



# Re-building the social licence for **asset recycling**

*The need for asset transfer conditions that  
focus on delivering real public benefits*

**March 2019**



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# EXECUTIVE SUMMARY

Asset recycling provides governments across Australia with a valuable tool that can help address the current challenges of keeping pace with infrastructure investment demands in our growing cities and regions.

Asset recycling 'unlocks' capital from an existing infrastructure asset through a transfer agreement with private sector investors, with proceeds from the transfer re-invested into priority areas, such as new infrastructure. This enables governments to increase and maximise the value realised from infrastructure investments, particularly when needs are growing, while minimising the need to increase taxes and public debt. Asset recycling also provides a counterweight to the circumstance where future operations, maintenance and renewal costs are not adequately accounted for in budgets – under asset recycling these costs must be accounted for and a funding source identified.

When delivered appropriately, asset recycling also results in real and direct public benefits. Aside from additional funding for new infrastructure, asset recycling drives improvements in the efficiency of operations and service outcomes. These improvements are driven from market mechanisms and other competitive pressures, and by governments setting appropriate asset transfer conditions that protect public interests. For example, market mechanisms and transfer conditions can encourage the uptake of new technology that improves the user experience and helps manage an asset more efficiently.

The challenge facing governments today is ensuring that asset recycling initiatives are delivering these public benefits by getting the right balance between public and private sector interests. It is equally important for governments to identify where the interests of all stakeholders align, ensuring the benefits of asset recycling initiatives are shared as much as possible.

This report discusses how governments can address this challenge by ensuring transfer conditions with the private sector:

- limit profit maximising opportunities;
- set clear service expectations;
- enable a competitive market or opportunities where arrangements with investors can be regularly contested by other players; and
- are supported by broader regulatory frameworks.

We believe these conditions must be underpinned by a preference for asset leasing in most circumstances. While the difference between an asset lease and asset sale is often confused in the debate on privatisation, a leasing approach enables governments to retain ownership and instead transfer the operation of assets to private sector investors. This creates a 'steward' approach where governments are able to include additional touchpoints to ensure assets are operating effectively and in the public interest.

Broader public concerns with asset recycling cannot be ignored. These concerns and unsuccessful examples of asset recycling highlight that governments are struggling to demonstrate benefits to the public, with some jurisdictions opting to turn away from the approach altogether. If governments do not address these concerns, they will continue to face an uphill challenge when pursuing asset recycling opportunities in the decades to come. The onus should therefore be on governments to improve how they engage with the public on asset recycling, and to back this up by delivering well-designed and successful initiatives.

Australia's growing infrastructure funding needs, and a shortfall in revenue available for these costs, creates a scenario described as an 'infrastructure gap'. With record investment needing to become the new normal, asset recycling can create a more sustainable funding model for our assets, such as through a road user charging approach, by leveraging the benefits of Australia's long-standing reputation as a sound investment destination. The case for asset recycling cannot be ignored by governments simply because of the challenge involved with building community support. Governments must instead prosecute this case by highlighting benefits such as a more sustainable funding model for taxpayers, and address concerns such as national interest impacts from foreign direct investments with practical protections.

We believe the case for asset recycling can also be strengthened by discussing where potential proceeds could be re-invested. The public appetite for new infrastructure is strong, particularly when addressing congestion and other population growth challenges in our cities and regions. The public appetite for asset recycling will therefore potentially increase if governments across Australia start a conversation with the community about infrastructure demands and needs, and on appropriate funding options.

To this end, our report outlines how a renewed approach can help re-build the social licence from our community for asset recycling. This approach should increase the focus of governments on creating the right conditions for successful transfers that are in the public interest, as opposed to those conditions that only focus on increasing the upfront asset transfer price. A renewed approach that also seeks to address challenges and maximise the benefits will help ensure asset recycling can remain one of the many funding mechanisms for governments to meet the task at hand for delivering Australia's infrastructure of tomorrow.

A number of recommendations are outlined in this report for Australian governments. These recommendations are summarised below.

- 1** *All jurisdictions to renew asset recycling policies centred around Consult Australia's eight key conditions for successful transfers*
- 2** *The Australian Government to re-establish an improved Asset Recycling Initiative focused on transfer conditions rather than transfer proceeds*
- 3** *Governments across Australia to link asset maintenance costs to infrastructure investments*
- 4** *Governments across Australia to assess the merits of an infrastructure investment cycle supported by asset recycling, focused on transferring assets to the private sector when they represent the best value*
- 5** *The Australian Government to take the lead on pursuing a road user charging model*
- 6** *The Australian Government to require the Foreign Investment Review Board to undertake public consultations as part of their foreign investment review process*

*Table 1: Consult Australia's recommendation for Australian governments*

# CONTEXT

Asset recycling is the transfer of commercially viable, publicly owned infrastructure assets to the private sector. Where proceeds from the transfer of assets to the private sector are greater than retention value, asset recycling helps reduce pressure on the ongoing balance sheets of governments,<sup>1</sup> and results in additional funding or 'capital recycling' for new government priority areas. When successful, asset recycling results in:

- more efficient management of assets through market mechanisms and through other competitive pressures;
- removing ongoing costs for governments by transferring maintenance, upgrades and expansion costs to the private sector;<sup>2</sup> and
- a 'win-win' scenario when the efficiency of private sector management of infrastructure and service provision outweighs higher borrowing costs and profit margins.

Furthermore, transferring assets to the private sector aligns with accepted bipartisan practice that governments should, where possible, seek to influence economic activities rather than take a hands-on approach. To this end, the transfer of assets to the private sector can improve the transparency of governments and the public sector by removing perceived or actual conflicts of interest from being both the owner and the regulator of infrastructure.<sup>3</sup>

Asset recycling does not lead to successful outcomes by default. There are numerous examples that point to successful and unsuccessful approaches to asset recycling. It is the unsuccessful approaches, and their prevalence, that have led to concerns about asset recycling as a concept.

This report seeks to address these genuine community and political concerns, and to outline how a more balanced approach to asset recycling, centred around transfer conditions that build social licence and deliver real benefits to the public, can provide a viable option for funding Australia's future infrastructure needs.

## The ongoing need for investment in infrastructure to support economic growth

Despite the current scale of infrastructure investments across Australia and how this funding is transforming the economy, particularly in New South Wales and Victoria, the ongoing demand for new infrastructure in our regions will not dissipate.

New infrastructure provides valuable links for society and the economy. It enables businesses to grow, provides better connections to services and supports population growth. In short, ongoing investments in the right infrastructure will compound economic growth across the country – enabling a thriving economy, increasing productivity, and improving the day-to-day lives of Australians.

To meet the infrastructure task at hand across Australian cities and regions, governments have an ongoing challenge to maximise the capital available to them to appropriately fund a pipeline of future projects. This pipeline needs to respond to growing demand on infrastructure from current population growth and help to catch up on a deficit of investments in previous years. To achieve this, many governments are looking to private sector demand to invest in assets with long life cycles and to recycle capital from previous investments into new infrastructure projects. New South Wales and Victoria are examples of how this approach is supporting a sustainable overall increase in the total infrastructure spend.

In August 2018, Infrastructure Partnerships Australia (IPA) released their *2018 Infrastructure Budget Monitor* report. This monitor analyses infrastructure spends by all Australian governments, ranking each by considering its share of total government expenditure. IPA highlights that New South Wales and Victoria's asset recycling approach and the investment of proceeds back into new infrastructure projects is directly supporting growth in these two states and enabling both to lead the nation on taxpayer funded infrastructure investments. The two states are now making up 65.2 per cent of total investments (despite making up 57.7 per cent of the population across 13.4 per cent of Australia's landmass), with New South Wales' forward investment increasing by \$16 billion over the past twelve months through proceeds from leased assets.<sup>4</sup>

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<sup>1</sup> Infrastructure Australia, *Australia's Public Infrastructure: Part of the Answer to Removing the Infrastructure Deficit* (2012)

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> IPA, *Australia Infrastructure Budget Monitor 2018-19* (2018)

## History of asset recycling in Australia

Despite asset recycling being a relatively new term popularised by the Australian Government's 2014 initiative, Australia has a long history of transferring assets to the private sector through long-term leases or sales. Below is a broad timeline, and summary of some successful and unsuccessful examples.



Table 2: Some key milestones in Australia's history of transferring assets to the private sector

### Commonwealth Oil Refineries

The Commonwealth Oil Refineries Ltd was established in 1920 as a venture between the Australian Government and the Anglo-Persian Oil Company (APOC) (later renamed the British Petroleum Company) to develop Australia's capability to refine up to 200,000 tonnes of crude oil per year, primarily through the construction of an oil refinery in Laverton, Victoria. This was part of a broader strategy at the time to increase Australia's own supplies of liquid fuel for both commercial and defence purposes.<sup>5</sup>

The joint venture was funded as a public private partnership with each funding A£2 million over a six-year period. The Australian Government sold its share in the venture to APOC in 1952 for A£2.72 million, due to APOC's commitment to construct a new oil refinery in Western Australia capable of producing 3 million tonnes of crude oil per year. This equaled 40 per cent of Australia's requirements at the time at a cost of A£40 million.<sup>6,7</sup>

The Commonwealth Oil Refineries joint venture provides an example of a government playing a role in establishing an industry which has since attracted additional capital from the private sector, and has provided a foundation for longer-term prosperity.

### Electricity Market in Victoria

Victoria, followed closely by South Australia, was the first jurisdiction in Australia to transfer assets from the electricity industry to the private sector. The case was pitched to the public as a way to rescue the Victorian Government from high levels of debt and associated interest payments.<sup>8</sup>

In August 1993, the Victorian Government commenced a review of the structure and operation of the electricity industry in Victoria which led to disaggregation of the State Electricity Commission into companies based around function – generation, transmission, and distribution and retail. These businesses were then progressively corporatised and privatised between 1995 and 1999.<sup>9</sup> Revenue from these asset transfers totalled \$20 billion, exceeding expectations at the time.<sup>10</sup>

The privatisation led to productivity improvements in the sector throughout the 1990s, with private owners significantly cutting capital expenditure to help repay high debts incurred from the purchase of assets. However, it has been argued that the fiscal impact on the Victorian Government from electricity privatisation has been neutral. Additionally, significant increases in capital investments and employment to compensate for delayed spending on maintenance, and for reliability and capacity improvements, have seen a sustained decline in the sector's productivity over the last decade.<sup>11</sup>

<sup>5</sup> University of Sydney, In Pursuit of Liquid Fuel Security: The Commonwealth Oil Refineries Venture, 1920-1952

<sup>6</sup> National Library of Australia, Australia gets £2,72,000 from sale of COR shares (The Courier Mail - 1952)

<sup>7</sup> National Library of Australia, This is Kwinana (The Argus - 1955)

<sup>8</sup> Ibid.

