

VALUE CAPTURE AND GETTING SMART

THE AUSTRALIAN GOVERNMENT HAS IDENTIFIED VALUE CAPTURE AND INNOVATIVE FINANCING AS KEY ELEMENTS OF ITS SMART CITIES PLAN. THE MOVE WILL HAVE SIGNIFICANT IMPLICATIONS FOR TRADITIONAL PROJECT FINANCE. BY **PAUL KENNY**, SECTOR LEADER, GOVERNMENT, AND **PHILLIP CORNWELL**, PROJECT FINANCE, PARTNERS AT **ALLENS**.

Infrastructure funding and financing has rarely seen the level of interest it currently enjoys from policy makers and finance sector participants.

The volume of government reports, independent analysis and popular commentary on the subject has grown exponentially over the last decade.

The most recent contribution is the Australian Government's Smart Cities Plan, which was released by the Prime Minister and the Assistant Minister for Cities and Digital Transformation on April 29 2016. The Smart Cities Plan sets out the government's plan for maximising the potential of Australia's cities through better investment, policy and technology. In relation to infrastructure funding and financing the plan signals two key policy developments that, if carried through, will have significant implications for the infrastructure sector in the medium and long term.

The first development is the government's commitment to the use of value capture as a means of promoting increased investment in productive infrastructure. According to the plan, all levels of government can do more to realise the potential benefits of value capture, especially in an environment where "our cities need smarter investment, but they also need more investment". In other words, the government sees value capture not just as an alternative infrastructure funding source, but as having the potential to bring forward investment in projects that might otherwise be delayed or not occur at all.

Of course, the Australian Government is not a major player when it comes to direct infrastructure investment – this is primarily the responsibility of state and territory governments. It nevertheless has the capacity to exert significant influence on infrastructure project investment through its decisions around commonwealth funding contributions, which so often make the difference between whether and when a project proceeds.

The government's value capture policy commitment is reflected in a requirement that value capture mechanisms be addressed early in all business cases seeking commonwealth funding for infrastructure. The Smart Cities Plan also foreshadows an intention to issue a discussion paper on the government's approach to value capture.

With respect to infrastructure financing, the plan confirms a trend already evident in commonwealth infrastructure funding arrangements, which is that infrastructure funding should be treated as an investment wherever possible.

Commonwealth contributions to state and territory infrastructure funding have traditionally been contributed as a grant. In the future, the government will more actively consider the use of innovative financing approaches, including structuring its contribution to be held as a long-term asset, whether as equity or debt.

Steps in this direction have already been taken in the WestConnex project, where part of the commonwealth's contribution was provided through a A\$2bn concessional loan facility, and with the establishment of the Northern Australia Infrastructure Facility (NAIF). The NAIF will offer up to A\$5bn in concessional loans to encourage and complement private-sector investment in economic infrastructure that otherwise would not be built or would not be built for some time.

The same thinking is reflected in the Australian Government announcement of a A\$2bn National Water Infrastructure Loan Facility as part of the 2016/17 Federal Budget, under which concessional loans will be available to finance water infrastructure projects.

These initiatives will be supported by the establishment of an infrastructure financing unit within the commonwealth bureaucracy to work with the private sector in developing financing solutions to fund key government projects.

This paper first looks at what value capture is, and why it has recently become such a topical issue. It then examines the projects that are most likely to benefit from the value capture initiative. Finally, the paper turns to the implications of value capture, as well as the government's innovative financing initiative, for the traditional project finance in the development of new of infrastructure.

Value capture

There is no simple, universally accepted definition of value capture. At its most basic level it refers to the concept of capturing the value that is created by new infrastructure, monetising that value, and using it as a source of funding for the infrastructure.

A new rail line or road connection can be expected to enhance the value of adjacent land. This value uplift, known to economists as a positive externality, reflects a range of value impacts that may be present in particular infrastructure projects, including reduced travel times, improved amenity (eg, through reduced traffic on existing roads) and increased economic activity in the area served by the infrastructure.

