

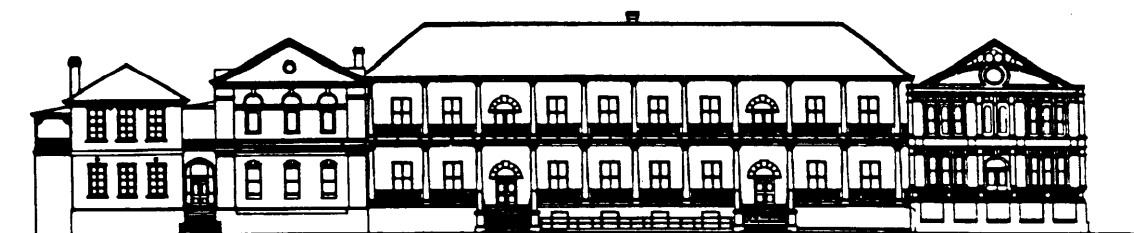


PUBLIC ACCOUNTS COMMITTEE

PARLIAMENT OF NEW SOUTH WALES

The Financing of Infrastructure Projects

DISCUSSION PAPER



Report No. 76

November 1993

This publication has been catalogued in the New South Wales Parliamentary Library as follows:

New South Wales. Parliament. Public Accounts Committee.

The financing of infrastructure projects: discussion paper / Public Accounts Committee, Parliament of New South Wales. -- [Sydney, N.S.W.]: Public Accounts Committee, 1993. -- 38 p. ; 30 cm. (Report no. 76, November 1993)

ISBN 0 7240 8832 6

- 1. Infrastructure (Economics)--Finance (LCSH)*
- 2. Cities and towns--Finance (LCSH)*
- [1. INFRASTRUCTURE--FINANCIAL--ASPECTS] (Parliamentary thesaurus)*
- [2. URBAN--AREAS--FINANCIAL--ASPECTS] (Parliamentary thesaurus)*
- I. Title*
- II. (Series) Report (New South Wales. Parliament. Public Accounts Committee),'*
1993/76

711.4 (DDC20)

Secretariat

Patricia Azarias, MPA *Princeton*, BA(Hons) *Oxon.*, BA(I-lons); Director

Ian Clarke, BSc *Syd*, DipGeosc. *Macq.*: Senior Project Officer

Jozef Imrich; Clerk to the Committee

Caterina Sciara; Assistant Committee Officer

Wendy Terlecki; Assistant Committee Officer

Public Accounts Committee

Parliament House

Macquarie Street

Sydney NSW 2000

Telephone: (02) 230 2631 Facsimile: (02) 230 2831

MEMBERS OF THE PUBLIC ACCOUNTS COMMITTEE

**Mr Andrew Tink, BA, LLB,
MP, Chairman**

Before becoming Liberal Member for Eastwood in March 1988, Andrew Tink practised as a barrister in equity, commercial and shipping law. He has since served on numerous parliamentary and government committees, holding the position of Chairman of the Joint Committee on the Office of the Ombudsman prior to his appointment to the Public Accounts Committee. He is also a Temporary Chairman of Committees in the Legislative Assembly, its representative on the Macquarie University Council, and a member of the Committee on the Independent Commission Against Corruption.

**Mr Peter Cochran, MP, Vice-
Chairman**

Following a background in farming, the Army, the Commonwealth Police, ASIO, and the Cooma-Monaro Shire Council, Peter Cochran won the seat of Monaro for the National Party in 1988. His other parliamentary responsibilities include the chairmanship of the Minister's Advisory Committee on Land and Water Conservation, deputy chairmanship of the Committee for Police and Emergency Services, and membership of the Committee for the Environment and the Select Committee on Public Sector Superannuation. He is also the Premier's representative on the Anzac House Trust and the Anzac Memorial Trust.

Mr Geoff Irwin, ProdEngCert,

DipTech, DipEd, MP

Geoff Irwin was elected to Parliament in March 1984 as the Labor Member for Merrylands, and he has been the

Member for Fairfield since March 1988. Before entering Parliament he worked in industry as a planning and supply manager and taught business studies at TAFE. He served as a member of the Select Committee upon Small Business and as Opposition Spokesperson on Business and Consumer Affairs.

Mr Terry Rumble, FCPA, MP

Terry Rumble was elected Labor Member for Illawarra in March 1988. Before entering Parliament he qualified as an accountant and was employed in public practice and in the coal mining industry. He has served as a member of the Regulation Review Committee and is the Chairman of the Leader of the Opposition's Backbench Committee which involves Treasury, arts and ethnic affairs.

Mr Ian Glachan, MP

The Liberal Member for Albury since 1988, Ian Glachan has had a varied background. He served five years at sea as a marine engineer, was a farmer for ten years, and operated a newsagency in Albury for 18 years. Mr Glachan is also a past president of the Albury-Hume Rotary Club and a Paul Harris Fellow, an active member of the Anglican Church, and the Legislative Assembly member on the Board of Governors of Charles Sturt University. Other parliamentary responsibilities include chairmanship of the Minister's Advisory Committee on Health, and vice-chairmanship of the Minister's Advisory Committee on Roads and Transport.