<sup>9</sup> Parliament of Australia, Research Paper: Electricity Industry Restructuring: The State of Play (1998)

<sup>10</sup> Australian National University, The fiscal impact of privatisation of the Victorian electricity industry (2002)

<sup>11</sup> University of Sydney, Electricity Privatisation in Australia: Briefing Note (2012)

## Airport Divestment Initiative

In 1987, the Federal Airports Corporation was established as a Government Business Enterprise (GBE) to operate the 22 airports owned by the Australian Government. From 1997, the Australian Government commenced a process to lease out all federally owned commercial airports through 50-year leases with a 49-year extension option.<sup>12</sup> Between 1997 and 2002, all federally owned commercial airports were transferred to 'airport-lessee companies' with leasing arrangements and regulatory requirements being managed under the *Airports Act 1996*, such as restrictions on foreign and airline ownership.

The Airport Divestment Initiative raised \$61 billion, and air passenger movements have doubled over the past 20 years resulting in airport-lessee companies investing in new infrastructure to improve the efficiency of their operation and the user experience (such as new runways and terminals).<sup>13</sup> To this end, divestment has helped airports respond more rapidly to demands through market pressures.

Today, the Australian Department of Infrastructure, Regional Development and Cities regulates the operations of leased airports by approving airport master plans, environmental strategies, and development plans, and the Australian Competition and Consumer Commission (ACCC) manages the quality of airport services and compliance with competition requirements.

## Adelaide to Darwin Railway

In 1999, the AustralAsia Rail Corporation (co-managed between the Northern Territory and South Australian governments) awarded contracts for a 'construct-own-operate' 1,420-kilometre rail project between Darwin and Alice Springs, completing the rail connection between the two jurisdictions.<sup>14</sup> The contract's components included the right to operate the full length of the Adelaide to Darwin rail line, which was awarded to FreightLink.

To support the construction of the \$1.2 billion project and the operation of the full rail line, the Australian, South Australian, and Northern Territory governments provided more than \$560 million in grant funding. The project was completed in 2004.<sup>15</sup>

In 2008, FreightLink sold its assets and the 50-year lease for operating the rail line for \$334 million to a US-owned rail company. The sale was described as a 'big discount', representing less than FreightLink's \$500 million debt, and the additional funding contributions from governments towards the project.<sup>16</sup>

## Asset Recycling Initiative

In 2014, the Australian Government's Budget committed \$5 billion to establish an Asset Recycling Initiative, centred around the Australian Government's infrastructure growth plans. The purpose of the initiative was to provide incentive payments to state and territory governments to sell assets, and to reinvest proceeds into new infrastructure.<sup>17</sup>

Acknowledging that state and territory governments in Australia tend to be 'asset rich' but often 'cash poor', the Asset Recycling National Partnership Agreement sought to encourage states and territories to 'unlock capital' in balance sheets and to create opportunities for investors in assets around Australia. As an incentive, state and territory governments received a bonus 15 per cent of the transferred asset price to invest in eligible infrastructure projects on a first-come, first-serve basis. For new infrastructure projects to be eligible for funding, state and territory governments were to submit proposals that:

- demonstrated a clear net benefit;
- enhanced the long-term productivity capacity of the economy; and
- provided enhanced private sector involvement in infrastructure funding and financing (if possible).<sup>18</sup>

The initiative was scrapped in the Australian Government's 2016-17 Budget, before the original planned end date of 2019. Of note, the uptake of the initiative was uneven across the country and by asset type (both being recycled, and the new infrastructure being invested in). In total, \$3.3 billion from the scheme was allocated to the New South Wales, Victoria, Northern Territory and the Australian Capital Territory governments.

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<sup>12</sup> University of Canberra, *Airport Privatisation in Australia* (2014)

<sup>13</sup> Productivity Commission, *Economic Regulation of Airports* (2018)

<sup>14</sup> *Railway Gazette*, *Darwin Deal* (1999)

<sup>15</sup> Rail Personnel, *Rail News* (20 May 2008)

<sup>16</sup> ABC, *Taxpayers funds sought from new rail owner* (2010)

<sup>17</sup> Australian Government's Budget 2014-15, *Asset Recycling Initiative* (2014)

<sup>18</sup> *Ibid.*



## When delivered successfully, asset recycling results in more efficient management of infrastructure through market mechanisms and competitive pressures.

The New South Wales Government led the way under the scheme, with the well-publicised \$24.1 billion 'Poles and Wires' asset recycling programme serving as the primary funding source for a \$20 billion 'Rebuilding NSW' infrastructure programme, which included:

- \$8.9 billion for urban transport projects, including Sydney Metro, Parramatta light rail, bus priority infrastructure and network enhancements;
- \$2.4 billion for urban road projects, including WestConnex northern/southern extensions, pinch points and clearways, smart motorways and traffic management upgrades;
- \$4.1 billion for regional transport projects, including regional growth roads, 'Bridges for the Bush' and regional road freight corridors;
- \$1 billion for health projects, including the Hospital Growth Programme, regional multipurpose service facilities, and a primary and integrated care strategy;
- \$1 billion for education projects, including future focused schools; and
- \$1 billion for water security projects, including the Regional Water Security and Supply Fund.<sup>19</sup>

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<sup>14</sup> Railway Gazette, Darwin Deal (1999)

<sup>15</sup> Rail Personnel, Rail News (20 May 2008)

<sup>16</sup> ABC, Taxpayers funds sought from new rail owner (2010)

<sup>17</sup> Australian Government's Budget 2014-15, Asset Recycling Initiative (2014)

<sup>18</sup> Ibid.

<sup>19</sup> New South Wales Government, Rebuilding NSW: Delivering on our \$20 billion infrastructure program (2017)

## Four types of asset recycling classes

In 2012, Infrastructure Australia released a report titled *Australia's Public Infrastructure: Part of the Answer to Removing the Infrastructure Deficit*. This report builds a narrative around the need to catch up on the infrastructure investments needed across the country and presents a case on how transferring assets to the private sector, with the appropriate conditions in place, can provide the means to achieving this objective.<sup>20</sup>

This report highlights how there cannot be a one size fits all approach to transferring infrastructure assets to the private sector. Instead, Infrastructure Australia outlines four types of asset classes in the table below that must be considered from the outset in order to enable an appropriate transfer to the private sector.



Table 3: Infrastructure Australia's four types of asset classes<sup>21</sup>

This table and its four categories also highlight a potential cause for previous failures, where appropriate conditions and regulatory changes are not in place or achieving their desired outcomes, and are prompting public concerns around privatisation.

These previous failures, coupled with the reality that much of the 'low hanging fruit' in category one and two have already been transferred to the private sector, highlight a need to improve how assets in category three can be appropriately shifted to category two, and be ready for transfer to the private sector.

If governments can put a process in place that ensures the transferring of assets to the private sector can be supported by the right conditions and will not create a market failure, trust with the public around privatisation will improve and an opportunity to unlock billions from assets to fund future infrastructure needs will open up. To this end, this report discusses the challenges governments will need to address in the next section.

<sup>19</sup> New South Wales Government, *Rebuilding NSW: Delivering on our \$20 billion infrastructure program* (2017)

<sup>20</sup> Infrastructure Australia, *Australia's Public Infrastructure: Part of the Answer to Removing the Infrastructure Deficit* (2012)

<sup>21</sup> Ibid.



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**Asset recycling results in a ‘win-win’ for all stakeholders when improved efficiency and service provision outweighs higher borrowing costs and profit margins.**

# CHALLENGES TO ASSET RECYCLING

This section outlines challenges facing asset recycling and privatisation more broadly. These challenges must be addressed if a successful and long-lasting approach to asset recycling is to be established.

## Public concerns around privatisation

While the privatisation of public assets and services has become increasingly popular for governments around Australia, public sentiment against privatisation is continuing to grow. A wide range of research suggests a majority in the community are not sold on the benefits of privatisation to the public, instead believing these benefits are skewed towards private sector investors through unregulated monopolies and higher costs for consumers. Many in the community are also concerned with foreign investments in assets, particularly around property costs and national interest concerns. Below is further detail and research on the key public concerns around privatisation.

### Foreign investment

Most Australians are concerned about foreign investments in Australian assets. Foreign investment concerns in Australia have a long history, with concerns about large-scale investments from the United Kingdom in Australia's early settlement history, from the United States between the 1950s to the 1970s, and from Japan in the 1980s being well documented.<sup>22</sup> In recent years, foreign investment concerns have shifted to China, particularly in regard to the scale and breadth of these investments.

In 2016, Essential Research conducted a survey on foreign investment in different assets types and the impact on the Australian economy. In all asset types, more respondents perceived foreign investments as 'bad' for the economy than 'good', with real estate, infrastructure and agriculture having the most decisive results by a factor of more than two to one. Foreign investment in mining provided the closest results with the most respondents believing foreign investment has no impact on the Australian economy. Between 12 to 15 per cent of respondents didn't know the impact on the Australian economy from foreign investment in each asset type.

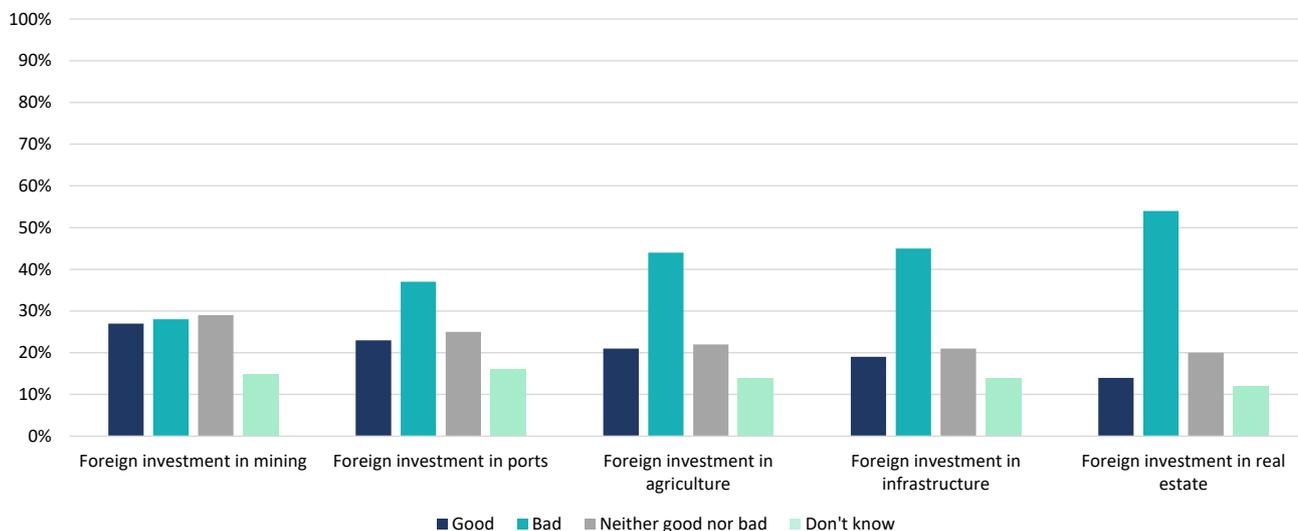


Table 4: Essential survey on foreign investment and the impact on the Australian economy (August 2016)<sup>23</sup>

<sup>22</sup> The University of Sydney, Takeover: Foreign Investment and the Australian Psyche (2015)

<sup>23</sup> Essential Research, Foreign Investment Survey (2016)

## Case study 1: Housing prices and foreign investments in Sydney's property market

The University of Sydney, University of Technology Sydney and Western Sydney University conducted a survey of 900 Sydneysiders to investigate views on foreign investment in real estate.<sup>24</sup> The survey focused on perceived links between housing affordability and foreign investment.

