

FUNDING AND FINANCING DRAFT ADDITIONAL INFORMATION PAPER

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What this document is about

This document supports our discussion paper, *All things considered*, by providing additional information on funding and financing options.

If you are interested in understanding the types of funding and financing mechanisms that could be used to support our infrastructure priorities, this document will explain them for you. This paper explains:

- the difference between funding and financing
- the advantages, limitations and implementation considerations for each funding and financing mechanism.

What this document is not about

This document does not contain a detailed assessment of each funding and financing option. The precise impact of these options on our economy, society, environment and finances depends on their design and specific application. Funding and financing options will need to be assessed on a case-by-case basis to ensure we get value for money.

This document does not make recommendations on prioritising funding and financing options.

Infrastructure Victoria's guiding principles

Our guiding principles have informed how we looked at funding and financing options:

- **Consult and collaborate**
- **Drive improved outcomes**
- **Integrate land use and infrastructure planning**
- **Use evidence wisely**
- **Consider non-build solutions first**
- **Promote responsible funding and financing**
- **Be open to change**

Our *promote responsible funding and financing* principle is particularly relevant.

Promote responsible funding and financing

Infrastructure Victoria does not fund infrastructure directly, but our advice, if taken, could have major budgetary implications. Victoria's fiscal position is sound. However, over the long term, revenue growth may struggle to keep pace with growth in spending, particularly on health and, as such, ongoing sustainable fiscal management will be important.

Funding infrastructure responsibly means making hard choices about what to fund and what not to fund. This includes looking at non-build solutions and taking into account lifecycle costs. Financing infrastructure responsibly also means making hard decisions about how and when the community pays for infrastructure. This includes looking at when the costs and benefits of infrastructure are incurred, getting value for money and considering all the funding and financing options available.

How you can get involved?

Our discussion paper, *All things considered*, is the focus point of consultation for this stage of the strategy's development. It lays out our initial view of options that should be taken further based on our infrastructure needs. However, we welcome your feedback on *All things considered*, the *Draft options book* as well as this draft paper on funding and financing.

If you would like to provide feedback, visit yoursay.infrastructurevictoria.com.au

- share a thought
- take our survey
- make a formal submission.

Funding and financing options

When choosing options to meet our infrastructure needs, government also needs to consider how we pay for or 'fund' these options, and when we use financing arrangements to pay for them. Funding and financing are separate but related concepts. How we pay for and finance infrastructure can significantly affect:

- which community needs are met
- who can access infrastructure
- how we use it
- when we pay for it.

Funding and financing options can help us get more out of our infrastructure and increase value for money by:

- changing behaviour and managing demand
- getting better use from our infrastructure.

Funding and financing are separate concepts that affect how we use infrastructure

Funding represents all the revenue needed to pay for infrastructure. It ultimately comes from the community through existing cash surpluses or by increasing revenue (through increasing taxation or user charges) or reducing expenditure.

Financing affects when we pay for our infrastructure. We can finance using our cash surpluses now, or by borrowing (which we need to service and repay later). Debt is a financing tool, not a funding source. It enables a purchase (such as a new asset) to be brought forward and be paid for later.

For example, when we purchase a house, if we don't have enough available funds to pay for it all now, we arrange finance, via a mortgage. Financing allows the capital cost to be covered up front. We then must repay the mortgage (including interest) from our future household income stream.

Ultimately, our household income from working or other investments, funds the cost of our home, including mortgage costs.

Funding

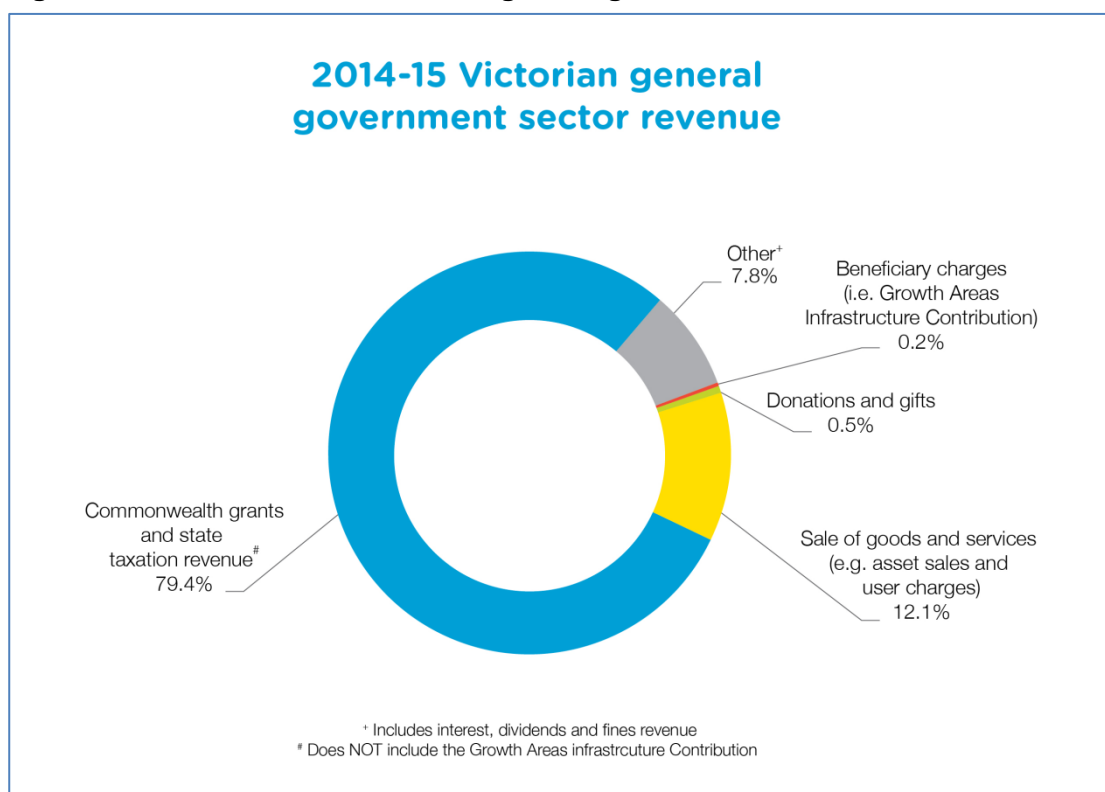
All public infrastructure funding ultimately comes from the community through:

- existing cash surpluses
- increasing revenue, which means the community pays more via taxation or charges, or
- reducing expenditure by reducing funding for services (such as health or education), or improving productivity.

This is the case for all governments.

Figure 1 demonstrates that the majority of Victorian general government revenue in 2014-15 came from a combination of commonwealth grants and general state government revenue (such as payroll tax and property tax). General government sector revenue does not include all the revenue from government business enterprises such as water businesses or all commercial activities. It is a general funding pool and it changes every year.

