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# Australia Letter from Canberra

## The Coming Infrastructure Boom: Politics, Reality & Implications

- **Infrastructure catch-up**. Notwithstanding a pick-up in privately provided infrastructure in recent years, there is significant political pressure for greater investment in infrastructure to address bottlenecks holding back productivity and to improve living standards.
- **The Coalition is looking at a number of infrastructure funding initiatives**. These include tax rebates on infrastructure bonds, establishment of special purpose bonds that are backed by the Commonwealth's triple-A rating and extension of the maturity structure of government bonds to 30 years.
- **We see merit in these initiatives**. We believe a new 30-year bond would bring the Australia sovereign curve more into line with the world's major government curves. Such an extension would provide a much needed benchmark to the long-end of the swap and forward curves and be attractive to domestic super funds and offshore investors. Special purpose bonds could lower the cost of debt funding for private infrastructure projects, although equity funding would still be needed and the bonds would represent a contingent liability on the Commonwealth.
- **More funding doesn't remove the need for careful evaluation of projects**. There is a lack of consensus across federal and state governments and infrastructure planning bodies on which projects should be given highest priority. This suggests more independent assessment of project benefit and costs will be needed if more resources are to be devoted prudently to infrastructure in the years ahead.
- **A material ramp-up in infrastructure for countercyclical purposes is unlikely**. Some commentators have called for greater infrastructure spending to take some of the burden from monetary policy in filling the gap in the economy as mining capex peaks. But given the lead time on kick-starting infrastructure projects, any major step-up is more likely a mid-decade story.

**Paul Brennan**
+61-2-8225-4899
paul.brennan@citi.com

**Josh Williamson**
+61-2-8225-4904
josh.williamson@citi.com

*With thanks to*
Stephen McKew

# Coalition Infrastructure Policy

## Introduction

It has been suggested that Australia's infrastructure needs over the next 10-15 years could be between $500 billion and $700 billion. If this is correct then funding becomes a major political issue because, regardless of which party is in Government, the Budget is likely to remain under pressure.

Given this we are expecting the Coalition to consider a number of new measures to meet this funding challenge if they win the next Federal election scheduled for 14 September 2013.

Some of these measures were announced in the lead-up to the 2010 general election, such as the strengthening of the role of Infrastructure Australia and the introduction of the Infrastructure Partnership Bond Scheme. We believe these policies are still under consideration for 2013.

In conjunction with these policies, we understand that the Coalition is also considering the development of Special Purpose Bonds that could access funding using 30-year Commonwealth government bonds.

## Infrastructure Partnership Bond Scheme

As part of their 2010 election platform the Coalition committed to the introduction of an Infrastructure Partnership Bond Scheme (IPBS).

Under the plan the Coalition was committed to creating a new form of infrastructure financing product "to attract household savings through generous taxation arrangements to lower the cost of financing infrastructure and ultimately boost Australia's domestic savings and its productive capacity."

It is proposed that infrastructure projects will qualify for the concessional tax treatment through meeting set criteria including:

- The project qualifies as a national priority under Infrastructure Australia's pipeline of projects,
- A public cost benefit analysis of the project has been conducted, and
- The project generates sufficient returns such that the debt can be serviced by the revenues generated by levies or charges that relate directly to the project.

Private infrastructure operators and State and Local Governments will be eligible to apply for the concessional treatment. Eligible operators will be able to issue 10-year Infrastructure Partnership bonds which will receive a tax rebate.

- "Specifically the assessable interest income generated from the bonds will attract a 10 per cent tax rebate irrespective of the tax status or rate of the tax payer."

In 2010 the Coalition proposed the cost of the scheme to the Government be capped at $A150 million per annum, which they estimated to provide sufficient funding to generate financing for up to $A20 billion of bonds.

It would appear that this policy, or something similar, is still part of the Coalition's consideration for infrastructure funding post the September election.

## Special Purpose Bonds

Another option for the Coalition is the development of special purpose vehicles (SPV) which could borrow at the Government bond rate or be funded directly by Commonwealth bonds. We further understand that these bonds could be issued for 30 years.

The Coalition could help to kick-start greenfield infrastructure projects by using its balance sheet and triple-A rating to provide the lowest cost of capital for new projects. This would help lower the upfront funding cost of a project which otherwise might not proceed because its income stream does not commence for some years. Examples could include motorways, high speed rail networks, infrastructure associated with utilities, ports and so on.

The private entity undertaking the project would issue 30-year bonds that in effect are guaranteed by the Commonwealth government, thus lowering the interest rate on the bond.