The researchers noted that while there was limited empirical evidence on the effects of foreign investment in real estate in Sydney (i.e. broader impacts on the housing market), the survey results indicate that respondents have strong views on the topic.

### Drivers of housing prices

The survey asked respondents to select up to three factors driving housing prices in Sydney. Foreign investment in the housing market was by far the most nominated factor for increases in house prices, ahead of poor urban planning and a lack of land supply, tax concessions to property owners such as negative gearing, and low interest rates.

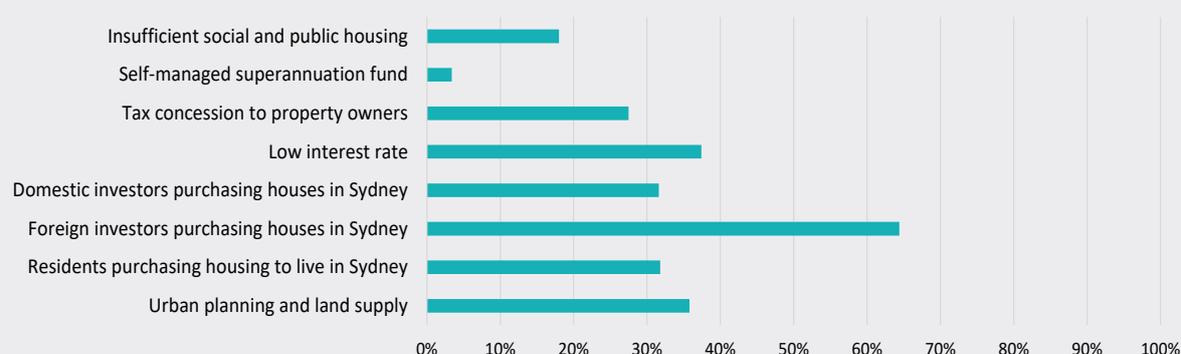
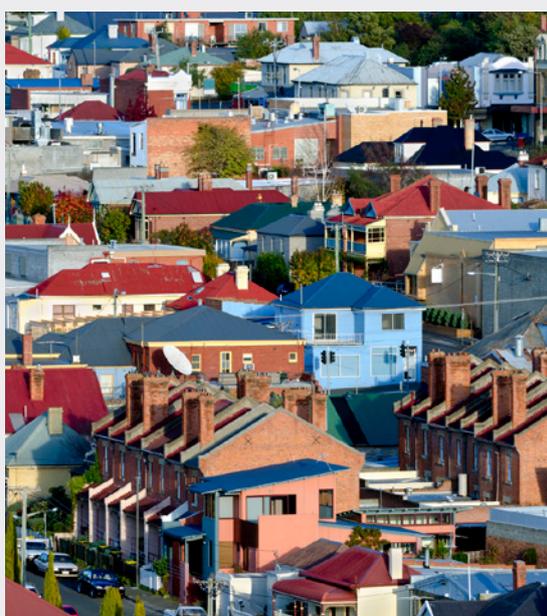


Table 5: Drivers of housing prices in Sydney<sup>25</sup>



### The influence of governments on foreign investment in Sydney's housing market

The survey also highlights that many believe governments are not doing enough to limit a perceived negative impact of foreign investment on the housing market – 52.5 per cent of respondents disagreed or strongly disagreed that governments have effectively regulated in this area, with only 16.1 per cent agreeing or strongly agreeing governments have been effective.

In terms of a future approach, only a small minority of respondents (12.3 per cent) agreed that governments should do more to encourage foreign investment in Sydney's housing market, while 63 per cent disagreed or strongly disagreed.<sup>26</sup>

These findings suggest many believe there is a role for governments to safeguard or ensure the impact of foreign investments in real estate is positive to the overall housing market.

<sup>24</sup> The Conversation, Sydneysiders blame foreign investors for high housing prices – survey (2017)

<sup>25</sup> Ibid.

<sup>26</sup> Ibid.

## Threats to national interests

Public opinion on the privatisation of assets tends to highlight concerns about Australia's national interests, particularly when considering foreign investments. The primary concern is that the interests of the general public are not being considered by the private sector and foreign investors in assets.

National security concern is a factor often flagged in the argument against foreign direct investment. This topic has recently become more prominent in the public debate about privatisation from the Australian Government's decision to exclude Chinese companies, Huawei and ZTE, from being involved in the development of a 5G mobile communication network, and to exclude Chinese and Hong Kong companies, State Grid Corporation and Cheung Kong Infrastructure, from bidding for the 99-year lease of Ausgrid. Both decisions were made on national security grounds.

It was during the debate around the 99-year lease of Ausgrid that the CFMEU launched a campaign in 2016 outlining concerns with State Grid Corporation as the 'likely buyer' of the lease, highlighting the company as owned and controlled by the Chinese Government, and outlining broader concerns with foreign investment in the electricity network.<sup>27</sup>

Economic security concerns from privatisation are also viewed by many in the public as a threat to Australia's national interests. These concerns are often centred around the consequences of foreign investment on Australia's energy security and food security. The 2017 Lowy Institute Poll, which interviewed over 1,200 people, revealed that 84 per cent of respondents saw foreign investments as a critical or important threat to Australia, and 84 per cent of respondents also viewing China's foreign policy as a critical or important threat to Australia,<sup>28</sup> suggesting that many see a link between the two. Public opinion about foreign investment has been described as being influenced by broader concerns around the transparency and interests of investors,<sup>29</sup> a public sentiment that appears to be reflected in the Lowy Institute Poll results.

'Selling off the farm' is a popular description of the public's current concerns about foreign investors. Similar public concerns in the 1970s around Japanese foreign investment in Australia's agriculture and resource sectors led to the establishment of the Foreign Investment Review Board (FIRB) in 1975. While these public concerns about Japanese investment have since dissipated (with ownership today equating 0.1 per cent of Australia's land assets), the FIRB still plays a major role in advising the Australian Government whether foreign direct investments are in the national interest, including through the enhanced review process introduced in 2015.<sup>30</sup>

In a speech by Patrick Secker (FIRB board member) in June 2017 at the Agri Investor Forum, it was noted that public opinion around foreign investment was not factored in to the FIRB review process and it was his view that public opinions around foreign investment concerns in agriculture sector were misplaced.<sup>31</sup> This perhaps highlights the public sentiment that the wider approach taken by governments to foreign investment is disconnected from public opinion.

## Unregulated monopolies

A widely held view about the privatisation of assets is that it often creates natural monopolies. This increases when arrangements facilitating the transfer of an asset to the private sector are heavily structured around maximising upfront prices.

Rod Sims, the Chairman of the Australian Competition and Consumer Commission, has highlighted examples of asset transfers to the private sector that have hampered productivity and had a negative impact on the economy because of the conditions included in the privatisation arrangements. These conditions have focused on boosting proceeds from asset transfers by restricting competitions and creating favourable revenue raising opportunities for private sector investors. In effect, Sims argues that asset transfers such as the Port of Melbourne and the electricity markets in Queensland and New South Wales have not been created with suitable regulations to fairly manage operations by controlling how much private sector operators can charge users. The end result has been significant price rises, for example, power prices in Queensland and New South Wales have more than doubled over five years.<sup>32</sup>

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<sup>27</sup> ABC, Ausgrid lease: Treasurer Scott Morrison blocks sale to Chinese, Hong Kong bidders (2016)

<sup>28</sup> Lowy Institute, 2017 Lowy Institute Poll

<sup>29</sup> The Age, Selling the farm? Who's buying? (2015)

<sup>30</sup> ABC Rural, Rare FIRB speech reveals review process at odds with public sentiment around foreign investment in farmland (2017)

<sup>31</sup> Ibid.

<sup>32</sup> Sydney Morning Herald, Privatisation has damaged the economy, says ACCC chief (2016)

## Limited benefits to the public

Perhaps the most significant concern of privatisation is the view that the transfer of assets to private sector investors does not deliver real public benefits. Instead, many believe that privatisation only benefits private sector investors through profits from increased user charges.

A 2015 Essential Research survey on privatisation of Government-owned assets found that the vast majority of respondents believe prices increase when services are privatised, that privatisation mainly benefits the corporate sector, and that some key assets are too important to be sold off. Half of the respondents disagreed privatisation results in more competition that benefits consumers, and that selling off public utilities will help the economy. More people disagreed that selling government assets frees up money to reallocate to other services and infrastructure.<sup>33</sup>

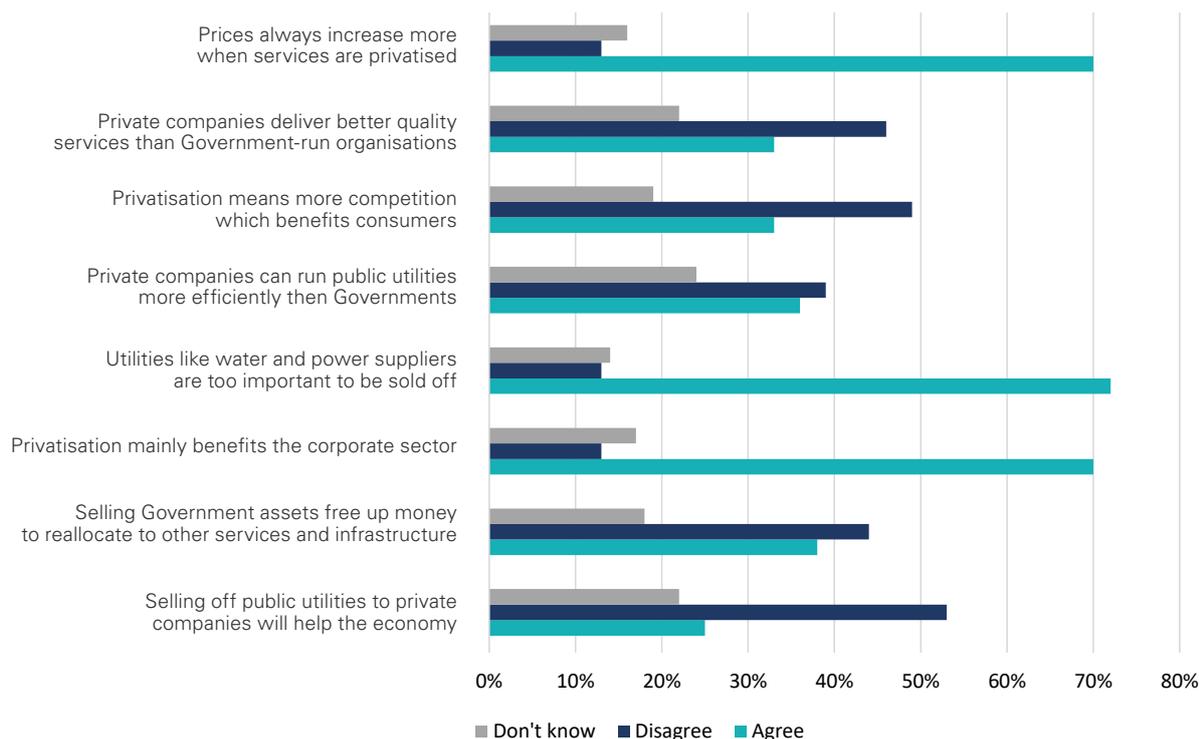


Table 6: Essential survey on privatisation of Government-owned assets<sup>34</sup>

The above table suggests people do not see a win-win scenario from transferring assets to the private sector, and instead see a zero-sum game where the investor's gain is the public's loss. Noting the survey was conducted in 2015, it would be interesting to see if these views have changed from the New South Wales Government's asset recycling initiative and the substantial increase in infrastructure funding.

