Joint
IFM, AIST and ISN submission

Tax loss incentive for designated infrastructure projects
Discussion Paper October 2011

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Industry SuperFunds
Industry Super Network

Australian Institute of Superannuation Trustees

Background

On 10 May 2011, the Government announced that they would introduce a new infrastructure tax incentive to promote private investment for infrastructure projects designated to be of national significance. This infrastructure tax incentive is part of a broader package of reforms to build the infrastructure Australia needs to compete in the twenty-first century.

Following is a joint submission from Industry Funds Management ("IFM"), The Australian Institute of Superannuation Trustees ("AIST") and Industry Super Network ("ISN") in relation to the contents of the 'Tax loss incentive for designated infrastructure projects' Discussion Paper October 2011 ("The Discussion Paper").

IFM

IFM is one of the largest global infrastructure investment managers, and participates in both equity and debt financing of infrastructure assets in Australia. As at 30 June 2011, IFM managed $30 billion across four asset classes[1] on behalf of institutional investors, including major Australian superannuation funds. IFM is owned by 32 leading not-for-profit Australian superannuation funds.

AIST

The Australian Institution of Superannuation Trustees (AIST) is a national not-for-profit organisation whose members are superannuation fund trustee directors and officers of industry, public sector, and corporate superannuation funds who operate with a representative Trustee Board of Directors.

AIST advocates on behalf of its members, it undertakes research, develops policy and provides professional training, consulting services and supports trustee directors and staff to help meet the challenges of managing superannuation funds and advancing the interests of their fund members. AIST members manage $450 billion of retirement savings for Australian workers.

ISN

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members.

[1] IFM manages products across the infrastructure, debt investments, private equity and listed equities asset classes.

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Executive summary

IFM, AIST and ISN welcome the opportunity to participate in the consultation process.

We support the public policy goal of facilitating well-targeted investment in physical infrastructure, and agree with the Government's position articulated in the May 2010 Regulation Impact Statement that meeting Australia's infrastructure needs will involve attracting private financing to projects.

However, we are concerned that the proposed measures will have little or no impact on the appetite of superannuation fund investors for greenfield infrastructure investment.

The fundamental barriers to superannuation funds investing in financing greenfield infrastructure projects such as the lack of project pipeline, complex and costly bid processes, and regulatory risk remain to be addressed.

Our submission focuses on the proposed tax loss incentives. However, we would be pleased to discuss the broader issues central to infrastructure investment by superannuation funds.

In relation to the Discussion Paper, our key comments are:

- The uplifting of tax losses at the 10 year government bond rate does not reflect an investor's true cost of capital, and ultimately offers little real financial incentive once investment returns are distributed to an investing superannuation fund.

- Further details of the process for conferring designated status need to be developed. The process should be efficient and timely to facilitate investment decisions.

- The "first come basis" is inappropriate and inefficient as it will mean that those projects that are closest to being ready for assessment will receive the funding, not necessarily those projects that are most useful or the best projects.

- We propose that the rules should contemplate and address whether certain activities should be permitted to be carried on without jeopardising the designated status.

Commentary

IFM, AIST and ISN broadly support the intent of the proposed tax loss incentives.

However, we are of the opinion that creating incremental "value" in projects through these measures will have a marginal or no impact on the appetite of superannuation fund investors for greenfield infrastructure investment.

In itself the proposal does not address the fundamental reasons why superannuation funds are not more active in financing greenfield infrastructure projects – it does not address the fundamental risk/return dynamics in these kinds of projects. Some of the more fundamental issues that need to be addressed in order to stimulate more super fund investment in greenfield infrastructure developments include:

a. lack of a defined pipeline of projects;

b. a lack of innovation in PPP models coupled with long and uncertain bidding processes involving substantial bid costs; and

c. political and regulatory risk (e.g previous experience of government not following its stated process in a PPP tender).

The issues influencing the capacity of super funds to invest in infrastructure are complex and cannot be sensibly addressed by any single level of Government. The establishment of Infrastructure Australia is an important step in developing a pipeline of national priority projects, however further efforts need to boost the resources and expertise of State Governments to bring projects to market in forms that are commercially viable for private sector participation.

Integral to this is the need for State Governments to innovate in respect to the financing models and consider more carefully the needs of the long term owners and managers of assets rather than financial intermediaries who currently dominate the bid processes and extract rent during the financing and construction period, and have little or no exposure to project outcomes post-construction. Encouraging early participation from long term owners and inverting the bid processes would provide an incentive for superannuation funds and their investment managers to prepare and adequately resource for PPP investment.

In other instances the most efficient approach may involve increased cycling of existing public infrastructure to free up capital for new projects. We would encourage the Federal Government to work more closely with State Governments and possibly tie future infrastructure funding to reform of bid processes to better meet the needs of long term owners of assets, and thereby to encourage the participation of such owners.

Tax reform if undertaken should compliment and support a more effective model for delivery of infrastructure projects.

