FERGUSON

ADELE FERGUSON • AFERGUSON@BRW.FAIRFAX.COM.AU

Left with the bill

Australia needs to spend $330 billion on infrastructure in the coming decade but without improvements to risk assessment, the taxpayer will repeatedly bear the inevitable cost blow-outs.

Infrastructure projects are a high-risk game, highlighted by a string of projects that are drowning in red ink – and controversy.

AFTER TWO DECADES OF wanton neglect and underinvestment, it is no surprise that vital elements of Australia's infrastructure assets are looking tired, old and in some cases, in serious disrepair. It is also no surprise that governments at all levels are being forced to play catch up and announce record levels of infrastructure spending in their budget papers and planned capital expenditure.

The upshot is that more than $330 billion could be spent on infrastructure over the next decade, according to ABN Amro, and of that amount, up to $80 billion will be private money. In New South Wales alone, the state government has indicated that up to 15 per cent of its capital expenditure will be procured through privately financed projects.

The feeding frenzy in infrastructure projects will be a boon for steel, construction and contract management companies such as Leighton Holdings, Boral, OneSteel, Transfield and Rinker, and it could induce companies such as Macquarie Infrastructure Group, Transurban and Babcock & Brown Infrastructure to seek new equity to acquire some of the new assets. All will seek to share in the spoils.

However, infrastructure projects are a high-risk game, highlighted by a string of projects that are drowning in red ink – and controversy. It is not hard to see why: most projects get up because there are a lot of people with vested interests. To make the project look viable these people underestimate costs, overestimate revenues, undervalue environmental effects and overvalue regional development effects. Indeed, many projects end with a lot of people getting burned due to crippling debt, as well as negative environmental and social impacts.

This certainly fits the description of what happened to Sydney's Cross City Tunnel project, which is in a sea of red ink due to underestimated costs and overestimated revenues. Right from the start, the Cross City Tunnel consortium overestimated the number of vehicles a day. The government chose the bid with the highest estimate on the grounds that it received a payment in advance, and, through the public-private partnership had transferred the financial risk for the $680 million tunnel to the private sector.

Some countries have started to wake up to the problems and change the way projects are costed. Australia is yet to do so.

WARREN TAYLOR

With so much infrastructure set to be funded in the next decade, Australia needs to follow the lead of countries such as the United Kingdom, the Netherlands and South Africa, to reduce the risk of cost blow-outs.

In the world of infrastructure, Denmark's Professor Bent Flyvbjerg is becoming a cult figure. After years of studying infrastructure projects and public policy, writing books and advising 40 government departments around the world, Flyvbjerg has isolated why most infrastructure projects suffer cost blow-outs. He has offered a solution to reduce the problem, so-called "reference class forecasting", which has been adopted by the UK Department for Transport as a standard in bidding for infrastructure projects.

In a groundbreaking survey that looked at several hundred infrastructure projects in more than 20 countries, Flyvbjerg discovered why most infrastructure projects have problems: underestimated costs, overestimated revenues, undervalued environmental effects and overvalued economic development effects all equate to project approval. "Many project proponents don't hesitate to use this formula for project approval, even if it means misleading parliaments, the public and the media about the true costs and benefits of projects," he says. "The result is an unhealthy 'survival of the unfittest' for large public works and other construction projects."

Having studied projects that date back 70 years, he says that 50 per cent of the calculated costs of rail infrastructure projects are inaccurate. Similarly, 34 per cent of the costs of bridges and tunnels are inaccurate, as well as 20 per cent of road costs. "During project implementation, when fact defeats fiction, the consequence is huge cost overruns, delays, revenues that don't materialise, crippling debt and, to add insult to injury, often also negative environmental and social impacts," Flyvbjerg says.

These numbers they do not seem unreasonable given the number of projects that have gone off the rails over the years.

If Australia is to spend hundreds of billions of dollars in the next few years on projects that are going to be given the green light based on inaccurate costings – whether privately financed, publicly financed or a combination of both – there needs to be a radical overhaul of the way project costs are calculated.