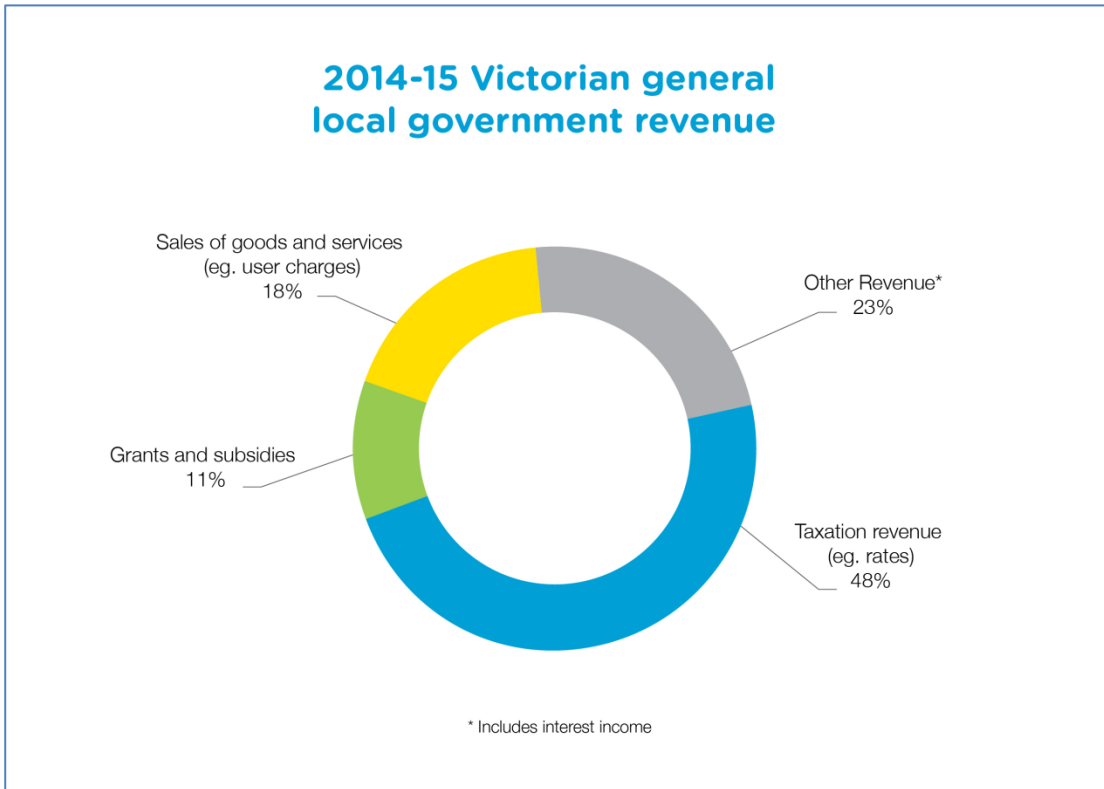
Figure 1. Victoria’s revenue 2014-15: general government sector



Source: Adapted from 2014-15 Financial Report of the State Of Victoria

Figure 2 demonstrates that the majority of local government revenue in 2013-14 came from local government taxation, such as property rates.

Figure 2. Local government revenue Victoria 2013-14



Source: Australian Bureau of Statistics, Government Finance Statistics, Australia, General government – local – Victoria 2014-15, Table 332, Table_1

We need to consider revenue options that optimise the funding we get (without being too onerous on the community or constraining economic growth) and help us get more out of our infrastructure.

These revenue options may still not raise all the funding we need to deliver the infrastructure we want. For example, if we charged a levy of about \$100 per household per year for the next 30 years, it would only raise about \$10 billion. This amount is extremely small relative to historical government spending of about \$5 billion a year on infrastructure. But we should still use funding options that help us get more out of our infrastructure.

If we choose to increase revenue to fund the infrastructure we want, it may also have a significant impact on us all and the Victorian economy.

When thinking about how to fund infrastructure, we need to strike a balance between raising more revenue, using our infrastructure efficiently and encouraging business and individuals to be productive. This in turn helps create jobs and economic growth. We also need to choose and prioritise our infrastructure options carefully. With this in mind, any assessment of funding and financing options for infrastructure must consider how to:

- change behaviour and manage demand
- promote the highest and best use of our infrastructure
- optimise our infrastructure (including its maintenance) and services

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- align the cost of infrastructure with users and those who privately benefit from it
- implement easy, and relatively inexpensive revenue options.

Incentives for creating jobs and economic growth are also important considerations for government when evaluating infrastructure funding and financing options.

Mechanisms to raise revenue

There are many ways to raise revenue to fund infrastructure. Different revenue options affect who pays and who benefits, how we pay for and use our infrastructure. Options include:

1. User charges
2. Beneficiary charges
3. Property development
4. Asset sales
5. Donations and bequests
6. General commonwealth and state government revenue
7. General local government revenue

A description of these revenue options, their advantages, limitations and implementation considerations are outlined on the following pages.

1. User charges

What is it?

User charges are fees we pay for using infrastructure. Government or independent regulators set prices and consumers pay for either accessing an infrastructure network or for how much they use an asset.

User charges are widely used in many public and private infrastructure projects including; energy, water, ports, airports, roads and public transport. Examples include: toll charges collected for using CityLink, the flat rate water service charge on our water bills to access water, and camping fees charged by Parks Victoria to access certain campsites. We also pay fares for using our public transport. The charges we currently pay to use our public transport are not extensive and are low relative to the cost of our infrastructure, its maintenance and operations. For example, user charges collected through public transport fares only account for about 32 per cent of operating cost of metropolitan Melbourne's public transport system. In comparison London, United Kingdom recovers over 50 per cent of the operating costs of its public transport system through fare revenue¹.

Some infrastructure such as hospitals, schools and public transport also generate benefits for the broader community and economy, not just users, so it is often appropriate that these assets are partly funded from general government revenue.

User charges can have two objectives. They can help recover the cost of infrastructure and provide incentives for users to use infrastructure more efficiently by managing or shifting demand. The objective

¹ Derived from Transport for London 2014, Annual Report and Statement of Accounts, London
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we choose to focus on will affect how user charges are designed and set. Tensions can arise between attempting to recover capital and operating costs through user charges or 'pricing', and creating incentives to manage demand for infrastructure. Finding the right balance can be challenging.

Differences exist between direct user and network user charges. Network user charges are levied on individuals or businesses for accessing an infrastructure network regardless of how much they consume. Direct user charges are levied for the specific or actual use of infrastructure. For example, in the case of electricity, the network user charge is the fee for accessing and maintaining the electricity grid, while the per kilowatt charge is the direct user charge based on how much electricity is used.

There are varying views on increasing or expanding user charges such as introducing a Transport Network Pricing Regime. Road pricing has the highest community profile and is being used increasingly overseas (see the case study on page 12 for additional information).

