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24.4.14

Mr. David Murray
Chairman
Financial System Inquiry
GPO Box 89
Sydney, NSW 2001

Dear Mr. Murray

In my recent submission on financing Infrastructure to the Finance Review I highlighted the serious issue of initial financing for long construction major projects like the nationally significant VFT 2 Project for HSR/FFR which would create many jobs along the east coast.

I posited a 10 year construction period for M/S and the S/B in series. After a long feasibility study, the original VFT Project planned a 5 year M/S construction from January 1992 to December 1996. It would be possible to build M/S and S/B in parallel in 5 years. This would shorten and enlarge the financial task. It would reduce accumulated interest expense and enhance viability. Large amounts of value would be captured during the 5 years further improving viability. It should increase financability.

The original $15b VFT Project for HSR from Sydney to Melbourne did not have the same issues. During 1988-90 staff of the VFT feasibility study and bankers came up with an innovative tax allowance system for financing private infrastructure which was approved by Treasury. Although the VFT did not go ahead, many companies, including BHP, used the scheme to help finance their capital expenditure. Later the Treasury withdrew the facility owing to cumulative negative cash flow effect on tax revenue.

Incidentally, the VFT did not happen in 1991 because the Treasury did not accept the patronage projections and declined other business tax proposals. It turns out that the previous Government's recent Report on HSR estimated its base patronage year in 2011 at 20% more than the original VFT projection for the same year.

The effective original tax allowance scheme may be worth re-visiting in order to get investment moving. However, it would have a greater impact on the Federal budget than government guarantee of private finance for infrastructure (addendum attached) and may have a more limited life-span.

I look forward to your solution for financing the VFT 2 and similar major, long term projects.

Yours sincerely

Peter

Peter J Knight
Chairman, The VFT 2 Project

Addendum: Government Guarantee of Private Finance for Infrastructure

The task of government is to live within its means and secure a prudent, prosperous and growing economy in the long term. This may be measured as structural budget balance, zero government debt and strong economic growth over the business cycle.

The task of rating agencies is to assess the sovereign risk of governments not meeting their task. This means whether they are deferring the hard decision. In practice, they may be running deficits when there is no recession, and/or giving new unwarranted government guarantees (GG) for private finance of infrastructure, and/or issuing excessive quantitative easing (QE) towards the point where the position is unrecoverable without turmoil. Before this stage is reached, rating agencies would reduce their ratings and exchange rates would decline.

The government is the single decision maker in a recession that can boost actual spending with a deficit while the many decision makers in the economy will not or are reluctant to spend. GGs are an extension of the government budget (GB) in these situations, while QE is far more uncertain in stimulating others to spend and create more jobs. Government guarantee has a valid role in government fiscal and monetary policy.

The actual liability on the balance sheet of the Central bank of a country for open ended, ineffectual QE is an indirect liability, not a contingent liability, within the government's consolidated balance sheet liabilities in terms of sovereign risk, even though it is not directly on the budget. QE will be taken into account by rating agencies when determining AAA or other ratings of governments' finances. It may be regarded as a form of contingent liability.

The contingent liability of GGs is also taken into account by rating agencies, but it is more effective than QE as it represents actual spending of others that the government (the single decision maker) can induce to stimulate the economy.

While neither the liability for GGs nor QE is in the budget, GGs are more directly associated and clearer than indirect QE on Central Bank balance sheets for which the government is also responsible.

From the point of view of rating agencies, the budget deficit is the most direct liability. The mix of Government Budget, government debt, GG, Central Bank balance sheet and QE is also important in assessment of the consolidated government balance sheet position, since a small effective GG is preferable to a large ineffective QE relative to a budget deficit and to total government finances.

In this context, the new Australian Government appears to be about to make the first hard decision to recover sustainable prosperity in the May 2014 budget. It is running a deficit during average economic growth. It is unlikely to issue QE. It may need to give substantial GGs to private finance for infrastructure to support stronger growth without adding to the deficit. It would regain the confidence of consumers, business and finance in recovering strategic budget balance and reducing government debt for greater growth of prosperity.