, p. 3.

43 *Committee Hansard*, 14 August 2015, p. 21.

44 *Committee Hansard*, 14 August 2015, p. 21.

45 Ernst and Young, *Strong Foundations for Sustainable Local Infrastructure: Connecting Communities, Projects, Finance and Funds* (June 2012), p. 3.

46 Ernst and Young, *Strong Foundations for Sustainable Local Infrastructure: Connecting Communities, Projects, Finance and Funds* (June 2012), p. 3.

47 Ernst and Young, *Strong Foundations for Sustainable Local Infrastructure: Connecting Communities, Projects, Finance and Funds* (June 2012), p. 3.

have done a lot of work in that space to understand what productivity improvements we can get across the city in certain projects and different economic infrastructure projects that we have a pipeline to. A lot of other cities do not have work or do not have the expertise in local government to actually identify those. It is not a case of just being asked to go to the other cities and say, 'This is what we think. Let's pool.' We also need someone to actually help work with the cities to identify those so that it does not become a wish list which says, 'We have got this road or we have this piece of infrastructure.'⁴⁸

6.48 Mr Schinck added that the assistance would be with 'packaging up the asset classes in a way that is going to be attractive to a commercial market'.⁴⁹ He suggested that this might not necessarily be based on geography but it might be based on types of asset classes:

It might be that it is more synergetic for large-scale regional cities to bundle together. However, I would be really interesting in looking at models that blend those larger regional councils with smaller rurals that have less capacity...

Really, the technical advice that we require is the opportunity, I think, to look more broadly and nationally at how we would most effectively bundle those infrastructure investment opportunities that are going to be attracted to the commercial centre.⁵⁰

6.49 Mr Schinck informed the committee that the Municipal Association of Victoria (MAV) has commenced issuing municipal bonds which is a cooperation between MAV and a large commercial bank:

I think the first or inaugural issue was for about \$200-plus million worth of bonds that was then accessible to the participating councils in a fixed rate, interest-only loan as an alternative way of financing particularly the money that is required to keep pace with the capital growth of those cities. So if I look at the cities that have accessed that, I would see the cities that are not getting a good deal out of banks or the cities that are dealing with very acute, high-growth pressures and that have an enormous civil infrastructure program that needs to be funded and funded in a way that is cost-effective for that council.⁵¹

6.50 Citi Research outlined that the strong financial position of municipal bonds could result in a new industry whereby bonds could eventually have a high credit rating in their own right.⁵²

48 *Committee Hansard*, 5 November 2015, pp 30-31.

49 *Committee Hansard*, 5 November 2015, p. 31.

50 *Committee Hansard*, 5 November 2015, p. 31.

51 *Committee Hansard*, 5 November 2015, p. 29.

52 *Submission 76*, p. 5.

Legislative issues

6.51 The Western Australian Local Government Association (WALGA) raised legislative restrictions as an additional constraint:

...Councils in WA are often constrained by restrictive legislation that limits their ability to more efficiently invest in the required infrastructure.⁵³

6.52 Mr Raymond Tame, Chief Executive Officer, City of Armadale, outlined that current legislation limits access to finance:

We have a little thing called the Local Government Act, here, which severely limits our capacity to get into private partnerships. We have to get some relaxation of that, based on aversion to risks going to historical features of state government 25 years ago.⁵⁴

6.53 Mr Schinck explained that there needs to be a greater exploration of funding that does not require grants from a higher government tier.⁵⁵ Mr Schinck indicated that the current funding model is anchored on population and financial availability. The opportunity to factor in the potential for growth is not taken into consideration:

If we were to try and fund a project now, it would really depend upon our existing book of commitments, our current financial situation and, quite honestly, what our rate revenue looks like for the next couple of years. What we are trying to get to here is a position where in fact there is a suite of financing opportunities that are available to local government in order to catalyze those projects that are going to have a long-term impact on advancing growth...⁵⁶

6.54 Mr Michael Foley, Chief Executive Officer, City of Swan, reported that the situation is compounded because borrowing from state government is still the cheapest and most reliable option:

I think the current rate is 3.09 per cent for 10 years, which is still quite cheap compared with what it was years ago. We can still do that at the moment and go and borrow too much money.⁵⁷

6.55 Dr Martinus indicated that the current approaches to funding infrastructure at the local government level are limited:

When trying to fund infrastructure...if local government, with a decent balance sheet, and knowing it can project itself for 20 or 30 years of rates, does not look at other opportunities for debt mechanisms or putting something to the market in a package, it will be limited. As was mentioned earlier, we wait on applications for federal funding or we go to the states

53 *Submission 72*, p. 4.