Advantages

- Raising revenue by increasing user charges ensures those that use and benefit from infrastructure contribute to its costs, including maintenance and future improvements. For example, network user charges can help improve our existing assets by ensuring people who access infrastructure networks (such as water, transport or landfill) contribute to its cost, maintenance and upgrades.
- Prices can be set or charges levied to influence when and how people use infrastructure and the services it provides. This helps 'spread' and 'shift' demand and can optimise the use of our infrastructure. Examples include: time of day and congestion pricing, premium pricing for a higher level of service (such as high occupancy toll lanes), and transport pricing based on distance travelled.
- Appropriately priced user charges help promote the highest and most efficient use of our infrastructure. They can help us achieve social and environmental outcomes by providing pricing incentives to minimise waste or pollution through efficient natural resources use.

Limitations

- Introducing or increasing user charges for accessing and using infrastructure could become unaffordable for some members of the community. This could increase inequality, lead to adverse social and economic outcomes and make access to infrastructure, services and jobs inequitable. However, pricing regimes can be adjusted for those that cannot afford to pay through concessions, subsidies, exemptions or taxation arrangements.
- Setting prices too high (such as for road tolls or public transport fares) can result in infrastructure being underutilised, increasing pressure on other infrastructure (such as other roads or public transport). Equally, setting prices too low may not optimise the use of our infrastructure.

Implementation considerations

- Introducing oversight mechanisms such as price monitoring or regulation could help ensure charges are not set well above the cost of providing and maintaining infrastructure. This could prevent user charges from adversely affecting economic activity, growth or consumers.

- Administration and enforcement costs are required to implement user charges. However, schemes to introduce new user charges should be designed so that they ensure the revenue collected is greater than the costs of administration and enforcement.
- In designing user charges we should not duplicate charges or fees already collected for an asset. For example, introducing the Transport Network Regime or an overall road network user charging regime is likely to require removal of the existing fuel excise levy (designed to help recover some of the cost of our roads) or provide a mechanism to refund it.
- This type of change could also present administration and governance issues which will need to be resolved. For example, a Transport Network Regime based on a per kilometre charge is likely to be collected by the state, whereas the existing fuel excise levy is collected by the commonwealth.
- Technology can make user charges easy to use and implement. Advances in technology are making it cheaper to implement pricing regimes.
- To optimise the use of infrastructure and account for the 'spill over' effects, user charging will have to be coordinated across infrastructure networks (such as the entire transport network). Spill over effects are when the use of one asset or the benefits created affects the use of another asset. For example, this includes accounting for the effect changed public transport user pricing will have on the use of the road network, or vice versa.

Case Study: Road user charging

Applying a user charge to access the road network is probably the highest profile example in the community.

User charges by kilometre are a more equitable and effective way to manage demand and recover some of the infrastructure and maintenance costs than the current fuel excise. Vehicle fuel efficiency improvements and the growing popularity of electric vehicles will also continue to erode the receipts of the fuel excise collected by the commonwealth government.

User charges can be designed to help achieve policy needs. For instance, dynamic road pricing that applies a higher charge when the network is congested to discourage discretionary motor vehicle travel has the potential to reduce congestion.

Distance-based road user charging depends on technology, but recent advances have made the technology required to record and measure trips accurate and cheap. The US State of Oregon is using GPS technology to trial road pricing based on distance instead of other taxes.

Premium pricing can also be used to provide users with a premium service. In parts of the United States a premium is charged to single-occupant vehicles for using high occupancy toll lanes on freeways, which are priced dynamically to minimise travel time.

For more information about the Oregon road pricing trial, visit <http://www.myorego.org/>

2. Beneficiary charges

What is it?

Beneficiary charges seek contributions from individuals and businesses that indirectly and privately benefit from government investment in public infrastructure, or planning decisions. Contributions are collected by levying charges or taxes on these individuals or businesses.

Individuals and businesses often privately benefit from their location in relation to planning and zoning changes or infrastructure investment (such as a new train station) and the related increase in services and broader economic activity, even if they do not actually use the infrastructure. These benefits are usually reflected through increases in property values or economic activity. This includes economic activity generated from increased movement of people, improved access to jobs or a larger employee pool and other 'spill over' effects from increased proximity to infrastructure. For example, high levels of public transport infrastructure in the CBD and surrounding areas helps drive growth in land and property values as businesses can access greater levels of skilled labour and customers.

Beneficiary charges seek to 'capture' or recover a portion of the extra value created for individuals and businesses as a result of government infrastructure and planning decisions. They are often referred to as 'value capture' mechanisms and help align the cost of infrastructure with those who benefit from it, regardless of whether or not they use it. Capturing a portion of the value created from our planning and infrastructure investment decisions can help contribute to the cost of providing infrastructure. Under current taxation arrangements, some of the benefits of economic activity created by state infrastructure investment accrue to the commonwealth through income and company taxes, and GST receipts.

Beneficiary charges have been widely debated and investigated by many jurisdictions and think tanks. The commonwealth government recently acknowledged the benefit of applying value capture to help fund projects. It also mooted commonwealth contributions towards funding for major public infrastructure could be conditional on states imposing levies on local individuals and business.

We can raise funds through the following three types of beneficiary charges:

- A. Land value uplift charges
- B. Betterment levies
- C. Developer contributions.

A. Land value uplift charges

Land value uplift charges seek to capture a portion of the increase in land values from government infrastructure investment or planning changes. This involves increasing existing taxes, or levying a new charge on individuals and businesses (within a defined catchment) whose land values have increased from their proximity to new infrastructure or planning and zoning changes. These taxes and charges recover some of the cost of public infrastructure or contribute to new infrastructure.

Public infrastructure can affect land values and house prices. For example, many residents experience increases in property values from being located close to public transport. Land value uplift charges can be applied to new (greenfield) and existing (brownfield) developments.

Land value uplift charges are not new. Capturing the value created from increasing land values to fund state significant infrastructure has been investigated by many jurisdictions.

B. Betterment levies

Betterment levies seek a contribution from individuals or businesses when public infrastructure increases amenity and economic activity in a defined catchment. This includes the benefits they receive from increased economic activity and the wider economic impacts generated by the new infrastructure. Examples include:

- increased economic or business activity generated from increased movement and proximity of people
- improved access to jobs or larger employee pool
- other 'spill over' effects.

Betterment levies also help align the cost of infrastructure with those who privately benefit from it. They are not new – The Melbourne City Rail Loop was partly funded by a betterment levy, which collected funding between 1963 and 1995. Betterment levies are being used increasingly in other jurisdictions. For example, the case study on page 17 of this document describes how a betterment levy has helped fund London's Crossrail project.

C. Developer contributions

Developer contributions are one-off monetary or in-kind contributions towards the cost of providing infrastructure in a development area. Developer contributions are levied on individuals or developers who benefit from the increased value created through public infrastructure investment or planning decisions. Developer contributions also seek to recover some of the cost of infrastructure required as a result of new development.

When a developer contribution is levied can vary relative to when public infrastructure is provided or a planning decision is made. For example, developer contributions can be levied in advance of government investing in infrastructure, such as the Growth Areas Infrastructure Contribution, or it can be levied on new developments which occur in the vicinity of new infrastructure.