John Quiggin from the University of Queensland notes that from the viewpoint of many 'ordinary' Australians, privatisation policies have consistently failed but continue to be pushed at both corporate and political levels. Despite the idea that 'privatisation is always desirable' dominating public policy for the last 25 years in Australia, many in the public are drawing the opposite conclusion. The continued push for privatisation through the current approach is turning voters to populism in response, and a flat rejection of the concept, rather than assessing desirability on a case-by-case basis.<sup>35</sup>

<sup>33</sup> Essential Research, Privatisation (2015)

<sup>34</sup> Ibid.

<sup>35</sup> The Conversation, A privatised monopoly is still a monopoly, and consumers pay the price (2014)

## Finding the balance between investor and public interests

Private sector investors are naturally going to focus on maximising profits. A profit-maximising approach will almost always lead to negative outcomes for the public if the activities of private sector operators are not appropriately managed or aligned to public interests.<sup>36</sup>

In many areas of the economy, competition is the solution to aligning a profit-maximising approach to public interests. Competition benefits the public through the desire to:

- provide a better service; or
- charge less to attract more customers.

However, competition is not always viable for asset recycling and this is why governments also need regulations to ensure private sector operators are not exploiting market power.<sup>37</sup>

When looking at successful toll road initiatives, it is clear that the public are prepared to pay to be a consumer if the offering is an improved service. The recent growth in tollway usage in Melbourne and Sydney highlights this demand, and internationally the public approval of toll roads in Sweden and Norway outline how consumers are seeing benefits to extra costs. These improvements include better road quality and faster journey times.<sup>38</sup> The additional challenge for governments and the private sector for asset recycling is justifying additional costs when services are linked to revenue for private sector investors. However, the value for money principle also applies in this circumstance.

To ensure asset recycling represents good value for the public, the key challenge for the government is putting in place the right controls to balance investor and public interests. This is outlined on the table below.

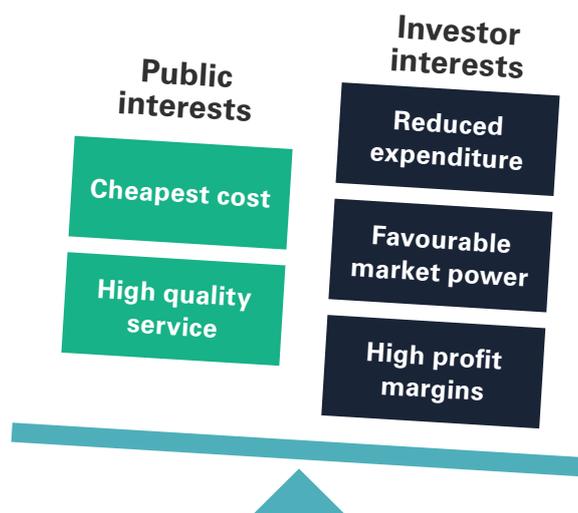


Table 7: Balancing public and investor interests through competition and regulation

## Differing interests between governments and the public

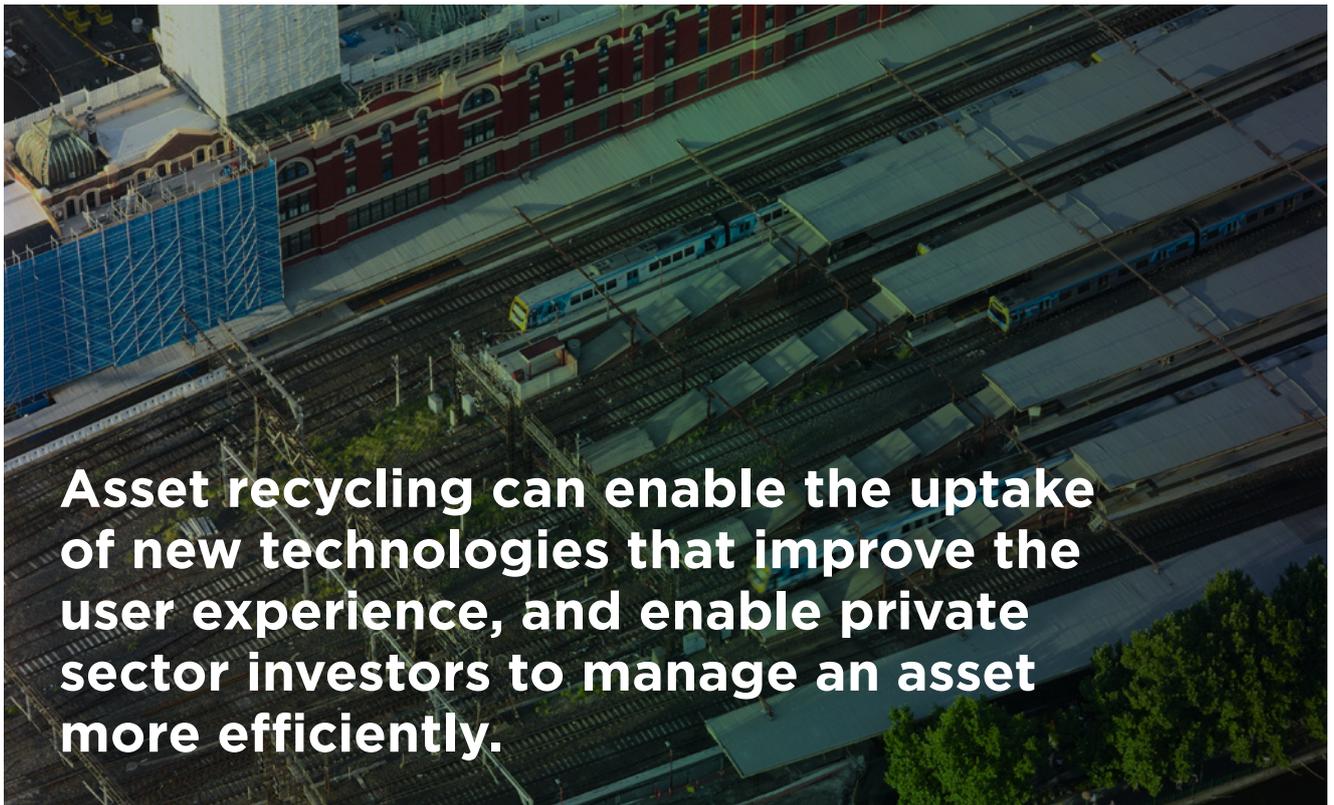
Finding the right balance between public and investor interest is often difficult because governments are themselves often seeking to maximise the value of an asset for recycling. While this government interest is motivated by perceived public interests (reducing debt and increasing funding for other priority areas), these are sometimes not viewed as public benefits when there are a number of unreasonable trade-offs for the community.

The challenge with finding the right balance may require governments to decrease the value of an asset by ensuring regulations and sufficient competition are in place to control profits. This is because the revenue a government receives from transferring an asset to the private sector will always reflect expected profits, and this value increases when there are more favourable conditions for investors.<sup>39</sup>

<sup>36</sup> The Conversation, A privatised monopoly is still a monopoly, and consumers pay the price (2014)

<sup>37</sup> Ibid.

<sup>38</sup> RAC Foundation, The Acceptability of Road Pricing (2011)



**Asset recycling can enable the uptake of new technologies that improve the user experience, and enable private sector investors to manage an asset more efficiently.**

But the community will not see maximising the value of an asset as being in the public interest if it results in increased usage costs or a poorer quality service from the asset. Governments, by their nature, tend to look at public interests from a holistic and an abstract perspective, and this is not considering the on-the-ground perspective when looking exclusively at an asset and privatisation (i.e. what the users are gaining from the asset being recycled).

The challenge for governments is ensuring asset recycling tangibly results in public benefits through the lens of those impacted by the change, both in the short-term by unlocking additional capital and in the long-term through improved efficiency of operations and ideally service improvements.

### **The lack of Australian Government incentives on asset recycling**

The introduction of the Australian Government asset recycling incentive scheme for state and territory governments in 2014 resulted in a cascade of asset transfers to the private sector. This cascade was primarily through the Commonwealth's commitment to provide an additional 15 per cent of the price when proceeds were re-invested into infrastructure projects.

With this scheme being scrapped in the Australian Government's 2016-17 Budget, the incentive for state and territory governments to pursue the benefits of asset recycling have been reduced. These benefits are outlined further in the next section of this report.