The Public Accounts Committee

From left: Geoff Irwin, Ian Glachan, Andrew Tink (Chairman), Terry Rumble,
Peter Cochran (Vice-Chairman)

CONTENTS

A. CHAIRMAN'S FOREWORD.....	2
B. BACKGROUND.....	3
C. SOME PROPOSED GENERAL PRINCIPLES.....	7
(a) A partnership approach between the Government and the private sector will be more productive than suspicion and antagonism.....	7
(b) Transparency.....	11
(c) Competition.....	11
(d) Process should not overwhelm outcome.....	14
D. PUBLIC-PRIVATE CO-OPERATION.....	16
(a) Enhancement of commercial factors.....	16
(b) Direct participation in an Infrastructure Development Fund.....	24
(c) Rating and insurance.....	32
(d) Project administration.....	32
E. OTHER ISSUES.....	34
(a) Taxation.....	34
(b) Loan Council.....	35
(c) Infrastructure bonds.....	37
F. CHAIRMAN'S CONCLUDING REMARKS.....	38

A. CHAIRMAN'S FOREWORD

In the lead-up to the preparation of the Volume 1 report on *Infrastructure Management and Financing* the Committee held a workshop on contract confidentiality, involving key players in the field. The workshop proved to be of great assistance in formulating major recommendations promoting transparency in public–private contracts.

This discussion paper is designed to provide a summary of options which are under consideration by the Committee in the context of its Volume 2 report on infrastructure financing.

The Committee proposes to hold a further workshop discussion to explore some of the main financing issues and to obtain feedback from some key interested parties.

The discussion paper is not designed to be exhaustive, nor to suggest that the ideas it puts forward are the only possible ones, or indeed that these will be the concepts set out in Volume 2. The Committee welcomes feedback not only from workshop participants but from anybody who reads this document.

I wish to acknowledge the very important work done by the Committee's Director in preparing this report, which draws on advice from the NSW Treasury Corporation and the Australian Industry Development Corporation (AIDC). The assistance of these two bodies is gratefully acknowledged, although they should not be held responsible for the contents.

Andrew Tink, MP

10 November 1993

B. BACKGROUND

There are six traditional sources which States and their authorities draw on for infrastructure financing:

- retained earnings of authorities, mostly gained from user charges;
- support from the Consolidated Fund, using ordinary State taxation and other less important sources like dividends, tax equivalent payments and guarantee fees;
- borrowings by the Government or by its agencies;
- proceeds of asset sales;
- Commonwealth grants;
- relatively small-scale contributions from the private sector, e.g. special levies like the 3 x 3 fuel levy and the Special Environmental Levy, as well as section 94 contributions (Environmental Planning and Assessment Act).

All of these suffer from limitations:

- Retained earnings of government agencies are circumscribed by the level of user charges, and anyway need to be used for other purposes.
- Ordinary State taxation and other State revenues have to pay for other community needs, and indeed in NSW the proportion of State tax revenues spent on infrastructure has declined from 39% in 1988–89 to 32% in 1991–92

in favour of those other community needs. This declining trend will probably continue.

- Borrowings by the State and its authorities are constrained by Loan Council limitations, which, although redesigned under the new rules¹, still restrict overall borrowings.
- Proceeds from asset sales are of their nature irregular. The percentage of the total capital program funded from asset disposals has moved up and down dramatically since 1987–88: 4% in 1987–88, and 15%, 9%, 7% and back to 4% in each of the subsequent financial years. Asset sales cannot be relied on as a dependable source of infrastructure financing.
- Commonwealth grants to NSW for infrastructure have also declined over the last five years.
- The 3 x 3 fuel levy will be operated only for a limited period (so far, to 1995), and the amount raised by the Special Environmental Levy would raise no more than \$488m over five years.
- Section 94 contributions are significant mainly in the city fringe, and were never intended to fund the community's larger urban infrastructure facilities such as motorways, railways, and water and sewage treatment plants.

While the traditional sources of funding for infrastructure are limited, the infrastructure needs of States are increasing. One may debate whether a particular road should be built in preference to an increase in rail capacity, question how great the contribution of infrastructure is to a State's productivity, impute pork-barrel motives to

¹ See Section E(b) below.

the construction of an individual infrastructure facility, and point to examples of excess infrastructure.² Even allowing for all these arguments, however, the fact will still remain that the community needs more major infrastructure facilities than can be paid for easily and in a timely fashion out of the six traditional sources listed above.

The private sector is the most logical seventh source.

There are advantages and disadvantages to using private sector sources for infrastructure funding. Since the alternatives to the private sector are limited, the challenge for State governments is to make use of the advantages and restrict the disadvantages of private sector funding for infrastructure.

The two principal advantages of private sector financing are:

- It frees government resources for other community needs. These include expensive maintenance on existing infrastructure, which the private sector would never finance but which is very much needed.
- It commonly results in a facility which is built faster and more efficiently than if the Government had financed the construction.

The disadvantages include:

- frequent lack of transparency in the contracts;
- the need for user-pays cost recovery, which may incur public opposition;
- the scarcity of facilities which the private sector can finance and operate alone, without government assistance of one kind or another (that is, which are viable based on project revenue alone);

² These issues were dealt with in Volume 1 of the Committee's report.

Financing of Infrastructure Projects

- the difficulty of mobilising private sector funds from non-banking sources;
- the higher borrowing costs incurred by the private sector.

Government action of various kinds can mitigate each of these disadvantages:

- Lack of transparency was addressed in the Committee's Volume 1 report, where the Committee made a series of precise recommendations for government action to improve openness in contract information.
- The Government could explain more effectively to the public the need for private sector financing.
- Government assistance, as outlined in Section D of this discussion paper, could be used to mobilise and supplement private funds for infrastructure, at relatively little cost to the Government and for considerable benefit to the community.
- Higher borrowing costs would normally be offset by greater private sector efficiencies, which could be made possible by government action.

C. SOME PROPOSED GENERAL PRINCIPLES

(a) A partnership approach between the Government and the private sector will be more productive than suspicion and antagonism

The corollary to this proposition is that it is not impossible to design intelligent mechanisms for co-operation between private and public sectors in infrastructure funding.

There are two main reasons for setting out this proposition: it is practical and beneficial.