Historically, developer contributions have been used to fund local infrastructure through a levy on residential or commercial developments, or other property transactions and improvements. In key **Infrastructure Victoria** Funding and financing: draft additional information paper

development areas such as designated 'Growth Areas', developers have also been required to contribute (in-part) to providing state infrastructure as part of approving planning changes. Where decisions to provide public infrastructure are already made creating extra value for developers, a developer contribution could be applied through other mechanisms.

Advantages

- Individuals and businesses who benefit from increased land values or economic activity created by government infrastructure investment and zoning decisions, contribute to its cost.
- The cost of providing infrastructure aligns with those who privately benefit from it whether or not they use it. For example, landowners in agricultural or surplus industrial areas would be affected if a charge was levied to capture a proportion of the increase in land values resulting from zoning changes. However, they also receive significant benefits from the value created from zoning changes and the likelihood of future infrastructure investment.
- Beneficiary charges allow government to 'capture' some of the benefit from its infrastructure investment and planning decisions that would otherwise accrue to individuals or businesses. This can help optimise the use of our infrastructure, its maintenance and the services it provides.
- The scale and scope of the value captured represents a proportion of the value created by infrastructure or planning decisions. This should not affect economic growth, property prices, or future development in a significantly adverse way. Therefore, infrastructure investment and planning decisions will still deliver a net increase in wealth and benefits to society.
- Land value uplift taxes, in particular, minimise incentives for land banking if a proportion of the benefits from zoning changes are recouped through a mechanism such as land tax.
- Once designed, they can be relatively cheap to implement and easy to use.
- Beneficiary charges can be used by state and local governments.

Limitations

- Beneficiary charges and 'value capture' approaches are unlikely to fully fund the cost of new infrastructure. They can, however, contribute to the cost of infrastructure with the added benefit of better aligning those who benefit with those who contribute to the cost.
- It can be difficult to demonstrate a clear and strong link between government investment and planning decisions, and the value a group of beneficiaries receive. Mechanisms need to be developed to differentiate between increases in land value driven by new infrastructure and other factors.
- Individuals and businesses may oppose charges or levies imposed to capture value, unless the value accruing to them can be clearly demonstrated.
- Unexpected impacts on the economy may arise depending on the magnitude and scope of beneficiary charges implemented.
- Developer contributions which levy fees for state infrastructure and coordinated planning of strategic development sites may result in developers passing these charges on to home buyers.

Implementation considerations

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- Designing beneficiary charges and their application to avoid duplication. For example, land value uplift and betterment levies could capture the same beneficiaries.
- Choosing the right type of beneficiary charge or combination of charges to maximise the value received and get better use out of our infrastructure. This will vary depending on the type of project and will need to be assessed on a case-by-case basis.
- Beneficiary charges can be designed in various ways, using existing taxes such as land tax or rates or new charges depending on the anticipated beneficiaries.
- The funds raised, particularly from land value uplift charges, may be constrained if levied under existing state based land tax arrangements, as primary residences are exempt from land tax.
- Accurately measuring the additional value created or realised and setting appropriate rates.
- Aligning when a beneficiary charge is levied with when the additional value is realised. This includes selecting the appropriate timeframe for imposing levies and collecting value. For example, land value uplift charges based on increased rates or levies may be applied, but a property owner may not realise the increased value until their property is sold. This may affect those that own property, but have insufficient income to pay the charges, such as pensioners who own their own home. Adjustments can be made for those who cannot afford to pay.
- Charges could be implemented upfront, or recovered over time. For example, betterment levies can be imposed for a period of time to capture a set funding target.
- Clearly demonstrating the link between the additional value created and the value captured is likely to help build acceptance.
- Determining the extent of cost recovery achieved. Consideration will have to be given to how the rate of cost recovery interacts with other objectives such as level of use.
- Defining beneficiaries and geographic boundaries. For example, the value created for individuals will vary depending on the relative proximity to physical infrastructure or planning decisions. Issues will arise once boundaries are set which divide who pays and who doesn't, or at what rate they pay. Variable or fixed charges could be implemented to mitigate these impacts.
- The impact of and interactions with other taxation arrangements, including capital gains tax, other state property based taxes and local government rates. If the state seeks to collect beneficiary charges for its infrastructure investments through local government rates, arrangements would need to be made between local and state governments.
- Beneficiary charges can be designed fairly as adjustments can be made for those who cannot afford to pay.
- Betterment levies, in particular, are likely to be more appropriate for major infrastructure projects or large scale infrastructure programs, such as new train lines, stations, level crossing removals and housing renewal projects, because of the increased economic activity they are likely to generate for individuals and particularly businesses.

Case Study – user pays and beneficiary charges as a funding source – Crossrail

Crossrail is one of the most costly and complex projects undertaken by Transport for London. It is a 118km rail route, including 42km of rail tunnel through London, which is currently being constructed. The project will significantly increase capacity in the existing London Underground rail network with central London’s rail capacity increasing by 10 per cent. The project started in 2007 and is expected to be operational in 2017.

The project will cost £14.8 billion and is being funded through a variety of sources including general government revenue, user charges, beneficiary charges and sale of existing government assets.

- City of London will contribute £7.1 billion but will recover around £4.1 billion from London businesses by levying the Business Rate Supplement (BRS), Community Infrastructure Levy (CIL) and other mechanisms.
 - The BRS is a levy on non-domestic property with a rateable value exceeding £55,000.
 - The CIL is a levy on additional floor space created across London. The size of the contribution is calculated once a planning application is submitted to the local authority.
- The national government will contribute £4.7 billion.
- Fare payers will contribute an estimated £2.15 billion based on patronage forecasts.
- Network rail will contribute up to £2.3 billion from projected national rail network operating cost savings attributed to the Cross London railway.
- The remainder is funded by other government and private beneficiaries of the project including City of London Corporation, Heathrow Airport Holdings Ltd, Canary Wharf Group and Berkeley Homes.
- A significant proportion of funding is from beneficiary charges and user pays. Londoners and London businesses who benefit from the project are directly paying for the infrastructure.

Businesses and Londoners are contributing directly to the project because:

- There is a direct and measurable benefit to businesses when other businesses and people relocate nearby in increasing numbers. Businesses located near the Cross London railway benefit from more people travelling to the area allowing greater access to new customers and new employees, as well as other businesses. This will result in increased turnover.
- Passengers using the Cross London railway benefit from travel time savings, improving their access to employment and education.
- The project funding is considered more equitable because the people who benefit from the project contribute to the project cost, reducing the burden on general tax payers.

More information on the Crossrail project is available at <http://www.crossrail.co.uk/>

3. Property development

What is it?

Selling development rights – both land rights, and air rights (the right to develop the space above a property) – around or as part of public infrastructure when upgrading or building new infrastructure. It includes commercially leasing premises within publicly owned infrastructure.

We have used this option before in Victoria when air rights at Melbourne Central Station were sold to contribute to the cost of building the station, resulting in significant retail and commercial development. An overseas example is the Hong Kong railway, built by private company MTR by selling property development rights to the airspace above each station. This facilitated the integration of stations with high-rise residential towers and retail complexes.

