QIC

BUDGET INSIGHTS

MAY 2017

THE 2017/18 AUSTRALIAN BUDGET
Changing the fiscal landscape – an infrastructure perspective

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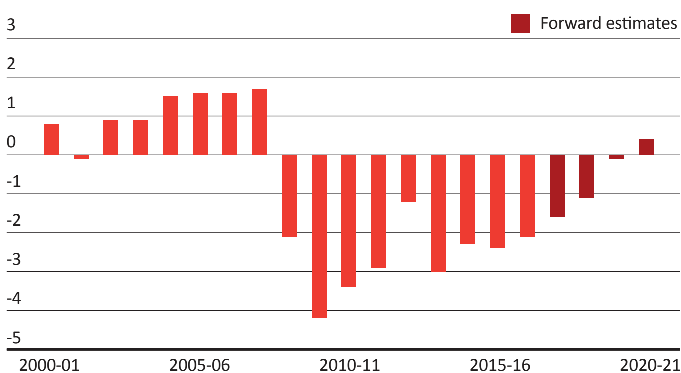
THE PROMISE OF CHANGE

Scott Morrison's 2017/18 Budget seeks to reframe Australia's fiscal landscape. Gone are over $13 billion of unlegislated and unpopular *zombie* budget cuts from the Abbott/Hockey era.

The government is seeking to meet Labor half-way on health and education, with the re-indexation of Medicare payments and Gonski 2.0. The Budget also opens the possibility of negotiation around various tax policies such as the Medicare Levy and the Budget Repair Levy with a greater chance of compromise and progress than has been the case over the last four years.

Figure 1: Australia – Federal Budget balance
(% of GDP)



Sources: ABS, QIC, Budget Papers

A RESPONSIBLE BUDGET

The Budget is fiscally responsible. Economic projections appear reasonable, although slightly more optimistic than QIC's. While growth and wage forecasts are higher than QIC's and consensus forecasts, we estimate that our softer view on the economy deteriorates the Budget by around $6 billion over the four years of the forward estimates (i.e., 2017/18 to 2020/21).

This means that in the final year of the forward estimates (2020/21) the Budget surplus would be $6 billion instead of $7.4 billion, as projected by Treasury. This differential between Treasury and those implied by the consensus of Australian forecasters is well within a tolerable range of error.

Federal government net debt peaks at 19.8% of GDP in 2018/19 before gradually drifting lower. Ratings agencies have shown support for the Budget. Moody's and Fitch have noted the budget is consistent with Australia's AAA rating.

Importantly in this Budget, the government has sensibly refrained from making rash decisions around stapled ownership structures, preferring to engage the industry further by extending its current review until the end of July 2017. QIC's assessment of the debate around stapled ownership structures is presented in the Special Box section of this report.

A NEW APPROACH TO INFRASTRUCTURE

The Budget also pursues a significant $75 billion infrastructure program. In addition, it proposes a new funding model, with the potential for a clear line-of-sight between a Federal government-based build-and-operate phase and a transfer phase to the private sector. This represents a movement away from a predominantly State based approach historically driven by Federal government grants.

Figure 2: Federal government infrastructure program

Major government projects	$ billion
National rail program	10.0
Melbourne to Brisbane Inland Rail	8.4
Western Sydney Airport	5.3
Snowy Hydro 2.0	2.0
Other projects	50.0
Total	**75.0**

Source: Budget Papers

INFRASTRUCTURE SPENDING AND THE AUSTRALIAN ECONOMY

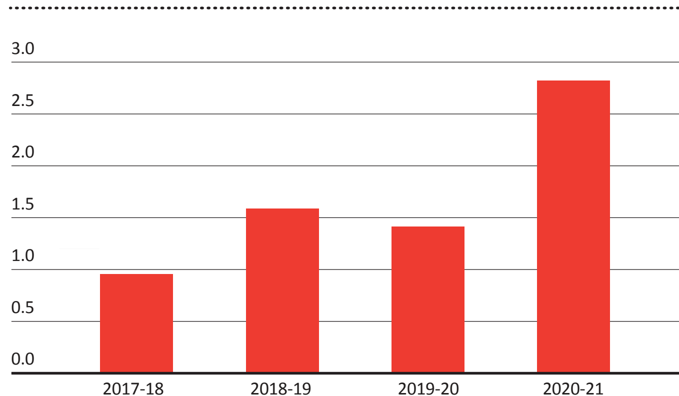
The government's program promises to unleash infrastructure spending that will assist in the current post-mining capex transition of the Australian economy.

The economy will benefit from the infrastructure program in three important ways.

1. When the infrastructure becomes operational, it facilitates efficiencies in economic activity. Without continual renewal and development of infrastructure, Australia risks reducing its competitiveness in international markets.
2. Spending during the construction phase of the infrastructure program tends to soak up unutilised and under-utilised resources, delivering a multiplier impact on the economy. In our analysis of infrastructure spending, we find a multiplier of 1.4 for transport infrastructure projects such as those proposed in the Budget. This means that for every $1 spent on the construction of infrastructure a further spending of $0.40 is created in the economy, as industries along the supply chain are stimulated and as additional income growth also stimulates general spending in the economy.
3. Additional economic growth increases the government's tax base generating a growth dividend for the Budget.

While reasonably modest at $75 billion spread over 10 years, our simulations indicate the increased infrastructure spending will generate around 25 basis points of additional real GDP growth over the coming four years and deliver a Budget growth dividend of around $6 billion.

