Rethinking the role of Australia’s infrastructure – four reform agendas?
Australia cannot have a productivity agenda without a long-term commitment to infrastructure. This will not only promote economic, social and environmental outcomes, but also help the economy rebalance as investment patterns and employment levels shift in other sectors, such as mining and oil & gas.

Importantly, the commitment needs to be more than a list of big transport projects. It is about developing good policy and reform measures, robust strategic long-term plans, viable funding mechanisms, good procurement processes and better services, delivered more efficiently. It is also about thinking broadly about “infrastructure” across the sectors – for example, the investment needed in social services to support the vulnerable.

This paper touches on four key areas of Australia’s pathway to meeting future infrastructure needs – capturing value created by infrastructure to pay for new projects, a pathway for strengthening Australia’s nascent social investment market, the developing renewable energy market and reforming Australia’s tax system to make infrastructure investment more efficient.

We hope it acts as a catalyst for key stakeholders to engage in productive and challenging discussions.

David Larocca
EY Oceania Partner
Head of Infrastructure Advisory
Value Capture – can it solve the catch-22 of infrastructure investment?
When it comes to investing in infrastructure, Australian governments appear to be in a Catch-22 situation. Well-functioning roads, ports and power grids are critical to the economy’s smooth running and the community’s well-being. Infrastructure spending can also significantly boost growth through higher demand for resources in the short run and through higher supply of services in the long run.

But this essential infrastructure comes with a very high price tag. In a constrained fiscal environment, governments are reluctant to significantly increase debt or taxes to pay for even popular infrastructure projects. At the time the economy most needs the boost of infrastructure spending, governments are least able to produce the funding required.

Value capture offers governments an important opportunity to help resolve these conflicting issues.

Value capture is an umbrella term for a variety of mechanisms that enable governments to capture (and use for project funding) the increased value and economic activity that occurs as a direct result of infrastructure investment; for example, the increase in land values adjacent to a new rail line. This project funding can, in turn, be applied to raising and repaying financing. It can also support the development of more efficient and sustainable financing strategies.

Although no silver bullet, value capture has the potential to deliver better designed projects and an improved pipeline – while also reducing the call on conventional budget funding.

Value sharing mechanisms can create revenues that can support project finance

A fairer approach to infrastructure funding

With the exception of some road projects fully or partially funded by toll revenues, our infrastructure has historically been funded from consolidated revenue derived from taxation and grants. In other words, the cost of this infrastructure has been borne by all taxpayers proportionate to the amount of tax they pay, but irrespective of how much benefit they actually receive from the project.

Value capture overcomes this issue by taking into account the many different types and distributions of value that infrastructure can generate – for users, infrastructure operators, landowners and occupiers, developers, businesses and even governments. Since it’s now possible to quantify these, value capture mechanisms
can enable funding contributions to be monetised (collected from beneficiaries) and used to repay project financing.

As demonstrated in the figure below, this can be done in a way that confirms only a portion of value is captured and substantial residual value remains for the project’s beneficiaries.

The key to making value capture work is to analyse the most suitable available mechanisms on a case-by-case basis. This analysis should take into account criteria such as public interest, equity and stakeholder acceptance, deliverability, efficiency, cash flow robustness and risk.

Mechanism options include:

- **User charges** – currently Australia’s most common value capture mechanisms, user charges are good at linking funding with direct beneficiaries, but can prove inequitable and often run into challenges around community acceptance and efficiency. Because such mechanisms depend on usage levels, cashflows often involve a high degree of revenue risk, making them inefficient in supporting project financing.

- **Residential betterment levies** – on the landowners, occupiers and developers who share some of the uplift in land and property value generated from government-delivered infrastructure.

- **Developer charges and contributions, the sale of property rights and commercial betterment levies** – to capture contributions from the uplift in commercial activity and development profits.

