ABC:sh:B2581

14 April 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Sir,

A Platform for Consultation
Submission on Chapters 8 and 9

Transfield Holdings Pty Limited is pleased to make this submission on the issues raised in chapters 8 and 9 of "A Platform for Consultation: Building on A Strong Foundation".

Our comments are restricted to the issues of section 51AD and Division 16D.

We strongly endorse the comments by the Review that section 51AD is an impediment to the further development of Australia's significant infrastructure industry and should be repealed.

It is essential for Australia's economic future that any anti-avoidance provisions introduced to deal with unacceptable arrangements of the type described in chapters 8 and 9 are drafted precisely enough to ensure that they do not hinder private investment in the provision of public infrastructure.

Australia's stock of infrastructure is widely regarded as being inadequate. Several economic studies have developed a range of statistics confirming this situation – other studies have directly linked the development of major infrastructure projects with the generation of real growth in the economy generally. There are numerous major projects in Australia that require development and funding and in the face of government's reluctance to undertake major works because of fiscal and budgetary constraints, the private sector has shown an appetite and an ability to deliver cost effective infrastructure to Australian businesses and consumers. It is therefore extremely important that the Australian tax system does not impede this investment, in its attempt to combat unrelated transactions.

Ongoing consultation with industry is the key to a successful outcome to the initiatives of the Review of Business Taxation. Accordingly, we would welcome the opportunity to meet with you or your representatives to discuss our submission, or provide any further information which may assist.

Yours sincerely,

TRANSFIELD HOLDINGS PTY LIMITED

B.D. ESLICK

Chief Financial Officer

Transfield Holdings Pty Ltd

Submission to the

Review of Business Taxation

A Platform for Consultation:
Building on A Strong Foundation

Chapters 8 and 9

1. Introduction

The Transfield group is a leading developer, owner and provider of operations, maintenance engineering and construction services with turnover exceeding $1.5B pa. and employee numbers exceeding 6000.

Transfield leads Australia in the development of private sector infrastructure projects having completed or commenced projects throughout the region to the value of $4 billion over the past 10 years. Transfield's infrastructure experience spans various markets including roads, railways, bridges, tunnels, power stations, water treatment and gas pipelines.

This experience makes Transfield uniquely qualified to comment on the proposals contained in chapters 8 and 9 of “A Platform for Consultation” and how they will affect private investment in public infrastructure.

The purpose of this submission is to make specific comment on the matters raised in chapters 8 and 9 of “A Platform for Consultation” so far as they relate to private infrastructure investment.

It needs to be clearly understood that the terms “private investment in public infrastructure” and “private infrastructure investment” mean investment under which private investors bear commercial risks <u>over and above</u> those which would be normally borne by a debt financier providing finance to a tax-exempt entity.

Accordingly, we append to this submission an explanation of the development of private infrastructure investment, risk allocation and the future for private infrastructure investment.

We also attach (as Appendices 2, 3 and 4) the following submissions by Transfield to Government on the subject of section 51AD:

- our letter to the Department of Treasury dated 7 November 1995;
- our previous letter to the Review of Business Taxation dated 15 December 1998 (excluding attachments); and
- our letter to the Prime Minister of 18 June 1998, and his response of 2 December 1998.

2 Section 51AD must be Repealed

Transfield strongly supports the criticisms directed by the Review of Business Taxation (the “Review”) towards the following features of section 51AD:

- the uncertainty and broad application of the “effective control” test; and
- the severity of the application of section 51AD.

The “effective control” test causes extreme difficulties for public infrastructure projects. By its very nature, new infrastructure must be integrated with existing facilities in order to ensure effective operation which is beneficial to the public. For example, power stations must be integrated with the existing distribution network and privately operated roads must be integrated with existing roads. Contractual terms necessary to ensure such integration usually causes the tax authorities to question whether there is “effective control” by the government.

Transfield endorses the finding of the Review that “there is no need for the current draconian section 51AD ...” (para 9.78). We also endorse the recommendation in para. B4 that section 51AD be repealed.

