The Auditor-General
ANAO Report No.38 2016–17
Performance Audit

The Approval and Administration of Commonwealth Funding for the WestConnex Project

Department of Infrastructure and Regional Development

Infrastructure Australia

Australian National Audit Office

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14 February 2017

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken an independent performance audit in the Department of Infrastructure and Regional Development and Infrastructure Australia titled *The Approval and Administration of Commonwealth Funding for the WestConnex Project.* The audit was conducted in accordance with the authority contained in the *Auditor-General Act 1997*. I present the report of this audit to the Parliament.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's website—http://www.anao.gov.au.

Yours sincerely

Grant Hehir
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

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Summary and recommendations

Background

1. The WestConnex project in Sydney is one of Australia's largest land transport infrastructure projects. As of December 2016, it was being delivered progressively through three main stages, which have a current estimated total cost of $16.8 billion. It is also the first road project to receive Australian Government support through the provision of a concessional loan.

2. Both the Coalition and the Australian Labor Party announced commitments of at least $1.5 billion in grant funding towards the project prior to the September 2013 Federal Election.[1] In May 2014, a further $2 billion concessional loan for the project was announced by the recently elected Australian Government.

3. Advice relating to the eligibility and appropriateness of infrastructure projects for Australian Government funding is the responsibility of the Department of Infrastructure and Regional Development (DIRD). Infrastructure Australia is a separate entity and is responsible for conducting independent assessments of infrastructure projects, as proposed by respective project proponents. These assessments are made publicly available once complete.

4. As of December 2016, construction work on the WestConnex project was underway. Specifically, construction of the main works for the first two stages had commenced, and planning had begun for the third stage (with construction forecast for commencement in 2019 and completion in 2023). By 1 November 2016, all $1.5 billion of Australian Government grant funding had been paid to New South Wales (NSW) and, as of February 2017, $408.1 million of the concessional loan had been drawn down.

Audit objective and criteria

5. The objective of the audit was to assess whether appropriate steps were taken to protect the Australian Government's interests and obtain value for money in respect to the $3.5 billion in funding committed for the WestConnex project. To form a conclusion against the audit objective, the ANAO adopted the following audit criteria:

- Was the decision to make a financial commitment to the project informed by appropriate advice and made through the processes that have been established to assess the merits of nationally significant infrastructure investments?
- Were the decisions to approve the commitment of $1.5 billion in direct funding, and make respective milestone payments to date, informed by appropriate advice?
- Was the decision to enter into a $2 billion concessional loan arrangement for the WestConnex project informed by appropriate advice?
- Do the terms of the concessional loan arrangements represent value for money?

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1 The Labor Government announced a commitment of $1.8 billion towards WestConnex in May 2013. A $1.5 billion contribution towards the project was announced by the Coalition Opposition in June 2012 and reaffirmed prior to and following the September 2013 Federal Election.

Conclusion

6. The Department of Infrastructure and Regional Development took a number of steps to protect the Australian Government's financial interests, particularly in relation to the risk of the concessional loan not being repaid. The upfront payment and approach to agreeing and adjusting milestones for later payments did not adequately protect the Australian Government's financial interests. Additionally, the provision of the concessional loan did not achieve the Australian Government's objective of bringing Stage 2 of the project forward by approximately two years.

7. The WestConnex project had not proceeded fully through the established processes to assess the merits of nationally significant infrastructure investments prior to Australian Government funding being committed. This situation was identified in departmental advice to decision makers prior to decisions being taken.

8. Funds have been paid in advance of project needs. Advice provided prior to the first payment (of $500 million in June 2014) identified that a payment of that magnitude was not yet required. The ANAO estimates that as of November 2016, the total cost of amounts provided in excess of project needs since June 2014 has been approximately $20 million.

9. The May 2014 decision to make the $500 million advance payment led to the project being approved without there being any documented analysis and advice to Ministers that the statutory criteria for giving such approvals had been met. Advice seeking the necessary approval for later payments (of $250 million in June 2015, $450 million in June 2016 and $300 million in November 2016) addressed those criteria. But those three milestone payments were designed and administered in a way that did not adequately protect the Australian Government's financial interests. This was because, in order not to delay payments, milestones were agreed to after the respective event had already occurred or amended shortly before the payment was due to be made where NSW had not met the milestone.

10. Departmental advice to Ministers focused on the benefits of providing a concessional loan to the WestConnex project. The key benefits identified were the:

- lower net financial impact on the presentation of the Federal Budget of a loan compared with further grant funding (due to the differences in the accounting treatment of loans and grants, and because a loan would earn interest income and be later repaid);
- increased construction activities between 2015–16 and 2016–17 from accelerating the second stage; and
- potential to reinvigorate the private sector lending market in relation to demand risk toll roads.