- **Incremental or ‘automatic’ taxation revenues** – diverting taxes received by governments as a result of infrastructure delivery has a strong theoretical rationale. However, establishing a robust and agreed methodology for quantifying the uplift, isolating the beneficiaries and hypothecating the revenues, is likely to be extremely challenging.

Value capture mechanisms are different from traditional developer charges used to fund essential infrastructure (roads, sewerage) needed to support property development where none already exists; for example, broad acre residential development on the outskirts of urban areas. In contrast, with value capture, the infrastructure comes first, such as a significant public transport link, creating the commercial development opportunity.

**Improved project outcomes**

In addition to supporting the funding task, a crucial benefit of value capture is its potential to strengthen the link between project benefits and project planning. Taking a broader view upfront of the value created by a project can introduce options for project design to solve other problems and create additional value for beneficiaries.
In this context, value capture funding mechanisms can come from the market in the project development and procurement process; for example, being proposed by developers or other participants. By embedding these considerations into the business case, governments can both optimise the funding solution, but also (as examples overseas have shown) motivate the private sector to propose (and even fund) project enhancements.

**Turning funding into financing**

The timing mismatch between early investment expenditure and receiving funding revenues means that a financing strategy is usually required to bring the benefit of value capture funding streams into present-day capital to finance construction.

Value capture mechanisms have the potential to support, and even improve, the efficiency of conventional investment models. By providing revenues over an expanded timespan, they can support the allocation of government revenues or assist in repaying borrowings as and when the obligations arise.

They can also support the development of ‘alternative’ financing strategies, such as new types of loan or bond products. Importantly, these strategies have the potential to broaden the investor base for infrastructure, especially to institutional investors such as pension and superannuation funds, and increase the competitive tension of a financing market that at present is largely limited to conventional bank debt.

**Making value capture work in Australia**

To harness value capture, governments need the tools and processes to design, evaluate and execute the appropriate mechanisms. This will require legislative or regulatory reform, and developing policy frameworks in which value capture is supported and routinely considered by policymakers and practitioners developing projects.

The framework should promote key considerations around equity, proportionality, efficiency and benefit realisation. Crucially, it must confirm that the focus is on value creation early in the development of infrastructure solutions, and that the priority remains delivering the right infrastructure for the community. Value capture should be a ‘means to an end’, and not an ‘end’ in its own right.

An excellent first step, which is being explored in some jurisdictions, would be establishing a dedicated unit within Government to develop, roll-out and then administer the policy framework and associated methodologies.

---

**Darrin Grimsey**

EY Oceania Partner
Infrastructure Advisory
A challenging target has been set for Renewables in Australia. Can the market deliver?
Since the Renewable Energy Target (RET) was revised to 33,000 GWh almost 12 months ago – creating certainty for the first time in several years of fluctuating renewable energy policy – activity in the renewables sector has intensified.

There is now a clear requirement for participants to meet the RET by 2020 (over 5,000 MW), as well as many ‘additional’ renewable energy procurement schemes underway or in development in the market (over 1,000 MW). If the required capacity is not delivered, penalties will be paid (currently $93/MWh pre-tax), with generation then required from conventional sources.

Where will this 6,000+MW come from?

Based on our evaluation of over 180 renewables projects in the development pipeline, we expect much of the new demand will be met by wind and solar projects. In simple MW terms, the supply is there to meet the target. A large number of wind projects in the pipeline are well advanced from a planning, permitting and grid connection perspective. Solar projects are less well developed. But, with a cost structure that continues to improve with technology and lessons being learned from large scale deployments, financiers are becoming more comfortable with the solar risk profile.