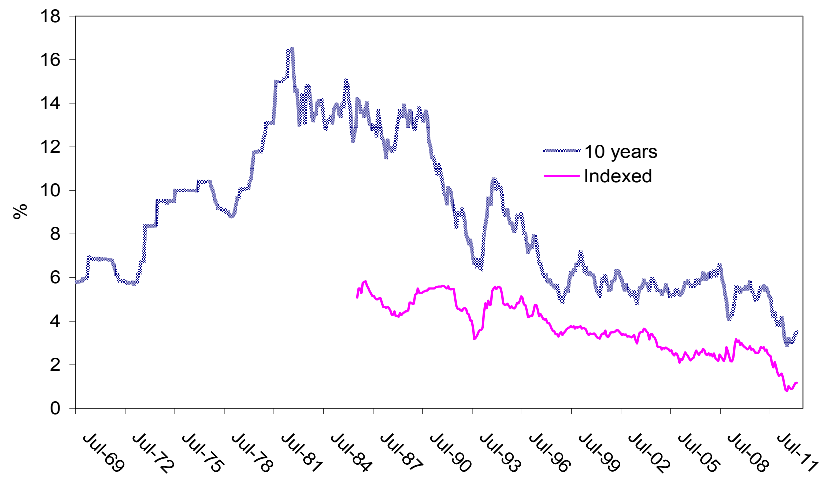
While SPVs could be used for projects that eventually have an income stream, 30-year bonds could also be used for the funding of nation building projects that may not generate an income.

In recent weeks some of the Coalition's ideas for the development of northern Australia, including the building of dams and the development of new agricultural areas, have been canvassed in the media. These projects however are unlikely to meet the strict conditions proposed for the issue of Infrastructure Partnership bonds so would need to be funded directly.

We believe that there would be demand for longer dated maturities, i.e., for an extension of the yield curve in Australia (see below). For fund managers with long maturity investment mandates there would be an appetite for longer dated government bonds. This would allow those fund managers to better match assets to the structure of their liabilities. At present those fund managers are attracted to investment in infrastructure directly, but there is a limited pool of high quality infrastructure projects in Australia.

Timing for an extension of the yield curve also is good. While off their lows, global interest rates remain at historically very low levels, providing the government a unique opportunity to fund infrastructure cheaply (Figure 1).

Figure 1. Australian government bond yields




Source: RBA & Citi Research

## Economic implications

Several economists have called on the federal government to use infrastructure spending as a way of helping to fill the gap in the economy that will be left as the mining capex boom rolls over. If monetary policy is relied on too heavily to stimulate consumer spending, housing and business investment, this could run the risk of encouraging asset price inflation, speculative investments and a new round of leverage.

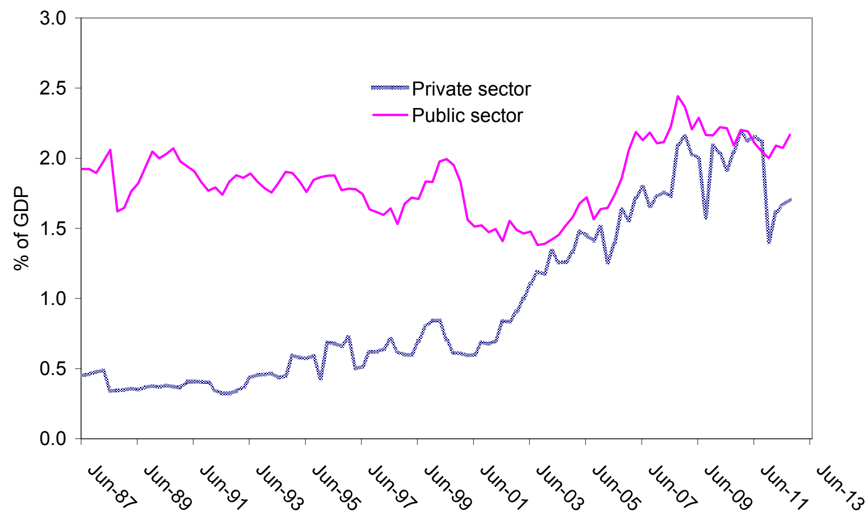
Spending on infrastructure represents around 4% of GDP (Figure 2). This is a meaningful base of spending with significant multiplier effects and only moderately less as a share of the economy than housing investment. If infrastructure spending could be increased by one quarter it would add 1% of GDP to the economy.

However, a material ramp-up in infrastructure for countercyclical purposes is unlikely.