In infrastructure financing, the proposition might be put into practice by the Government “leveraging” the dollars it has, in order to build, together with the private sector, more projects than it could have built by relying solely on its own resources. For any given level of resources, the Government would be able—by co-operating with the private sector in project financing—to make available to the community more projects than it could have put in place by using only its own resources without private supplementation. Moreover, with the use of this co-operation, those projects would be available to the community now rather than some time in the future.

An example, simplified for illustration, could be the following:

If the Government has a certain amount—say for argument's sake \$60m—available for infrastructure, it could *either* spend that \$60m on funding all the costs of one item of infrastructure, *or* contribute—say \$20m—to each of three projects, with the private sector covering the rest. If it chooses the latter course, the community benefits from

having three new items of infrastructure instead of one, and it has them now instead of in ten or fifteen years' time.

Thus the result of a public–private partnership could be eminently practical and beneficial to the community. By “leveraging” its dollars, the Government has produced a better result for the community than by sticking to a rigid theoretical formula requiring funding for infrastructure to be *all* public or *all* private. Theoretical arguments might be made about possible inefficiencies in the allocation of overall resources, but the practical result—three items of infrastructure instead of one, and all the benefits which those three bring compared with just the one—will speak for itself. In any case, the forms of public–private partnership in infrastructure provision can be carefully designed so as to allocate resources and risks appropriately.

Partnering as a concept in the management and financing of infrastructure projects is becoming increasingly popular. A recent article in *The Economist*³ sets the scene for this recent change. In the United States, particularly in California, the concept is also being introduced actively.

There are of course costs associated with this system. For example, one is the higher cost of private sector borrowing. Private sector efficiencies and other advantages need to be carefully weighed to ensure that they more than counterbalance these extra costs.

There are some projects—relatively few, however—which can be funded exclusively by the private sector, with no government participation at all⁴. Even for these few, there still needs to be interaction between public and private sectors. The Government has to work through and generally finance the approvals process, contracts need to be

³ “Private-public Partnerships - Chug, chug, chug” *The Economist* October 30, 1993, p. 64.

⁴ An example is the Dartford Bridge outside London. The traffic from the M25, the busiest road in England, is forced on to the Dartford Bridge to cross the Dartford River. There are no competing facilities. This is a unique and interesting proposition for the private sector.

negotiated, and risks need to be allocated. There are many more projects which do need government support; in other words, their revenues are not commercially acceptable but the Government considers them necessary for social and broader economic reasons and is prepared to “kick in” whatever is necessary to get the deal done. For these, the level of co-operation between the Government and the private sector needs to be that much closer and better organised.

In many cases co-operation between private and public sector has not been close, systematic or institutionalised. Mechanisms have not generally been devised to make the Government's and the private sector's interests coincide. Instead, mutual antagonisms, long delays, costly legal services, indecision and abrupt cancellations by governments past and present, have all been frequent.

There thus seems to be only a patchy and limited appreciation by public sector officials of:

- the need to use public and private sources for infrastructure financing in tandem;
- the need to adopt a partnership approach with the private sector in negotiations rather than one based on hostility and wariness.

The resistance to the “partnership” proposition appears to be based on several grounds:

- Political interference might mean pork-barrelling.
- Accountability, probity and transparency might be compromised.
- The Government's exposure might be open-ended.
- The structure of any such co-operation might be messy and over-complicated

(e.g. HomeFund).

- The management of any such co-operative structures might not be professional (e.g. Victorian Economic Development Corporation).
- Any given public–private partnership might result in an inefficient allocation of resources.
- There could be difficulties with the Loan Council. (This argument has now been superseded).⁵

It is the Committee's contention that it is possible to design mechanisms of public–private partnership in infrastructure financing which avoid these pitfalls. A principal task of this paper is to suggest concrete forms for such partnerships which skirt these dangers or tackle them head on. Some possible forms are outlined in Part D of this paper.

The fundamental principle for determining which type of government involvement is appropriate in any individual BOO- or BOOT-type project is that each sector should carry the risk it is best equipped to bear. The most efficient outcome will be reached if the Government and the private sector each bears the risks that are appropriate for each. Allocating to the Government risks which the private sector is best equipped to bear, and vice versa, will probably lead to unnecessary costs and inefficiencies. This has frequently happened in Australia, partly because of problems with Loan Council guidelines.

⁵ See p. 20 below.

(b) Transparency

The second principle the Committee wishes to establish at this point is that all BOO- or BOOT-type contracts, whether they include government involvement or not, must be conducted with transparency. In Volume 1 of its report, the Committee detailed the elements of a contract which should be made available to the Parliament and the public.

There would be little need, in the Committee's view, for unsubstantiated allegations based on lack of information if these guidelines were followed. The need for transparency is closely related to the next principle the Committee sets out—that of competition.

If the Government wishes to enter into a public–private partnership, its reasons for doing so must also be made transparent. If the Government sees social or economic benefits in a project whose returns, especially in the early years, may not be commercially acceptable, these benefits must be made clear to the Parliament and the public.

(c) Competition

The private sector has stated many times to the Committee that when it proposes projects itself to the Government, it considers that the Government should never go out to the market with these ideas because this essentially constitutes theft of intellectual property. The Government, on the other hand, believes it has a responsibility to the community to secure the best and cheapest alternative, and that the best way of doing that is to go out to tender.

In its Volume 1 report, the Committee adopted a compromise position—that where the

original ideas interest the Government, it should go out to the market but not with those specific ideas. Rather, it should go out on a “broad needs” basis, or simply specify the outputs it wants and leave the private sector to design the inputs.

