TREMENDOUS AND GROWING—AUSTRALIA'S INFRASTRUCTURE NEEDS IN 2008

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The past 12 months have seen an acceleration in public and private sector initiatives to address Australia's infrastructure bottlenecks. Public private partnerships (PPPs) or privatisations have increasingly been the preferred model for such initiatives. Australia's broader project financing market had a lacklustre 2007, but new life was breathed into the PPP market due to greater cooperation between levels of government, increased competition for high quality, high credit projects and more States embracing the PPP procurement methodology. This article deals with some recent developments in the Australian PPP and privatisation markets.

CHANGES IN THE REGULATORY LANDSCAPE

National infrastructure coordination

A primary criticism of Australia's PPP market is the involvement of three levels of Government with disparate infrastructure investment priorities, resulting in scarce resources not being allocated efficiently. Many commentators and market participants agree that a coordinated approach is needed to bridge the gap in infrastructure expenditure. Infrastructure Partnerships Australia advocated a 'new federalism' involving the Commonwealth Government taking a more proactive role in creating the conditions for functioning national markets 'without the artificial impediments of state boundaries'.[1] This echoes similar calls from the Business Council of Australia which, in its report, *Reshaping Australia's Federation*, noted that the current federal model results in economic inefficiencies of approximately A$9bn annually.

In response to such criticism, the Commonwealth Government has formally approved establishing a statutory advisory council, Infrastructure Australia (IA). IA is to be founded under the Infrastructure Australia Bill 2008 (Cth) and, when enacted, will be chaired by Sir Rod Eddington, the former Chairman of British Airways. IA's primary role will be to advise the Federal Minister of Infrastructure, governments and private sector investors on auditing nationally significant infrastructure, developing an infrastructure priority list to guide government spending and private investment, and facilitating policy. The Government's intent is for IA to finalise 'nationally consistent, best practice PPP guidelines' in 2008.[2] The Federal Department of Finance and Deregulation has also established a PPP Unit to advise the Commonwealth Government on the use of PPP arrangements, to assess specific PPP proposals and oversee the application and development of PPP policy.

Tax reform

In September 2007, the *Income Tax Assessment Act 1997* (Cth) was amended to introduce a new Division 250. Division 250, which generally applies to transactions entered into and the use of assets after July 1, 2007, replaces the problematic and, at times, economically annihilating section 51AD and Division 16D from the *Income Tax Assessment Act 1936* (Cth).

Division 250 is concerned with preventing the transfer of taxation benefits from tax preferred end users to taxpayers in asset financing arrangements. This is achieved by denying the taxpayer capital allowance deductions where the taxpayer cannot show a predominant economic interest in the asset. Under the former tax regime, taxpayers were often required to enter into costly and often protracted contingent equity arrangements in order to maintain a predominant economic interest in the asset, potentially frustrating the economic viability of a transaction. Division 250 seeks to alleviate some of this cost and burden by introducing a number of exceptions, carve–out provisions and de minimis rules to avoid triggering the application of the Division.

While the old section 51AD assessed all income and denied all deductions in relation to an asset, potentially crippling a transaction's economic viability, Division 250 only assesses the notional interest component and permits the taxpayer to make all other deductions, other than for capital allowance. Under Division 250, the taxation treatment is far less draconian and represents a more cost effective and tax sensitive regime for taxpayers.

PPPs

Each of Australia's three levels of government may be involved in procuring infrastructure assets. It is estimated that some 10% of their aggregate infrastructure procurement budget is allocated to PPPs. A summary of recent events in each jurisdiction comprises the remainder of this article.

Commonwealth

The Commonwealth's first privately financed facility, the Headquarters Joint Operations Command Project, was awarded in June 2006.A similar project, also involving the Department of Defence, is the Single Living and Environment Accommodation Project (LEAP). Financial close for LEAP Phase 1 was reached in December 2006 and it is anticipated that the Government will reach a decision as to the successful tenderer for LEAP Phase 2 in 2008. Also in 2008, contracts signed by the Commonwealth Government, Surveillance Australia and Australian Helicopters for the A$1bn Civil Maritime Surveillance project take effect.

According to the National PPP Forum, the Commonwealth will embark on a number of PPPs under the AusLink National Network Programme. However, with the recent change of Government, the status of such deals, and AusLink itself, is unclear.