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<sup>39</sup> RAC Foundation, The Acceptability of Road Pricing (2011)

# BENEFITS TO ASSET RECYCLING

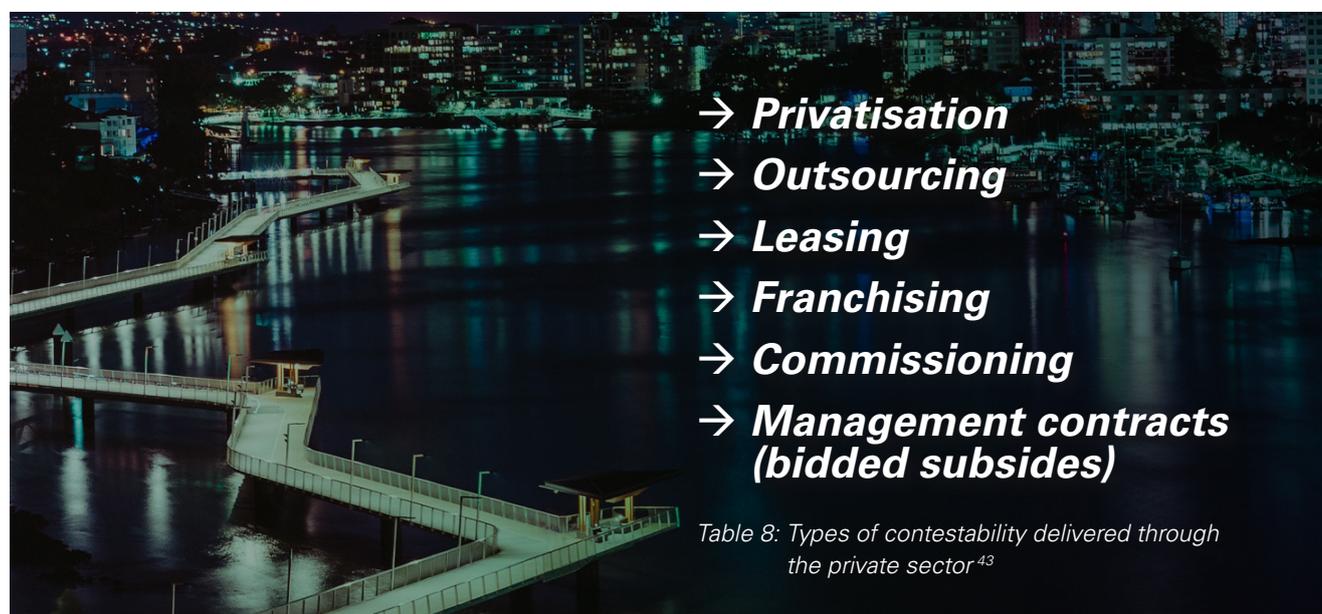
This section outlines the benefits of asset recycling and privatisation more broadly. These benefits must be a focus and be promoted for future initiatives if a successful and long-lasting approach to asset recycling is to be established.

## Delivering better value for money

Asset recycling can deliver better value for the public through the principles of contestability. To this end, contestability can improve the efficiency and outputs of an asset by focusing on the service being provided for consumers, and influencing asset operators through incentives and other drivers.

The Australian Government's Department of Finance defines contestability as the 'prospect of competition in public sector functions to improve both the efficiency and effectiveness of contributing to achieving the government's outcomes'.<sup>40</sup> It is important to note contestability also focuses on the potential for competition to maximise public value from services provided, particularly for services which are natural monopolies and may not be exposed to competition on a day-to-day basis.<sup>41</sup>

A focus on contestability allows governments to review their role and how services align to priorities, to consider how best to achieve a service's desired outcomes, and to encourage entities to improve the efficiency and delivery of a service through the possibility of competition.<sup>42</sup> It can be delivered in a number of forms, as outlined below.



A common misconception around contestability is that it focuses on delivering cost savings. While cost savings is one component to improve the efficiency of a service, the primary focus of contestability is to improve services for users, and to ensure long-term sustainability of those services.<sup>44</sup> This sometimes can result in additional investments in the asset.

The 99-year lease of the Port of Darwin is an example of how contestability for an asset viewed as a natural monopoly has resulted in improved efficiency and services.

<sup>40</sup> Department of Finance, Contestability Programme Guidelines (2015)

<sup>41</sup> NSW Business Chamber, Diversity and Contestability in the Public Service Economy (2012)

<sup>42</sup> Ibid.

<sup>43</sup> Deloitte, Contestability: a new era in service delivery reform (2015)

<sup>44</sup> Ibid.

## Case study 2: Port of Darwin

The Northern Territory Government's leasing of the Port of Darwin for 99 years, in addition to the controlling stake in the port operator, involved a number of steps. These steps occurred in two distinct stages: the decision to lease the port; and the bidding process that led to Landbridge Group being awarded the lease and the controlling stake as the port operator.<sup>45</sup>

The decision to lease the Port of Darwin was due to significant growth in demand and the need to meet growth projections through significant investments. The Northern Territory Government was advised the port could reach full operational capacity in the short-term future, and sought advice on securing additional capital investment to increase the port's capacity following the Australian Government's decision not to provide any additional funding. A long-term lease was recommended as the best option to expand and develop the port.

In January 2015, the Northern Territory Government commenced a process to gauge interest (internationally and nationally) in the Port of Darwin. This resulted in 33 investors registering interest in leasing the port, which eventually led to Landbridge Group being successful. This process also included the Foreign Investment Review Board reviewing the Landbridge Group bid and deeming it appropriate given the exemption status for assets owned by Australian governments. The total price of the lease package came to \$506 million and the lease commenced on 16 November 2015.<sup>46</sup>

The lease agreement includes a plan for an investment of over \$1 billion, which includes:

- the development of a luxury resort and upgrades to the port's facilities to increase capacity including harbour support assets;
- increasing the port's capacity for cruise ships (size of vessels and passenger capacity); and
- extending the quay line by 1000 metres to increase cargo volume capacity.<sup>47,48</sup>

Since the lease commenced in 2015, the port has seen around a 30 per cent increase in the number of cruise ship passengers, however total trade has reduced due to market conditions.<sup>49</sup>

Governments should be emphasising to the public that a contestability approach to managing infrastructure assets can deliver public benefits through better services and reduced public costs.

## Separating the regulator from the asset operator

Asset recycling can also create clearer governance arrangements by separating the role of governments as regulator, the owner and the operator of an asset.

Governments face what can be viewed as a perceived conflict of interest for assets that are regulated and publicly owned and managed. It can be argued that governments are conflicted because they are responsible for maximising profits (similar to how any private sector investor would need to operate) and ensuring standards are fairly designed and enforced.<sup>50</sup>

While many governments seek to address these concerns by establishing independent 'arms-length' regulatory bodies or similar asset management arrangements, the challenge and the conflict of interest can still remain if these agencies rely on governments for funding to conduct their business.

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<sup>45</sup> Australian Senate Economics Committee, Lease of the Port of Darwin to the Landbridge Group (2016)

<sup>46</sup> Ibid.

<sup>47</sup> FT, Australia port project highlights schism over Chinese investment (2017)

<sup>48</sup> Darwin Port, Port Development Plan (2016)

<sup>49</sup> Darwin Port, Port Statistics (2018)

<sup>50</sup> International Social Science Journal, Resolving conflicts of interest in state-owned enterprises (2009)

An Infrastructure Australia report from 2012 titled *Australia's Public Infrastructure: Part of the answer to removing the infrastructure deficit* also highlights how private sector management of assets can remove conflicts of interest that face governments. The report outlines this conflict can:

- distort markets;
- discourage new entrants who are concerned about the level of competitive neutrality and political risk; and
- encourage governments to be reticent to fund replacements or expansions of assets, even when there is a clear public benefit, because of budget impacts and other political considerations.<sup>51</sup>

The benefits of having a clear and transparent governance arrangement for assets, including how this can protect competitive neutrality and attract others to the market, should be emphasised to the public further.

## Leveraging new technology to improve the user experience

Another benefit of asset recycling is that it can enable the uptake of new technologies that improve the experience of users, and at the same time also enable private sector investors to manage an asset more efficiently. These new technologies include:

- big data analytics to identify where efficiencies can be leveraged and to deliver real-time actionable intelligence;
- remote asset management, which, for example, can centrally diagnose maintenance needs and an asset's pressure points; and
- artificial intelligence to drive business processes and to engage with users to improve their experience.<sup>52</sup>

The uptake of new technologies to manage assets and deliver services is often more conducive through the private sector due to the need for investors to find innovative ways to maximise profits. However, governments can also ensure this is encouraged by putting in place transfer arrangements focused on these outcomes, particularly by ensuring there are conditions in place that align profit maximising incentives of investors with public benefits.

## Maintaining public ownership through leasing arrangements

The ongoing ownership of assets can remain in the public's hands by taking an asset leasing approach, as opposed to full asset sales. The use of asset leasing, either through long- or short-term arrangements and through franchising or concessions, ensure governments have greater control over an asset when transferred to the private sector while reaping many of the same benefits.

The language between lease and sale is often confused in the media and public debate around asset recycling. Many assets that were recycled under the Australian Government's 2014 initiative were leases. This includes the Port of Melbourne, New South Wales' 'Poles and Wires', Port of Darwin, and the Land Titles Office in South Australia.<sup>53</sup>

These examples enabled governments to take a controlled contestability approach to the ongoing management of the asset and set handback conditions.

Leasing of assets to the private sector can be more appetising for the public when assets have a history of being developed and controlled by the public sector. The Concessional leasing arrangement for London's Overground Network in the United Kingdom is an example of how this approach has led to increased public support and better service outcomes.

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<sup>51</sup> Department of Finance, Contestability Programme Guidelines (2015)

<sup>52</sup> NSW Business Chamber, Diversity and Contestability in the Public Service Economy (2012)

<sup>53</sup> Ibid.

### Case study 3: London Overground Rail Network



The Overground Network is a suburban network of rail services owned by Transport for London (TfL). The network is operated by Arriva Rail under a £1.5 billion concessional agreement for seven years.

Under this agreement TfL is responsible for setting fares and marketing services, and outlining service level requirements (SLRs) on how the network will operate. TfL retains all revenue and Arriva Rail is responsible for delivering services against the SLRs, managing all operations, rolling stock and infrastructure assets owned by TfL. Arriva Rail is paid through regular payments with bonuses or deductions based on performance.<sup>54</sup>

Performance and customer satisfaction on the network are exceptionally high when compared to other networks operating under franchising leasing arrangements. 94.6 per cent of trains arrived within five minutes of the schedule and 84.25 per cent of customers were satisfied over the last 12 months.<sup>55</sup>

This case study highlights clear service benefits from ‘allocative efficiency gains’, ensuring assets are being utilised effectively by removing broader policy obstacles and having clear SLRs in place.<sup>56</sup> The benefits of allocative efficiency gains should be explored and promoted further by governments.

### Providing additional revenue for governments

The central rationale for the Australian Government’s 2014 Asset Recycling Initiative was to unlock capital for states and territories to fund additional investments in infrastructure. Under the scheme, a total of approximately \$51.3 billion was unlocked from the transfer of assets to the private sector, helping states and territories to invest \$54.5 billion in infrastructure projects in addition to investments from other sources.

Despite the initiative no longer being in place today, the opportunity and benefits for state and territory governments to continue unlocking capital through an asset recycling approach remains.

The benefits from unlocking capital through asset recycling are highlighted by the New South Wales Government. The scale of infrastructure investments in New South Wales currently dwarfs every other state and territory, having grown to a total of 17.65 per cent of the state’s budget and totalling \$65.71 billion over the forward estimates. New South Wales’ asset recycling initiative has been credited as having allowed the state to substantially and sustainably increase these investments across successive budgets.<sup>57</sup>

On the contrary, Queensland Government’s stance against privatisation is impacting the state’s infrastructure investments. The percentage of infrastructure funding in the state’s budget has dropped compared to the decade average, and represents \$29.11 billion over the forward estimates. The IPA notes that Queensland will also struggle to maintain these investments levels over the long-term without reform due to constraints from high levels of debt.<sup>58</sup>

The ability to use revenue from asset recycling to substantially and sustainably increase funding for other infrastructure projects is a benefit that must be promoted further.