11. But the advice to Ministers did not adequately identify or quantify the costs and risks associated with providing a concessional loan. Key issues that detract from the loan providing value for money include:

- there is evidence that the loan was not needed to accelerate the second stage of WestConnex and, in any event, the project has not been accelerated to the extent projected by DIRD (by up to two years); and
- the interest rate on the loan was set well below comparable market rates with no margin included to cover the Australian Government's loan administration costs or risks.

Supporting findings

Grant funding of $1.5 billion (Chapter 2)

12. A $1.5 billion contribution towards the project was announced by the Coalition Opposition in June 2012 and reaffirmed prior to and following the September 2013 Federal Election. Similarly, the Labor Government demonstrated its support for the project by providing $25 million towards the development of the business case in March 2013, as well as a commitment of $1.8 billion towards the construction of the project in the May 2013 Budget. The commitments announced by both the Coalition and the Australian Labor Party were made before NSW had finalised the July 2013 WestConnex business case. The business case was provided to DIRD and Infrastructure Australia in September 2013 and June 2014 respectively.

13. The decisions by both parties to provide significant support for the project were inconsistent with the advice produced by both Infrastructure Australia and DIRD. At that stage, Infrastructure Australia had assessed the project as being at a formative stage of development. DIRD’s advice consistently flagged that the project was in the very early stages of development and could not yet be recommended for Australian Government financial support.

14. Ministers were provided with well-considered advice on the advance payment. The advice to Ministers clearly indicated that such a payment would be in advance of project needs.

15. The subsequent May 2014 decision to make the $500 million advance payment led to the project being approved without there being any documented analysis and advice to Ministers that the statutory criteria for giving such approvals had been met. This was because DIRD had not yet received the documentation it required from NSW to undertake an assessment against those criteria. DIRD was advised by NSW in mid-2014 that the state would not be in a position to provide this information until early 2015, once project planning had sufficiently progressed. Further, NSW had informed the Australian Government that it did not require an Australian Government funding contribution until 2014–15.

16. DIRD's approach to linking payments to the achievement of milestones was not effective as a control. While the payments referred to project milestones, some of those milestones were:

- agreed to after the respective event had already occurred; and
- amended shortly before the payment was due to be made where NSW had not met the milestone.

17. The purpose of these amendments was to ensure that payments would not be delayed.

18. Expenditure of the grant funding was minimal (as a proportion of the Australian Government funding already provided to NSW) until mid to late 2015, once construction activity had commenced for the M4 Widening and King Georges Road Interchange Upgrade (KGRIU) sub-projects. Based on NSW’s expected spending patterns and the actual expenditure reported by NSW to DIRD, the funding has been largely front-loaded into Stage 1. This was to allow for it to be the first section completed and privatised, with those proceeds to be used for the construction of Stage 3.

The $2 billion concessional loan (Chapter 3)

19. A concessional loan for the WestConnex project was recommended as a preferred alternative to further grant funding. This was because concessional loans have a smaller impact on the presentation of the Australian Government Budget than grant funding. A loan to accelerate Stage 2 of the project was also expected to increase construction activities between the 2015–16 and 2016–17 financial years and to reinvigorate the private sector lending market when it comes to demand risk toll roads.

20. The approach recommended by DIRD provided a convenient legislative mechanism for loan drawdown. But a tailored approach, similar to that subsequently adopted for the Northern Australia Infrastructure Facility, would have provided a more effective framework.

21. There is evidence that Stage 2 could have progressed towards construction as planned without the concessional loan. The concessional loan was used as a replacement for the financing that could have been obtained from private sector lenders and through the privatisation of Stage 1 in 2019–20.

22. Negotiation of the loan terms commenced in November 2013. A Memorandum of Understanding (MoU) signed with the NSW Government in May 2014 set out the key commercial principles for the Australian Government loan.

23. There are relatively few features built into the loan contracts for the benefit of the Australian Government in its role as subordinated lender. Nevertheless, the risk that the Australian Government loan will not be repaid was adequately addressed by DIRD.

24. Interest on the Australian Government loan is charged on the loan at 3.3637 per cent per annum, being the yield on the 2033 Australian Government Bond at the time of financial close for the loan. This rate is well below comparable market rates, with the cost of this concession estimated to be at least $640 million. The interest rate on the loan is fixed, meaning the Australian Government is exposed to interest rate risk as the cost of borrowing to finance loan drawdowns will vary over time. The rate includes no margin to cover Australian Government loan administration costs and risk.

25. In addition to providing a $2 billion loan at below market interest rates, the Australian Government has reduced liquidity risk for the NSW Government and senior lenders on WestConnex. This was done by the Australian Government agreeing that no interest will be paid on the loan until 2027. Rather, interest will be accrued and added to the loan balance for the first 12 years. This is a more generous concession than was provided by senior lenders, who agreed to capitalise interest for the first three and a half years (that is, for the period of construction only).