54 *Committee Hansard*, 9 October 2015, p. 5.

55 *Committee Hansard*, 5 November 2015, p. 27.

56 *Committee Hansard*, 5 November 2015, p. 33.

57 *Committee Hansard*, 9 October 2015, p. 6.

and we beg, but we rarely look at our balance sheets or a public-private mechanism.⁵⁸

Private sector investment

6.56 The PC report provides data on the scale of private sector investment in public infrastructure:

...the ABS National Accounts data indicates that the value of Australia's capital stock of public infrastructure was approximately \$991 in 2013 (at current prices, comprised of general government (\$432 billion), non-financial corporations (\$520 billion) and financial corporations, households and not-for-profits (\$39 billion) (ABS 2013b). The non-financial corporations category includes both private and public corporations. While no accurate data are available, an indicative estimate is that public non-financial corporations owned about half the infrastructure in these selected industries, and private non-financial corporations owned the other half (or about \$260 billion).⁵⁹

6.57 The PC considered that privately issued bond finance 'can play a role in infrastructure investment, the availability of this type of finance can be a source of competitive pressure on other types of finance'.⁶⁰

6.58 A number of witnesses recognised the option of private sector investment and ownership of public infrastructure. Mr Eslake, expressed the view that there is:

...a role for private finance in infrastructure spending and not all infrastructure spending needs to be financed by government debt. Not all infrastructure assets need to be owned and managed by governments.⁶¹

6.59 Dr McLeod noted that the appropriateness of private sector investment is related to the source of funding.

There are projects where I think a proponent could say, 'This ought to be justifiably done with government money,' and there are others where you could justifiably say, 'This is almost a purely private work. User charges would essentially fund it and that is how we intend to do it.'⁶²

6.60 Similarly, Professor O'Neill made the point that:

The thing that drives the delivery and operation of infrastructure is the source of funding. So it is not, 'What is the capacity of governments to borrow?' It is, 'What is the capacity of governments to actually provide either a taxation stream to fund that finance, or to generate the conditions

58 *Committee Hansard*, 9 October 2015, p. 4.

59 Productivity Commission, (2014), *Public Infrastructure, Inquiry Report No. 71*, Volume 1, p. 180.

60 Productivity Commission, (2014), *Public Infrastructure, Inquiry Report No. 71*, Volume 1, pp 230-234.

61 *Committee Hansard*, 14 August 2015, p. 6.

62 *Committee Hansard*, 9 October 2015, p. 34.

for user pays in order for other ways to be put in place for that finance to be funded?⁶³

6.61 However, Professor O'Neill also noted the cost of private sector financing:

Certainly, if you issued government bonds there would be a slightly lower cost of capital than if the private sector raised the same amount of money. The issue is how you pay for the cost of capital.⁶⁴

6.62 Professor O'Neill also pointed out that where the private sector does own public infrastructure that it is important for the government to regulate the market to deliver public benefit:

The role of governments is to create the conditions for market competition. Only governments can regulate the way that the market operates. Only governments can legitimise the securing of profit and its subsequent ownership as private wealth. The private sector would love to do it in a much more streamlined process where they do not have to compete for it, but we know that the benefits of private enterprise are at their greatest when private enterprise is subject to competition. That is the role of government in the infrastructure sector: to make sure that there are no easily gotten gains and that, once the private sector secures ownership and operation of the asset, there are dynamic efficiencies that are brought to bear through the regulatory structures in order to make sure that the public benefit is maximised.⁶⁵

Public-private partnerships

6.63 Public-private partnerships (PPPs) are a mechanism for facilitating private sector investment in infrastructure projects. A PPP is a long term contract:

...between the public and private sectors where government pays the private sector to deliver infrastructure and related services on behalf, or in support, of government's broader service responsibilities. PPPs typically make the private sector parties who build infrastructure responsible for its condition and performance on a whole-of-life basis.⁶⁶

6.64 The committee heard from Standard and Poor's Ratings Services that, PPPs could have substantial benefits for government:

As well as potentially freeing up funds that can be allocated in other areas, cost overruns are typically lower in privately-financed projects, and risk is also transferred, with the private party bearing the overrun cost. It is often the case that good infrastructure benefits the whole economy. Typically privately-backed projects are more innovative and efficient on several

63 *Committee Hansard*, 14 August 2015, p. 9.

64 *Committee Hansard*, 14 August 2015, p. 9.

65 *Committee Hansard*, 14 August 2015, p. 16.