Some of these externalities will be reflected in increased property values, with a portion of that increase captured in time through existing taxation measures such as rates, land taxes and conveyancing duty. But this level of capture is modest, slow and haphazard. Value capture mechanisms seek to appropriate part of that value uplift more directly and immediately for the benefit of the community, rather than leaving all or most of the value in the hands of the owners or occupiers of the relevant land.

Broadly, there are three ways in which this can be done.

The first is the imposition of a tax on the owners of the land that benefits from the infrastructure. This could be in the form of a special rate or statutory levy, and is often referred to as a betterment levy. A betterment levy might be put in place for a period of time, geared to the government's estimate of the value uplift and designed to recover some part of the cost of the infrastructure over the life of the levy.

Second, land value increases can be captured through developer contributions. This involves an upfront payment or an in-kind contribution by property developers that contributes to the cost of infrastructure in new areas to be served by road, rail or other publicly funded community infrastructure. Developer contributions are already a feature of planning law and practice, but arguably can be better targeted and utilised within a value capture policy framework.

The third mechanism for capturing the property value uplift associated with government investment in infrastructure is through commercial development of land that is either released or made available for alternative uses as a result of the infrastructure development. Typical examples of this include the development of air rights over railway or metro stations for residential and commercial development and the commercial development of adjacent land.

While most of the discussion of value capture focuses on the uplift in land values, it need not be limited to this. A broader concept of value capture extends the range of beneficiaries of the infrastructure to include users. Under this broader conception, user charges in the form of public transport fares, road tolls and other user charging mechanisms also form part of the value capture tool kit.

A key point to be made at the outset is that value capture is about infrastructure funding rather than infrastructure financing. In other words, it is about finding alternative sources of revenue to pay for infrastructure, and not about structuring the

financing of the project once a decision has been made to proceed. Though the two can be combined, as they are in the United States where municipal authorities can borrow ("tax increment financing", discussed further below) against projected increases in land tax collections that are expected to result from specific infrastructure improvements or urban redevelopment.

Growing interest

If this is what value capture comprises, why has it become a subject of such immediate and growing interest? There is nothing new or surprising in the notion that new or better infrastructure will improve adjacent property values. And yet it seems that every new government report, policy paper or commentary on infrastructure, and especially those focusing on infrastructure funding, identify value capture as a key contributor to the infrastructure funding task.

The most obvious answer to this question is that, at a time when critical infrastructure needs continue to grow, we are in a period of highly constrained fiscal settings at all levels of government. Traditional budget funding of infrastructure is limited by reduced taxation revenue and ongoing budget deficits.

Moreover, governments remain reticent about borrowing to fund infrastructure for fear of the credit rating implications of increasing government debt. In this environment it is easy to see why the potential to fund new projects through a currently untapped revenue source attracts the attention of policy makers

Although the fiscal environment may be the immediate catalyst for reform, however, it would be wrong to overlook the role played by serious policy analysis in the infrastructure sector, which has grown in both volume and sophistication over the past decade. Value capture is not just an additional source of funding for infrastructure, but is seen as a more equitable and efficient one.

The equity argument starts from the proposition that all public infrastructure funding ultimately comes from the community – in the form either of user charges or general taxation revenue. The question, then, is whether the current mix between those sources represents an equitable share of the funding burden, or whether equity would be better served by allocating more of the cost of building infrastructure to those who benefit from it.

The beneficiaries are primarily the future users of the infrastructure and those who receive indirect benefits through land value uplift and increased economic activity in the area served by the infrastructure. Of course, a reorientation of the mix towards users and other beneficiaries raises its own equity considerations, most particularly the impact on low income and vulnerable members of the community whose access to public infrastructure might be impacted by a "beneficiary pays" model. However, those concerns might be better addressed by targeted relief rather than a broad cross-subsidy by taxpayers in favour of users and other beneficiaries.

The efficiency arguments include the benefits of price signals for more efficient infrastructure use and investment decisions, and the benefits of land taxes compared with other forms of taxation as a means of raising revenue for infrastructure funding.

