# TOP 10 TRENDS IN AUSTRALIAN INFRASTRUCTURE

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Legal Briefings – By **David Ryan** and **Aldrin de Zilva**

Herbert Smith Freehills advises across all aspects of the Australian infrastructure sector. This, together with our global operations, allows us to observe the key macro-level trends affecting infrastructure investment in Australia. This publication highlights the top 10 trends we are currently seeing.

In short, infrastructure investment in Australia faces several challenges but still presents a much more positive outlook than many other jurisdictions. Considerable opportunities exist for those investors who can recognise the opportunities and react accordingly.

Further to the trend summaries below, additional detail on each trend can be accessed by clicking on the relevant sub-heading.

### 1. Reduced brownfield investment opportunities

Opportunities for investors to acquire State and Federal infrastructure assets have reduced as the State and Federal privatisation programs slow and the pro 'asset recycling' governments of NSW and Victoria have largely exhausted the core infrastructure assets available – or publically acceptable – to privatise. The election of anti-privatisation governments in WA and Queensland abruptly halted privatisation activity in those States some time ago, and there are no signs yet of any change of view in those States. Meanwhile, many infrastructure investors face significant pressure to deploy accumulating investor funds.

This is resulting in intense competition for any remaining brownfield infrastructure transactions of scale and a willingness from investors to expand the scope of what is regarded as "infrastructure". We are seeing investors consider unlevered transactions and unsolicited proposals, searching for offshore investment opportunities and moving down the risk curve by showing a greater willingness to look at greenfield and development infrastructure.

## 2. Demographics are driving greenfield projects

Experts predict Australia's population to double in the next 50 years. The Federal Treasury's Intergeneration Report from 2010 (*Australia to 2050: future challenges*) forecast a national population of 35.9 million by 2050. The Australian Bureau of Statistics currently forecasts the Australian population to increase by up to 42 million people by 2056. Most of this growth will occur in Sydney and Melbourne. Australia's infrastructure needs to keep pace with this expected population boom.

Over the past year we have seen the Federal and State governments intensify their focus on developing transportation infrastructure, including road, rail, airport and intermodal facilities. By investing in this type of infrastructure, governments are seeking to increase efficiencies and capacities across the national supply chain. This is to ensure Australia remains competitive in the global market-place and can cope with the projected increase in the national freight task and continued urban population growth. Recent examples include the Western Sydney Airport and road and rail projects, Melbourne Metro, Sydney Metro, Inland Rail, Parramatta Light Rail, NSW Regional Rail, Cross River Rail and intermodal terminal development. We expect to see further significant activity in these sectors.

## 3. Outcomes-based approach to social infrastructure

Governments are increasingly looking to involve the private and not for profit sectors in public service provision: eg. hospitals, social housing and prisons. This is driven by budgetary pressures, population growth and a desire to encourage innovation in service delivery.

This requires different ways of thinking about what assets and services are being provided by the private sector to Government. For example, the cost to Government of providing services over the long term can be much greater than the cost of building the facility in which those services are provided. Where this is the case, we expect to see a greater focus in Government procurements on the desired outcome of the service rather than the development of a specific asset or provision of a specific service, particularly if the accounting treatment allows the supply/service arrangements to be off the Government's balance sheet.

In the case of social and affordable housing - a major issue for Governments across the country - the solution requires Government, the infrastructure sector and not-for-profit organisations to think of social housing as a service as they develop innovative new models, unlock land, and attract more private capital. Governments are employing a large range of initiatives to achieve this, presenting significant opportunities for infrastructure investors.

## 4. Asset recycling is quickening pace

“Privatisation” is often a dirty word in Australian politics. The NSW Government cleverly repositioned asset sales as “asset recycling” initiatives, taking much of the heat out of the privatisation process. The key difference with traditional privatisation programmes is that under asset recycling the Government commits to use the proceeds of asset sales to fund additional infrastructure development rather than paying down debt or simply funnelling the proceeds into the Government’s consolidated funds.

The asset recycling model also appears to be evolving, with Governments now using public capital to “seed” new infrastructure development and introducing private sector infrastructure investors at a much earlier stage. The Government takes some or all of the development and construction risk, and then sells down to infrastructure investors to fund its remaining contribution to finalise development of the project, and to recycle its capital into developing further projects. The proposed WestConnex toll road transaction in NSW is an example of this evolving model.

**5. Awareness of the opportunities presented by unsolicited proposals**

While unsolicited proposals are not a new phenomenon, investors are becoming increasingly aware of the opportunities that their incumbent positions and existing assets may hold in opening up greenfield or redevelopment project opportunities. Unsolicited proposals allow investors to use existing assets to develop and finance new infrastructure, including through models such as extending existing concessions (see NorthConnex).