As suggested by the Review, in today's economic environment, adequate controls on tax preference transfers by tax exempts can be implemented through amendments to Division 16D of the Tax Act

3 Amending Division 16D

Transfield is a member of the Australian Council for Infrastructure Development (AusCID) and notes the recommendation in its submission to the Review of December 1998 that "Division 16D be amended to:

- abolish the "use" test;
- restrict the "control of use" test to a "*substantial* control of use" test; and
- define "substantial control" to be an exclusive concept such that only one party can be deemed to be a substantial controller of a given asset at any given point in time. This definition should contain a further provision to the effect that a tax-exempt authority will be deemed not to have substantial control if the private sector owner or associate assumes the majority of material risks of the project.

Consistent with the fundamental tenant of all of our submissions Transfield considers that it is inappropriate for private infrastructure projects to be adversely affected by anti-avoidance provisions.

4 Public/ Private Partnerships are NOT Tax Avoidance

This submission highlights the relevant differences between private infrastructure investment and the arrangements which are discussed in chapters 8 and 9 of "A Platform for Consultation", together with the adverse affect on private infrastructure investment that the proposals therein contained may create, in order to impress upon the Review the need for further detailed industry consultation on any redesigned Division 16D.

Taxation problems with private infrastructure investment currently arise because such investment is adversely affected by anti-avoidance provisions which were designed for other purposes. In particular, Section 51AD and Division 16D were designed to prevent tax avoidance by the use of leasing and similar arrangements between taxpayers and tax exempt entities at a time when there was no private ownership of public infrastructure. Such arrangements are entirely different to private infrastructure investment in a maturing market such as the presently existing market, which involves a taxpayer investing in public infrastructure and bearing the commercial risks of such investment (refer appendix 1).

Chapters 8 and 9 of "A Platform for Consultation" are directed towards tax avoidance involving the use of leasing and similar arrangements. These are purely financing arrangements. They are fundamentally different to arrangements for private infrastructure investment and it is essential this distinction be recognised. We are concerned that if these differences are not recognised, private infrastructure investment will continue to be impeded by unnecessary and outdated anti-avoidance provisions.

The cameos in chapters 8 and 9 identify tax benefits associated with leasing arrangements which do not exist where there is bona fide private investment in public infrastructure. These tax benefits arise from payments being structured differently to the grantor's cost of providing the asset, and the transfer of tax preferences.

The following considers the issue of tax benefits from leasing in the context of private infrastructure investment:

(a) Structuring payments differently to the grantor's cost of providing the asset.

"The payments" referred to in chapters 8 and 9 are payments made by a tax-exempt entity to a taxpayer for the use of an asset. These payments are fixed at the commencement of an arrangement, and are based on the cost of the asset. In their simplest form, they are lease payments.

There are no equivalent payments under private infrastructure investment projects. This is because any "payments" received by an investor represent income arising from business operations, and are directly related to the success or otherwise of those operations. Most often, this income is derived directly from the public, although there may be circumstances in which the payment is made by the state but based on the success of operations (such as payments for treated water). Occasionally, where a business is traditionally a loss-making business, the state may pay a subsidy to the investor. This subsidy is not, however, related to the cost of the asset but rather to the forecast loss from operations. The subsidy is fixed at the commencement of the arrangement, so that the investor makes any gains or losses from the success or otherwise of operations.

As the income of the investor is related to the outcome of business operations, and is not directly related to the cost of the asset, it is not possible to obtain a tax benefit by "structuring" the payments differently from the cost of providing the asset.

(b) Transferring tax preferences

Para 9.27 states that tax loss entities are currently generally able to access the benefits of accelerated depreciation through leasing.

It is correct to say that with private infrastructure investment, and in the absence of anti-avoidance provisions, an investor is able to utilise tax preferences (such as accelerated depreciation). However, it is also correct to say that private infrastructure investment is undertaken for the purpose of making a profit, and that such profit will be subject to tax (either in the hands of the investment entity, or the ultimate investors).

Therefore, if it is the case that non-taxable entities are able to access the benefits of accelerated depreciation through private infrastructure investment, it must also be recognised that non-taxable entities must bear some of the cost of taxation on the profit from private infrastructure investment. This is demonstrated by the fact that any payments which are made by investors to the state in consideration for the right to operate the infrastructure are based on estimated rates of return which must be increased to cover the taxation liabilities of investors.

The fact that private infrastructure investment results in net tax payable demonstrates that such investment is not entered into for taxation purposes, but rather for commercial purposes.

5 Difficulties with the "sale and loan" approach

The two reform options suggested in chapter 9 each involve a "sale and loan" approach whereby an investor is taken to have made a loan to a tax-exempt entity.