For example, in relation to betterment levies the Productivity Commission says that, in principle, a betterment levy can be an efficient means of recovering the cost of infrastructure that has diffuse benefits across local residents and businesses. It can be administratively simple and is likely to be less distortionary than other taxes. Economists and the property industry would like to see a broader based land tax replace inefficient state taxes such as conveyancing duty, and such a tax would be more efficient at capturing value uplift. But taxing the family home would require bipartisan support, which seems unlikely to be forthcoming.

These principles of equity and efficiency are consistent themes in all of the recent literature on the use of value capture as part of the infrastructure funding mix, and are at least as important as the contribution it can make to alleviating the consequences of the current focus of Australian governments on fiscal consolidation.

Projects likely to benefit

Although value capture is discussed in relation to public infrastructure generally, there is no doubt that urban rail projects are the most likely to benefit from the development of a value capture policy framework. Rail projects generally, and urban rail in particular, have been the most common projects where value capture mechanisms have been used to-date and this will continue to be the case.

Among the most commonly cited examples of successful value capture projects internationally are the London Crossrail project, MTR Corporation's use of property development to contribute to the funding of Hong Kong's rail network, and the Dallas Area Rapid Transit tax increment funding model.

The leading domestic examples include the Melbourne Underground Rail Loop, Melbourne Central railway station, Gold Coast Rapid Transit and Parramatta Light Rail. This is not to say that other projects cannot and will not benefit from the use of value capture mechanisms, but simply that it is large, city-shaping projects of this kind where value capture is likely to make the most substantial contribution to bringing forward infrastructure investment.

There are a number of reasons why rail projects are particularly amenable to value capture. First and foremost, value capture relies on a demonstrable and credible connection between the infrastructure and the creation of value, particularly where the value to be captured is associated with increased property values. The empirical data to-date suggests that this connection is most evident in relation to rail projects.

A literature review by the Bureau of Infrastructure, Transport and Regional Economics in 2015 identified more than 100 studies on value uplift around mass transit nodes, and found that

on average land values increased, although there was considerable variation in timing and amount. There were too few studies on the effect of road infrastructure investment on land values to make an assessment.

Second, the nature of rail infrastructure is most conducive to the release of land for residential and commercial development. Developments on and around new or redeveloped stations, particularly in areas of high urban density, create the ideal opportunity for the sale or co-development of commercial rights. This is unlikely to be present in the same way in relation to road projects.

A good recent illustration is the Melbourne Metro Project business case, which was released by the Victorian government in February 2016. The business case includes an analysis of value capture opportunities for the project focusing on integrated development and other commercial opportunities at the five new stations and the portals that will be developed as part of Melbourne Metro.

The analysis includes an assessment of the potential to incorporate retail or other commercial opportunities within the new stations, expand station infrastructure to accommodate additional development, develop air rights above the new infrastructure, and develop surplus land. The business case limits itself to integrated development opportunities; it does not consider potential value capture mechanisms such as tax increment financing, new levies or new contributions.

The London Crossrail project, which is a new 118km rail line in London, is perhaps the best example of the effective and innovative use of value capture in making a significant contribution to the funding of new rail infrastructure, as well as responding to the equity and efficiency objectives outlined above. This is because it employs a range of value capture mechanisms that identify and target all of the various beneficiaries of the project. This use of multiple mechanisms is likely to be one of the keys to the successful deployment of value capture, and underlines the need for a comprehensive and transparent policy framework to guide early project planning and development.

The expected cost of the Crossrail project is over £14bn. The City of London will contribute £4.1bn raised through a business rate supplement and a community infrastructure levy – these correspond to the betterment levy and developer contributions described above. Users are expected to contribute £2.5bn through the farebox. There are also substantial contributions from Heathrow Airport and Canary Wharf, which will benefit from commercial development opportunities associated with the project.

Finally, Network Rail will contribute £2.3bn from forecast rail network operating cost savings attributable to the project. Hence, through a broad identification of beneficiaries and tailored

value capture mechanisms targeted at each of them, well over half the total project cost will be defrayed by value capture revenues.