66 Department of Infrastructure and Regional Development, (2008 December), National PPP Guidelines Overview, p. 7.

measures, including energy consumption, with benefits flowing through to other areas of the economy.⁶⁷

6.65 Mr Jack Gilding, Executive Officer, Tasmanian Renewable Energy Alliance Inc, supported the use of PPPs and provided an example where it has been successfully used to produce renewable energy infrastructure:

... the ACT government put out to tender for what they called a reverse auction. They said, 'Who will bid the lowest price to give us renewable energy for the next 20 years?' The price that the ACT government got was 8c a kilowatt hour, which is certainly a little bit higher than the current wholesale price, but it is a fixed price for 20 years. So when you do the net present value of that, it is actually a very affordable source of electricity. That is the way of the energy consumer seeing that they got the best possible value—by getting private developers to compete against each other and coming up with the cheapest price for a new renewable capacity.⁶⁸

6.66 Mr Martin Locke, appearing in a private capacity, suggested that there are a number of risk management factors that should inform whether projects are undertaken as a PPP:

...you actually have to have an equation where you can say the benefits from cost efficiency or risk transfer more than outweigh the higher costs of raising private financing, as compared to public financing...When I look at this concept of risk transfer, what it is really saying is that the private sector is putting its hand up and saying, 'We are in a better position to actually manage those risks and give you, the public sector, a better outcome'. So, in terms of management of construction risks or maintenance risks, the private sector, in some cases, has certainly been seen to demonstrate that it can generate value over and above public sector delivery.⁶⁹

6.67 However, Ms McGill challenged the notion that risk could be transferred to the private sector:

This issue of de-risking is a really interesting one, because we had a lot of projects that failed based on overly optimistic forecasts around demand and people became more and more reluctant to take on that risk, and the supply of capital around tollway projects pretty much dried up. Someone then came up with this notion that they will de-risk projects so that the government would hold on to that patronage risk or that demand risk and then the project could be financed. We take a different view. The use of availability payments, like they did on the Peninsula Link, does work in certain circumstances, but why would governments engage with the private sector in this sort of PPP arrangement if they are not transferring risk to the private sector to be managed?⁷⁰

67 *Submission 63*, p. 9.

68 *Proof Committee Hansard*, 14 April 2016, p. 9.

69 *Committee Hansard*, 14 August 2015, p. 35.

70 *Committee Hansard*, 5 November 2015, p. 10.

6.68 Dr McLeod commented that, then:

...there is the question of whether we have the right financial instruments to feed into the processes. Many PPPs, as I pointed out in that research paper, end up being very, very complex structures with very, very many participants, which makes the process of risk management even harder over time, because the consortium members have different expectations.⁷¹

6.69 While Professor O'Neill agreed that private sector involvement in infrastructure had its place, he suggested that governments need to take a new approach to PPPs. Professor O'Neill called for closer regulatory requirements to ensure transparency and effective assessments of when private investment is most appropriate:

...We really need to know under which circumstances and under what sorts of regulations private infrastructure provisions thrive, and in which regulatory circumstances private infrastructure does not thrive. When does the public get most benefit?...Whether you are an advocate of public sector efficiency or of the benefits of the market, what we do know is that efficient knowledge and learning from the past in order to improve to the future is at the core of economic progress. And here we have in the infrastructure sector -probably the newest emerging private economic sector in the world -governments intervening in ways that inhibit learning, because we do not know the conditions under which privatisations take place, so we cannot say: 'That is good. That is not working. This is working. Let's move the regulatory regime in that particular direction.'⁷²

6.70 The committee heard that while the use of PPPs has been increasingly popular over recent years there have been 'mixed results'.⁷³ Ms Terrill informed the committee that:

Recent large infrastructure projects in Australia have typically suffered from cost overruns of about 15 per cent, while patronage has been 15 per cent lower than projected.⁷⁴

6.71 While the PC noted several successful PPPs they also highlighted examples of PPP infrastructure projects that had incurred financial losses. For example, the Latrobe Regional Hospital in Victoria suffered operational losses incurred from a low initial bid price and because of the 'inability of the private sector consortium to make the efficiency gains originally assumed.' The New South Wales Government incurred losses from the Sydney Airport Rail Link after the PPP partner failed to meet scheduled payments to creditors.⁷⁵

71 *Committee Hansard*, 9 October 2015, p. 28.

72 *Committee Hansard*, 14 August 2015, p. 11.

73 Productivity Commission, *Public Infrastructure, Inquiry Report No. 71* (2014), Volume 1, p. 7.

74 *Submission 65*, p. 6.