<sup>54</sup> TfL, London Overground Train Operating Concession (2016)

<sup>55</sup> TfL, London overground performance (2018)

<sup>56</sup> PwC, Funding Australia’s infrastructure – is it as simple as ‘ABCD’? (2014)

<sup>57</sup> IPA, Australia Infrastructure Budget Monitor 2018-19 (2018)

<sup>58</sup> Ibid.

## Delivering maintenance at a more efficient cost

Asset recycling can enable ongoing maintenance costs for infrastructure assets to be delivered more efficiently, which can ultimately result in savings for end users or taxpayers. A profit-maximising approach that is well controlled by governments will motivate private sector investors to maintain assets efficiently to avoid costs compounding. This differs to governments who may need to balance expenses with other priorities and politically challenging budget circumstances.

Shifting ongoing maintenance costs to the private sector can also improve the quality of assets. As service provision is often linked to revenue for operators or investors, the private sector will have a greater incentive to deliver a better-quality service through the notion of contestability and competition.

Furthermore, with around \$174 billion currently being invested in infrastructure by the Australian Government and state and territory governments alone over the coming years to 2020/21,<sup>59</sup> we are entering unprecedented territory with scale of infrastructure being delivered. While these investments are important for the economy and to enable growth, a challenge facing all governments is the considerable cost to maintain and upgrade these infrastructure assets over time – substantial ongoing maintenance costs that Infrastructure Australia highlight have not even been quantified by governments.<sup>60</sup>

The challenge of increasing maintenance costs for infrastructure is exacerbated when governments are not accounting for these costs in long-term budgets as ongoing operational expenses, instead funding infrastructure projects as one-off capital expenses.<sup>61</sup> This approach requires future governments to identify funding from other priorities to fund maintenance costs, increase government debt, or compound these costs by deferring asset maintenance requirements over the short-term.

To this end, developing a better understanding of ongoing infrastructure maintenance costs, both publicly and in government budgets, will help balance the conversation about the merits of asset recycling to addressing longer-term funding challenges.

## Setting handback conditions and key performance indicators

Asset leasing allows governments to set handback conditions and key performance indicators (KPIs) with enforcement provisions as part of the negotiations to transfer assets with private sector investors.

Handback conditions can require private sector investors to ensure assets are well maintained and agree an approach to delivering upgrades from the outset. This helps ensure assets are returned at a good standard, avoiding the asset being 'run into the ground'. Handback conditions also enable governments to clearly outline improvements that may not be feasibly delivered if the asset was to remain in public hands, due to broader political and policy challenges highlighted. Tasmania's rail infrastructure serves well as an example of where an ongoing failure to maintain assets by governments and private sector investors has resulted in assets deteriorating.

KPIs (or SLRs outlining required service outcomes) can require private sector operators to ensure an asset is operating to an acceptable standard by a private sector investor based on set performance requirements and minimum standards. Private sector operators are incentivised to meet or exceed KPIs through a performance-based payment approach (including bonuses and deductions) or by including exit clauses based on a failure to meet an acceptable standard.

The benefit of handback conditions and KPIs, with enforcement provisions, in driving improvements to the quality of an asset and user experiences, particularly for assets with limited competition, should be promoted further with the public.

## Increasing the focus on user pays

Shifting assets to the private sector can also help ensure those who benefit most from particular assets are contributing the most, as opposed to assets being cross-subsidised by taxpayers to deliver a service for users at a price that does not reflect cost. Asset recycling can help a steady shift to a more sustainable approach where prices for users reflect full cost recovery for the infrastructure provided.<sup>62</sup>

The principles of user pays can also positively influence user behaviour, particularly when implemented through a technology solution. A user pays arrangement can help an asset be managed more efficiently and support broader policy objectives (such as modal shifts) by optimising the way infrastructure is being used and paid for.<sup>63</sup>

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<sup>59</sup> IPA, Australia Infrastructure Budget Monitor 2018-19 (2018)

<sup>60</sup> Infrastructure Australia, Australian infrastructure plan: priorities and reforms for our nation's future (2016)

<sup>61</sup> ABC, Budget contains hidden investment 'timebomb' (2018)

<sup>62</sup> The Conversation, Should users pay the toll for Australia's infrastructure problem? (2013)

<sup>63</sup> PwC, Funding Australia's infrastructure – is it as simple as 'ABCD'? (2014)

In the Productivity Commission's 2014 inquiry report into public infrastructure, it was noted that user charges are the norm in many infrastructure sectors (including electricity, gas, telecommunications, water, ports, airports and public transport). The report recommends this approach should be used to the maximum extent that is economical as it provides a sustainable funding base to improve the use and augmentation of infrastructure when designed effectively. While the public have uncertainties around user charging, the report notes that infrastructure can only be funded from taxation, borrowing and direct user charging.<sup>64</sup>

The current tax model and desire to limit borrowing presents a significant challenge for infrastructure unless a user charging model is more widely embraced.

The benefit of a user pays model, as one approach to how infrastructure can be funded, must be promoted further, particularly on the important role it can play in:

- closing the gap between revenue collected from infrastructure and required expenditure; and
- creating a more equitable approach to current tax models that are based on the use of infrastructure, if designed through a dynamic approach.

#### Case study 4: Transurban toll roads in Brisbane, Melbourne and Sydney



Transurban is a road operations company that manages and develops toll roads in Australia, Canada and the United States. It was established in 1996 to manage Victoria's CityLink and today owns most toll roads in Australia and is the eleventh biggest public company in the country.<sup>65</sup>

While its monopolistic dominance of toll roads in Australia is questioned, particularly around a lack of competition at the bidding stage due to traffic data the company now holds,<sup>66</sup> it has normalised the concept of a road user pay model in Australia in lieu of upfront and ongoing public funding commitments to build new road infrastructure.

One benefit from a company the size of Transurban operating in Australia is that its current revenue has transformed the organisation into an 'infrastructure bank' capable of underwriting projects that governments either could not or would not be able to deliver alone.<sup>67</sup> The New South Wales Government's \$9.3 billion sale of a 51 per cent stake in WestConnex, ultimately merging a public-private partnership (PPP) procurement and an asset sale together, is a prime example of where the state has transferred risk to the private sector, freed up funding for additional infrastructure projects, and is still in a position to raise more revenue from the remaining 49 per cent stake in the project.<sup>68</sup>

<sup>64</sup> Productivity Commission, Public Infrastructure Inquiry Report – Overview (2014)

<sup>65</sup> The Age, Transurban: the making of a monster (2016)

<sup>66</sup> The Sydney Morning Herald, WestConnex sale makes sense but state still has a role (2018)

<sup>67</sup> The Age, Transurban: the making of a monster (2016)

<sup>68</sup> The Sydney Morning Herald, WestConnex sale makes sense but state still has a role (2018)



**Consult Australia believes the case for asset recycling is stronger when it helps unlock new capital for additional infrastructure projects.**

### **Strong appetite from private sector investors**

A strong appetite from the private sector, domestically and internationally, to invest in Australian infrastructure presents a significant opportunity for the public and Australian governments. Infrastructure assets are attractive for investors because they represent a long-term opportunity for investment profiles and enable sufficient time to improve assets through additional investments.

A research report by Industry Super Australia in 2016 titled *Industry Super and the Australian Economy* outlines this appetite from industry super funds in Australia to invest, particularly in unlisted assets.<sup>69</sup> AustralianSuper has also highlighted that a short supply of Australian infrastructure assets to invest in is sending this capital overseas instead.<sup>70</sup>

Demand from the private sector to invest in existing infrastructure is strong, and this presents an opportunity for governments and the public to get better value for money than seeking private sector investments for new infrastructure projects. This is because private sector investors are more likely to see risks and challenges in greenfield construction projects, which are often beyond the remit of investors.<sup>71</sup>

A stronger appetite for existing assets should encourage governments to promote the benefits of asset recycling over seeking private investment in new projects. This approach could promote a new cycle that represents better value for money to the public by following the below steps:

1. Governments publicly fund new projects;
2. Governments transfer mature assets to the private sector when they represent a lower-risk option, are a higher value, and are in the public interest; and
3. Revenue raised from asset recycling is reinvested back into new publicly funded projects.

Public benefits from funding infrastructure through the above approach, rather than seeking private finance upfront, should be explored and promoted further by governments.

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<sup>69</sup> Industry Super Australia, *Infrastructure boost critical for super returns and economy* (2016)

<sup>70</sup> SMH, *AustralianSuper has \$4b appetite for public infrastructure asset sales* (2015)

<sup>71</sup> PwC, *Global infrastructure investment: the role of private capital in the delivery of essential assets and services* (2017)

# CREATING THE RIGHT CONDITIONS FOR ASSET RECYCLING

Following Consult Australia's review of the challenges and benefits for asset recycling, this section outlines what we view as the right conditions required for successful transfers of assets to the private sector. These conditions focus on how governments can build a social licence with the public for asset recycling by focusing on longer-term impacts from asset transfers.

## Competition, contestability or regulatory controls

Asset recycling needs to be complemented with conditions that create sufficient competition, contestability pressures, or regulatory controls when the nature of an asset creates a natural monopoly. These conditions and controls are required to limit the profit maximising opportunities of private sector operators and to ensure a base level of standard for users of the asset.

Competition could be ensuring the privatisation of an asset, or network of assets, is structured in a way to ensure multiple private sector operators are in a market together to provide services to consumers.

Particularly when governments are unable to create sufficient competition, asset recycling arrangements should be structured in a way that creates regular contestability touchpoints. This could involve shortening the length of time for asset leasing arrangements and having regular tender processes to ensure the chosen private sector operator is delivering the best value for money. To this end, a contestability process should involve a review of previous performance in addition to proposals for the next leasing period.

Given the nature of how infrastructure assets operate, it is likely that open competition and contestability will be difficult to emulate alone in many circumstances. Like many other parts of the economy, governments should put in place arrangements that are protecting consumers and ensuring services are being delivered in line with public interests. In addition to general safety and security requirements on assets, regulatory controls should also protect consumers from the negative outcomes that result from unfair competition and unreasonable price hikes.

Regulatory controls to support asset recycling should include broad principles that are applicable to all cases (such as the contestability process, and performance reporting), and should also be tailored based on specific assets when required (such as capping profits).

## Asset leasing over asset sales

An asset leasing approach should be the preference in circumstances where governments believe there is an ongoing responsibility to ensure an asset is operating effectively and when sufficient competition cannot be created or emulated exclusively through regulatory controls. We therefore believe an asset leasing approach should be preferred in circumstances where contractual arrangement related to performance and service outcomes for users, and/or regular contestability touchpoints are needed to ensure an asset is operating in line with public interests.

Asset leasing provides the opportunity to review performance on an ongoing basis and to ensure minimum standards are being met. As we believe this opportunity is needed in most cases in order to deliver the best outcome for the community, asset leasing should be the preferred approach in all but exceptional circumstances. These exceptional circumstances should be when governments believe they should no longer have a role in a particular market, as was the case when the public stake in Commonwealth Oil Refineries Limited was sold to BP in 1952.