26. The ANAO's analysis was that DIRD should have provided more comprehensive advice to Ministers on the size and cost of the interest rate concession (relative to a comparable market rate), and obtained specific Ministerial agreement to the loan interest rate including no margin to cover Australian Government loan costs and risk.

27. The estimation of the impact on the fiscal balance of the concessional loan incorporated the effect of the interest capitalisation period. But advice to Ministers did not specifically canvas the merits of agreeing to an extended interest capitalisation period, rather than requiring interest to be paid as it is accrued, or from when construction is completed (as occurs with senior lenders).

28. Notably absent from the advice prior to the Budget, and subsequently, was analysis of impacts of the concessional loan on the Australian Government's finances for portfolios other than Infrastructure and Regional Development. Specifically, due to the concessional loan being provided by the Australian Government rather than a taxpaying entity, there will be no assessable income from the interest paid on the loan on which company tax will be paid but capitalised interest on the loan as well as capital works depreciation will be available to be claimed as tax deductions.

29. According to the data held by DIRD, Stage 2 is currently less than six months ahead of its originally scheduled completion date. The 13 May 2014 announcement of the accelerated project stated that the project would be completed up to two years earlier than planned.

Recommendation

Recommendation No.1

Paragraph 3.66

The Department of Infrastructure and Regional Development improve the advice on any future loans for major infrastructure projects by:

(a) developing a more robust and tailored administrative framework to govern the possible provision of loans;

(b) clearly identifying, and quantifying the impact of, all key aspects of the proposed commercial arrangements; and

(c) providing Ministers with a range of options on the key terms for agreement on the parameters within which the Department is authorised to negotiate.

Department of Infrastructure and Regional Development response: *Agreed.*

Summary of entity responses

30. The proposed audit report was provided to DIRD, Infrastructure Australia, the Department of Finance and the Department of the Treasury.

31. Formal responses to the proposed audit report were received from DIRD, Infrastructure Australia and the Department of Finance. A summary of entities' responses are below, with the full responses provided at Appendix 1.

Department of Infrastructure and Regional Development

The Department of Infrastructure and Regional Development (the Department) notes the ANAO's findings and agrees with the recommendation in relation to the Department's involvement with the WestConnex project. The Department has concerns in relation to a number of the audit findings and has provided further comments in its full response.

Infrastructure Australia

Infrastructure Australia notes the report and believes that it accurately reflects Infrastructure Australia's role in the analysis of the WestConnex project.

Department of Finance

The Department of Finance notes the findings of this report and that the recommendation in the report is consistent with the current Budget Process Operational Rules (BPORs). The BPORs, which took effect from October 2016, strengthen the information requirements to Government on the costs and financial risks associated with loans.

Audit Findings

1. Background

The WestConnex project

1.1 The WestConnex project was announced as the NSW Government’s next motorway priority project in Sydney in October 2012. Once completed, it will deliver 33 kilometres of new and upgraded motorways linking western and south-western Sydney with the CBD, Kingsford Smith Airport and Port Botany precincts. It is largely being constructed in the existing M4 and M5 corridors and involves approximately 14 kilometres of road above ground and 19 kilometres of tunnels, including a new tunnel connecting the two corridors (see Figure 1.1).

Figure 1.1: Map of the WestConnex project

Source: NSW Government, WestConnex Updated Strategic Business Case, November 2015.

1.2 By the 2013 Federal Election, both the Coalition and the Australian Labor Party had announced significant funding commitments towards WestConnex. Specifically:

- Labor had announced a $1.8 billion direct funding commitment, of which $1.3 billion was profiled for provision beyond 2018–19; and
- the Coalition Opposition had committed $1.5 billion to be provided over the immediate three years, with $250 million initially earmarked for provision in 2013–14.

1.3 Accordingly, the May 2014 Budget included the $1.5 billion Australian Government funding contribution to the project, but with an increase in the quantum of funding to be provided in the first year (see Table 1.1). A further $2 billion concessional loan, specifically for the construction of Stage 2, was announced as part of a new $11.6 billion Infrastructure Growth Package introduced within the May 2014 Budget.

Table 1.1: WestConnex funding profile as outlined at the Mid-Year Economic and Fiscal Outlook (MYEFO) and in the 2014 Budget

	13–14	14–15	15–16	16–17	17–18
	($ million)				
Infrastructure Investment Programme—Direct grant funding					
December 2013 MYEFO	250	600	650	0	0
May 2014 Budget	500	250	450	300	0
Infrastructure Growth Package—Concessional loan					
December 2013 MYEFO	-	-	-	-	-
May 2014 Budget	0	3.8[a]	96.6	344.5	314.9

Note a: The $3.8 million allocation in 2014–15 was for DIRD's due diligence expenses.

Source: ANAO analysis of 2014 Budget documents, MYEFO documents and DIRD records.