75 Productivity Commission, *Public Infrastructure, Inquiry Report No. 71* (2014), Volume 1, p. 7.

6.72 Mr Locke was also concerned that currently the flow of investment into Australia was pushing the rate of returns too low for many investors to find PPPs attractive:

...the pressure of the flow of money internationally and from the domestic superannuation fund is actually putting real downward pressure on the yields available in infrastructure, and certainly some commentators would say that we are at a point where, almost, the returns are being pushed too low. If you are looking at it from the perspective of a superannuation fund, given the significant reduction in yields available in the bond market, it becomes quite difficult to see how you can easily get longer term yielding assets to provide the rate of return that superannuants are looking for.⁷⁶

Local government

6.73 The committee heard that for investors, local government projects were often insufficient in size and had limited return on investment. As a result obtaining infrastructure finance is difficult. Mr Brenton West, Chief Executive Officer, Southern Tasmanian Councils Authority considered that:

The scale of the state is sometimes prohibitive without government incentive to make it occur. There are a number of brownfield and greenfield sites throughout the region that could be infilled, but it is getting the right investment conditions and the right incentives to make it occur.⁷⁷

6.74 Mr West re-iterated that user pays funding⁷⁸ such as tolls and taxes may not work for local governments:

With the small size of southern Tasmania, with a diverse and spread-out population, it is difficult to see that we have the scale of Melbourne or Sydney or a culture of toll roads.⁷⁹

6.75 Mr Schinck explained that in regional Australia it is difficult to attract private equity, capital or investment regardless of the improvements it will generate:

...simply because the returns on investment are not always there or not always comparable to capital cities, to airports, to other forms of infrastructure. We find it very difficult to be able to package up blended investment into projects. As I said, it quite often relies on the council...having to fund projects to a large extent or having to leverage off both state and federal opportunities for funding...⁸⁰

76 *Committee Hansard*, 14 August 2015, p. 35.

77 *Committee Hansard*, 6 November 2015, p. 18.

78 *Committee Hansard*, 6 November 2015, p. 18.

79 *Committee Hansard*, 6 November 2015, p. 13.

80 *Committee Hansard*, 5 November 2015, p. 27.

Superannuation funds

6.76 Standard & Poor's Ratings Services highlighted that Australia's expanding superannuation industry provides an opportunity to fund infrastructure investment that will in turn drive stronger economic growth:

...the pool of superannuation funds could be used to help fund infrastructure, given the budget constraints faced by Australian governments.⁸¹

6.77 Standard & Poor's noted that Canadian pension funds are some of the largest investors in Australian infrastructure. They highlighted to the committee a number of barriers preventing greater investment from the superannuation industry in local infrastructure, namely:

...the mismatch between superannuation funds' liquidity needs and the illiquid nature of infrastructure as an investment class. Canadian pension funds, for example, don't face the same requirements and therefore can invest much more heavily in infrastructure. As defined benefit schemes (as opposed to defined contribution schemes, as in Australia), Canadian funds can focus more strongly on maximising long-term returns and less on investing in liquid asset classes. In particular, Australian super funds need to maintain liquidity because consumers can switch between super funds at will to seek higher returns; in Canada, defined benefit schemes mean consumers have little reason to switch between pension funds.⁸²

6.78 The PC also mentioned the difference between Canadian and Australian funds and noted that:

...the majority of superannuation funds in Canada are larger defined benefit funds, whereas Australia's are predominantly smaller defined contribution funds, which might allow Canadian funds to accept more liquidity risk.⁸³

6.79 Standard & Poor's expressed the view that the participation of Australian superannuation funds should be encouraged as they 'may provide a more stable source of funding'⁸⁴ and suggested that to address the issue of liquidity other models should be considered:

If growth is a key policy objective, and illiquidity is determined to be a key inhibitor to accessing private sector funds to fund viable infrastructure projects, then supporting the development of liquid, tradable claims on infrastructure projects through private sector innovation or co-investment

81 *Submission 63*, p. 10.

82 *Submission 63*, p. 10. This example solely illustrates the impact of the liquidity mismatch, and does not suggest defined benefit schemes are superior or preferable to defined contribution schemes.

83 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 119

84 *Submission 63*, p. 10.

models with the government would appear to be worthy in our view of further consideration.⁸⁵

6.80 Mr John Lawrence, appearing in a private capacity, commented that 'infrastructure spending will grow the national pie.'⁸⁶ Mr Lawrence advocated for a mandated purchase of government bonds by superannuation funds to finance infrastructure investment:

For me, the rationale to borrow for infrastructure does not rely on the fact that government borrowings are low compared to other countries or that interest rates are at record lows. The reason it is a good idea is that payment of interest does not consume resources or reduce GDP; it is simply a split up of the enlarged pie. For every dollar of government borrowings someone holds a financial asset. It can easily be mandated that super funds, for instance, especially those in the pension stage that are paying nil tax and wishing to hang onto their tax concessions—which look like they may be revised—use a small fraction of their two trillion in assets to buy government bonds....