A preference for asset leasing, and a focus on transferring the operation of an asset rather than the ownership, will also likely address community concerns around privatisation and national sovereign interests.

## A true upfront public engagement process for asset recycling

The process for governments when developing asset recycling proposals should include an upfront public engagement that is truly gauging interest from the community. We believe seeking feedback from the community should not simply be a consultation that many may not be aware of, but it should instead focus on actively engaging and actively seeking views from the community about the merit of a proposal and if other options should be explored. The onus should be on those proposing a change to ensure there is support from the community, as opposed to the approach not being opposed in the limited input received.

When looking at the challenges facing asset recycling and privatisation more broadly, we see the key issue for governments as winning the public debate about the merits of these concepts and gaining support when seeking to transfer an individual asset to the private sector. This report highlights research that suggests many in the public are rejecting these concepts because of concerns about merits and that the impacts on users are not being listened to. To this end, truly engaging in a conversation with the public about asset recycling and the opportunities the concept presents, is one option to financing new infrastructure and unlocking capital, will be an important step towards re-building the social licence from the community on the topic. We believe Consult Australia and PwC's previous report, titled *Valuing Better Engagement: An economic framework to quantify the value of stakeholder engagement for infrastructure delivery*, provides an effective approach to ensuring public engagement processes are effective.<sup>72</sup>

## Handback conditions and enforcement provisions

All asset leasing arrangements should include clear handback conditions to ensure assets are in an acceptable standard at the end of a contract, and private sector operators are not maximising profits at the end of a lease by returning an asset that has been worn down. These handback conditions could include a requirement to implement an improvement plan for an asset that formed part of the leasing arrangement.

Handback conditions must be backed up by strict enforcement provisions. There must be a strong enough disincentive for private sector operators to not breach handback conditions, such as significant financial penalties and/or exclusions from future opportunities.

## A 'steward' approach – KPIs and performance funding

Asset leasing should be viewed as a steward arrangement. That is, a private sector operator is providing a service on behalf of a government for the public. We therefore believe that in order to ensure asset recycling is being delivered through a steward approach, it must be done by having clear KPIs determining alignment with public interests. These KPIs should be focused on service outcomes for users.

KPIs should be backed up by performance funding as this creates an incentive for private sector operators to manage an asset accordingly. The experience of the London Overground in the United Kingdom highlights how performance funding can ensure appropriate service outcomes are delivered and ultimately result in increased support from the public on the leasing arrangement.

## Testing longer-term impacts on user costs

The onus should be on governments to determine if asset recycling proposals stack up. Previous failures suggest governments have not informed themselves sufficiently to determine impacts on users over the lifecycle of a transfer arrangement, particularly around service standards and impacts from unrestricted profit maximising opportunities.

We believe governments should focus more on modelling the range of impacts that a transfer agreement will result in on user costs. This modelling should be used to inform a decision to ensure transfer arrangements are appropriate, or if additional measures or approach, are required to ensure services align with public interests. Having an informed understanding of longer-term impacts on user costs will be useful for selling the case for the transfer of an asset to the private sector, particularly during a public engagement process.

Arrangements for testing longer-term impacts on user costs should be in line with the approach for public private partnerships for new infrastructure projects, and consider a range of options.

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<sup>72</sup> Consult Australia and PwC, *Valuing Better Engagement: An economic framework to quantify the value of stakeholder engagement for infrastructure delivery* (2015)

## Invest proceeds from asset recycling into new infrastructure

We believe the case for asset recycling is stronger when it relates to unlocking capital for new infrastructure projects. Any transfer of assets to the private sector that results in an increase in capacity of the overall infrastructure network is a benefit that users can clearly understand and aligns with interests, particularly when viewed in the context of a congested or stretched network.

There is merit in flipping how asset recycling is viewed when considering investments in new infrastructure. If new projects are proposed first and this is followed by a discussion on appropriate financing approaches (such as capacity in existing budgets, shifting funding from other budget measures, increasing government debt, or asset recycling opportunities), the appetite for asset recycling from the public may increase.

### Case study 5: WestConnex



The WestConnex project in Sydney involves the construction of a 33 kilometre predominately underground motorway scheme. The project connects the M4 Motorway with the M5 Motorway, via a new link through the inner west of Sydney. The project is being constructed in stages up until 2023.

The project is being delivered by an innovative financing model which includes initial contributions from the Australian and New South Wales governments, with private sector debt and tolling revenue providing the remaining funding. The project was pitched as enabling government equity in the project to be 'sold down' to fund future projects, and later stages of WestConnex. This model has effectively enabled the New South Wales Government to manage the financing of the project from asset recycling elsewhere, and to also recycle its investment in WestConnex to fund later stages and projects elsewhere.<sup>73</sup>

The New South Wales Government's 'Rebuilding NSW' infrastructure programme invested \$1.8 billion in the project from asset recycling proceeds from long-term leases of parts of the state's electricity network.<sup>74</sup>

In August 2018, a consortium led by Transurban won the right to lease 51 per cent of the asset network for \$9.3 billion. This includes a 42.5-year concession over the asset network. A majority of the proceeds will fund part of the last stage of the project, with the remainder to be funded by borrowing and an additional contribution from Transurban. \$4 billion of the proceeds will also be used for investments in other infrastructure projects across the state.<sup>75</sup>

The remaining 49 per cent stake in WestConnex is currently held by the New South Wales Government, and is required to offer the stake to the Transurban consortium as a first right of refusal when it decides to sell. This will likely occur after construction for the full project is complete.<sup>76</sup>

While there are public concerns on WestConnex, particularly on community impacts, it is an example of a project funded effectively through asset recycling, enabling a project of this scale to be delivered.

<sup>73</sup> Sydney Motorway Corporation, \$1.7 billion funding secured for WestConnex

<sup>74</sup> New South Wales Government, Rebuilding NSW: Delivering on our \$20 billion infrastructure program (2017)

<sup>75</sup> SMH, Transurban wins big for majority control of Sydney's WestConnex (2018)

<sup>76</sup> AFR, Transurban secures control of Sydney's WestConnex with \$9.3 billion bid (2018)



**Consult Australia calls for the Australian Government to re-establish an improved asset recycling initiative focused on the ongoing transfer conditions rather than the upfront transfer price.**

### **Tangible benefits to users impacted by asset transfers**

Governments cannot exclusively focus on the macro public benefits of asset recycling. While a transfer to the private sector may result in significant additional funding for governments, many in the public will not agree with these benefits if they are not also being experienced on-the-ground, which in some circumstances is resulting in clear negative outcomes.

When considering public benefits of asset recycling, governments should also focus on ensuring these are tangible for those impacted by the change. We see this as critical for increasing public support, particularly given those who are negatively impacted are often the most vocal in their concerns. Governments should therefore be ensuring users of assets are benefiting from asset recycling through clear improvements to service outcomes, and investments in new infrastructure in the community surrounding the asset.

# FUTURE OPPORTUNITIES – RECOMMENDATIONS FOR GOVERNMENTS

This section outlines Consult Australia’s recommendations for achieving social licence from the community for asset recycling. Our recommendations therefore seek to address the challenges and maximise the opportunities for asset recycling that have been outlined in this report.

We believe the primary focus of governments should be ensuring transfers of assets to the private sector deliver long-term benefits to the community throughout the lifecycle of an asset, and not just at the upfront point of transaction.

## **Recommendation 1: Renew asset recycling policies centred around eight key conditions**

Given previous shortcomings around asset recycling, Consult Australia believes the onus is now on governments across Australia to truly demonstrate to the community that transfers of assets to the private sector can deliver public benefits. This requires governments to focus less on maximising the upfront value of an asset, and to instead go back to basics by ensuring the right conditions are in place that deliver community improvements and quality service outcomes for users.

Consult Australia believes current policies focused on asset recycling, and those more broadly focused on delivering infrastructure and services in partnership between the public and private sector, are not achieving this outcome, and instead deliver an approach to asset recycling that appears ad hoc. We therefore recommend governments across Australia renew policies related to asset recycling, by focusing on the importance of social licence as the first principle for successful transfers. These policies should adopt the eight key conditions for asset recycling outlined in this report, as listed below.

- Asset recycling must be underpinned by competition, contestability or regulatory controls that protect public interests by appropriately limiting the profit maximising opportunities of private sector investors.
- A preference to transfer assets to the private sector as a lease as opposed to a full sale, continuing government ownership and instead shifting the ongoing operations of assets to the private sector.
- All asset leases should include clear handback conditions relating to ongoing maintenance and upgrades, managed through strong enforcement arrangements.
- Ensuring asset transfers are structured as ‘steward’ arrangements which include performance indicators and funding schedules aligned to service outcomes.
- An asset recycling process that includes a requirement for governments to model longer-term impacts on user costs from asset transfers to the private sector.
- An asset recycling process that includes an upfront public consultation to provide an opportunity to understand and address community concerns before an asset is transferred to the private sector.
- Re-investing proceeds from asset recycling into new infrastructure projects.
- Ensuring asset recycling is resulting in tangible benefits for users impacted by transfers to the private sector, through service improvements and/or re-investing some of the proceeds on infrastructure needs in the surrounding area.

## Recommendation 2: Re-establish an Australian Government Asset Recycling Initiative

The asset recycling approach of state and territory governments must be aligned across Australia. It is important that no jurisdiction falls behind with a structural funding gap that limits their options in meeting future infrastructure needs, which ultimately impacts end users and the local economy.

The Australian Government has an important role to play in driving consistent reform across the country to improve how states and territories plan, deliver and manage infrastructure assets. As highlighted by Infrastructure Australia, the Australian Government is best placed to address the current 'vertical fiscal imbalance' between jurisdictions by using its responsibility to address disparities (through funding allocations) as a tool for implementing reform.

We recommend the Australian Government re-establish an improved Asset Recycling Initiative to improve the approach taken across the country. The initiative should be designed around the below principles.

- Increasing the appetite of states and territories to explore asset recycling options through an incentive scheme.
- A nationally consistent approach to asset recycling focused on improving service outcomes for users, delivering tangible public benefits, and aligning with national interests.
- A national view on appropriate asset recycling by asset type and transfer conditions.
- Encouraging the uptake of new technology to manage assets more efficiently and to improve the user experience through asset transfers.
- Requiring states and territories to reinvest all proceeds from asset transfers into new infrastructure to be eligible under the incentive scheme.
- The incentive scheme should not be based on the asset transfer price. Instead, the incentive scheme should be based on an assessment against the Australian Government's position on appropriate asset recycling, discouraging the desire to maximise the upfront value of an asset at the expense of transfer conditions.
- Including some balance across states and territories in regard to funding contributions. The incentive scheme should no longer be a 'first in, best dressed' approach. Instead, funding under the scheme could be limited by caps for each jurisdiction.