Despite this growing momentum, the industry continues to face a number of challenges:

- It takes time to agree and arrange finance for projects. Given it takes around 1.5 – 2 years to construct a wind farm from financial close (less for solar), most projects will need to reach financial close by 2018 to make the 2020 timeframe. But, reaching financial close itself requires 6 – 12 months of work, depending on the complexity of EPC, O&M and Power Purchase Agreements (PPAs), arranging grid connection, securing financing arrangements (debt and equity) and obtaining all the necessary approvals/licences. Those only just starting this process face a significant task, which explains in part the frenetic activity we’re witnessing in the industry today.
- Developing projects economically will become more difficult within the RET penalty price: Given today’s costs structures, the current $93 LGC penalty price (pre-tax equivalent), plus the underlying power value, may be adequate to recover project capital costs by 2030 (the final year of RET obligations). However, as we move closer to 2030, and assuming the most economic projects are developed first, those remaining projects may struggle under the current penalty price.
- PPAs are difficult to strike with appropriate timing: A PPA – often a key enabler for projects – offers revenue certainty and is essential for many projects to reach financial close. Although a number of PPAs from new (typically Government related) schemes are coming to market, those developers pushing ahead to meet this demand are facing headwinds in reaching financeable agreements.

Where will demand come from?

The greatest demand for additional renewable generation is expected to come from the larger energy retailers, who are obligated to surrender LGCs. To date, few retailers have been entering into long-term PPAs for new greenfield projects due to two structural factors:

- Comparative tenors – Retailers’ end customers give them shorter certainty than the PPA tenor developers typically seek, meaning there is risk in committing to long-term PPAs.
- Banked RECs – Many retailers previously acquired and banked large volumes of RECs (predecessor to LGCs), and have been using these to satisfy their obligations.

However, banked RECs are expected to be exhausted within the next 1 – 2 years. Accordingly, we are seeing retailers re-focussing on procuring renewable energy from projects.

With the recently higher spot prices for LGCs, and low prices for PPAs (where publicised), the gap is widening between what energy intensive commercial and industrial (C&I) customers currently pay under short-term procurement and the lower price they could pay with a long-term PPA. This is increasingly creating opportunity and demand for long-term “Corporate renewable energy PPAs”.
Will the market meet the RET target?

Based on the recent hive of activity, we believe the market has the capability to overcome the challenges in meeting the 2020 target (actually the penalty mechanism provides another 3 years). We are encouraged by:

- Developers accelerating their projects and looking to raise funding to support this activity
- Numerous energy procurement processes focussed on greenfield renewables underway or in planning
- Major retailers actively re-focussing on procurement from renewable projects
- Government initiatives to support the sector in their own states
- Corporates beginning to consider how they can directly procure from renewable projects
- Investors actively looking for new investment opportunities, and increasingly considering opportunities earlier in the project lifecycle
- Lenders beginning to consider how they are best positioned to participate in the sector

Heading into the election, the sector will be watching policy statements closely from all sides, in particular regarding maintaining policy certainty around the RET, CEFC and ARENA funding arrangements and any indication of policy post 2030. Although it is a ‘watch this space’ for renewables, there is also plenty to be confident about.

Matt Rennie
EY Oceania Power and Utilities Leader

Luke Panchal
EY Oceania Director
Infrastructure Advisory

Renewable energy developers seeking PPAs and financing for their projects should consider:

- **That policy risk remains:** Despite greater policy stability, most participants are concerned about the risk of a change in government and changes to the RET. Who will wear the change in policy risk is a key topic in most PPA discussions. The other unanswered question is: What happens post 2030?

- **The challenges in rapid development:** Projects are constrained by lag times in sourcing global equipment and local construction resources, adding to both construction time and cost structure.

- **The availability of funding – Debt:** Most domestic banks have made bold statements on their appetite for renewables. However, local projects are having to look to overseas markets for competitive pricing and debt tenor reflective of the project’s timeframes.

- **The availability of funding – Equity:** Strong appetite exists for operating projects, and developments with secure contracts in place (EPC/O&M/PPAs/approvals). Increasingly investors are also looking at early stage developments (pre-PPA), and new targeted funds continue to come to market. Investors are less willing to take forward renewable projects on a pure ‘merchant’ basis (or with short term PPAs).