...Payment of interest, the splitting up of the GDP pie, then becomes part of retirement income policy.⁸⁷

6.81 Mr Fitzgerald, cautioned against using Australian superannuation as a funding source for infrastructure without value capture:

The problem there—and perhaps I should have qualified it—is that superannuation could be a funding source, but only if there is a value capture mechanism supporting the user charges and possible federal grants. If it was part of the funding mix, that would be okay, but I am just horrified by the thought of workers' hard-earned savings being thrown to the wolves because of these extravagant infrastructure costs, extravagant traffic flow funding models, and then a poor financing mechanism using \$14 or \$15 tolls for people to get to work each day. It is just not going to work.⁸⁸

Industry super funds

6.82 Ms McGill informed the committee the superannuation system currently had assets exceeding \$2 trillion. This is set to increase to \$6 trillion by the mid-2030s 'when we would rival the banking system in total assets'.⁸⁹

6.83 Ms McGill confirmed that investment in infrastructure is already occurring and they 'have assets around the world'.⁹⁰ Ms McGill explained investing in infrastructure is an attractive option for industry superannuation funds:

85 *Submission 63*, p. 10.

86 *Proof Committee Hansard*, 14 April 2016, p. 14.

87 *Proof Committee Hansard*, 14 April 2016, p. 14.

88 *Committee Hansard*, 5 November 2015, p. 46.

89 *Committee Hansard*, 5 November 2015, p. 7.

90 *Committee Hansard*, 5 November 2015, p. 7.

As you would be aware, the funds have very long investment time horizons, which make it possible for them to invest in such illiquid assets. On average, the funds have 20 per cent of their assets in unlisted assets like infrastructure. Our wholly owned fund manager, IFM Investors, is the largest infrastructure investor in Australia and one of the top three infrastructure investors globally, so we already playing with the big boys. They have delivered fantastically for our members. Over two decades their fund has achieved an average return of 11.5 per cent after tax and after fees, which is a very attractive return compared with equity markets.⁹¹

Greenfield investment

6.84 Ms McGill indicated that most of their investments are in brownfields assets and they almost never invest in greenfields projects.⁹² The PC explained that:

Brownfields asset classes are attractive to institutional investors, such as superannuation funds, because they provide a long-term stable net revenue stream with low operating risks...⁹³

6.85 The Industry Super Association informed the committee that changes in Australia around the current bid model for infrastructure investments are needed to allow the superannuation industry to realise investment in greenfields projects. Ms McGill highlighted that the current bid process for greenfields projects are convoluted, costly, time-consuming and uncertain.⁹⁴

6.86 Ms McGill outlined that the superannuation funds are in a different position to short-term investment banks. Short-term investment banks can put capital at risk, with a view to winning one out of three or four projects. Ms McGill commented that superannuation funds cannot use member money to loss lead a project:

We are not in a position to say 'We are going to bid for this project and by the way we need \$10 million out of the funds in order to cover the costs of the bid.' If the bid costs stay as high as they are now, we will stay on the sidelines in terms of greenfield investment. We do not want that to be the case. We want to begin to engage in the greenfield sector. It is great diversification for us and offers high returns because there are greater levels

91 *Committee Hansard*, 5 November 2015, p. 7.

92 *Committee Hansard*, 5 November 2015, pp 7-8. The PC explained that 'Greenfields infrastructure involves construction of new assets (which may require land acquisition and environmental and planning approvals) for which there is no pre-existing demand for the service. Greenfields projects can also involve high construction cost-risk and if the project fails there is no or limited alternative use for the asset. Demand risk is high as there is little data available to assess patronage risk and the like. In contrast, brownfields projects involve assets for which demand for the service already exists and is well understood but where the assets may be in need of improvement, refurbishment or expansion.' See Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, pp. 130, 187.

93 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 188.