Governments are bound by requirements for competitive and open processes. The unsolicited proposal regime is a significant exception to this. The requirement of every unsolicited proposal is “uniqueness”. From the very outset the private sector must convince the Government that the relevant proposal is so unique that it cannot be delivered by any other party nor be a potential outcome of a competitive procurement process. The existing ownership of substantial infrastructure assets, whether in the form of unexpired concessions or significant real estate which is central to the expansion of existing infrastructure, is the catalyst for potentially unique proposals to be framed by the market.

**6. Using technology to do more with less**

Infrastructure owners are seeking to unlock more capacity and efficiency from their existing assets. This includes getting more from less: either by the expansion of existing assets, or the better utilisation of existing capacity. For example, better signalling and network management tools are being used to increase the utilisation of train networks and the number of services available. Sector-specific technology is central to this trend.

Technology is also improving infrastructure operations and maintenance activities. For example, remotely piloted aircraft (ie. drones) have the potential to change the way infrastructure owners conduct their maintenance and inspection activities, offering both safety and efficiency improvements. Despite initial scepticism, autonomous vehicles and door to door transport solutions are now being seriously considered.

There is also a strong trend among infrastructure owners to search for new revenue streams from existing assets. This is particularly prominent amongst Australia's privately-owned airports, which have sought to diversify their revenue streams, including the commercial development of unused land.

### 7. Social and ethical investment

Social and ethical (or "impact") investment in Australia has significantly increased in recent years. This has been prompted in part by retail investors wanting their superannuation assets to be deployed into investments with a social, economic or environmental benefit, in addition to a financial return.

The demand for ethical or sustainable investing has resulted in over 50% of all professionally managed assets in Australia operating under responsible investment strategies. There is a broad range of metrics and rationales that investors apply when assessing these criteria – for example, the Future Fund overtly states that its environmental, social and governance policies will ultimately support its long-term maximisation of returns.

There is also a movement for infrastructure investments to consider broader social issues, through the development of models focussed on service demand and supply within a region or precinct. More sophisticated models in the social infrastructure sector are requiring investors to focus on desired outcomes such as preventing future service demand through education, safety measures and other programmes to reduce the demand for future health and corrections services.

### 8. Increased political and regulatory uncertainty

The current Australian political environment is extremely partisan and is subject to large swings. We have seen great volatility in Federal and State politics, significant differences in policy positions between political parties for individual projects and the rise of populist policies.

These factors have created a tendency for significant policy "flip-flopping" between respective political positions. A small number of commenced projects have subsequently being unwound following a change of Government, a situation that does not assist investor certainty. Australia's foreign investment policies have left foreign investors unclear about Australia's position on investment by certain nations in sectors such as energy and agriculture.

Similarly, conflict over climate change policies and philosophical disagreement about energy fuel sources threatens to paralyse the Australian energy sector at a time of significant change and technology disruption, triggering security of supply and affordability issues, and further investor uncertainty.

### 9. A return to heavy handed regulation?

Australia has seen the privatisation of a number of assets with monopoly like characteristics, but without significant regulatory pricing controls. The East Coast ports are a major example. The recent Federal Court decision between Glencore and the Port of Newcastle demonstrates that the freedom afforded to infrastructure investors to increase their prices may not be unconstrained. At the same time the Federal Government has acted to reduce the ability of investors to challenge the Australian Energy Regulator's revenue cap determinations for energy networks and there are proposals to re-introduce retail energy price regulation.

Governments are also focussed on the security of essential infrastructure, from the risks posed by a wide range of potential events including foreign ownership, terrorism (cyber and otherwise) and extreme weather events. The evolution of the newly-established Critical Infrastructure Centre will be watched with interest.

These changes signal a movement back to increased regulation of Australian infrastructure, and a need for investors to re-evaluate their regulatory assumptions.

**10. An activist ATO**

The Australian Tax Office is becoming more active in its consideration of infrastructure investments and investor structuring. This includes when the ATO is consulted by the Foreign Investment Review Board during the foreign investment approval process.

The ATO has revised, or is reviewing, its position on some significant aspects of infrastructure investment, including the use of stapled structures, related party debt and concepts of investor control (and in particular whether shareholder minority protections constitute "negative control"). In 2017 the ATO released Taxpayer Alert TA 2017/1, the draft Privatisation and Infrastructure Framework and updated draft positions on control for the purposes of Division 6C and the pricing of cross-border related party debt. The ATO's views on control are potentially significant as they could cause existing structures to be viewed as trading trusts. The interpretations on control being taken by the ATO for the purposes of section 102N of the *Income Tax Assessment Act* 1936 (Cth) do not necessarily align with the negative control test in section 50AA of the *Corporations Act* 2000 (Cth).

These positions, if fully implemented, will significantly impact the structuring and tax treatment of both new and existing infrastructure investments in Australia. They may also affect the attractiveness of Australian infrastructure investments to offshore investors. They may require the re-opening of existing investment structures, and the development of alternative investment structures and minority investor protections.

# KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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