They will also continue to face ongoing challenges, including grid capacity constraints, accounting and credit rating treatment, taxation treatment/planning and social license to operate.
Will infrastructure help social investment become mainstream?
Despite considerable interest in social investment, Australia has yet to develop a mainstream social investment market. Infrastructure projects offer important opportunities to create social investments of the scale and duration required to attract institutional investors.

Social investment is certainly not a panacea, but it can help to overcome the challenges of solving complex social issues with increasingly constrained recurrent budgets and short electoral cycles. For example, Social Benefit Bonds (SBBs) raise working capital from private investors, giving community service organisations funding to address social problems. If agreed measurable outcomes are achieved, Government rewards the private investors for use of their capital with competitive coupon rates of between 7.5% and 12%1. When SBBs work, people and communities get better outcomes, service providers have access to the working capital they need, and investors get a commercial return while knowing they have helped do good.

Many institutions appreciate this win-win situation, with some insurers and super funds already demonstrating a clear appetite for social investment. QBE has allocated over $100 million for social impact investment including investing in SBBs in Australia, Canada and the United Kingdom2. HESTA has established a $30 million Social Impact Investment Fund that will focus on delivering financial returns and “demonstrable social impact in sectors such as health, housing and community services3.”

**Hopeful signs from Australia’s early social investment projects**

At the supply end, Australia’s small number of existing social investment projects, most of them SBBs, are showing potential. New South Wales has led the way, with two SBBs funding Uniting and the Benevolent Society to operate programs relating to child restoration and keeping families together4. A further two SBBs in NSW are currently in joint development relating to youth homelessness and reducing reoffending. Two more, relating to mental health and managing chronic health conditions, are under consideration5.

In other states, South Australia has implemented an SBB addressing homelessness6. Queensland has recently launched its SBB pilot program and is looking to implement SBBs relating to reoffending, homelessness and issues facing Aboriginal and Torres Strait Islander people7.

However, these bonds are unlikely to be attractive to many institutional investors, being too small, in the order of $10 million, and operating over a relatively short 5 to 7-year term.

**Infrastructure key to building scale**

Infrastructure projects offer the scale and duration to make social investment more attractive to institutional investors. For example, building affordable housing – including for people with disabilities – along with support services would constitute a large-scale, long-term social investment opportunity.

To this point, the NSW Government in consultation with Infrastructure Partnerships Australia and NSW Council of Social Services has already established the $1.1 billion Social and Affordable Housing Fund8. The first phase of the Fund is to not just build and manage 3,000 new social and affordable dwellings but to achieve “housing enabled outcomes” by providing tailored support coordination services to help people live independently and for some to “successfully transition out of social and affordable housing and improve their economic independence”9.

Australia could also take social investment to scale by embedding social outcomes in public private partnership (PPP) infrastructure contracts to design, build and operate new prisons. At Ravenhall Prison in Victoria and Wiri Prison in New Zealand, operators receive incentive payments if they reduce re-offending across the prison population. This has led to operators facilitating community service organisations to engage with prisoners while in prison and after release10.

Another scale opportunity would be a national plan to provide community alternatives to hospitalising people who need mental health support. Financed by a large-scale social investment fund, this approach could deliver better outcomes for individuals and generate significant savings for Government11.

Linking social investment to bricks and mortar is clearly attractive to institutional investors. However, other purely service-related opportunities still need significant working capital if they are to be delivered state wide or nationally. For example, increasing and improving the self-management of chronic diseases such as Type 2 Diabetes would generate better outcomes and cost saving for government but may require significant investment including in e-health12.
The challenge for Government is to identify opportunities to focus infrastructure projects on achieving long-term social outcomes and extending PPPs to include community service organisations. Then, not-for-profit community service organisations can look to the future with confidence that they will be able to access the working capital they need.

