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Public Infrastructure

Submission to the Productivity Commission

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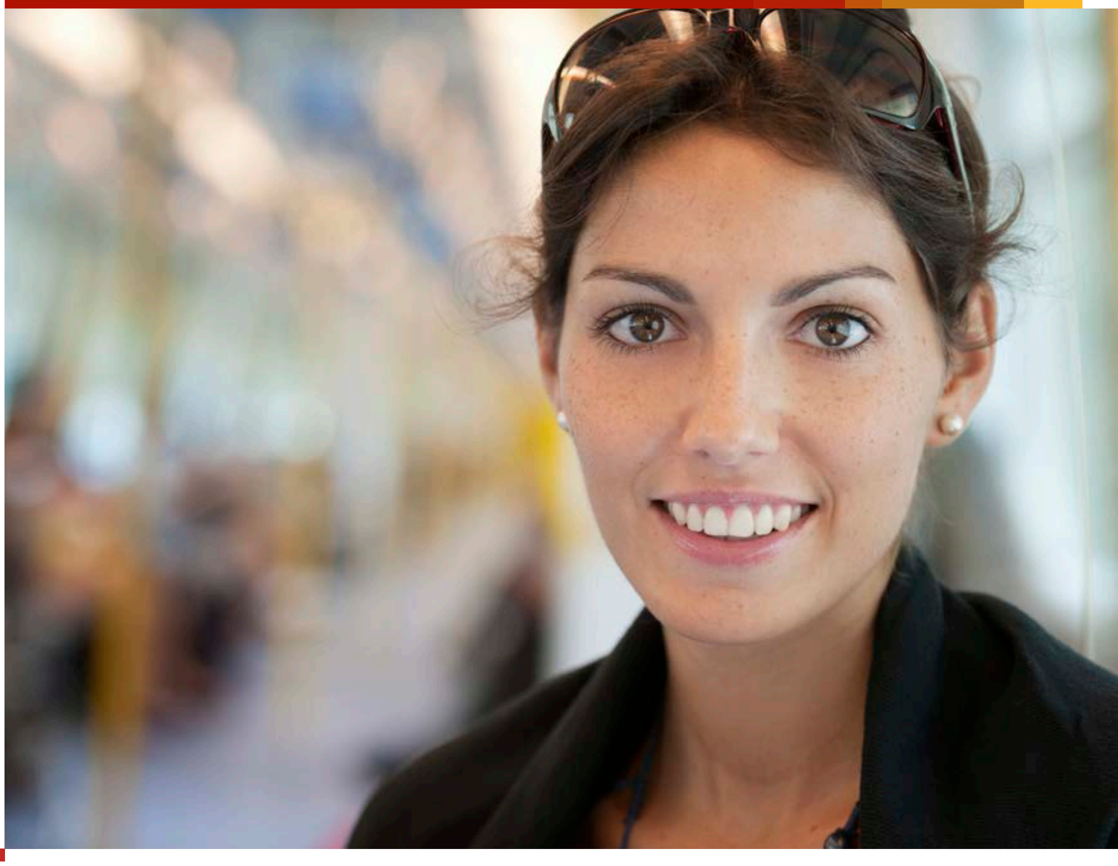

Purpose

The purpose of this submission is to provide input to the Productivity Commission Inquiry into *Public Infrastructure: Provision, Funding, Financing and Costs*. As one of the leading global providers of professional services we consider the firm is well placed to contribute to this valuable national inquiry.

The importance of infrastructure to our economy is made clear in the Commission's terms of reference, and the recent PwC CEO survey showed that 83 per cent of Chief Executives referred to infrastructure as the most pressing business issue inhibiting growth in the Australian economy.

This submission focuses on the issues of funding and financing. It does not comment on all aspects of the draft report. In doing so, we reflect on the previous PwC report of November 2013 *'Report to the Business Council of Australia on Infrastructure funding and financing.'* [i]

Summary

We applaud the considered analysis provided in the Productivity Commission's Draft Report and are strongly supportive of many of its key recommendations around project selection, public and private capital financing, funding through user charges, value capture and governance and institutional reform.

The debate on financing for infrastructure has progressed significantly in recent years to the point where certain aspects have gained broad acceptance:

- Government use of capital recycling is accepted as having merit in certain situations, and is actively considered and expedited across Australia.
- There is no shortage of private capital, in particular from superannuation funds, to fund infrastructure; the challenge is structuring projects (greenfield or brownfield) with appropriate returns to meet investor requirements.
- Private capital financing does require appropriate returns, and it is not a magic pudding.
- Government does not have surplus funds to pay for all new infrastructure requirements; given the combined annual fiscal deficit across all levels of government. PwC research shows the national debt could reach $75 billion by 2050.