Another proposal has been put to the Committee in evidence. As in architectural competitions, the Government might seek bids for the design of an infrastructure facility, or the identification of an infrastructure need, and then, in a subsequent and separate process, seek other bids for the construction of that facility. If a company submits an original idea, it should be paid for that idea and legal ownership of that idea should then pass to the Government. Then the Government could seek bids for the construction of the facility. There would be several advantages to this procedure:

- It would encourage the submission of creative ideas from the private sector.
- It recognises and rewards intellectual property.
- By throwing open all the steps of the process, it encourages competition and thereby ensures the Government achieves the best result at both design and construction stages.

Competitive forces must be retained while negotiating and establishing project fundamentals, but there must be an early point defined after which a co-operative model should be employed.

It is possible to illustrate in a highly simplified form the range of possibilities for public–private co-operation in infrastructure funding as follows:

Figure 1

Figure 2

In the bar charts of figure 1, all of the funding for project *ac* is shown to come from the private sector; while most of the finance for project *xz* comes from the private sector with the Government providing top-up or supplementary finance, either in the form of actual dollars (which it might in any case recoup later on⁶) or in the form of pledges. In project *bd*, the public sector has provided all of the finance.

Figure 2 depicts the same concept in another way, with the box *abcd* representing all infrastructure. The line *ac* represents a project which is 100% funded by the private sector, and the line *bd* one which is 100% funded by the public sector. Line *xyz* represents a project which is mostly funded by the private sector and to a small extent supported by the public sector. The position of the line *xyz* along the horizontal axis will determine the respective level of private and public sector contribution. As *xyz* moves from left to right across the diagram, the public sector component increases and the private sector component decreases.

⁶ See Part D(a) below.

It is important to stress again here that any private sector contribution must be handled by the Government with the maximum transparency and competition possible. Along the line *yz*, that is, where the private sector is involved, the principle of maximum competition should apply. Any collusive tendering problem of the “Building Industry Royal Commission” type, or financially questionable bids of the “pay television” type, should be rigorously policed during this process.

Along *xy*, that is, for the part of the financing that comes from the public sector, the maximum possible transparency should apply so that the public has the fullest possible information upon which to understand and debate the public sector financial contribution with a view to holding the Government fully accountable for its investment of taxpayers' dollars.

Other factors such as commercial confidentiality and the necessity for exclusive dealing in particular cases also need to be taken into account⁷.

(d) Process should not overwhelm outcome

Absolute probity is essential and non-negotiable. However, it is not necessarily best served by pedantic and expensive adversarial processes. The Water Board, for example, stated in evidence that it spent between \$1.5m and \$2m on legal fees for the negotiations on the water treatment plants. Proponents probably spent about three times that sum, and the consequent delays were very costly. In France, on the other hand, BOOT contracts are about 20 pages long and are negotiated speedily.

Granted that the French legal system is fundamentally different from the Anglo-Saxon,

⁷ See Committee's Volume 1 report, pp. 64 and 81, respectively.

the fact still remains that documentation based on clear, agreed principles and augmented by suitable agreed dispute resolution procedures saves time and money and offers more protection in the end than pedantically drafted and negotiated legal documentation with inordinate amounts of detail.

With a partnership approach, the onus is thus placed on both sides to develop a good working relationship and on each partner to appreciate the legitimate needs and expectations of the other.

D. PUBLIC–PRIVATE CO-OPERATION

There are many projects which the Government might consider desirable but which need a boost or a “lift” to enable them to pay their own way in financial terms. These could well be the appropriate candidates for public–private partnership arrangements, where risks and returns are appropriately allocated in transparent arrangements.

There are three ways in which the Government might co-operate with the private sector in the financing of public infrastructure:

- enhancement of commercial factors, which essentially is a boost to make the project commercially viable;
- direct financial participation in structures such as an Infrastructure Development Fund;
- improved administrative arrangements for mobilising and working with private sector finance providers.

(a) Enhancement of commercial factors

As pointed out above, projects often do not pay their own way financially (particularly in the early years) though they may have substantial wider social or economic benefits. They may be too large, too long-term, and may suffer from low or negative financial returns in their early years. They cannot therefore be financed easily from normal private sources of equity or debt. Commonly, for example, banks will, in practice, only provide up to a certain amount, which, even after taking into account proponents' equity, still falls short of the total amount needed. There is a “funding gap” which needs to be bridged.

Measures for bridging this gap are called “enhancement” measures. They enhance the viability of the project as far as the private sector is concerned, make it easier to attract private equity or debt, provide the critical level of reassurance to banks and equity providers, and ultimately get the project moving. For large, socially and economically desirable infrastructure projects, a logical source of these enhancement measures must be the Government.

It is possible to divide enhancement measures into two categories

- measures which do require the Government to have made a net financial contribution at the end of the day
- measures which do not necessarily require a net government contribution to have been paid out at the end of the day.

Measures in the first category do oblige the Government to have laid out real or net dollars at the end of the day. However, enhancement measures in the second category do not cost the Government anything at the end of the day. When the Government provides such measures, it is enabling, at no net cost to itself, projects to be realised that would otherwise remain on the drawing boards. The common characteristic of both categories is that the Government is providing just that amount of support which is needed to get the deal done.

Enhancement measures where the Government will have made a net disbursement at the end of the day

These include:

- a level of take-or-pay revenue which could set an absolute floor on the minimum project revenue and thus limit downside risks for debt after equity has absorbed the main risk;
- payment for insurance;
- grants;
- rebates of payroll or other State taxes;
- provision of land at no cost, for example for railways;
- payment for the EIS process.

These measures are reasonably well known and straightforward.