If larger scale social impact propositions do come to market, then institutional investors can turn their evident interest into reality.

In the meantime, implementing a variety of smaller-scale SBBs can attract other types of social investor and continue to demonstrate the potential of social impact investment.

In time, social investment should provide a pipeline of private capital allocated to large-scale and long-term programs with the potential to significantly improve the lives of millions of Australians.

---

1. AFR Weekend 18th November 2014 SBB makes sense for both families and government James Dunn
2. “QBE Insurance chief investment officer Gary Brader pointed to a lack of deal flow as the main reason more than 18 months only a sliver of the $100 million capital has been deployed”. Sydney Morning Herald 8th March 2016 Local Demand for social impact investments pegged at $18 billion – plus Sally Rose
4. AFR Weekend 18th November 2014 SBB makes sense for both families and government James Dunn
10. Victoria Correctional Services “plans for service providers to continue to engage prisoners after release to further reduce their risk of reoffending” and “Incentive payments for reducing reoffending across the prisoner population” http://www.corrections.vic.gov.au/home/prison/ravenhall+prison+project.shtml
How can tax reform make infrastructure funding more sustainable?
From a tax perspective, the 2016 Federal Budget was largely uneventful for the infrastructure sector, other than reducing the company tax rate over a 10-year period and a number of proposals designed to encourage investment in Australia. What will those proposals mean, and what should the Government consider in terms of future tax reform to make infrastructure funding more sustainable?

In a measure designed to improve access to more diverse sources of capital, the Budget removed barriers to infrastructure projects using asset-backed financing arrangements, such as deferred payment arrangements and hire purchase arrangements. These arrangements will now be treated the same way as financing arrangements based on interest bearing loans or investments.

To attract foreign investment in infrastructure projects, the Budget also introduced two collective investment vehicles (CIVs): a corporate CIV offering retail investment available from 1 July 2017, and a limited partnership CIV facilitating wholesale investment available from 1 July 2018. The new CIVs will need to meet similar eligibility criteria as managed investment trusts. They will be particularly attractive to residents of jurisdictions that do not commonly invest in large-scale projects through trust vehicles.

However, foreign investors may perceive changes to the Foreign Investment Review Board (FIRB) requirements as discouraging investment in Australia. In February 2016, the Government announced that it will apply new requirements on foreign investment applications. In particular, applications must provide information about any transfer pricing measures that may potentially apply. On Budget night, the Treasurer released a revised set of conditions designed to target certain foreign investments that “pose a risk to Australia’s revenue”. Foreign investors may be required to negotiate an Advanced Pricing Arrangement or obtain a private ruling from the ATO to obtain FIRB approval. How these measures are administered in practice by the ATO and FIRB will be critical to making Australia an attractive investment destination for foreign capital.

Possible future tax reforms

When assessing future tax reform impacting upon the infrastructure sector, the Government will quite possibly further consider:

Thin capitalisation

Some of the prospective measures impacting thin capitalisation might include:

- A further reduction in the allowable safe harbour debt to equity ratio to 2:1 (50% allowable gearing). This measure was notably absent from the 2016 Federal Budget despite strong rumours indicating otherwise.
- A thin capitalisation rule based on an EBIT measure rather than a balance sheet measure.
- Further limitations to the arm’s length debt test (ALDT).
- Although we have seen speculation about further limitations to the ALDT, the Board of Taxation Review of the Thin Capitalisation Arm’s Length Debt Test Report, December 2014 (BoT Report), broadly concluded:
  - Not many taxpayers rely on ALDT, but those taxpayers that do are generally of the kind that contributes significant economic activity – for example, the infrastructure industry.
  - The ALDT is particularly relevant when very high gearing ratios are required, such as the infrastructure sector, where cash flow analysis is a generally more critical factor supporting borrowings rather than debt/equity gearing levels. Taxpayers in many capital-intensive industries would typically fail the safe harbour test.
- The advantage of ALDT is that it generally reflects the economic circumstances of particular industries or businesses that operate with higher gearing ratios.