New South Wales

New South Wales has been at the forefront of the PPP movement, with projects totalling over A$8bn since 2001. Recent large–scale PPP initiatives in NSW include the Orange Hospital Redevelopment and the Bonnyrigg Living Communities Project. In April 2007, contracts were executed between the NSW Government and Bonnyrigg Partnerships for the Bonnyrigg Living Communities Project, a project for the redevelopment of an area in Sydney's western suburbs involving construction, refurbishment and tenancy management services for a 30 year period.[3]

In December 2007, the Bathurst, Orange and Associated Health Services PPP Project was awarded to Pinnacle Healthcare, which will involve the redevelopment of the Orange Hospital and associated healthcare services.[4] It is anticipated that the concession for the Royal North Shore Hospital

Redevelopment will be awarded in July 2008.[5] The PPP aspect of the project includes the redevelopment of the main hospital, new community healthcare facilities, alterations to existing buildings and car park extensions.

The NSW State Government is yet to formally commit to the troubled M4 East project. In July 2002, the State Government announced that it would investigate constructing an M4 East Motorway to connect the M4

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Motorway and the City West Link, in order to ease Sydney's traffic congestion. However, progress of the project has been stifled by community opposition. The State Government is expected to make an announcement in the first half of 2008 on the future of the project and whether it will proceed as a PPP.

Queensland

Queensland has a number of PPP projects, both in the market and in the pipeline, for 2008–2009. The influential size of some of Queensland's local councils has meant that the third layer of government is also an important actor in PPP procurement.

At the local government level, Brisbane City Council procured the 4.8km North South Bypass Tunnel by way of a PPP. The tunnel was originally expected to open in 2010 but is now likely to be completed nine months ahead of time. Further, the Brisbane City Council's proposed Northern Link, a predominantly underground toll road, is the subject of business case analysis which will determine if the estimated A$1.6bn project will be delivered as a PPP.

Through a statutory body corporate within the Department of Infrastructure and Planning, the State Government also has plans to deliver a largely underground toll road in Brisbane linking bypass roads at Bowen Hills with arterial roads at Kedron and Toombul. In addition, the Northern Busway will be constructed, linking the Royal Children's Hospital to Kedron.The successful bidder is expected to be announced in mid–2008.

Recognising the need to fast–track health, education and transport infrastructure assets into South East Queensland, an area attracting 5,000 new residents every month, the Queensland Government has committed to the following.[6]

- The construction and maintenance of seven new schools in and around south–east Queensland.
- A$940m for the completion of a new 450–bed tertiary hospital on the Sunshine Coast by 2014.
- A new road bypass to divert traffic from the regional transport hub of Toowoomba.
- A Gold Coast Rapid Transport Project, being developed in conjunction with the Gold Coast City Council.

Victoria

In Victoria, the State Government has confirmed its support for the delivery of public infrastructure through PPPs. It responded positively to the Public Accounts and Estimates Committee’s ‘Report on Private Investment in Public Infrastructure’ released in October 2006, which recommended changes to both legislation and policy guiding PPP procurement. Further, the Victorian Government's willingness to adopt and implement many of the key recommendations is a strong indication of its view of PPPs as an enduring and viable method of procurement.

Despite this, the pipeline for PPPs in Victoria has not been as strong as in previous years. However, where PPP procurement is used, the quantity of deals has likely been offset by transaction value, as demonstrated by the following:

- In the first half of 2008, the Victorian Government is expected to seek expressions of interest to develop a A$3.1bn desalination plant in Wonthaggi and a A$250m biosciences research centre (in joint venture with La Trobe University) at Bundoora, both by way of PPPs.

• In December 2007, the Department of Education announced that 11 new schools will be built in Melbourne's outer metropolitan suburbs under a PPP arrangement.

• In November 2007, the Department of Human Services entered into the largest healthcare PPP in Australia for the redevelopment and maintenance of the new A$1bn Royal Children's Hospital.

• In August 2007, the concession was awarded for the A$78m contract to deliver the Barwon Water Biosolids Management Project.

In relation to PPPs that have already come to market, the Victorian Premier, John Brumby, has confirmed that Melbourne’s massive EastLink toll road is on track to open to traffic about six months earlier than originally scheduled and, in June 2008, the new Royal Women's Hospital is scheduled to open for services.