Advantages

- Development may improve amenity, access to service and offer more choice in services and land use. For example, new residential and commercial development can provide new facilities such as housing, cafes, restaurants, shops or other businesses.
- Underutilised government owned land and air space (such as vacant land, car parks or air space surrounding transport corridors) could be put to a higher and better use.
- Leasing premises within or around public infrastructure (such as cafes in museums, or pharmacies and cafes in hospitals) could help contribute to the cost of providing public infrastructure.
- Selling development rights is likely to increase economic activity, property values and rents in surrounding areas. For example, new services and businesses established as part of commercial developments surrounding public infrastructure will increase business activity, helping the economy grow, causing land values in surrounding areas to increase.
- Significant revenue could be raised without incurring significant additional transaction costs.

Limitations

- There is potential for mismatch between the type of new facilities developed and the businesses and community requirements. Existing services may be displaced.
- Public open space may be reduced by residential and commercial developments on previous vacant government owned land or air space.
- Existing planning regulations (such as height limits) can restrict the extent of commercial and residential development.

Implementation considerations

- State and local governments will need to work together to facilitate development or leasing opportunities that maximise the revenue raised, and comply with planning regulations and community needs. This may include exploring opportunities to amend local planning regulations where necessary.
- Commercial skills will be required to effectively negotiate the lease or sale of development rights to maximise value for money and revenue.

4. Asset sales

What is it?

Sell, lease or privatise more state assets including land and enterprises. This can involve selling or privatising individual assets or bundling and consolidating a number of small, underutilised or surplus assets for sale.

Advantages

- Asset sales provide a one-off funding boost which can be used to deliver other infrastructure priorities. It can also reduce costs by avoiding future operating and maintenance costs and major asset upgrades.
- Privatising assets and services generates cash and can deliver infrastructure and services more efficiently and better than government. Privatisation allows providers to operate as commercial businesses with revenue sourced primarily from user charges and other pricing mechanisms with limited recourse to public finances (apart from community service obligations). This creates stronger incentives for private operators to select infrastructure upgrades that offer a consumer benefit and improve service delivery, although this depends on effective policy and regulatory frameworks also being put in place by governments.

Limitations

- Once government sells an asset it foregoes a future revenue stream (dividends and tax equivalents).
- Private sector interest is typically greater for mature assets with proven commercial returns, which is often reflected in the sale price. There may be less private sector interest in new assets or assets with unproven commercial returns which may also be reflected in the sale price. This may affect the cash received for selling or leasing such assets.
- Depending on which assets we sell and how we privatise assets, access to services for some parts of the community may be constrained and increase prices. Excessive price increases can be mitigated through regulation.
- Privatising assets and investing in new ones (asset recycling) poses risks. Government is effectively swapping ownership of a mature asset (with known demand and cost characteristics), with ownership of a new unknown asset (which may offer more risk due to unknown demand and cost characteristics).

Implementation considerations

- All governments including state and local governments can sell or privatise assets.
- Government can incur large transaction costs in privatising assets and require specialist commercial, financial and legal skills to manage and evaluate these complex transactions to ensure we receive value for money. Government also needs to plan and work with the private sector to ensure effective transition of infrastructure and services once the sale is completed.
- Regulation and oversight mechanisms need to be developed to support the privatisation of assets that involve user charges to ensure social and environmental obligations are met.
- Good planning is required to maximise revenue and to ensure we get the most out of our infrastructure. This includes exploring opportunities to structure asset sales such as bundling smaller assets for sale across a sector or in a particular location which could generate economies of scale and attract different investor groups. Additionally, planning for risks and uncertainties, which may influence future demand for infrastructure, need to be considered to determine the most cost-effective use of our asset portfolio.
- Effectively structuring asset sale or lease arrangements and processes to maximise the return and cash received. The final sale price and cash received ultimately depends on market and buyer interest. Government may raise much less or significantly more revenue from selling or privatising assets than it originally expected.

5. Donations and bequests

What is it?

Government investing resources to encourage more donations and bequests from individuals, businesses, community organisations or charities to fund public infrastructure and equipment.

Individuals, organisations, and deceased estates can provide funding for infrastructure via donations or bequests. When these funds are received from individuals or organisations they are donations, when they are provided by deceased estates they are bequests.

School communities regularly hold fundraisers to provide equipment, or receive in-kind contributions to help with infrastructure improvements. The Good Friday Appeal is a high profile annual fundraiser for the Royal Children's Hospital that raised over \$17 million in 2016.

Many cultural assets have also been gifted to the community, such as Alfred Felton's bequest to the National Gallery of Victoria (NGV) in 1904. This bequest created a charitable foundation known as the Felton Bequest, enabling the NGV to purchase artworks. Over 110 years later 80 per cent of the finest artworks at the NGV are owned thanks to the Felton Bequest and are valued in excess of \$2 billion².

Advantages

- Additional donations and bequests, made at the discretion of individuals or organisations, are extremely valuable and can provide infrastructure, assets or equipment free of charge. This can free up funding for other infrastructure needs.
- Donations and bequests are not controversial and do not impose charges on individuals, businesses or organisations.

Limitations

- While community fund raising and donations are important, for example to schools and hospitals, funds raised are unlikely to make a significant contribution to meeting our overall infrastructure needs. For example, donations and gifts received by the State of Victoria only represented 0.5 per cent (\$317 million) of its total revenue in the 2014-15 financial year (\$61.6 billion).
- Donations and bequests rarely cover the full capital cost of the infrastructure and impose ongoing operational and maintenance costs on government. For example, computer equipment gifted to schools requires storage, software, maintenance, insurance and replacement over time.
- Donations and bequests by their nature are discretionary and may not align with government priorities and our highest infrastructure needs.
- Donors can prescribe obligations or conditions when making donations and bequests that constrain the use of the asset.

Implementation considerations

Pursuing and promoting donations and bequests will incur costs.

² Equity Partners 2015, *The Alfred Felton Bequest*, www.eqt.com.au/charities-and-not-for-profits/grants/the-alfred-felton-bequest
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6. General commonwealth and state government revenue

What is it?

Revenue collected by commonwealth and state governments through general taxation revenue or regulatory charges such as fees and fines. Taxation revenue includes commonwealth taxes such as the Goods and Services Tax (GST), income tax, company tax, state taxes such as land tax, stamp duty and payroll tax.

General government revenue pays for the majority of public infrastructure and services we receive.

Victoria has little influence over the amount of commonwealth taxation revenue it receives. Changes to Victorian taxation arrangements that may affect the amount of general government revenue are determined by the government, not by Infrastructure Victoria.

Advantages

- General government revenue helps government provide infrastructure and services to achieve social, environmental and economic objectives.
- Paying for some types of public infrastructure from general government revenue, at least in part, helps to maintain equity especially when delivering public goods such as schools, hospitals and prisons.
- Taxation is the most efficient and cost-effective way of raising revenue to fund public infrastructure relative to other funding options. For example, it is often used when it is impractical and not cost-effective to directly or fully charge users. Consequently, a significant proportion of public infrastructure is likely to continue to be funded, at least in part, by government.
- It is an efficient way of raising funding. Taxation arrangements can complement other funding options such as increasing user charges, where these arrangements are used to address equity issues through refunds or concessions.
- Increasing or amending taxes can rapidly and significantly increase government revenue.