Enhancement measures where the Government will not necessarily have made a net financial contribution at the end of the day

These include:

- conditional or stand-by guarantees
- time-based guarantees
- soft loans
- subordinated loans
- convertible loans

Conditional or stand-by guarantees

Under one version of this arrangement, the Government and the private sector mutually agree on a certain level of patronage of the facility. Say for illustration that the facility is a road, and the mutually-agreed upon level is 1000 cars per period, say one year. (It could be six months, two years, or whatever the two sides agree on). If in one particular year, e.g. the first year, patronage is only 900 cars, the Government undertakes to pay to the private sector the toll that the missing 100 cars would have paid.

If in the next period (or at any time in the future) patronage goes up to 1100 cars, the Government has the right to obtain from the private sector the amount of toll which those extra 100 cars have paid (that is, the extra 100 cars over and above the agreed level of 1000 cars). In this simple case, the Government has “clawed back” or recouped the exact amount it contributed in the early, loss-making period.

If in the early, loss-making period the shortfall covered by the Government is still 100 cars, but if in the later, profitable period patronage goes up to, say 1500, then the Government has a choice. It could decide to claw back only that amount it had contributed in the early loss-making period, that is, the toll of 100 cars, and let the private sector take in the toll paid by the other 400 cars, or else it could agree that it could claw back to itself the toll which the 500 cars over and above the agreed-upon 1000 cars have paid.

This is a very simple illustration, and the actual deals will be more complex. However, the principle will remain the same: that the level of the Government's support will be conditional on the level of patronage of the facility.

Under another version of conditional support, the Government promises that it will support any debts an agency holds in respect of a project if that agency is privatised. Thus the Government's support is also conditional on that eventuality occurring.

Perhaps the most common version of the standby guarantee is that the Government announces that it will fund the difference (if any) between the cost of the project and the amount of equity plus debt which the private sector can raise for the project. This may or may not be called upon. In fact, the Government's expressed willingness to participate can succeed in winking out further debt or even equity, which then makes government participation unnecessary in the end.

Other forms of time-based guarantees

Under this type of arrangement, which is similar to the one outlined above, the Government agrees to supplement the project's revenue up to a certain ceiling for a strictly defined period, say five years. Thereafter, assuming patronage of the facility has improved, the private sector and the Government agree that the Government can share revenues beyond a certain mutually-agreed upon level (another type of “claw-back” arrangement). If patronage has not improved, the private sector equity and debt providers will be obliged to “take the hit”, in the idiom of the finance world (that is, take a loss).

Under another version of the same arrangement, the Government guarantees the project's payment obligations of capital and/or interest for a limited period, say five years. “Claw-back” provisions could also be included in this type of arrangement, whereby the Government has preferential rights over repayments from future profits. This is being done in California with a number of road projects. This arrangement represents a real potential benefit for the Government from the partnering concept.

Support funding from existing asset

The revenue stream from an existing asset, such as the Harbour Bridge toll, can be used to help fund construction of a project such as the Harbour Tunnel. This topic is discussed later in this paper, but the Committee has some concerns politically that there needs to be a reasonably close nexus between the revenue stream of the existing project and the new project.

Soft loans

These are loans at below-market interest rates. The Committee does not see anything wrong with such loans, provided the reason for them is made totally transparent and the argument justified that this is the best possible use of the money.

Subordinated loans

At the time of making these loans to the private sector, the Government agrees that it will remain the last in the queue for repayment of both interest and capital, behind any other creditors the project may have, such as banks. Again, the Committee sees nothing wrong with these arrangements with the same provisos which apply to the point above.

Convertible loans

Under this arrangement, the Government makes a loan to the project in its early years. The Government might even agree to let interest accumulate rather than insist on early repayment of interest. After a certain mutually-agreed upon date (say, after five years), the Government has a right to convert the total due (that is, the principal plus accrued

interest) to *equity* in the project in accordance with an agreed formula. This gives the Government the opportunity to profit from any increase in the project's value.

* * *

It is important to stress that there may be “downsides” to almost all of these measures. In other words, the risks that the Government is taking by implementing these measures may actually eventuate.

A common procedure in this context is for these risks to be weighted by their probability. An estimate is made of the probability of, say, the patronage being at each of level X, level Y and level Z, and the effect on the Government's risk is weighted by this probability.

The recently-proposed risk-weighting approach to the Loan Council treatment of private sector-financed infrastructure projects is relevant here and has been strongly pursued by the Committee with the Federal Treasurer. The new approach makes it possible to tailor the level and method of any necessary government enhancement measures to the real needs of individual projects.⁸

In this context it should be pointed out that there have been very few defaults, if any, on revenue bonds issued in the United States. These use the revenue of the infrastructure facility to pay back bondholders. Of course, this kind of success might not be duplicated in Australia.

However, even if the worst risk does eventuate and the private sector's operating losses are so severe that it is obliged to pull out, it should not be forgotten that the Government could then be left with a new infrastructure facility for which it has not

⁸ See Section E(b) below.

been the main financier. In other words, the Government may have got a bargain. If the private sector has to pull out during construction and the Government is left to finish the project, the Government is still not in a position of loss because at some time in the future, it is probable that the project would have been built anyway from government funds.

* * *

It is proposed that the Government, or more precisely the agency concerned, having conducted a competitive bidding process to get the best possible proposals from the private sector, should then carefully see if a project is suitable for a possible enhancement, and then, as the next step, decide what the nature and maximum level of its enhancement for that project should be.⁹ The agency should go through the list of possible enhancement measures, evaluating their suitability for the project under consideration, discarding some, adopting and modifying others, and making a final decision, which would be public knowledge, on the type and ceiling level of government support appropriate to the project. A major criterion in the bidding process might, for example, be the level and type of government enhancement sought—the lower the support sought, the greater the chances of being selected.

These enhancement measures would be devised and implemented in a spirit of partnership, and with full public knowledge. All such enhancement measures must be transparent, and offered in the context of a competitive bidding process.