Flyvbjerg, who is visiting Australia to spread the word about infrastructure projects – their problems and ways to reduce these problems – says that as countries start gearing up to spend more on infrastructure they need to change the way they assess project costs, demand and other factors. He recommends ditching the conventional method of assessing project risk and adopting the reference class forecasting method.

Put simply, the reference class forecasting method is a way to mitigate risk, based on a theory of decision-making that won the 2002 Nobel Prize in economics. Flyvbjerg says it achieves accuracy by basing forecasts on actual performance in a reference class of comparable projects and thereby passes strategic misrepresentations. It is based on the proposition that the next project will perform like the past 10-15 projects. So instead of trying to understand the detail, look at past performance.

It seems to be working for the UK Department of Transport. Given the conventional method of risk assessment is fraught with errors, the method is at least worth debate. But Australia is not listening. ABN Amro's head of financial markets advisory, John Martin, says there is pressure to try it but there has to be an impetus. "We see a real role for something like this but it will take time," he says. With record spending on infrastructure in the next few years, and more PPPs planned, another high-profile disaster will undoubtedly be the spark to convince governments that a new method of costing is required. ●

Overseas investors to avoid CGT here

On December 6, the Senate passed legislation that will eliminate capital gains tax from most forms of overseas investment into Australia. This amendment will have a profound effect on the equity market.

Tax experts have been lobbying the government for months to pass the legislation because merger and acquisition activity was being held up waiting for its parliamentary approval. Now that it has gone through, it will trigger the arrival of more overseas private equity groups into Australia, bidding for assets such as Qantas and Coles Myer because they have strong cash flow and can support substantial debt levels.

The bonus for them is that when they exit the business they will no longer be subject to CGT. This means they can bid even more for the asset because they have an advantage over Australian investors who have to pay CGT.

While the tax is aimed at increasing foreign investment in Australia, it has a downside: Australian investors are not eligible for CGT relief. Australian private investors will be forced to reincorporate their private companies overseas to take advantage of the capital gains tax advantage.

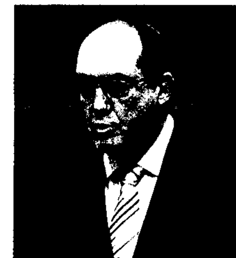
There will also be more joint ventures taking place between Australian companies and overseas private equity companies to take advantage of the new amendment. Already, Publishing & Broadcasting Limited, Kerry Stoke's Seven Network and APN News have gone down this route, no doubt in anticipation of the change in CGT.

As Senator Andrew Murray has long argued, this is not good for Australia. In a statement, Senator Murray says: "The revenue cost estimated by Treasury is considerable at a third of a billion dollars over four years. I predict it will be much much more."

Treasurer Peter Costello first revealed in the 2005 budget that significant reforms would be introduced to "enhance Australia's status as an attractive place for business and investment by addressing the deterrent effect for foreign investors of Australia's current broad foreign resident CGT base".

On June 22, these reforms were included in the Tax Laws Amendment (2006 Measures No. 4) Bill 2006.

Peter Costello: [Reforms] enhance Australia's status as a place for investment



Senator Andrew Murray: 'The revenue cost estimated by Treasury is considerable'

Infrastructure boom due

1. ABN Amro estimates that more than $330 billion will be spent on infrastructure over the next decade. It estimates that up to $80 billion will be private money and the rest will be government funding.
2. The New South Wales government has indicated that up to 15 per cent of the state's capital expenditure will be procured through privately financed projects.
3. More spending on infrastructure projects is good news for companies in the steel, construction and contract management business.
4. Most infrastructure projects are poorly calculated and many end up with cost blow-outs and over-estimations in revenue.
5. The assessment of risk needs to be overhauled to eliminate the vested interests associated with tenders for projects.
6. Professor Bent Flyvbjerg, of Aalborg University in Denmark, has found a promising approach to mitigating risk based on theories of decision-making under uncertainty which won the 2002 Nobel Prize in economics. It has been adopted by the UK Department of Transport as a bidding standard for infrastructure projects.