In Australia we are seeing increasingly constructive community discussion and momentum around capital recycling. The debate about the clarity of the pipeline of investment opportunities indicates that the merit of capital recycling is understood and supported, and substantial capital is available looking for infrastructure assets coming to market.

Clearly there is also further progress needed on some key financing aspects such as participation in longer term debt by superannuation funds. We also need to progress our Infrastructure bond market, and there are clear disparities to the Canadian market. The recent PwC *Submission to the Financial Services Inquiry*[iii] (para 4.5.1) references the need for progress towards an Infrastructure and Social Bond market. But these debates are underway and progressing albeit steadily.

However, from our perspective the community debate about funding reform requires further progress to keep up with the financing debate. Both the terms of reference to the Commission and the draft report state that infrastructure can be funded either by government taxation funding or by users through private user charges; and that expanding funding capacity requires widening the user-pays net. We agree with the draft report that "User charges should be used to the fullest extent that they can be justified" – and Recommendation 7.1 is critical in our view to the total infrastructure vision.

The debate about the user pays net and how it can be widened should consider a number of sectors. For example; roads, public transport and water, and how they are charged across all jurisdictions.

Progress on this issue can;

- support economic returns for infrastructure assets which then become appropriate vehicles for private capital investment,
- acknowledge the wider economic benefits of infrastructure,
- enhance understanding of the cost of infrastructure by the community; and
- support the significant current and future increase in spending on infrastructure referred to in the draft report – which has doubled in the last decade.

If Australia is going to succeed with getting the community engaged with an equitable framework for user charges and value capture, we need to rebuild trust and understanding including governance and institutional reform.

There are good examples which demonstrate the vital role of grass roots engagement. Looking at past experiences overall however highlights the inconsistency between different sectors of infrastructure and between jurisdictions.

Lastly, we note the progress and continuing importance of the other issues referred to in our report of November 2013, namely:

- expand the infrastructure funding role of the Commonwealth government,
- improve co-ordination of a new Commonwealth – State funding agreement; and
- improve innovation and risk sharing for greenfield infrastructure.

Background to our Comments

Australia has a proud history as a global leader in infrastructure investment and has significantly contributed to the creation of a global industry of private infrastructure investment during the early 1990's.

However, maintaining a leadership position in infrastructure is critical for our national competitiveness and productivity. Our long term vision for infrastructure is vital – and must holistically incorporate selecting, designing, financing, building, maintaining, funding and governance aspects.

In recent years we have arguably seen that leadership position challenged. New Zealand is looking to ways to tackle the reform agenda, including through institutional reform.

Since the 2006 *Building Canada*[iv] plan, Canada has grown its infrastructure financing capacity albeit with an availability based funding model. They have implemented concepts on financing such as that any project greater than $100m must be considered for PPP as a gateway to approval. In the UK the Government understands the need for reform of the strategic road network and is considering major institutional and governance changes with the Highways Agency.

We recognise that there are challenges with implementing reform in this area but we believe the time is right for a bold long term vision and discussion with the community.

- infrastructure was identified as the most pressing national issue on the minds of our CEOs in the recent PwC survey;
- the community is demanding improvements in transport and relief from congestion;
- Australian and international superannuation funds have the capital, expertise and appetite to invest.

Our superannuation funds have around 5 per cent of their assets invested in infrastructure, similar to the Canadian level – and have the expertise, appetite and innovation to deliver significant benefits through capital if we can create investable economic structures for our infrastructure. The duties of superannuation funds and their trustees is to invest in suitable assets for their obligations – infrastructure can deliver this.

However, many of the proposed reforms and the discussion about user pays have been moving forward slowly. The draft report identifies the key obstacles inhibiting action. We recognise that any reform in this tricky public area requires extensive community consultation.

Investment Models

The main factor holding back the wider application of user charges is community resistance to another 'tax'.

We strongly agree with the draft report that new institutional models for roads embracing superannuation fund investment would facilitate community acceptance. Good governance is key and we would frame broader introduction of user charges based on the following principles:

- The imposition of charges must viewed by the community as fair and equitable with consistent application and regulation.
- The revenue flowing from the user charges is committed to road development and maintenance.
- Infrastructure is prioritised and selected for development and charging where the users value the benefit being created.
- All users and beneficiaries, direct and indirect, contribute to the cost of the infrastructure.