This approach may be appropriate in the case of a lease, on the basis that the "tax treatments of leases and loans differ only in the following respect: whereas the full lease payments are assessable to the lessor and deductible to the lessee, for a loan only the interest is assessable to the lender and deductible to the borrower." (para. 9.7).

This approach is not appropriate for private infrastructure investment, where there is no loan equivalent.

As explained in part 4 above, there are no fixed payments from the state to the investor, (apart from a potential subsidy, or provision of services, which is not based on the cost of the asset). In most cases, any payments made are from the investment entity to the state for the right to operate the business. In these circumstances, there are no "payments" which could form the basis of an implicit loan calculation. A "sale and loan" approach would therefore have the effect of denying deductibility of depreciation to the investor, with no corresponding reduction in assessability of income. This would further discriminate against private investment in public infrastructure, as opposed to other forms of investment.

It is for this reason that, whilst Division 16D (which takes a "sale and loan" approach) may be appropriate for certain leases, it is not appropriate in its present form for taxation of private infrastructure investment where the investor bears the commercial risk. Private infrastructure investment is in no way economically equivalent to a financing arrangement.

In regard to Division 16D, section 159GK provides that "assessable arrangement payments" are assessable only to the extent attributable to interest on an implicit loan for the relevant property. "Arrangement payments" are defined in section 159GE(1) to be so much of any payments made under an arrangement relating to the use, or the control of the use, of an item of property as represent consideration for the use, control of the use, or sale or disposal of the item.

If Division 16D is found to apply to an infrastructure project by reason of the state's regulation of the use of the infrastructure, it is unlikely that any payments made to investors will be made in consideration for that "control". Payments made to investors will be made by the public for the infrastructure services provided, and possibly by the state as a shadow payment for infrastructure services to the public or as a subsidy for taking over a loss-making operation.

Therefore, if an infrastructure project is assessed in accordance with Division 16D, the investors will not be able to claim capital write-offs and will have no corresponding reduction in assessable income The impact of Division 16D in such circumstances would be as harsh as section 51AD. Accordingly Division 16D in its present form should not apply to such projects.

6 Limited or Non-Recourse Debt

Limited or non-recourse debt is a common means of financing infrastructure projects and is used extensively throughout the world. Such projects ordinarily involve large outlays so equity risk is shared between a number of investors. In these circumstances, project finance (where repayment is limited to the project itself, ordinarily during the operations phase and often also during the construction phase) is more appropriate than corporate finance (for which the individual investors could later become individually liable for the total debt). The decision to use project finance is thus a commercial decision, based on the unique nature of these transactions.

Given the significance of and the commercial requirement for the use of project finance, it is difficult to identify a reason for the existence of any provision which places taxation constraints on its use for infrastructure projects. Such constraints are contrary to the "investment neutrality principle", which is one of the three policy design principles identified by the Review in "A Strong Foundation".

Paragraph B.3 of "A Platform for Consultation" states that the only reason for the continuing separate existence of section 51AD "appears to be a potential problem of structured non-payment of non-recourse finance." Paragraph B.5 states that this can occur "if the finance is provided by the "purchaser" and it is always intended that the finance will not be repaid".

Such "structured non-payment of non-recourse finance" could not occur with project finance of an infrastructure project, because the lenders are third-party financiers who take great care to review all project arrangements to ensure the minimum risk of non-repayment.

It follows that the only justification identified for the existence of section 51AD is not relevant to private infrastructure investment. **We therefore strongly endorse the recommendation in paragraph B.4 that section 51AD be repealed.**

It is important, however, that any new provision introduced to address non-payment of non-recourse debt does not adversely affect private infrastructure investment.

The first option proposed by the Review in this regard is that reliance be placed on the existing anti-avoidance legislation in Part IVA. We endorse this proposal.

With regard to the suggested tax reform measures under option 2, we have the following concerns:

- there are difficulties with adopting "sale and loan" taxation in the context of private infrastructure investment, as discussed under part 5 above.
- consolidation of the benefits from non-repayment of non-recourse finance would remove the non-recourse nature of that finance to the extent of the existing tax rate. The tax system would thus be changing the nature of the transaction sought to be entered into by investors for the commercial reasons explained above.