94 *Committee Hansard*, 5 November 2015, p. 8.

of risk to manage, but it really flexes our muscles in terms of our capacity to manage assets over the long term.⁹⁵

6.87 Ms McGill pointed to a misalignment of interests between short and long term investors created by the current bid model. Short-term investors are currently bidding for, and building long-term infrastructure projects, yet are not in it for the long term:

They come in and they structure the bid, they earn in some cases tens of millions of dollars of fees for doing that, but as soon as financial close on that project has been achieved they are gone. That introduces a real dilemma because if you are not going to be accountable for your financial forecasts and the viability of the project, you are going to be really motivated to make overly optimistic forecasts because that is how you come out with the cheapest price and that is how you win the bid. You get your transaction fees and you go.⁹⁶

6.88 Dr Robert Bianchi, Associate Professor of Finance, Griffith University, encouraged more investment in greenfield projects and proposed:

...for the Australian Commonwealth government to finance and fund new greenfield infrastructure projects while they are in the design and construction phases. Once the infrastructure project progresses to the operations phase, the government can on-sell the asset to the superannuation industry as a mature infrastructure project...⁹⁷

6.89 Dr Bianchi also suggested changing the funding mix during the lifecycle of infrastructure projects to encourage greater involvement from superannuation funds: For example:

[The] superannuation industry can be encouraged to invest in a greenfield infrastructure project based on the investors receiving government availability payments when risk is at its highest in the design and construction phases. When the greenfield project progresses to the operations phase, the availability payment ceases and it is replaced by a market based toll/fee for the use of the public infrastructure.⁹⁸

'Inverted bid' model

6.90 Ms McGill suggested a different funding model called 'the inverted bid' which would lower the initial cost of participation by securing the long-term owner operator:

...it might be a Future Fund, it might be a QIC, it might be Aussie Super, it might be an IFM Investors, it might be a consortium of them. What is important is that they are equity investors, not debt, and that they are in it for the long haul. That does not mean they can never sell that asset down but they are much more likely to hold an asset like that for its life than they are to sell it. Once the government has established that partnership with a

95 *Committee Hansard*, 5 November 2015, p. 8. See also *Submission 68*, p. 14.

96 *Committee Hansard*, 5 November 2015, pp. 6-7.

97 *Submission 66*, p. 15.

98 *Submission 66*, pp 15-16.

group of long-term equity investors, they then move onto phase 2, where they have a bundled tender for the other project partners. The other project partners would be your construction, your operation and maintenance and all your legal and other advisory services. You pay a small price to get into the game at the outset and going through what is called this equity funding competition to see if you are the successful bidder. If you are unsuccessful you walk away, you have not lost a great deal of money; if you are successful, you will incur further costs but it is in connection with a real, tangible project.⁹⁹

6.91 The committee heard that the inverted bid model would be suited to larger, more complex projects because:

...[t]he inverted bid model brings a level of sophistication and elevates the quality of the partnership with government around a project that is more complex and hence more risky. It also gives you the scope for government and the investment partner to actually say, 'Let's imagine down the track that something changes, how would we manage adjusting the contract to achieve that outcome?' That is not possible under the current model. So yes, complex and risky projects and probably large, expensive projects.¹⁰⁰

6.92 Ms McGill indicated that Industry Super Australia has participated in the PC review and have undertaken extensive consultation in relation to the inverted bid model. The process was favoured by construction companies as:

Construction companies hate the current bid process, because they have to bear quite a lot of the cost in order to be involved. They see our model as a much neater solution, because the money is already there on the table and they just have to do what they do best and bid for the construction of a project.¹⁰¹

6.93 The PC ultimately came up with its own 'hybrid' model 'which pursues the same objective as the inverted bid model and adopts a number of its elements' while overcoming 'some of the shortcomings' and 'offers a more gradual change'.¹⁰²

Self-managed super funds

6.94 Mrs Andrea Slattery, Managing Director and CEO, Self-Managed Super Fund (SMSF) Association, told the committee that the SMSF sector is suited to investing in and funding infrastructure:

With \$590 billion funds under management in the SMSF sector, which is predicted to grow to \$2.2 trillion by 2033 by the Deloitte Access Economics report, with about one-third of these funds held in low-risk assets, we believe the SMSF sector is ideally suited to infrastructure

99 *Committee Hansard*, 5 November 2015, p. 8.

100 *Committee Hansard*, 5 November 2015, p. 9.

101 *Committee Hansard*, 5 November 2015, p. 9.