It is important that having made these arrangements public, the Government should stick to them. Changes in the arrangements—for example, unscheduled bailouts by the Government—should be made practically impossible.

⁹ It would be desirable for the EIS process to be completed before any of this happened.

Once the Government has decided on the kind of enhancement measures it was willing to adopt, the commercial funding for the project would then be considered as the next step in the process. It may be that the private sector proponent would be able to obtain sufficient funds from a bank, although banks are not generally suitable lenders for infrastructure because of their short time horizons.

The Government might consider participating, as an equity investor or as a facilitator, in another alternative—a specially-designed Infrastructure Development Fund.

(b) Direct participation in an Infrastructure Development Fund

Government participation in an Infrastructure Development Fund would have one main aim: to act as a catalyst mobilising major private sector investment. Several infrastructure funds have been proposed to date by the private sector, but so far without overwhelming support. The difference between the fund described below and those which have been put forward by the private sector is—a very limited level of *government* participation.

The Fund proposed would be a private-sector entity with a maximum level of government participation set at, say, 10% to 20%. The Government's votes on the Board would be commensurate with the proportion of equity it holds in the Fund.¹⁰ The Government's equity contribution could be obtained from the Consolidated Fund or possibly from existing or “brownfields” government-owned assets, although the Committee has some misgivings where, for example, the brownfields asset is of a different class to the asset sought to be funded.¹¹ If existing assets were used, they may be taken as an equity contribution to a project, resulting in a public–private

¹⁰ The Government may not actually invest any funds itself. It may need only to underwrite a portion of the seed equity to achieve the necessary level of participation from other investors.

¹¹ The pros and cons of brownfields sites are discussed on page 3d.

partnership, or sold into an Infrastructure Development Fund, with the Government receiving equity in the Fund in exchange. The public–private partnership may have particular application in the area of extensions and missing links to existing motorways, while other revenue-producing assets may be better suited to equity transfers in an Infrastructure Fund. The established revenue of the asset would be the attraction for potential non-government equity providers.

Arrangements such as these would “give the risk profile a haircut”, that is, reduce the risks in the early years.

Of course, the Government would have to weigh the benefits of using the asset in these as opposed to other ways.

The aim would be that the Government's seed equity would attract other equity providers from the private sector, which would have the other 80% to 90% of the equity and of the votes on the Board. Still other members of the Board would be respected and credible individuals from the private sector. Each equity partner would have the right of veto on investment in a particular project. Each equity provider would have shares in the Fund. The Fund could operate as a homogeneous entity investing in all classes of infrastructure project, or be divided into classes, e.g. the Road Fund, the Water Fund, the Maritime Fund. The debt supporting the Fund might be rated by the various rating agencies; the debt supporting the various subfunds and the individual projects could also be rated to provide a measure of comfort to potential investors.

The Infrastructure Development Fund would be managed by professional private sector fund managers, not by public servants. These managers would have the professional expertise to carry out all the due diligence analyses required. It is proposed that the Government's own 10% to 20% equity would be managed by a

statutory corporation—the Infrastructure Development Corporation—which could be handled by a small, say, three-person unit inside the NSW Treasury Corporation, and which would report to Parliament and be obliged to adhere to all the requirements of the Public Finance and Audit Act. The unit would not be expected to be a particularly active one—it may meet once every quarter to decide on how to manage the Government's involvement in the Fund. The managers of the Corporation would sit on the Board of the Fund.

There would be no intention that this should be the only Infrastructure Fund in the market, or that it would enjoy preference in any way to any other Fund which might develop in the market.

A major aim of the Fund would be to attract debt. Once the equity providers are in place, it would be expected that debt would follow. A frequently-used ratio is \$4 of debt to \$1 of equity.

It would be highly desirable for the Government's investment to take the form of purchase of shares in a public company which is subject to the Corporations Law. Co-investors would also purchase shares. It is very important that the vehicle be an ordinary company subject to the Corporations Law. This is so that the precise nature of the responsibilities and duties of care of directors is very clear.

The Government as an investor in the Fund would be entitled as a shareholder to appoint directors. Other investors would have similar rights to vote. All directors would be subject to the normal obligations applicable to company directors under the Corporations Law.

The relevant Minister under whose portfolio the investment fell would be accountable to the Parliament for the commercial performance of the investment, but only in his

capacity as a shareholder on behalf of the State. An underlying shareholders' agreement (or a "golden share") between shareholders could be used to govern relative voting powers. Under this, for example, a unanimous vote could be required for specific investments, investments over a specific amount and/or to preclude investments in areas other than infrastructure areas.

The Fund should be distanced as far as possible from the State so as to reduce the assumption of an implicit guarantee. As officers of a company, directors and management of the Fund would be subject to all the duties and liabilities (including personal liability for insolvent trading) imposed by the Corporations Law. This is of itself an important force in keeping the Fund focused on purely commercial investments.

Management of the Fund could be undertaken internally or could be contracted out. As an incentive to perform, consideration should be given to selecting a manager who is prepared to itself put moneys at risk as an investor in or co-investor with the Fund.

Consideration may also be given to ending the Government's involvement in the Fund after three years. This would have the effect of creating a catalyst without threatening long term competitiveness in the infrastructure financing market. In fact, it would be hoped that this Fund would provide a stimulus for the creation of other similar funds entirely from within the private sector.

It is important to stress that despite the best efforts of the professional manager, there will be the occasional project which will not meet expectations and where the Fund will take a loss. Of course this should be balanced by the others which will make their foreseen returns, and this is the advantage of having a spread of risks in the Fund. However, the potential for a loss should not be glossed over.