However, in the context of the current model, we recognise that the tax loss retention measure removes one potential obstacle to investors participating in infrastructure investments at the brownfield stage and the subsequent trading of unlisted assets. Notwithstanding this facilitation it will in substance act as a subsidy for the project seller with the benefit effectively bid away in the sale price. Put another way, tax losses that would be accessible to the buyer as a result of the proposed tax measure are likely to be incorporated into a higher sale price for the assets. We would encourage continued consideration of whether this is a desired effect.

Uplifting carry forward designated infrastructure project tax losses

The 10 year Government bond rate does not reflect the true cost of capital of investors in infrastructure projects and does not fully compensate for the erosion of the real value of early stage tax losses of an infrastructure project.

We submit that the rate by which unutilised tax losses are uplifted should be increased to better reflect private investors' true cost of capital. The equity market risk premium for operating assets is typically 6% above the long-term government bond rate, excluding any additional risk premium associated with greenfield projects.

Furthermore, the uplift will not provide real incentive for superannuation funds to invest, unless the incentive is maintained at the superannuation fund level when investment returns are distributed out of the project vehicle (see below).

Tax treatment of distributions from a designated project

Superannuation funds are generally subject to tax in respect of returns from investments in companies and trusts. Investment decisions are made taking into account the after tax returns to the investor, and are not confined to investment returns at the project entity level.

In respect of designated projects, the uplift of tax losses is expected to provide a temporary tax shelter at the project entity level (in the case of a project company) and limited deferral of tax for investors (in the case of a project trust). Either way, much of this benefit will be unwound as investment returns are distributed to investors by the project entity and taxed at the investor level.

We submit that a stronger incentive for superannuation fund investors to participate would be to treat the corresponding distribution as a non-taxable amount. For example, in the case of a project entity that is a trust, by treating that part of the distribution as a non-assessable amount that does not require a cost base adjustment. This would increase the revenue cost of the incentive.

Process for conferring designated status

We agree with the Discussion Paper that the decision making process for conferring designated infrastructure project status must be clear, objective and transparent.

The presumption is that the projects to which these rules will apply are all greenfield developments given that only projects on Infrastructure Australia's National Priority list will be eligible to apply for these new tax loss rules.

We would like to see further details of the process and evaluation criteria, as well as how the process is envisaged to work in practice. In particular, we recommend the following be considered in the design:

1. There should be a single integrated process for conferring designated project status and awarding the project to a private investor.

For example, in the context of a State sponsored PPP, we envisage that the relevant State agency should be able to seek designated status on behalf of bidders prior to bringing the investment opportunity to market. Whether an investor obtains the benefit of the designated status should not be subject to a separate decision making process. This should be more efficient than each individual bidder seeking designated status separately and provide more certainty to better achieve the Government's objectives.

2. Designated status must be irrevocable before a decision to invest.

   The discussion paper suggests that designated status is irrevocable once a project commences. We submit that designated status needs to be irrevocable from an earlier point in time which must be before an investor is required to make a binding commitment to the investment. Ideally, this would be conferred before the investment opportunity is brought to market.

   Otherwise, investors do not have sufficient certainty and are unlikely to fully value the tax incentives. Investors will also need to cater for the possibility that designated status is not conferred (i.e. require maintenance of tax losses under the ordinary tax loss recoupment rules), thus defeating the intended purposes.

3. The design needs to instil confidence in the integrity of the process.

   For example, designated status should generally be conferred to projects capable of investment by a broad and not a confined group of investors.

Further we believe that the "first come basis" is inappropriate and inefficient. This will mean that those projects that are closest to being ready for assessment will receive the funding, not necessarily those projects that are most useful or the best projects (i.e. projects most worthy of support through this tax incentive mechanism). We would prefer to see a relative assessment of potential projects that are raised in 6 or 12 month period, with only the best projects being approved.

Defining unrelated businesses

We propose that the rules should contemplate and address whether certain activities should be permitted to be carried on without jeopardising the designated status. A project entity undertaking an unrelated business could jeopardise the designated project status, thus unrelated businesses need to be identified and quarantined into separate entities outside the tax consolidated group that includes the designated project. This could be impractical or introduce unnecessary complexity and costs.

We foresee the following activities as potentially affecting a project's designated status:

1. Undertaking a variation to a project during a concession period where project variations are contemplated but cannot be known at the inception of a project.

2. Undertaking an expansion project where the revenue streams from the existing project and the expansion project are inseparable (e.g. toll road widening).

Similar issues could be relevant to existing assets where the project seeking the concession status is an expansion project (e.g. widening an existing toll road). Such projects may effectively be precluded from seeking concession status unless the expansion project can be quarantined from the existing asset.

However, we recognise that this may conflict with the global capital expenditure cap particularly if the $25 billion cap is already reached.

Conclusion

We broadly support the intent of the proposed tax loss incentives, but we are concerned that the fundamental barriers to superannuation funds investing in greenfield infrastructure projects have not been addressed.

We would be pleased to discuss these broader issues with the Government.