102 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 257.

investment. This large pool of low-risk preferred capital would be viable in a stable source of Australian infrastructure funding in the years to come.¹⁰³

6.95 Mrs Slattery explained that infrastructure offers an attractive alternative investment as it has a risk-return point between cash and fixed interest and equity investments:

Additionally, the asset's characteristics of low volatility, stable yield and acting as an inflation hedge is attractive to SMSFs, whether they are still saving or in the retirement phase. Such assets help SMSF investors attain sustainable retirement income and manage longevity risks.¹⁰⁴

6.96 However, the committee heard that while there is appetite for investment in infrastructure, currently there are significant barriers to this occurring in the areas of liquidity and high investment management fees:

Currently SMSFs are extremely limited in investing directly in infrastructure due to the high dollar threshold for infrastructure investment and the illiquid nature of the required investment. Also, the high investment management fees for non-direct infrastructure investments can be a disincentive for those cost-aware SMSF investors. We believe that addressing these liquidity issues and removing administrative barriers will provide the most significant challenges in allowing SMSFs to have better opportunities to invest in infrastructure projects.¹⁰⁵

6.97 Mrs Slattery suggested that overcoming the current limitations could be achieved by unitising investment and infrastructure projects to smaller investment units or parcels for SMSFs, in the area of \$25,000 units or issuing small scale government or other infrastructure bonds. Developing a secondary market for these products would allow SMSFs to manage liquidity risks, especially in retirement phase so they can realise their SMSF capital to generate income.¹⁰⁶

6.98 Mr Jordan George, Head of Policy, SMSF Association, explained that with the length of infrastructure projects, bonds would have different values at different times which would allow people to get in and out at different phases.¹⁰⁷ Mr George stressed that people with self-managed superannuation funds need to have assets or products that generate stable, long-term returns but with flexibility.¹⁰⁸

6.99 The PC also noted liquidity requirements which, it was argued, constrained the ability of superannuation funds to invest in relatively illiquid asset classes such as infrastructure. They also noted that others have argued against such changes in order

103 *Committee Hansard*, 5 November 2015, p. 35.

104 *Committee Hansard*, 5 November 2015, p. 35.

105 Mrs Slattery, *Committee Hansard*, 5 November 2015, p. 35.

106 *Committee Hansard*, 5 November 2015, p. 35.

107 *Committee Hansard*, 5 November 2015, p. 39.

108 *Committee Hansard*, 5 November 2015, p. 39.

to assure stability in the superannuation system. The PC concluded that the primary objective of superannuation funds is to provide benefits to retiring members:

Australian superannuation funds already have relatively high average asset allocation to unlisted infrastructure relative to other developed country pension funds, and can invest in infrastructure assets through a range of channels — particularly in mature brownfield assets — either directly, or through pooled open-ended unlisted infrastructure funds and various index funds.

More generally, infrastructure funds have an incentive to optimise their portfolio between different asset classes, with liquidity being one of the considerations. Interventions that blunt those incentives would be sub-optimal.¹⁰⁹

Accounting and management

6.100 IA state in their Infrastructure Plan that:

More effective use of public borrowing that differentiates between 'good debt' for infrastructure investment and 'bad debt' to meet unsustainable operating expenses.¹¹⁰

6.101 Mr Eslake strongly supported the separation of infrastructure spending in the Commonwealth government accounting:

...state and territory governments have, in most cases, for 15 or more years presented their budgets and subsequent financial reports, mid-year economic updates and the like in overtly accrual accounting terms so that the measure of their fiscal prudence or otherwise is usually the net operating balance, which is revenues minus recurrent expenses, including interest and depreciation. Separate consideration is then given to the capital budget, financed by the operating surplus, if there is one then government borrowings, various leasing and other financing transactions. That would encourage what I think is a more mature, sensible and commercial view of infrastructure spending. And accrual accounting is, of course, the way listed companies and private businesses manage their financial affairs and very few businesses regard borrowing to fund long-term investment as inappropriate.¹¹¹

Infrastructure funds

6.102 Professor Hewson, agreed with the separation of infrastructure spending from recurrent spending, and suggested money raised from infrastructure bonds:

109 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 244.

110 Infrastructure Australia, *Australian Infrastructure Plan – Priorities and reforms for our nation's future* (2016) – Report, p. 90.

111 *Committee Hansard*, 14 August 2015, p. 5

...go into a separate fund, separate from consolidated revenue, that would be professionally managed and administered. It would be available for use as equity and/or debt finance for specific projects.¹¹²

6.103 The PC explains:

The term 'infrastructure fund' potentially captures a variety of models. Some involve funding dedicated to a specific-purpose fund within the public sector. This may or may not be accompanied by new rules, criteria and processes (including between levels of government) to determine the allocation of funds. Other models may involve the creation of a new entity to administer the funds and/or other forms of financial support. Such approaches are more akin to the 'infrastructure bank' model.¹¹³

6.104 The PC noted the suggestion of infrastructure funds as a means to:

...address problems with the availability and certainty of funding for infrastructure projects, and could also include governance arrangements which provide incentives for better project selection and more efficient delivery.¹¹⁴