South Australia

In South Australia, the State Government has accelerated its support for delivery of public infrastructure through PPPs. In December 2007, it sought expressions of interest for three new major projects: the development of six new schools in and around metropolitan Adelaide, four new adult correctional facilities and a secure youth training centre. The South Australian Government has also decided that a new A$1.7bn hospital to be built in Adelaide will be delivered under a PPP arrangement. Construction of the new 800–bed Marjorie Jackson–Nelson Hospital, which will replace the ageing Royal Adelaide Hospital, will be the largest hospital PPP to be undertaken in Australia.

IMPACT OF GLOBAL LIQUIDITY CRISIS ON AUSTRALIAN PPPS

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Currently, affected projects have retained an underlying investment grade rating, but the indigestion in the debt capital markets and ratings downgrades of monoline insurers will:

• cause bondholders to suffer write–downs in the value of their assets and may require some APRA–regulated institutions to divest themselves of the bonds in question;

• increase the cost of funding for future deals, thereby re–invigorating the question whether private sector financing of PPPs can compete with AAA–rated governments that can issue treasury securities at the risk free rate; and

• result in ratings agencies tightening their ratings systems and criteria for PPPs, particularly the more highly–geared social infrastructure deals.

In the short term at least, particularly for current or imminent tenders, bank debt is likely to see a resurgence. The requirement for long–maturity debt may be a complicating factor for these traditionally medium–term debt models but, in practice, banks with an Australian presence are generally able to sell–down or sub–participate their exposures in relatively liquid secondary markets.

Interestingly, an alternative to traditional methods of PPP funding has emerged in Queensland. It appears to be loosely based on the UK's Private Finance Initiative, whereby the UK Treasury issues gilts to fund the senior debt tranches of large PPPs in exchange for a guarantee from the project's private sector backers.The financing model adopted in a recent EOI invitation for the construction of schools in South East Queensland is known as the ‘supported debt model’. This model relies on 100% private sector funding (debt and equity) during the construction phase, and then approximately 70% of the project's post–construction financing requirements are provided by the State by way of a senior debt facility.The State considers that this arrangement is a ‘value for money’ solution: the 70/30 split was arrived at because the State estimates that 70% of the financing for the operational phase is notionally risk–free (on the basis that it is the minimum proportion of project debt that would be able to be recovered over the life of the project), and that it should therefore be funded at the State's risk–free borrowing rate.

While the Queensland Government decided to forego some rights usually given to senior creditors, there may be other issues around priority, subordination, voting and step–in that will see increased tension between the public and private sectors. Also, a decreased role for the private sector on financing PPPs could be a disincentive for the usual sponsors of Australian PPPs as it removes some of the economies of scale that investment banks and external debt providers find appealing.

DEVELOPMENTS IN THE PRIVATISATION MARKET

In December 2007, in response to the recommendation by Professor Anthony Owen in the 'Inquiry into Electricity Supply in New South Wales' (Owen Report), the NSW Government announced plans to privatise the electricity industry in NSW. According to the Owen Report, privatisation of the supply of electricity would save the Government A$1bn a year over the next 10–15 years and better place the Government to meet projected demand. Part of the proceeds from the sale and leasing arrangements would be placed into an 'Intergenerational Fund' to finance other infrastructure developments, particularly in the areas of health, education and transport.

Despite the apparent economic benefits of privatisation, a number of groups have expressed concern over the potential impact for consumers in the event of insufficient private sector investment, potentially leading to a situation akin to California's 2001 blackouts. Unions have also raised the spectre of the impact Victoria's privatisation of its electricity industry on workers in the Latrobe Valley.

Credit rating agencies have expressed approval of the Government's plan, noting that the sale could ease the State's capital requirements and reduce its exposure to the risks inherent in the current electricity market (including the uncertainty over the price of carbon and the level of investment required to bring existing generators to 'carbon capture' standards). However, one agency has recently warned that the potential economic benefits to be derived from the deal could be eroded because of the difficulty purchasers may face in obtaining funds at a satisfactory cost, given the current global liquidity crisis.

CONCLUSION

In summary, while Australia's privatisation market is somewhat erratic, with specific industries like power and water being the most active, the PPP market continues to expand and mature in spite of global financial market uncertainty. Recent empirical studies have shown that Australian PPPs 'provide superior performance in both the cost and time dimensions' when compared with traditional methods of procurement, and that the benefits accrued from the PPP structure increase with the size and complexity of the project in question.[7]

While the financing components of PPPs may vary in 2008/09 from the wrapped bond solutions seen on recent deals, there is still ample appetite for PPP procurement at all levels of government. And, certainly, there is sufficient rivalry from private sector participants to ensure competitive tension in any major tender process.

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