Thus to sum up the features of the proposed Fund:

- The Government's participation would be limited to no more than a small percentage, say, 10% to 20%.
- The Government's participation would be transparent through the medium of the Infrastructure Development Corporation.
- The Government would seed the Fund using existing assets.
- The Fund would be managed by professional private sector fund managers.
- The Board would consist of the major equity providers plus respected private sector individuals.
- The Fund would issue shares.
- The Fund could be divided into a number of subfunds based on sectors, or even directed to one particular project.
- The Fund, the subfunds, and the projects would all be rated.

The superannuation funds are the most likely and suitable source of funds for private investment in infrastructure, although banks would retain their primary role in the construction and development phase. There are many advantages of infrastructure facilities for superannuation funds:

- They offer long life and a steady cash flow.
- They have a safe market, which is often monopolistic.
- They are not subject to the whims of the consumer.
- They will not be made obsolete by a new wave of technology.
- Many of them meet the “social needs” criteria set by some superannuation funds.

However, despite the advantages of infrastructure as an investment destination, superannuation funds are still not putting their money into it. The Committee has been given a number of reasons for this reluctance:

- They have never invested in infrastructure before and are unwilling to consider it as a new investment category.
- They typically have no expertise in assessing the risks of infrastructure projects.
- There is always a political risk, for example, that the Government will change the rules.
- The potential for high profits is limited.
- The risks are considerable in the early, start-up phase.
- There is a perception that the lack of a marketplace is a tremendous disadvantage. This diminishes tradeability or liquidity.
- They are unwilling to wait for 20 or 30 years to reap the full advantage of their equity position.
- Taxfree or low tax bonds were not attractive to superannuation funds, which pay low or no tax anyway.

The Infrastructure Development Fund's structure outlined above has been designed to help meet a number of these objections:

Infrastructure as an investment category is new, untried and unfamiliar; pension funds have no facilities for carrying out due diligence analyses.

The Government's strategic but limited involvement would be aimed to reassure potential investors. The professional fund managers will carry out all due diligence analyses.

There is a perceived high degree of political risk.

The Government's involvement would be strictly limited, say, to 10% or 20%; the Fund would be managed by professional fund managers, and the Board would be dominated by the private sector. It would be neither possible nor in the Government's interest to subvert the ordinary commercial processes.

The degree of political risk would probably be mitigated if the Government's own financial contribution looked as though it would be adversely affected by political interference. If the Government's own money is on the line, the Government is much less likely to interfere politically if that interference could result in a financial loss for the Government.

Early risks are high

One way of lessening risk is for the Government to use brownfields assets to even out the risk profile in the early years. An example is the Harbour Tunnel where toll revenue from the Harbour Bridge has helped to directly fund the Tunnel and lower the risk profile.

Where a revenue stream from one facility is used for an immediately adjacent facility of a similar type, the Committee has little difficulty. However, where road toll money is used as an injection to a fund which is financing the building of a power station somewhere else, then the political perception of a cross-subsidy is of concern to the Committee, and the issue requires further consideration.

There are perceived problems of liquidity and/or tradeability of financial instruments relating to infrastructure.

The Infrastructure Development Fund's shares would be tradeable, if necessary at a discount. The Government's involvement should make the shares more attractive and tradeable. In any case, many superannuation funds have a high proportion of relatively illiquid assets.

There is a risk that undue interference in project decisions would be made by the Government without any accountability mechanisms to keep it in check.

The fact that the Government has to report to the Parliament on the operation of the Infrastructure Development Corporation under the Public Finance and Audit Act provides a measure of accountability and insurance against political interference. Its involvement in each particular project would have to be outlined and justified in the Corporation's annual report.

Other objections which the proposed structure is designed to meet are:

- *The Government's exposure in the Fund might be open-ended.*
The Government's involvement in the Fund would be permanently limited. If the project failed, it would lose the equity it had put into that project, but not more. The other equity providers would lose their equity as well. Any danger of uncapped liability would not come from the Fund, but at the earlier, enhancement stage, and the Government could avoid that by specifying a ceiling on its enhancement.
- *The Fund's structure would be complicated, like HomeFund.*
The structure proposed is simple and clear.
- *Private sector attempts have already been made to establish a similar fund.*
The Government's use of already established and performing assets would give

the fund an initial established revenue base. This by definition is not part of any private sector fund.

<p>The main aim of the Infrastructure Development Fund would be to act as a catalyst mobilising major private sector investors.</p>

(c) Rating and insurance

Infrastructure projects can be rated by ratings agencies in the normal way to provide an estimate of the risks inherent in each project. Relevant criteria include competition for the service, geographic service area, revenue-raising flexibility, legal structure debt structure, institutional characteristics and market structure. Rating of infrastructure projects is not done strictly on a series of ratios, as is the case with corporate bonds. Other factors are commonly taken into account, and each project has its own risk profile.

Rating would be useful because it would show to potential investors what their chances are of getting repaid. Project rating would also seem to work well with the new Loan Council guidelines, which weight risk. The Committee seeks to explore further the potential value of rating of infrastructure projects.

Insurance of projects is carried out by specialised firms. For a fee, they provide insurance which guarantees a triple-A rating for a project. To qualify, however, a project would normally be of investment-grade quality, that is, B or above. Typically, the credit quality of the underlying income stream of the project is the relevant criterion. The Committee seeks to explore this insurance possibility further as well.

(d) Project administration

The special regulatory and administrative environment relating to government infrastructure investment requires, among other things:

- specialist expertise
- central collection of experience
- consistency of analysis and management
- development of effective interfaces between the Government and the investing institutions
- consistent methodology relating to loan council evaluation
- conformity with the Public Finance and Audit Act.

These objectives are poorly served by expecting all government agencies to meet standards in these specialist areas which are generally outside their normal activities. Recent experience has illustrated the very high costs associated with each agency “learning on the job” in negotiating and finalising BOOT contracts between the private and public sectors.