Implications for traditional project financing

In the short term it is unlikely that the increased focus on value capture will have significant implications for traditional project financing of infrastructure. The current focus of value capture in business cases for new projects is on integrating residential and commercial development in the project scope and design. As already noted, this is the focus of the Melbourne Metro business case.

The implications of new infrastructure projects including integrated commercial development for project financing will depend on how the government chooses to realise the value of the development – in particular whether it sells development rights separately, participates in the development, or seeks to realise the value up-front by asking bidders to price-in the value of the development in the overall project cost. In the first two scenarios, the use of value capture will reduce the overall cost of the project to the budget but should not impact on the financing arrangements for the project itself.

Where the commercial development is included as part of the bid proposition, the bidding consortia will need to make an assessment of the value of the commercial opportunities and factor this into their bid. This will increase the complexity of the transaction and add to the due diligence and risk assessment for both bidders and their financiers.

In particular, financiers will need to be satisfied with the overall economics of the project, taking account of the commercial development, and will need to factor in the proposed residential or commercial development as an additional risk on top of their assessment of the project's construction and operating risk. The commercial development risk might be mitigated by the addition of new consortium members focused on this component of the project, adding complexity to the intra-consortium arrangements. None of these issues, however, are fundamentally different to those that are already common and regularly addressed in project financing.

In the medium term, there is the prospect of value capture leading to more innovative financing structures in which the revenue streams associated with the broader range of value capture mechanisms (such as new or increased land taxes and levies) are securitised. However, this relies on the development of legal and institutional frameworks that do not yet exist and will take some time to develop.

An illustration of the type of structure used in other jurisdictions is tax increment financing (or TIF). This involves the government hypothecating an anticipated increase in a tax revenue stream attributable to a project and using this as security for a debt facility to finance the project. TIF is referred to in virtually all of

the value capture discussion papers and reports, but there is no immediate impetus for it to be implemented in any Australian jurisdiction. It is difficult to see what impetus will emerge when governments currently have adequate borrowing capacity at historically low interest rates, but are nevertheless generally disinclined to borrow for infrastructure development.

Putting value capture aside, the more immediate impact on project financing will come from the commonwealth's move to more actively consider innovative financing approaches as an alternative to simple grant funding. Where the commonwealth contributes to projects in the form of equity or concessional loans, this has the potential to increase the complexity of the transaction for project financing, both in terms of decision making processes and inter-creditor arrangements.

Infrastructure Victoria has suggested a cautious approach in discussing these arrangements. It suggests that while a concessional loan allows the state to access marginally cheaper commonwealth debt, the savings are likely to be minimal, with the current interest rate differential between Victorian and commonwealth bonds being only about 0.20 percentage points.

Moreover, although a concessional loan benefits the commonwealth's balance sheet, as the loan is treated as an investment, unless well structured it may constitute an addition to net debt on the state's balance sheet (as compared with a grant, which is treated as revenue). Certainly, it will increase the commonwealth's net debt, the rapid growth of which is starting to generate some concern.

Infrastructure Victoria also suggests that the governance arrangements supporting concessional loans between the state and the commonwealth are likely to affect project finance and delivery, including by adding to the complexity of negotiations and risk allocation.

Our experience with the WestConnex Stage 2 concessional loan suggests that this will not be a material factor. However, those loans were subordinated to the senior bank debt, and there are signs, eg, with the NAIF, that the commonwealth would prefer to have its concessional loans ranking equally with senior bank debt, even if on softer payment terms and at a lower interest rate.

This approach is supported by the very successful Transportation Infrastructure Finance and Innovation Act (TIFIA) loan structure in the United States. The TIFIA credit programme is designed to fill market gaps and leverage substantial private co-investment by providing supplemental and patient capital for major transport infrastructure projects. TIFIA loans are typically subordinated to senior bank debt in cashflow terms but equal ranking on enforcement of security.

It remains to be seen whether the Australian bank market can accommodate co-financings on terms similar to the TIFIA loans. ■