Figure 3: Growth dividend impact on Budget from infrastructure investment
($ billion)



Source: QIC

PROSPECTS FOR INFRASTRUCTURE INVESTING IN AUSTRALIA

Infrastructure is clearly a focus of the Budget and the Australian government. The new infrastructure program allows for more private sector involvement and while Western Sydney Airport and Inland Rail are to be built by the Federal Government, it is likely that these large scale assets will be privatised in the future.

The government is keenly aware of the economic benefits that large infrastructure spending bestows on the Australian economy. In this note, we have quantified the significant growth and fiscal benefits of the government's current infrastructure program over just the first four years of its construction phase. More benefits from the infrastructure program will be delivered once the infrastructure becomes operational.

In addition to the government program, the private sector is also spending significant amounts on both ongoing maintenance capital expenditure and on Greenfield infrastructure projects. Together with its partners, QIC is engaged in around $8 billion of new infrastructure expenditure.

Figure 4: QIC infrastructure expenditure

Major QIC projects	$ billion
North Connex tunnel Sydney	3.0
Port of Brisbane Motorway	0.2
Brisbane Airport second runway	1.4
Powering Australia Renewable	3.0
Other projects	0.5
Total	**8.1**

Source: QIC

Given the government's focus on infrastructure as a key enabler of the Australian economy, we remain optimistic that in its tax review of stapled ownership structures, the government will give ongoing support for current arrangements for core public benefit infrastructure in Australia.

CONCLUDING REMARKS

By breaking the Senate deadlock around zombie measures and opening the door for a long term infrastructure program, the 2017/18 Australian government Budget seeks to reframe Australia's fiscal landscape. The Budget is fiscally responsible, with a real chance of surplus by 2020/21. This has been confirmed by ratings agencies, which have shown support for the Budget. QIC is encouraged by the government's willingness to compromise on policy. We look forward to a more bipartisan approach to public finances between the government and the Labor opposition.

SPECIAL COMMENT: REVIEW OF STAPLED OWNERSHIP STRUCTURES

The Australian Taxation Office ("ATO") has been reviewing stapled ownership structures over recent years, culminating in the release of their January 2017 Draft "Privatisation and Infrastructure – Australian Federal Tax Framework" document. This document can be commended for publicly articulating, for the first time, the ATO's views on how stapled ownership structures should be established and operated.

However, this document and subsequent ATO consultation has raised two major concerns amongst sophisticated long term infrastructure investors.

1. The ATO is already retrospectively applying their views and actively attacking past transactions/structures.
2. They have also made it clear that they believe all infrastructure staples are potentially a breach of Australia's general anti-avoidance rule ("Part IVA"). "Litigator's prerogative", an ATO phrase, enables them to decide which structures to attack (e.g. private to private transactions) and which to leave be (privatisation transactions).

These practices are clearly at odds with:

- advice obtained from leading tax advisors when stapled structures holding long term public benefit infrastructure were established;
- infrastructure privatisations by States since 2012 promoting stapled structures with the ATO having a significant supporting role via related private rulings and bidder engagement; and
- the ATO completing tax reviews of stapled structures without concern in the past and providing private rulings to stapled structures about associated tax matters whilst having knowledge of the stapled structure.

Restructuring an existing stapled structure to comply with current ATO views is a difficult and timely exercise, even before attempting to unpick any perceived historical tax liabilities and dealing with the threat of an attack under Part IVA. For future transactions, uncertainty around Part IVA makes it difficult to undertake a stapled infrastructure transaction.

During a public briefing session organised by the ATO in Sydney on 22 March, investors and tax advisors were left confused as to what type of land and infrastructure assets the ATO would accept in stapled structures.

Two days following the briefing, Treasury released a consultation paper asking for submissions by 20 April. Treasury's paper raised prospects of eliminating both past and future stapled structures. Foreign investors and domestic tax-exempt investors, who are unable to obtain a refund of franking credits, would be the most impacted, although QIC believes that in the near term all investors would suffer a reduction in the market value of their Australian stapled structure infrastructure investments.

QIC understands that there have been a large number of submissions from domestic and foreign infrastructure investors, investment managers, industry bodies and the tax advisors in response to the paper. Below are the key points from QIC's submission.

- Stapled structures are the favoured holding structure for long term capital intensive infrastructure because it enables more efficient debt financing, more efficient cash extraction and allows for a more level playing field for different types of investors, which in turn permits a broader and more liquid market for infrastructure equity. This is the primary reason QIC and other Australian infrastructure fund managers have set up funds like the QIC Global Infrastructure Fund and QIC Infrastructure Portfolio as stapled structures (noting funds are not an intended target of the ATO or Treasury reviews).
- Any legislative or administrative changes impacting future transactions need to consider the cost of equity capital for long term capital intensive assets like public benefit infrastructure. A move to taxation under the corporate tax system at a comparatively high 30% rate will ultimately increase the cost for government procurers and public-end users as investors are unlikely to fully absorb tax increases in a competitive world market, regardless of how well Australia rates on other investment risk metrics.
- Any legislative or administrative changes adversely impacting past transactions will reduce the market values of existing investments which are predominantly held by Australian and foreign superannuation funds, have a material impact on the pricing, quantum and availability of debt financing for these assets and may even result in contractual breaches by investments in some cases. For these reasons, public benefit infrastructure, properly set up in accordance with contemporaneous advice from leading tax advisors, should be grandfathered.
- Being supportive of new rules to prevent abuse of stapled structures and ensure existing tax concessions are appropriately targeted.

We remain optimistic on the likely outcome of the review, especially since the government is now not rushing on what is a very sensitive matter. Further, the new measures to enable MITs to make investments in affordable housing are encouraging in that government must consider that MITs (being a key element of stapled structures) remain an effective tax tool to encourage long term investment by investors.

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