Limitations

- Like all other funding options it involves administration and enforcement costs.
- Taxation arrangements have significant effects on our society and economy.

Implementation considerations

- Government must consider how changing tax settings can affect economic growth and achieving social objectives intended by government.

7. General local government revenue

What is it?

Advantages, limitations and implementation considerations are similar as for general commonwealth and state revenue. Property rates are local government's largest source of revenue.

The state government introduced rate caps at the end of 2015. For 2016-17, the state government has capped increases to 2.5 per cent of the amount paid by the average ratepayer. The cap is calculated by the Essential Services Commission, and is based on the consumer price index, wage price index, and an efficiency factor.

Over the past 10 years, average rate growth across Victoria has been six per cent a year.

If councils have evidence (including strong community support) that the rate cap will affect their ability to deliver essential services and infrastructure, they can apply to the Essential Services Commission for a variation. 10 of the 79 councils in Victoria have applied for a higher rate cap in 2016-17.

Local governments have argued for the removal of the cap, as it would allow them flexibility to use their largest revenue source – rates –, to raise more revenue to provide services and infrastructure. However, they already have the ability to seek exemptions. This option could have significant implications on rate-payers and local government finances, particularly in high growth areas.

Advantages

- Allowing councils to set their own rates would allow them maximum flexibility to raise more revenue to meet community service and infrastructure needs.

Limitations

- Removing rate capping would reduce certainty for ratepayers on annual rate increases.
- Removing rate capping could reduce incentives for councils to drive efficiency or explore opportunities to consolidate or alter underutilised assets and optimise the use of their existing assets better as well as raise revenue.

Implementations considerations

- Caps do not impose total revenue limits. The rate cap is based on the general rate and municipal charges paid annually by the average ratepayer. This means that total local government revenue will still reflect population growth, in addition to the 2.5 per cent increase allowed in 2016-17.

Financing

Financing changes how the cash inflows and outflows required to meet the commitments of new infrastructure are spread over time. Government can arrange finance itself or via other parties such as private financiers who also must be repaid. How we finance our infrastructure changes how much is paid and when.

Government can finance infrastructure by either:

1. using existing resources by using existing cash surplus, **reducing expenditure** or **increasing revenue** via taxes and user charges; or
2. borrowing by 'issuing' or increasing its debt.

Financing infrastructure from existing resources provides flexibility to respond to future unexpected infrastructure and service needs. When government finances using debt, borrowing costs and repayments must be met from existing funds such as existing cash surpluses or by reducing expenditure or raising taxes. In the long run, we still need to pay. This means government borrowing and taxation are effectively the same things.

Borrowing is a financing option, not a funding source. It allows capital or 'debt' to be raised upfront to meet future costs at a point in time. This helps us 'bring forward' investment in infrastructure. All borrowing comes at a cost and it must be repaid. When we borrow, the costs associated with debt, such as interest expenses and repayments, need to be paid by either reducing expenditure or increasing revenue via taxes.

Borrowing instruments to finance infrastructure

How we borrow and procure our infrastructure changes the risks we incur, the price we pay (including finance costs) and the infrastructure and services we receive.

If it chooses to do so, government can borrow to finance infrastructure in a number of ways. These include:

1. State government issued bonds
2. Social impact bonds
3. Borrowing by private financiers
4. Tax increment financing
5. Concessional loans from the commonwealth government
6. Local government borrowing
7. Tailor finance for specific investor groups.

We looked at how we can borrow and procure to minimise risks and maximise the value we get from infrastructure and the services it delivers over time. This included: considering the total price we pay to finance, the standard of infrastructure and services we get, and the risks we incur.

A description of these financing options, their advantages, limitations and implementation considerations are outlined in the following pages.

1. State government issued bonds

What is it?

Continuing to finance infrastructure by Treasury Corporation of Victoria (TCV) issuing state government bonds to access debt (i.e. borrow). State government bonds have a AAA credit rating. This is the most common form of borrowing used by government.

Advantages

- Financing or borrowing costs are relatively low due to the state's overall AAA credit rating and is typically the cheapest form of borrowing for state governments.
- Debt can be raised quickly as state government bonds are popular with investors.
- There is deep liquidity in the market for state government bonds. Investors can easily sell TCV bonds quickly and convert them into cash without a price penalty.
- Recent banking regulations have increased demand for semi-government bonds like TCV bonds. Under obligations set by the Australian Prudential Regulation Authority in 2014, banks must hold high-quality, highly-liquid assets that exceed their next 30 days of net cash outflows in stress situations. Commonwealth and state government bonds (such as TCV bonds) are a highly regarded and highly liquid asset, which banks need to hold to meet their asset management obligations.
- Like all forms of borrowing, it allows government to bring forward infrastructure investment.

Limitations

- Any decision to finance infrastructure by borrowing, regardless of the instrument used, needs to be repaid, including interest. Government can only fund these repayments through raising more revenue, including increasing taxes or charges, or reducing services. This can constrain government's ability to meet future community needs.

Implementation considerations

- There are no implementation considerations. Administrative arrangements already exist to facilitate issuing state government bonds.

2. Social impact bonds

What is it?

Social impact bonds (also known as social benefit bonds) allow private financiers to raise capital (debt/‘borrowings’ or equity) and partner with service providers to deliver agreed social outcomes and better manage risk. Government then makes bonus payments for achieving agreed targets or ‘outcomes’. Improved social outcomes can include reduced reoffending by former prisoners. That in turn lowers the need for government expenditure on justice system pressures such as custodial services.

These arrangements do not fund the infrastructure or services required to improve social outcomes. Private financiers and service providers need to be repaid over time, as well as bonuses for achieving agreed social outcomes.

Social impact bonds enable service providers such as the not-for-profit sector and private financiers to partner and deliver innovative solutions. Bonus payments provide financial incentives to minimise risks, reduce costs and deliver results. Cost savings to government from achieving improved social outcomes can be used to repay the upfront investment plus a financial return.

Social impact bonds could be applied to social and environmental infrastructure and programs. They can be arranged in a variety of ways.

Social impact bonds have been used were used in the UK since 2010 and are now being used in Northern America and Europe. In 2013 NSW started using social impact bonds for child protection. They have been and can be applied to a range of sectors including, social housing, homelessness, preventive healthcare, offending and environmental services. In the 2016-17 State Budget, the government allocated funding for the market testing and procurement phases of a pilot program for social impact bonds.