- Having broken its budget surplus promise for FY13, the government would want to limit the size of the deficit this year and likely would want to include in this year's Budget a forecast budget surplus for FY15.
- It takes time to ramp-up infrastructure spending. Projects require cost benefit analysis, environmental impact reviews, arranging finance, letting and vetting contracts, and so on.
- There is not necessarily consensus between the Commonwealth and state infrastructure planning bodies, the Commonwealth and state governments and other interested parties on what are the preferred infrastructure projects. For example, the Connex West in Sydney and East Link in Melbourne road projects touted by the state governments are not on Infrastructure Australia's last published threshold and ready to proceed project list (Figure 3).

Consequently, we suspect that the current push for infrastructure catch up could see a bunching of infrastructure projects from around the middle of the decade as governments belatedly rush to address bottlenecks and political pressures that have been developing for a number of years. This could place new pressures on the cost of materials and labour at that time.

**Figure 2. Value of infrastructure project commencements**




Source: ABS & Citi Research

## Bond market implications

For the bond market, the prospect that is likely to be of most interest is the potential issuance of a 30-year bond. The longest maturity currently offered by the AOFM is effectively 16 years for nominal bonds (the April 2029 line) and 17 years for indexed bonds (the September 2030 line). A new 30-year line would result in a substantial extension to the yield curve, bringing the Australia sovereign curve more into line with the world's major government curves.

Such an extension to the Australian sovereign yield curve would provide a much needed benchmark to the long-end of the swap and forward curves. This would help pricing and hedging. For real money investors, a number of large offshore pension funds would probably like to extend the duration of their AUD portfolios. There might even be some reserve managers that would take up the offer of duration extension. At current running yields, the government could issue a very long bond at a rate that would be historically low. For investors, it would offer an exposure to the highest grade of sovereign debt, without the extremely low interest rates offered by comparable sovereigns.

For a 30-year bond to be acceptable to the market, the AOFM would need to build-up a sizeable maturity bucket. Based on the liquidity performance of current lines, we suspect that total issuance would need to be a minimum of $5 billion AUD. Anything less may risk less support from investors in the secondary market. One way the liquidity of a new 30-year bond could be enhanced is by the Commonwealth taking the opportunity to undertake an “operation twist” and refinance some of its shorter duration debt by the issuance of longer-term paper.

Our best guess is that at present the Commonwealth could issue a 30-year nominal bond at a yield of 4%-4½%.

Fund managers with a higher allocation towards infrastructure typically have mandates of “CPI plus”. This often yields a preference for index linked securities over nominal securities. However, given the lack of liquidity in the indexed linked space, the government would most likely have to pay a premium over the conventional bond if it issued a 30-year inflation linked bond.

A second question is by using SPVs would the debt be off the Government's balance sheet? There already is a precedent for off balance sheet funding of infrastructure with the National Broadband Network. That said, debt associated with SPVs would still represent a contingent liability for the Commonwealth. The Commonwealth would want to be very confident of the cost-benefit of projects using SPVs, including having the Productivity Commission review the project economics. Indeed, rating agencies would likely take account of debt held in SPVs when reviewing Australia's triple-A rating. Thus there is still a financing constraint on infrastructure, even if it is more generous than traditional funding models.

Before proceeding with the concept of SPVs and issuance of 30-year bonds we would expect that the Coalition would first seek advice from the Australian Office of Financial Management and the Treasury.

## Equity market implications

Financing initiatives that allow for the delivery of more infrastructure projects would be a significant development for a number of companies in the share market, most directly Contractors and Building Materials suppliers. Our analysts note that in the case of certain Building Materials suppliers, up to 25-30% of Group revenue is linked to the civil or engineering sector (i.e. roads, highways, bridges, tunnels, etc). For Contractors the proportion of revenue linked to engineering construction varies, but in some cases is up to 45%.

Outside of the Oil, Gas and Mining sectors, there's currently a dearth of civil projects on offer. And mining investment is expected to peak this year. Additionally, any significant pick-up in commercial property construction is quite a way off. So increased infrastructure spending would benefit earnings and sentiment towards these sectors, although increased activity likely would attract more offshore players which could affect the margins of domestic incumbents.

Our analysts also are of the view that significant new investment in rail, such as the development of an inland rail network would increase the likelihood of a material modal shift to rail which would have implications for transport companies.

Even if SPVs provided cheaper funding for infrastructure companies, it is still unlikely that projects would be totally funded through debt. Equity funding also would probably be needed, in which case the market would require confidence in the projects' future revenue and of project execution risk given the past history of cost overruns and disappointing revenue on some projects.