The draft report discusses four models, the Departmental model, the road fund model, the regulated public road agency model and the private provision model.

Draft recommendation 7.2 advocates implementing institutional reform with greater adoption of user charging and hypothecation and, "the Commission considers that a road fund model should form the basis of starting a long-term transition to a more commercial approach to project selection and road provision".

The Commission also states that if more extensive user charging were introduced to roads, it would be possible to implement elements of corporatisation along the lines of regulated utility sectors. We support contributions to the debate such as that of Infrastructure Partnerships Australia and the Motoring Clubs in calling for further discussion specifically in regards to roads – and believe that considerable further debate and progress is needed.

Australia could consider a regulated road agency model operating on a commercial basis with funding from Government and revenue from direct charges on heavy and light vehicle road users.

New Zealand has made great progress with the establishment of a road fund involving one entity responsible for both road funding and provision.

As the Commission has set out with proper oversight from a regulator, this model has the potential to generate efficiency benefits. Public good aspects of roads can be addressed through community service obligations.

Australia does present challenges with the need to explore different models for metropolitan and regional roads and how to engage with the States and the various road management agencies; but that doesn't mean put reform on the backburner.

In terms of private investment in regulated road agencies, the Commission refers back to the concerns expressed in 2006 over monopoly power, high transaction costs, interconnection and access issues and public interest issues which led to it being "neither feasible or desirable to provide all roads privately". We believe both the market and the community have moved on from this position.

Superannuation funds are promoting their ownership of roads to their members. Why not take this concept further with private investment in regulated road agencies? This will be the most effective way in breaking the nexus between community aversion to paying user charges and paying another tax and putting profit in the hands of the private sector.

Regulated agencies will be earning a return for the superannuation funds appropriate for the risks managed and efficiencies generated in running a commercial business as assessed by an independent regulator. None of the concerns noted by the Commission should be seen as unresolvable.

The Commission describes in some detail the process for industry engagement with HVCI and the groundswell of community support. However, the Commission notes this is a long journey requiring significant commitment across all levels of Government. Clearly progress has been made in HVCI seeking to introduce a market-based framework, but there is scope to do more and faster. Indeed the ALC expressed concern at the speed at which reform is proceeding.

The concept of developing markets around user charges for heavy vehicles is not new. The trucking community do not see this negatively as a new tax provided charges are hypothecated to road investment and maintenance. The Commission has highlighted how the use of vehicle telematics can be used to track precise kilometres travelled so a fair pricing mechanism is capable of being developed and applied.

Moreover, pricing reform will mean more efficient use and investment in road networks. Countries like Germany already use this approach. We also note the release of the IPA Road Pricing Report with the support of the motoring agencies.

Finally, we believe one of the key benefits of progressing with reform of the institutional investment model is to drive efficiency improvements and financial discipline that a separate entity provides around asset management and maintenance.

By linking the provision of funding to clear service standards, community opposition to user charging for roads will be countered. Not only does this apply to new roads but also to the maintenance of the existing network.

Funding Balance in Different Sectors

Wider adoption of user pays begs the question how to balance the relative contribution of user pays and public capital to specific infrastructure sectors and projects.

In the case of the early private sector toll roads these were largely 100 per cent funded through user pays. Given the more recent difficulty of banking uncertain projected toll revenue for greenfield toll roads, the need for public sector co-funding to make projects financially viable is clear at least until ramp up demand is settled and a more mature volume demand pattern established.

In the case of the rail sector, the relatively high capital cost of investment means it is difficult to fully meet the expected return requirements of the private sector without some level of initial government support.

Clearly, the application of user pays in other infrastructure sectors such as electricity and water has been more readily accepted by the community, supported by appropriate regulation. However, it is not consistently applied through all jurisdictions

Decisions on which infrastructure projects to pursue and prioritise are informed by economic cost benefit analysis and the Productivity Commission has highlighted that this process needs to be rigorous and consistent. However once this decision has been taken, the funding split decision between user pays and public capital is less well defined and communicated with little transparency.

The current approach appears to be based on maximisation of user pays to supplement funding to the extent that the community is willing to and has the capacity to pay, the user charges.

Value Capture

The concept of user pays is not just about charging but extends to broader capture of the value created by infrastructure.

We need to capitalise on the indirect economic benefits of infrastructure, which are not necessarily captured financially. Examples relate to relieving congestion, uplifting property values and creating jobs.