For these reasons, we hope that the infrastructure industry is be carved out of any such limitations to the ALDT.

Also, the widespread use of stapled vehicles in the infrastructure sector brings added complexity to the ALDT. In general, external lenders tend to take security directly over the assets of all entities in the stapled structure. This presents problems in satisfying the ALDT requirements since determining the arm’s length debt amount requires excluding credit support. Yet, providing security by other entities in the staple is widely accepted as constituting credit support. Importantly, the BoT Report recommended that explicit credit support should not be excluded for the purposes of calculating the arm’s length debt amount. However, legislative change is yet to be announced.

CGT discount

Contrary to speculation, the Budget did not deliver its mooted proposal to halve the capital gains tax discount for superannuation funds, which is currently 33%. Such measures may reduce the attractiveness of infrastructure investment to the superannuation fund industry relative to other investment options.
**Tax policy incentives**

The following incentives, which have been raised with the Government by the broader infrastructure community, Business Council Australia, and Infrastructure Australia, would also encourage investment in large infrastructure projects.

- Provide tax concessions for investors, such as flow through tax attributes to partially subsidise infrastructure projects.
- Allow all infrastructure investments to be treated as eligible investments for flow-through taxation purposes. For example, modifications to the definition of eligible investment business in the public trading trust provisions.
- Allow unit trusts to carry forward tax losses in the same manner as companies.
- Exempt dividend and interest income for Australian super funds to match the treatment for foreign super funds.
- At a State level, reform stamp duty to remove barriers to restructuring private investment in public infrastructure.

However, the resulting loss to Federal tax revenue may need to be replaced through other broader tax reform revenue raising measures in the short term until additional revenue flows from the resulting increased economic activity.

There is also an interplay with the tax system from calls in the community and from Governments for “value capture” mechanisms to help fund infrastructure. Such mechanisms, including “tax increment funding” (TIF) which seeks to tax appropriate beneficiaries from enhanced infrastructure, have been successfully implemented overseas but in a more limited way in Australia.

Other specific tax measures exist in overseas jurisdictions, to help with the funding task, including localised tax regimes specifically focused on funding trunk infrastructure for property developments, in a way which creates a secure rates (tax) base to facilitate the raising of finance – see for example the use of Special Districts and Utility Districts in the US.

**The right tax reform approach**

We believe that successful tax reform calls for a properly constructed and supported Australian Tax Reform Commission to consult widely and advise the Government on both long-term tax policy and overall tax system care and maintenance. Importantly, the body should be independent, apolitical and dedicated to tax reform research in the public interest.

An independent tax review body is an established international solution, with strong domestic precedents in the Productivity Commission and the Australian Law Reform Commissioner.

Research indicates that major strategic tax reform depends on ideas being circulated long before they are needed urgently, in order to give them a long gestation period. The benefit of regular long-term strategic reviews is entirely separate from the pressure for implementation.

Tax system flexibility is therefore a key to competitiveness. A tax system that is unable to keep pace with other comparator nations will let down the nation it is meant to serve.

Such an approach to tax reform would significantly benefit the infrastructure sector, which requires long-term planning and decision making to produce optimal economic outcomes.

Paul Laxon
EY Oceania Tax Leader — Energy
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organisation, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organisation, please visit ey.com.

© 2016 Ernst & Young, Australia.
All Rights Reserved.
APAC no. AU00002645
ED NONE S1629411

This communication provides general information which is current at the time of production. The information contained in this communication does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Ernst & Young disclaims all responsibility and liability (including, without limitation, for any direct or indirect or consequential costs, loss or damage or loss of profits) arising from anything done or omitted to be done by any party in reliance, whether wholly or partially, on any of the information. Any party that relies on the information does so at its own risk. Liability limited by a scheme approved under Professional Standards Legislation.

ey.com