## Infrastructure Australia's Role

A Coalition Government has committed to making Infrastructure Australia (IA) a more "transparent, accountable and effective advisor on the planning, selection and procurement of infrastructure projects."

In the lead-up to the 2010 Federal election the Coalition committed to a revised mandate and functional role for IA including:

- Developing a revolving 15-year infrastructure plan for Australia, with this plan being revised every 5 years,
- Clearly specify infrastructure priorities at a national and state level,
- Publish justifications for its project recommendations, including net present value of projects,

- Identify and estimate short- and long-term productivity gains from infrastructure projects,

The Coalition is also committed to releasing a cost benefit analysis behind infrastructure funding decisions.

We understand that this is still Coalition policy going into the 2013 election.

**Figure 3. Infrastructure Australia Selected Project List**

| | Early Stage | | Real Potential | | Threshold | | Ready to Proceed | |
|---|---|---|---|---|---|---|---|---|
| | Project | Cost ($m) | Project | Cost ($m) | Project | Cost ($m) | Project | Cost ($m) |
| **Transforming Our Cities** | | | | | | | | |
| **NSW** | Improvements and Expansion of Rail Networks | 795 | Integrating Sydney's Motorway Networks | | | | | |
| | North West Rail Link | 7,500 - 8,500 | | | | | | |
| **VIC** | Melton Rail Line Duplication | 1,300 | Melbourne Metro Stage 2 | tbc | | | Melbourne Metro Stage 1 | tbc |
| | Tram Route 86 Stages B and C | tbc | Dandenong Rail Capacity | tbc | | | | |
| **QLD** | Gold Coast Rail | 2,875 | | | Eastern Busway | 825 | Brisbane Cross River Rail | 5,311 |
| **SA** | South Road | tbc | | | | | | |
| **Competitive International Gateways** | | | | | | | | |
| **NSW** | Port Botany and Sydney Airport Transport | tbc | | | | | | |
| **VIC** | Port of Hastings | tbc | Melbourne International Freight Terminal | tbc | | | | |
| **QLD** | | | Abbot Point Multi Purpose Harbour | 3,300 | | | | |
| | | | Freight Access to Port of Brisbane and Brisbane Airport | 1,159 - 2,710 | | | | |
| **WA** | Transforming the Pilbara: Pilbara Cities | 2,900 | South West (Bunbury) Infrastructure | 605 | Oakajee Port (potential equity injection) | 5,400 | | |
| | Port Hedland Inner Harbour - Capacity Enhancements | 500-1000 | | | | | | |
| **SA** | Eyer Peninsula Port Proposals | tbc | Freight Access to Port of Adelaide - Northern Connector | 1,191 | | | | |
| **NT** | | | | | Darwin East Arm Port | 336 | | |

Source: Infrastructure Australia & Citi Research

Figure 3 cont'd. Infrastructure Australia Selected Project List

| | Early Stage | | Real Potential | | Threshold | | Ready to Proceed | |
|---|---|---|---|---|---|---|---|---|
| | **Project** | **Cost ($m)** | **Project** | **Cost ($m)** | **Project** | **Cost ($m)** | **Project** | **Cost ($m)** |
| **National Freight Network** | | | | | | | | |
| **NSW** | Northern Sydney Road Freight Access F3-M2 | 4,750 | North South Rail Freight Corridors | n/a | | | Pacific Highway Corridor Upgrade | 6,400 |
| **VIC** | | | Western Interstate Freight Terminal | tbc | | | | |
| | | | East West Link | tbc | | | | |
| **QLD** | Mount Isa to Townsville Rail Corridor Upgrade | 333 | | | | | | |
| | Bruce Highway Upgrade Strategy | 22,500 | | | | | | |
| | Bruce Highway - Coorey to Curra Section A | 852 | | | | | | |
| | Warrego Highway Upgrade Strategy - Helidon to Morven | 670 | | | | | | |
| **TAS** | Hobart to Launceston Transport Strategy | 1,662 | | | | | | |
| **Nation Wide** | | | Advanced Train Management System | 500 | National Land Freight Strategy | | | |
| | | | East West Rail Freight Corridor | n/a | | | | |
| **Adaptable and Secure Water Supplies** | | | | | | | | |
| **TAS** | An Innovation Strategy for Tasmania: Focus on Food Bowl Concept | tbc | Tasmanian Water and Sewerage Reform | 1,000 | | | | |
| **Digital Infrastructure** | | | | | | | | |
| **Nation Wide** | | | | | | | National Broadband Network | 35,900 |

Source: Infrastructure Australia & Citi Research

# Appendix A-1

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