Draft Recommendation 7.3 states that Government funding should be conditional upon pursuit of co-funding through user charges, betterment levies and property development charges.

This has led to further discussion around the introduction of Tax Increment Financing, which specifically seeks to capture the uplifts in economic value consequent upon infrastructure development. The idea is to use incremental taxes to fund infrastructure investment around the creation of Development Authorities and the UK is certainly progressing with this initiative.

We note the Commission has identified the issues around the risks of the TIF approach and the potential uncertainty as to whether the benefits outweigh the costs. Notwithstanding the Commission's cautionary words, we strongly support further consideration of this initiative in Australia and involvement of the Commonwealth as the principal tax recipient.

The introduction of a TIF can be coupled with tax reforms to achieve the infrastructure objectives. Incentives can be made to the States to participate in a TIF scheme by the Commonwealth directing increases in income and capital gains taxes from the target area to the State and local government in return for the States abolishing inefficient taxes such as stamp duty.

There is a timing issue here as the tax revenue only flows after the initial investment so the Commonwealth may need to step up and provide credit enhancement up front to get this concept moving.

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GMCA
GREATER MANCHESTER
COMBINED AUTHORITY

The Greater Manchester Combined Authority in the UK

This is an example of the community, local Government and National Government co-operating to accelerate development.

The Authority is investing over £1bn up front in infrastructure with repayment from future revenues. The model uses a formula linked to changes in rateable values over time to provide a dedicated revenue stream over 30 years.

Co-funding is provided by institutional investors including the GM Pension Fund. The Authority states that this is a major shift towards local decision making with the framework being used "to align funding and assets to prioritise growth in the region and cut red tape."

The scheme is intended to have lower overheads for appraisal and monitoring and provide increased returns through enhanced recycling of funds deployed. The initial funding could be reused 2-3 times over a 10 year period with scope for what they describe as, " increased leverage of private sector funding from a wide range of sources including pension funds, equity houses and sovereign wealth funds."

The Gold Coast Light Rail

This is a good example demonstrating the power of the local community to embrace user pays and value capture and catalyse infrastructure development.

The Gold Coast City Council promoted the project and levied a City Transport Improvement Charge on all ratepayers. This allowed the Council to contribute $120 million to the light rail project and accelerate its development. This project is all about city building and catalysing development; property value uplift is a major beneficiary.

Community Engagement

If Australia is going to succeed with getting the community on board to user charges and value capture, we need to rebuild trust and the Gold Coast and Manchester example demonstrate the vital role of grass roots engagement. Looking at past experiences highlights real inconsistencies.

Sydney's road network and approach to road pricing has demonstrated that building new roads does have a productive impact on the economy, for example strongly reflected with the M7, and standard application of distance based tolling is understood.

This is further leveraged with the development of the M1 and M2 link by the M7 shareholders. A great example of building on an existing user pays revenue stream, harmonising tolls and coming up with a financial solution that mobilises funding from the superannuation sector in conjunction with reduced funding support from the State and Federal Government.

Unfortunately the detractors of user charges have been fed ammunition by inconsistency. We have a quilt of user charges on the Sydney Motorway Network with different toll structures and toll free segments, and we reimburse users on the M5 for the tolls paid through the Cashback programme. Further we introduced time of day pricing on the Sydney Harbour Bridge – seemingly to fix a hole in a State budget with no allocation of funds towards roads.

Conclusions

We applaud the work already undertaken by the Productivity Commission and suggest there is scope to be more definitive around how to move forward with the implementation of user pays reform to avoid inertia.

The overriding objective has to be to engage with the community and build trust around the difficult concepts of user charging and value capture. We believe the time is right to break the nexus by using the private capital available to invest so that the long term revenues generated from infrastructure investment flow back to the community.

We have well developed models to finance and build infrastructure investment and strongly developing private capital finance markets.

This is the time to be bold and have a long term vision. Australia has the opportunity to regain a leading position through funding and thereby sustaining the very necessary infrastructure which the country needs.

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Case Study: UK Road Reform

The UK Government is investigating how it can transform England's Strategic Road Network and reform the Highways Agency. The Cook 2011 review highlighted the benefits of greater independence from central government and certainty of long-term planning and funding.

The Action for Roads report in July 2013 implemented the reform by proposing to convert the Highways Agency into a publicly-owned strategic highways company with far greater independence, greater certainty of funding and long-term strategic vision.

Other options for further institutional reform, giving the roads operator even greater independence were considered including models with the potential to bring in private finance; international experience suggests that this could lead to more efficiency, quicker delivery and better forward planning.