Advantages

- There is a direct financial incentive for service providers (such as the not-for-profit sector) and investors to achieve targets or make a measureable contribution to social and community outcomes. This is because they will profit if they are able to meet or exceed the agreed targets.
- Financial incentives increase the likelihood of providers measuring results to identify and abandon ineffective programs in favour of alternatives that are more likely to succeed. It also provides incentives to reduce costs, minimise risks, and better target programs to get results.
- The extra rigour applied by private financiers undertaking due diligence to understand risk and returns increases the likelihood of successful outcomes.
- Cost savings can accrue to government if the total price paid (including financing costs) to private financiers and service providers for achieving results is cheaper than if government delivered results itself.
- Capability across sectors can be enhanced by bringing together governments, service providers (including the not-for-profit sector), investors and communities to leverage skills, innovate and better manage risks.

- Progressively achieving results can help build expertise to address larger and more complex social problems.

Limitations

- They are a relatively new financing tool and long term results are yet to be assessed.
- Social impact bonds implemented globally have been relatively small scale, with most projects having a budget of about \$10 million.
- The finance costs of a social impact bond may be higher than simply providing a grant to a not-for-profit to deliver a service. This is because of the risk borne by service providers and investors. Social impact bonds are also less liquid because the group of investors is smaller than for TCV bonds. However, the total price paid to financiers and service providers should still be less than if government delivered the service itself.
- Government could directly pay a service provider for results, which may achieve the same outcomes for lower cost with less complexity. This is because it avoids the need for an artificial bond structure. However, social impact bonds can be effective because they introduce the discipline of private finance to achieve outcomes.

Implementation considerations

- To achieve results, it will be important to set clear roles for service providers and set key performance indicators that are: measurable, achievable, relevant, time-bound and outcome-based.
- If projects using this option did not deliver results, investor appetite may wane and prospects of similar projects would be reduced.
- It can be difficult for government to avoid 'political risks'. If a provider fails to provide the baseline service, the community may pressure government to fix the problem even if it is not the government's contractual responsibility. This is similar to any contractual arrangement entered into by government, and not a risk specific only to social impact bonds.
- The scope of initial pilots is likely to be small so that arrangements can be refined as we learn from our experiences.

3. Borrowing by private financiers

What is it?

Government engages private financiers to deliver public infrastructure and services (including maintenance). This approach is often paired with Public Private Partnership (PPP) procurement models. Financiers raise capital (debt or equity) to finance infrastructure delivery. Over time government still needs to pay the private financiers for delivering and maintaining infrastructure and services to an agreed standard. Government pays financiers (or allows them to levy a charge on users) and they use this revenue stream to service the debt as well as equity. Since 2000, the Partnerships Victoria policy has guided the delivery of PPP procurement models, where government partners with the private sector to deliver infrastructure and/or services to an agreed standard over a set period of time.

Victoria has a long history of delivering infrastructure via private financiers and PPPs. CityLink, the Royal Children's Hospital and the Melbourne Showgrounds Redevelopment were all delivered by partnering with the private sector using capital raised by private financiers.

Advantages

- Value for money can be delivered when the total price we pay private financiers and their partners for delivering infrastructure and services (including maintenance and borrowing costs) to an agreed standard is cheaper than if government delivered it itself and/or the risk to government is reduced.
- It can improve the standard and reliability of delivering infrastructure by allocating risk to the party best able to manage it. Transferring risk can result in significant cost savings. For example, government can avoid cost blow-outs, because private parties bear the risk and cost of unexpected events during construction. Construction risks can include price increases for materials or labour, bad weather or industrial action, or delays in supplies, delaying construction and increasing costs.
- It introduces a higher level of due diligence and private sector rigour to evaluating and managing risks which are transferred.
- The risk of performance is borne by the investor, not by government. Government does not pay the full amount if agreed standards or targets set out in the contract are not delivered.
- Payments based on performance provide financial incentives for financiers and the private sector to reduce costs, drive innovation, improve services, effectively manage risk and ensure assets are maintained. For example, where the private sector is responsible for design, construction and long term operations, they have the incentive to build to a high standard to prevent high maintenance costs and operational failures.
- It ensures a consistent standard of infrastructure, maintenance, and services to be delivered over time for an agreed price. It allows for greater budgeting certainty during the contract period, by 'locking in' a price upfront. This helps ensure our assets are maintained. It also helps to smooth out the cost government incurs for infrastructure and services over the period of a contract.
- Competition between the public and private providers can help private financiers drive innovation to set new benchmarks for delivering infrastructure and services to a higher standard, more consistently, and at lower cost.

Limitations

- The actual (non-risk-adjusted) cost of finance is often higher than if government borrowed itself.
- When compared to traditional government financing and procurement approaches, the total costs also may appear higher. However, this is because they often deliver higher standards of service and infrastructure (via more services or additional facilities, or higher quality services or infrastructure) and the infrastructure is fully maintained for the period of the contract.
- Government is unable to transfer all risks, especially 'political risks'. If projects or services fail, the community will often pressure government to fix the problem, even if it is not its contractual responsibility.
- Depending on the scale of the project, these financing approaches can be costly, time consuming and complex to evaluate and procure. However, value-for-money can be delivered when the total price we pay is cheaper than if government delivered infrastructure and services itself.

Implementation considerations

- The decision to apply this option should be assessed on a case-by-case basis to ensure value for money is maximised.
- Government uses this approach now under the Partnerships Victoria PPP model. Investors have often argued for a steady pipeline of infrastructure projects to gain efficiencies in project development and investment returns.
- Specialist commercial and financial skills are required by government to evaluate and negotiate commercial terms and agreements which deliver value for money. Ongoing contract management and monitoring is required to ensure risk allocation is maintained and contract terms and performance are met.
- Contracts for private financing arrangements are usually for 20 or more years. Circumstance will change during this time, so we need to balance flexibility to re-negotiate contract terms when needed with 'locking in prices'.

4. Tax increment financing (TIF)

What is it?

Quarantining and then diverting a portion of future taxation revenue from a defined revenue stream or particular tax as security to finance or borrow for infrastructure. The forecast taxation revenue captured is used to service the capital (debt or equity) raised (including interest and repayments) to finance infrastructure. This allows governments or private financiers to borrow against future taxation income streams.

The particular type of taxation revenue used in TIF to service capital determines the interest rate on the borrowing. Typically, the more reliable the taxation revenue, the lower the interest rate applied to a TIF financing arrangement. The opposite is also true.

Victoria pays a low interest rate on state government issued bonds. Jurisdictions that benefit from TIF have government issued bonds with a higher cost of debt. They may be able to achieve a lower cost of borrowing through TIF arrangements because they're borrowing against less risky taxation revenue. Although over the long term their government issued bond interest rate will increase.

TIF has been applied in the United States and United Kingdom to help facilitate value capture funding approaches. It can also be used to support other funding approaches.

Advantages

- It does not have to involve levying new or increased charges on the beneficiaries of new infrastructure. It can be implemented by capturing the forecast increases in taxation revenue arising from the provision of new infrastructure based on existing rates.
- Like other forms of borrowing, it allows government to bring forward infrastructure investment by using part of the forecast or 'expected' increase in taxation value generated by its investment to finance its costs up front.
- Can attract different investors by offering a wider range of risk and return options.