7. Recommendation

We concur with the review's conclusion that **there is no need for section 51AD to continue to exist.** It is an impediment to private infrastructure investment and **we recommend its abolition.**

We consider that Division 16D can be amended to function in a manner which does not impede investment in infrastructure projects.

We believe that a "sale and loan" approach will be inappropriate for private investment in public infrastructure, as would any constraints imposed on the use of limited recourse finance for investment in such projects.

We would be pleased to provide additional comment on any aspect of this submission

Appendix I

Private Infrastructure Investment

The Development of Private Infrastructure Investment

The development of private sector investment essentially commenced with the Sydney Harbour Tunnel project. This project was far removed from the transactions that spawned section 51AD such as the Eraring Power Station transaction. Under the Eraring transaction financiers essentially provided finance to a tax exempt authority on the basis of sovereign credit risk. Financiers took essentially the same risks that would be taken if they were lending money to a tax exempt authority (ie. this was a "banking" transaction in disguise).

The Sydney Harbour Tunnel project spawned a new era of private sector investment in the delivery of low cost infrastructure in Australia. That project saw the private sector assume over $500 million of fixed price construction risk, 35 years of fixed price operation and maintenance risks and associated financial and commercial business risks. The industry developed quickly thereafter and was followed by private sector investment in major water treatment plants (particularly in NSW and Victoria), further development of tollways, the expansion of the energy industry via the construction of new and refurbished power stations, the development of much needed health care facilities and the construction and development of new prison facilities.

The mid to late 1990s saw the advent of an expansion of privatisation of Australian infrastructure. This was spearheaded by the privatisation of electricity distribution and generating businesses in Victoria. The Commonwealth followed with major privatisations including most of the nation's Airports, Qantas and the initial partial privatisation of Telstra.

In 1999 we have an era where there are billions of dollars of projects in operation providing cost effective services for the community at large. The Australian infrastructure industry is now truly international with numerous major world-wide corporations investing in Australian infrastructure projects.

Australian institutional investors, notably superannuation funds, have embraced infrastructure as a separate asset class. All major institutions have sizeable equity portfolios in infrastructure projects. A number of infrastructure projects have been listed on the Australian Stock Exchange, including Transurban City Link, Hills Motorway, Envestra, United Energy, Infrastructure Trust of Australia, Infratil Australia Limited and Australian Infrastructure Fund. These companies together with other infrastructure related corporations such as AGL now form part of an infrastructure index on the Australian Stock Exchange.

Consequently in a period of approximately 13 years the Australian Infrastructure Industry has grown from nothing to being a major investment and development sector of the Australian economy.

Risk Allocation under Private Infrastructure Investment

The infrastructure projects of the 80s and 90s have no resemblance to transactions that simply result in financiers assuming Sovereign Risk (ie. they rely on all the assets of the State for repayment). The infrastructure projects to date have required the private sector to assume numerous risks over and above the normal risks associated with a financier providing debt finance to a tax exempt party. Typically infrastructure projects include the private sector assuming construction risk, financing risk, operations and maintenance risk and revenue risks. None of these risks are assumed by a financier who lends money to a tax exempt authority. When a financier lends money to a tax exempt authority, the performance of the project underlying the borrowing is of no concern.

Each new infrastructure project is slightly different to its predecessors and risk allocation between participants is becoming more sophisticated and complicated. In due course we may well see a move to a greater degree of risk sharing thereby enabling financing costs to be reduced and the cost of provision of services to the community reduced. This risk sharing will still result in the private sector owning and operating commercial businesses that will not produce expected returns unless the private sector delivers.

There is no logic as to why a private sector company with risk equity (of any amount - whether it be 5% or 50% of a projects costs is irrelevant) should be denied all the normal tax deductions to which any other business in the economy is entitled, simply because it provides infrastructure services that by their very nature require some form of integration into a wider system, and therefore require some form of government regulation.

The Future for Private Infrastructure Investment

Australia’s stock of infrastructure is widely regarded as being inadequate. Several economic studies have developed a range of statistics confirming this situation – other studies have directly linked the development of major infrastructure projects with the generation of real growth in the economy generally. There are numerous major projects in Australia that require development and funding and in the face of government’s reluctance to undertake major works because of fiscal and budgetary constraints, the private sector has shown an appetite and an ability to deliver cost effective infrastructure to Australian businesses and consumers. It is therefore extremely important that the Australian tax system does not impede this investment, in its attempt to combat unrelated transactions.