Alternative models to manage infrastructure include:

- **Contractual Model.** A DBFO-style approach could be applied to the strategic road network, with the private sector taking responsibility for the improvement and management of a section of the road network. This is intended to encourage innovation and lead to significant improvements in efficiency.
- **Regulated Utility Model.** Roads could be run on a similar basis to the privatised UK water sector subject to an independent regulator. The regulator reviews pricing based on expected operating costs, efficiencies and investment.
- **Trust Model.** This approach used in Canada involves a piece of infrastructure being handed over to a trust, an organisation designed to look after the network on behalf of its users. The trust is independent, separate from government, with profits being used to reinvest in the network or lower charges.

The UK government has decided at this stage not to bring forward plans to adopt any of these models but acknowledges that further reform might have real benefits for motorists. Further consultation with motoring groups and other stakeholders is contemplated to see whether there is a model for reform which all can trust.

Case Study: Contestable Services for Social Infrastructure

We note the draft report of the Productivity Commission is in reference to nationally significant economic infrastructure. However, some of the comments we make about the importance of progressing the user pays discussion, and the need for reform, also are relevant to social infrastructure projects.

Government has a key role to play in ensuring social infrastructure services are delivered to the community, such as healthcare and justice. Government recognises the need to provide the funding for these services and that this needs to be treated differently than economic infrastructure with user charges.

Northern Beaches Hospital

The Northern Beaches Hospital is intended to be a private hospital delivering services to both public and private patients to meet the needs of the Northern Beaches community. Unlike typical hospital PPPs, the private operator is to provide all clinical services in addition to the design, construction, operation and maintenance of the hospital.

The NSW Government is to make a capital contribution towards the cost of the facilities relating to public patients. The operator will be required to provide a minimum of 423 beds with approximately 250 for public patients. The State intends to purchase services for public patients from the operator on a volume basis at a price which will be set at a discount to a cost benchmark and offset against rentals from commercial opportunities and any abatements payable due to failure to meet KPIs.

This model is expected to offer the State both short term benefits in terms of a lower requirement for capital, and long term recurrent operating benefits, through contracting clinical services at a competitive price Moreover, the financial structure encourages innovation and cost efficiency with prospective improved utilisation of the hospital campus and generation of third party revenue.

Adelaide Courts Precinct Urban Renewal

RENEW ADELAIDE
Urban Renewal Through Creative Partnerships

The South Australian State Government is currently seeking to procure private sector involvement for the redevelopment of the courts precinct in Adelaide. The project is being progressed whereby the State is intending to partner with the private sector to maximise the development potential of the site. The State is seeking to identify a private sector entity to develop the site and lease courts and office accommodation to the State. This structure is intended to optimise the scope for innovation, third party use and deliver value for money to the State. Funding is to be provided by the private sector with the State's financial obligations being limited to the payment of rent. The role of the private sector developer is expected to cover the full suite of building management services including facilities management for the base building and fit-out.

Government should restrict its role, where possible, to simply providing policy and regulation and leave the actual delivery of services to the private sector

There is no requirement for Government to be the builder and maintainer of infrastructure and the employer of service providers, if these functions can be outsourced to the private sector. Clearly, any outsourcing needs to be considered on a case-by-case basis and provide value for money but has the potential to deliver cost efficiencies and innovation.

Both of the examples highlight the scope for:

- Transferring the responsibility for service delivery to the private sector with reduction in public sector function;
- Getting the private sector to step up and seize the value drivers around cost efficiencies, risk management and innovation;
- Structure infrastructure transactions so that they represent feasible investments for superannuation funds.

[i] PwC 17th Annual Global CEO Survey:
http://www.pwc.com.au/about-us/ceo-survey/assets/17th-Annual-Global-CEO-Survey-AU-Jan14.pdf

[ii] Report to the Business Council of Australia on Infrastructure funding and financing 2013
http://www.bca.com.au/newsroom/decision-time-on-infrastructure-funding-and-financing

[iii] PwC Submission to the Financial Services Inquiry 2014
http://pwc.com.au/media-centre/assets/PwC-Australia-Submission-Financial-System-%20Inquiry-Mar-14.pdf

[iv] *Building Canada* 2013
http://www.infrastructure.gc.ca/regions/ab/ab-nbcp-npcc-eng.html

[v] IPA Road Pricing Report 2014
http://www.infrastructure.org.au/Content/RoadPricing.aspx

www.pwc.com.au