6.105 During its inquiry, the PC noted that IA proposed consolidating government funding sources into a single national fund. IA suggested that this would:

...improve the quality, efficiency and transparency of infrastructure spending by leading to a more robust prioritisation of projects, and a move away from a project-by-project view of infrastructure development...¹¹⁵

6.106 In its Infrastructure Plan, IA again proposed establishing an infrastructure fund to encourage consistent decision making and to ensure funds are directed where they are needed most. IA's plan identified multiple Commonwealth infrastructure funding programs with singular purposes and individual assessment frameworks. IA identified that prioritising infrastructure projects is at times unnecessarily disjointed:

Infrastructure spending is dispersed according to often overlapping purposes of different funding pools. This means the outcomes of the Australian Government's infrastructure spending can be inconsistent and poorly directed. This situation reflects the tendency by governments to establish single funds to solve single problems rather than taking an integrated network approach.¹¹⁶

6.107 At the Melbourne hearing IA also spoke about this proposal:

112 *Committee Hansard*, 14 August 2015, p. 25.

113 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 291.

114 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1 p. 291.

115 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1 p. 291.

116 Infrastructure Australia, *Australian Infrastructure Plan – Priorities and reforms for our nation's future* (2016) – Report, p. 23.

At the moment there are lots of different separate funds. This is largely looking at it from a federal government level. There are lots of different federal funds. We are suggesting that, particularly within transport, that they are brought together in one fund.¹¹⁷

6.108 Professor Hewson proposed that an infrastructure fund could co-invest with banks and other private equity groups to develop some projects:

....every project would be structured in a projects-financed sense—perhaps differently one to the next, there are different mixtures of debt and equity—but that fund would be in a position to drive it. With the government putting its imprimatur, if you like, through the fund on such projects, I think the private sector bank and private equity sector would be well attracted to that.¹¹⁸

Infrastructure bank

6.109 The concept of an infrastructure bank is active in Europe in the form of the European Investment Bank¹¹⁹ and under consideration in the USA (the National Infrastructure Development Bank).¹²⁰

6.110 As noted earlier in this chapter, Dr Drew proposed an infrastructure bank for municipal borrowing:

The recommendation is a municipal bond bank where you can have the best of both worlds. They can also put small parcels of debt together, and if they were to be backed by the federal government or the state government then they would have a high bond rating and they could secure funds at a sensible interest rate.¹²¹

6.111 The PC noted the benefits of an infrastructure bank:

- increasing the pool of funds available for infrastructure investment and filling the gaps in private sector finance
- reduced transaction costs through improved procurement processes and the development of public sector expertise in infrastructure financing

117 *Proof Committee Hansard*, 1 March 2016, p. 8.

118 *Committee Hansard*, 14 August 2015, p. 25.

119 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1, p. 229. See <http://www.eib.org/about/> (accessed 2 December 2015) where it is noted that the EIB raises the bulk of lending resources on the international capital markets through bond issues. Their rating allows them to borrow at advantageous rates.

120 The Build USA Act would create an American Infrastructure Bank, as a wholly owned government corporation, to provide methods for funding transportation projects for states. See <https://www.congress.gov/bill/114th-congress/senate-bill/1296> (accessed 2 December 2015).

121 *Committee Hansard*, 14 August 2015, p. 20.

- the ability to diversify and spread specific project risks across a wide pool of infrastructure assets through the infrastructure bonds issued by the bank.¹²²

6.112 However, the PC found that the costs of establishing an Infrastructure Bank in Australia were likely to outweigh the benefits, as outlined:

- ...the pool of funds available for infrastructure and the extent of government involvement in funding are a distinct issue from how those funds are administered – an infrastructure bank is not a prerequisite for increasing government funding...
- ...the Commission can see risks associated with government ownership of a bank. Since the 1990s, the financial system in Australia has largely moved away from government ownership of financial institutions...
- ...there is a risk that the establishment of an infrastructure bank would create pressure to fund projects that would otherwise not pass a cost-benefit assessment, simply because there is capital available at any given time.¹²³

6.113 Ultimately the PC concluded that an infrastructure bank 'appears to offer little benefit in addressing the identified issues in Australian infrastructure investment'.¹²⁴ While noting some potential benefits, the PC could not justify providing unique specialised support for infrastructure via a dedicated funding stream.

122 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1 p. 228.

123 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1 p. 229.

124 Productivity Commission, (2014), *Public Infrastructure*, Inquiry Report No. 71, Volume 1 p. 207.