Limitations

- Applying TIF in Victoria is unlikely to result in interest rates which are significantly lower than the low interest rates we currently pay for state government issued bonds.
- The additional complexity, administration and transaction costs, and administrative changes required to quarantine future taxation revenue for specific projects could outweigh the short term benefits.
- Removing particular taxation revenues from the portfolio of taxes that support state government issued bonds may have an impact, in the long term, on the interest rate government must pay on these bonds.
- Removing particular taxation revenues from the portfolio of state taxes also reduces the flexibility of government to respond to changing priorities, or adjust the taxation setting of the quarantined taxation stream.
- The existing pool of state taxes is limited, reducing the number or type of taxes TIF could be applied to.

Implementation considerations

- Additional costs are likely to be incurred to implement changes required to the systems and processes which collect and administer taxation revenue (such as land tax or rates) to support this option.

5. Concessional loans from the commonwealth government

What is it?

Co-financing arrangements that allow the state to access some finance from the commonwealth for an infrastructure project can be structured in a variety of ways. For instance, a concessional loan allows the state to access marginally cheaper commonwealth debt. The commonwealth can access debt at a slightly cheaper rate than the state because the interest rate at which the commonwealth can borrow is slightly less than a state bond. Alternatively, the commonwealth provides direct capital contributions to the state for a project.

Advantages

- The commonwealth can access finance at a slightly cheaper rate than the state government.

Limitations

- Savings arising from cheaper concessional loans for Victoria are likely to be minimal. Victoria already pays low interest rates on state government bonds. At present market pricing, it may result in long term interest rate savings of about 0.20 per cent per annum, depending on the debt term. This equates to a saving of about \$2 million per year for a \$1 billion debt.
- Concessional loans and other financing arrangements with the commonwealth will only ever form part of overall financing arrangements for an infrastructure project.
- The governance arrangements supporting concessional loans between the state and the commonwealth are likely to affect project financing and delivery. The commonwealth may seek an increased decision-making role, and/or the concessional loan may give rise to extra obligations or liabilities for the state, increasing the complexity of overall project financing arrangements. The benefits may outweigh the costs. For example, we need to better understand where refinancing risks would reside if concessional loans or contributions are paired with borrowing sourced by private financiers and public private partnership (PPP) procurement. Traditional commonwealth funding contributions to infrastructure projects such as grants do not incur these risks.
- Pairing this arrangement with borrowing by private financiers and PPP procurement may increase the complexity of negotiating contracts, repayments to private financiers, risk allocation and who bears the refinancing risk. For example:
 - Capital contributions where the commonwealth will take some ownership would make debt negotiations with private financiers more complex and challenging.
 - When the commonwealth pays the state government, who in turn pays the private partner, the state has ongoing liabilities to the private partner, regardless of whether the commonwealth withholds or defers the loan or payment to the state.
 - When the commonwealth pays the private provider directly, it takes up some equity in the project. This raises complexity on how to structure the equity return, and the state is still exposed to the refinancing risk.

- These arrangements could significantly affect both project financing and the state's finances. When the commonwealth provide concessional loans to states like Victoria, they treat it as an investment. This is because they either receive equity or revenue via repayments in return. As a result, the funds provided by the commonwealth do not increase their net debt. However, the state's debt increases, because it must repay these loans to the commonwealth. In contrast, when the commonwealth provides a grant to the Victorian government, it is received as revenue, and does not affect the state's net debt.

Implementation considerations

- Additional time will be required and transaction costs could be incurred to structure and negotiate these co-financing arrangements.

6. Local government borrowing

What is it?

Local government financing infrastructure investment through borrowing, including accessing cheaper debt through discounted interest rates below commercial interest rates.

Local governments can already borrow for infrastructure from commercial lenders (subject to the *Local Government Act 1989*) or through the Local Government Funding Vehicle. The Local Government Funding Vehicle is a debt facility developed by the Municipal Association of Victoria and commercial banks. The first bond issue was in November 2014 and raised \$240 million for 32 councils across Victoria. A second issue of bonds is expected in 2016. The Local Government Funding Vehicle lends to local governments at a discounted interest rate.

Advantages

- Accessing cheaper debt could help bring forward local government infrastructure investment. However, the Local Government Funding Vehicle already lends to local government at a lower cost than commercial lenders.

Limitations

- Increasing local government borrowing does not increase the amount of community infrastructure delivered over the long term, it brings forward the timing of infrastructure projects considered to be “high priority” to meet growing needs. Not all local government infrastructure investment increases their revenue base or productivity, and as with all forms of borrowing, local government must repay debt by increasing rates or charges, or reducing services. Bringing forward future investment by using high levels of debt financing may significantly reduce future budget flexibility to meet community needs.

Implementation considerations

- There does not appear to be a barrier to local government borrowing lower cost finance, with 46 per cent of local governments already accessing the Local Government Funding Vehicle.
- As for all levels of government, local governments need strong financial management processes, and commercial skills and capabilities, to support borrowing and prudently manage their finances.

7. Tailor finance for specific investor groups

What is it?

Raising capital (debt or equity) to finance infrastructure by bundling together and tailoring financing arrangements for specific investor groups and infrastructure projects. This includes:

- Bundling debt and marketing it to specific groups such as individuals (i.e. local retail investors) or superannuation funds for specific infrastructure projects.
- Raising capital by selling 'shares' or the right to equity/partial ownership in a specific identifiable asset. Instead of interest payments, investors receive rental or lease payments. Sukuk or Islamic bonds are examples of this type of financing and because they are sharia compliant, they are attractive to Islamic lending groups.

There has been discussion in the financial and commercial sector about the willingness of superannuation funds to invest or raise capital to support the financing of infrastructure projects. This includes selling infrastructure based bonds to retail investors.

Islamic bonds are increasingly being used in the Middle East and Asia to finance infrastructure projects and are now being used in the United Kingdom. Although they represent a small proportion of total world financial assets they have grown at an annual rate of 17.6 per cent between 2009 and 2013³.

The commonwealth government announced in its 2016-17 budget that it will change taxation arrangements by 1 July 2018 to remove barriers for asset backed financing arrangements such as Islamic financing.

Advantages

- Increases the pool of new investors by attracting those that would not otherwise invest in public infrastructure. A larger group of investors could reduce the cost of finance.

Limitations

- Unlikely to raise significantly cheaper capital. Large investors such as superannuation funds can already invest in Victoria's infrastructure by investing in state government bonds issued by Treasury Corporation Victoria (TCV). There is not yet a well-developed financial market for trading specific or tailored financial products. There is however, an active market for traditional bonds issued by TCV which can be easily bought and sold by investors.
- Costs to develop new financial products or tailoring products to attract specific investors will be higher than traditional TCV bonds and are likely to outweigh the benefits.
- Islamic bonds which provide equity returns and lease payments for specific assets or infrastructure projects are likely to be time consuming to develop, difficult or complicated to collect, and involve additional costs to administer.

³ *"Islamic finance: Big interest, no interest", The Economist, The Economist Newspaper Limited, Sep 13, 2014.*

Implementation considerations

- These new financing instruments and arrangements are complex and will take time to develop. We will also incur additional costs in developing and administering them.