On the private sector side there are also needs relating to consistent and effective liaison with the public sector in the area of private–public partnership. Projects need to be adaptively designed to suit institutional investment portfolio requirements in their mix of yield, growth and risk profiles.

The Government should assist by proclaiming a specialist unit whose brief it is to form the nucleus of project specific task forces with participation by the relevant GTEs or departments for the analysis and implementation of project development in all cases where the private sector is involved.

Such a unit—similar in some ways to the Office for Public–Private Partnerships

within the Californian Department of Transportation—would form a bridge between the Government and the private sector, and should therefore not be seen to be a “part of government bureaucracy”, that is, belonging to a central government department. It would also perform the role of evaluating prospective capital projects for suitability as to private sector participation and do benchmark comparisons with internally costed solutions.

E. OTHER ISSUES

(a) Taxation

Several witnesses and submissions to the Committee stressed the importance of Division 16D and section 51AD of the Income Tax Assessment Act in acting as a disincentive to private financing of infrastructure projects.

These provisions were first introduced into the Act to counter tax avoidance stratagems, as used in the Eraring Power Station. Under such schemes, tax-exempt government bodies, many of which are State government bodies, sell a facility to a (private sector) taxpayer who is able to benefit from depreciation deductions, and then lease the facility back. These deductions can be substantial, and commonly— before the two above provisions of the Tax Act were introduced—the benefits of these deductions were shared by the private sector with the Government.

The problem with this scheme is that the Commonwealth Government was effectively giving a deduction to a tax-exempt body. On the principle that tax deductions should only be available to tax-paying entities and not tax-exempt bodies, and because this sort of strategem was losing revenue from the Commonwealth, the Commonwealth Government introduced the above two provisions to combat it. They essentially forbid private companies from benefiting from deductions in the context of infrastructure leasing arrangements.

However, this measure in turn has created problems. One witness has told the Committee, “Section 51AD . . . is absolutely draconian in its application”. Now that private companies can no longer benefit from deductions in the context of such leasing arrangements, their incentive to provide the finance for infrastructure projects has

seriously diminished. Another witness said that this did not serve the national interest. The Commonwealth, he said, is considering only the loss of tax revenue to the Commonwealth, and not the effect on the States of losing infrastructure facilities.

The effect of section 51AD and Division 16D on the enhancement measures proposed in section D(a) above needs further exploration, and the Committee seeks views on the matter.

(b) Loan Council

The Loan Council's regulations have appeared in three different forms in recent years.

Until July 1993, the rules effectively meant that if the majority of the risks of a particular project were deemed to be borne by the public sector, then the whole of the project would be counted as being inside the Global Borrowing Limits for each State. These somewhat illogical arrangements, which prevailed for a number of years and governed the majority of the deals now in force in NSW, including HomeFund, provided a clear incentive to structure deals artificially so that it appeared that the private sector was bearing most of the risks, even when this was not really the case.

In July 1993, new rules were introduced which meant that if *any* risk at all—not just the majority—were being borne by the public sector, the *entire* value of the project was counted as being inside the Loan Council Allocation.

The illogicality of these arrangements appeared even greater, and in October 1993 it was announced that, as of July 1994, an entirely new approach would be adopted—the so-called “risk weighting” approach. Instead of the all-or-nothing system of before, the new approach assigns a weighting to the risks carried by each sector and uses that weighting to determine how much of the project's value should be counted against the

amount a State may borrow.¹²

The Committee has vigorously expressed the need for such changes¹³ and is pleased to see them implemented.

The new approach has reduced the incentive to structure projects so as to fall outside Loan Council coverage. “Even with this less binding constraint, however, some jurisdictions could still see presentational advantages in achieving a zero weighting for individual projects.”¹⁴

The new system should eliminate much of the confusion, secrecy and illogicality characteristic of the old. “It estimates the degrees of public sector risk exposure in an infrastructure project. This estimate will then be disclosed and included in the Loan Council Allocation of the Government.”¹⁵ This system, which has its own difficulties, nevertheless opens the way for much more rational analysis of projects with regard to risk weighting and allocation between the Government and the private sector.

¹² Officer's Report on Loan Council Guidelines for Assessing Private Sector Involvement in Public Infrastructure Projects—Summary, attached to Treasurer's Press Release, *New Guidelines for Loan Council Coverage of Infrastructure*, 12 October 1993, p. 3.

¹³ “Olympic risk cover-up feared” by Danielle Cook, *The Sydney Morning Herald* 29 September 1993, p. 4.

¹⁴ op. cit., p. 3.

¹⁵ Press Release, op. cit., p. 1.

(c) Infrastructure bonds

Infrastructure bonds, as proposed in the *One Nation* statement, have proved unattractive for two main reasons:

- They have been structured to give a tax exemption to bond holders. The effect of this is to make the infrastructure bonds attractive only to taxpayers who are already paying a very high marginal rate of tax, and these are basically individuals rather than companies. So the market for the bonds has been limited. A related effect is that superannuation funds, which pay a low 15% rate of tax, are not particularly interested in a vehicle which offers a tax exemption. So superannuation funds—which hold large cash balances—have not been notable investors in these bonds.
- They do not allow the corporate issuer of the bonds to take a tax deduction on the interest it has to pay to bond holders.

F. CHAIRMAN'S CONCLUDING REMARKS

The ideas expressed in this discussion paper are not the final views of the Committee, but are designed to promote comment and feedback to assist the Committee in formulating its final report on infrastructure financing.

Responses to this paper are encouraged, and may be sent to:

The Director
Public Accounts Committee
Parliament House
Macquarie Street
Sydney NSW 2000