Consult Australia's primary concern with the previous Australian Government Asset Recycling Initiative was that the incentive scheme was focused on asset transfer transaction prices. We believe this can encourage a 'race to the bottom' where impacts on service outcomes from the transfer are not considered. We recommend an incentive scheme should focus on performance of the asset, and consider the historical approach taken by states and territories to improve service outcomes through asset recycling.

Lastly, we also believe an Australian Government Asset Recycling Initiative could also directly identify opportunities to transfer assets to the private sector across states and territories, and provide subject-matter expertise to assist with the transfer process.

## Recommendation 3: Link asset maintenance costs to infrastructure investments

Currently, governments across Australia are not accounting for longer-term asset maintenance costs when investing in new infrastructure. This runs the risk that we are creating a 'maintenance deficit' in the future.

A failure to account for longer-term maintenance costs will require future governments to identify funding by:

- Shifting funding from other budget measures;
- Increasing government debt; or
- Compounding these costs by deferring maintenance requirements over the short-term.

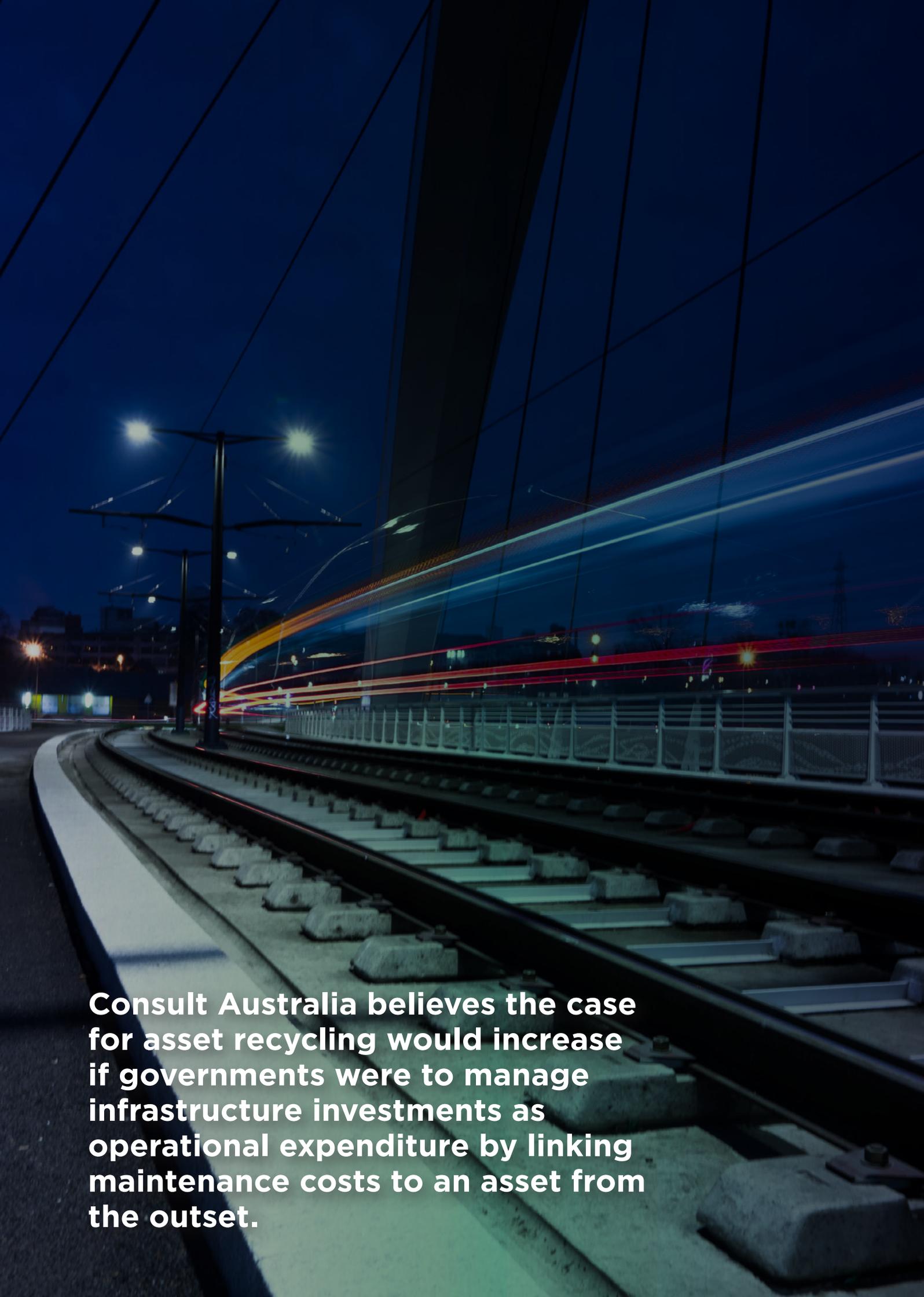
We believe if governments were to clearly identify maintenance costs linked to asset types, and the impact on government budgets from the outset of a project, it would help balance the conversation about the merits of asset recycling for addressing longer-term funding challenges. To assist with changing the debate around the ongoing funding of infrastructure, Consult Australia recommends governments across Australia manage infrastructure investments as operational expenditure, similar to the approach taken by New Zealand, as opposed to one-off capital expenditure.

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<sup>69</sup> Industry Super Australia, Infrastructure boost critical for super returns and economy (2016)

<sup>70</sup> SMH, AustralianSuper has \$4b appetite for public infrastructure asset sales (2015)

<sup>71</sup> PwC, Global infrastructure investment: the role of private capital in the delivery of essential assets and services (2017)



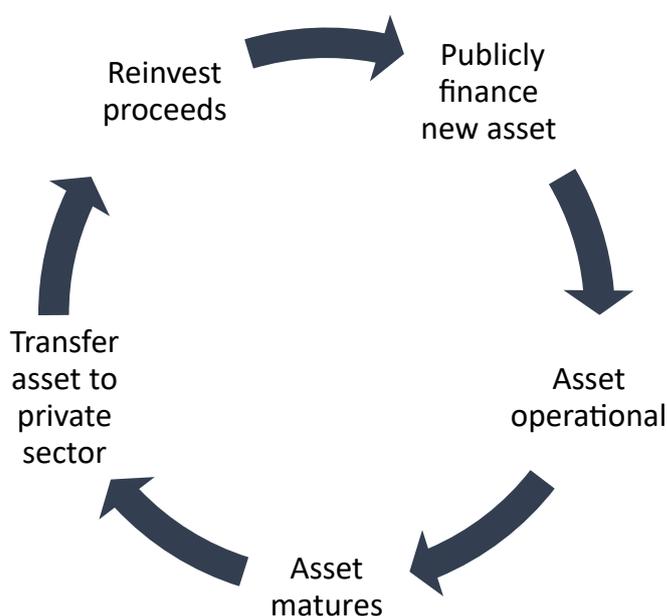
**Consult Australia believes the case for asset recycling would increase if governments were to manage infrastructure investments as operational expenditure by linking maintenance costs to an asset from the outset.**

## Recommendation 4: Investigate the merits of an investment cycle supported by asset recycling

Consult Australia believes governments across Australia should investigate if there are circumstances when publicly financing new infrastructure upfront with the intention to transfer the asset to the private sector when matured can deliver better value for taxpayers than seeking private sector finance upfront.

As highlighted in this report, private sector investors often see a reduced risk involved with investing in mature assets as opposed to those under development. This is because of risks associated with cost blowouts during the design and construction phase, and because the performance of the asset is more certain when it is operational. As a consequence, these risks will often be factored into how much a private sector investor is willing to invest in the infrastructure asset before it is operational.

Rather than governments seeking to maximise the value of an infrastructure asset through the transfer conditions to the private sector, we instead recommend governments better understand how an asset changes in value throughout its lifecycle, and to maximise these opportunities when considering private sector involvement. The table below outlines how this approach could work through an infrastructure investment cycle.



*Table 9: Infrastructure investment cycle supported by asset recycling*

An infrastructure investment cycle supported by asset recycling, as outlined above, enables governments to deal with risks associated with delivering new projects, which in some circumstances may be the preferred approach and in the best interests of taxpayers. This was the original plan for WestConnex in New South Wales and is currently the approach for North East Link in Victoria.

<sup>73</sup> Sydney Motorway Corporation, \$1.7 billion funding secured for WestConnex

<sup>74</sup> New South Wales Government, Rebuilding NSW: Delivering on our \$20 billion infrastructure program (2017)

<sup>75</sup> SMH, Transurban wins big for majority control of Sydney's WestConnex (2018)

<sup>76</sup> AFR, Transurban secures control of Sydney's WestConnex with \$9.3 billion bid (2018)

## **Recommendation 5: Investigate if current road user pays arrangements can be leveraged further**

As outlined earlier in the report, one of the key challenges around asset recycling is the perception that some assets are 'free' to use, and others have a cost. Assets can only be funded from taxation, borrowing and direct user charging, which is inconsistently applied across asset types. The results are that some assets, particularly road infrastructure, are providing a service at a price that does not reflect actual costs.

Changing vehicle technology, particularly the uptake of electric and fuel-efficient vehicles, will exacerbate this problem. These changes are significantly disrupting the current tax model associated with the use of vehicles on roads. If left unchanged, governments will continue to see a gap grow between the revenue they are collecting from the use of roads and the required expenditure to meet growing demand on road infrastructure.

To this end, we believe a network-wide road user charging model, complimented by asset recycling, can address this funding gap. A network-wide approach to road user charging, as opposed to the asset-by-asset approach currently taken in major urban centres, would ensure costs associated with the use of roads is funded by those who benefit most from their use. It would also ensure assets are optimised more efficiently if supported by a dynamic approach, potentially helping to ease congestion and reduce environmental impacts.

A network-wide road user charging approach provides an opportunity to ensure the user experience between privately and publicly operated roads is seamless. This would enable road assets to be transferred to the private sector without changing how a user pays to use the asset, which addresses the main concern with privatising roads and this report's earlier conclusion that public concern with privatisation increases when there is a greater direct impact on the general public.

Consult Australia therefore recommends that the Australian Government take the lead on pursuing a road user charging model to support the transition from traditional vehicle types to next generation vehicles. To provide further thought leadership in this space, Consult Australia will also be releasing a policy report on this topic in late 2019.

## **Recommendation 6: Require the FIRB to undertake public consultations as part of their review process**

Given the unique sensitivities around the public debate on foreign investment and privatisation, we believe the FIRB should consider public opinion and undertake public consultations as part of their review process. We believe giving the public an opportunity to outline concerns about particular foreign investments and requiring the FIRB to respond to these concerns when making a decision will help increase transparency and help the public better understand merits and concerns on the topic in Australia.

A failure to truly engage with the public about privatisation and the role of foreign investment is arguably the reason why the community is sceptical on these concepts. Consult Australia therefore believes having a balanced conversation with the Australian public about the concepts of privatisation and foreign investment, and on individual cases, will go some way to building a social licence around exploring asset recycling as an option when the numbers stack up.

# CONTACT US

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