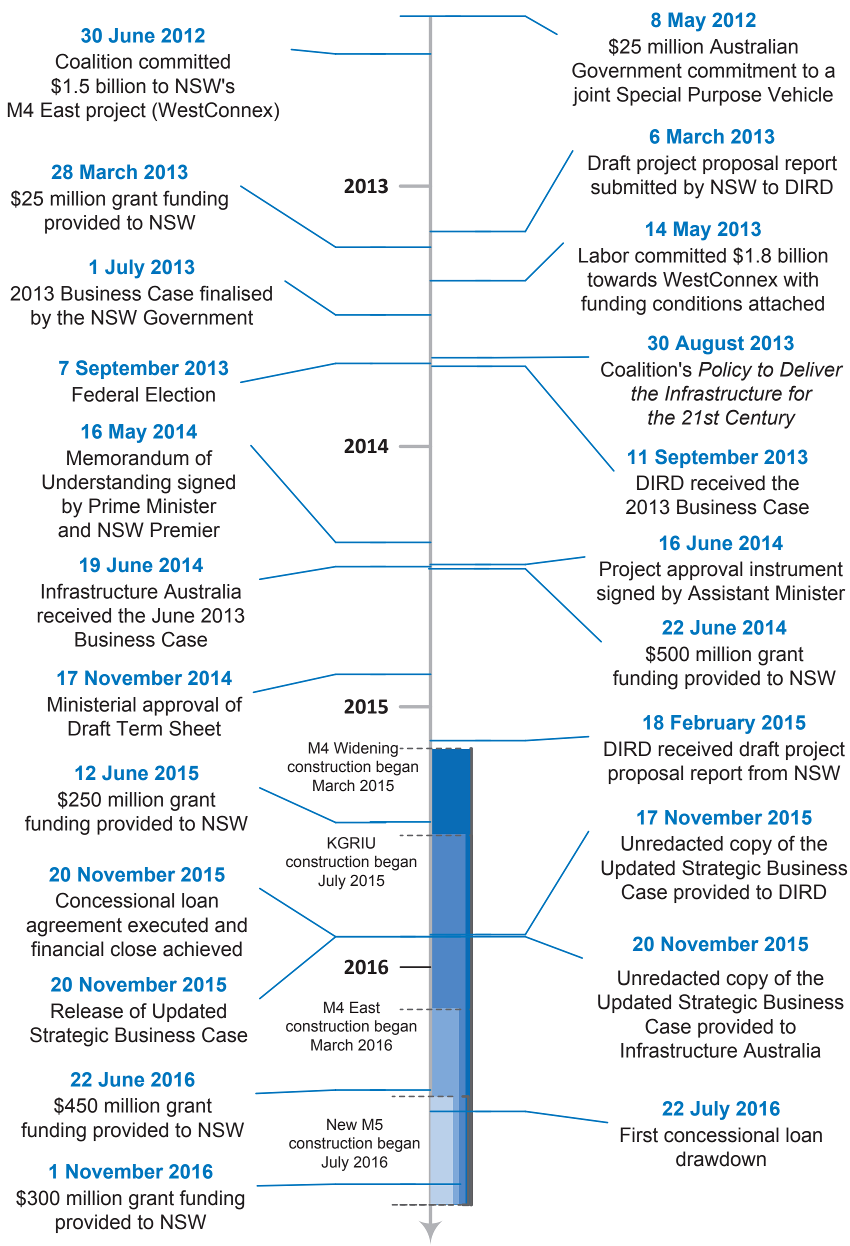
1.4 The terms and conditions for the concessional loan were developed through an iterative process by DIRD, its NSW Government counterparts and their respective advisers between November 2013 and November 2015. The final loan agreement was executed by the Australian Government and WCX FinCo Pty Ltd[2] on 20 November 2015.

1.5 The project is being delivered progressively through three stages, which are split into six sub-projects (detailed in Table 2.2). It is also the first major infrastructure project to have received a concessional loan from the Australian Government.

1.6 Construction work on the project is underway. As of December 2016, four of the sub-projects were in the main construction phase (outlined by Figure 1.2). By 1 November 2016, all $1.5 billion of the grant funding had been paid to NSW, and as of February 2017, $408.1 million of the subordinated loan facility had been drawn down.

2 Part of a wholly owned NSW Government special purpose financing vehicle. The financing and delivery strategy for WestConnex is examined in detail in Chapter 3.

Figure 1.2: WestConnex key project and funding milestones



Source: ANAO analysis of DIRD and Infrastructure Australia records.

Infrastructure Australia's assessment

1.7 Infrastructure Australia was established in 2008 to improve the quality of infrastructure planning and investment strategy, and to identify those investments expected to make the biggest impact on Australia's economic, social and environmental goals for least cost to the taxpayer. Accordingly, it is a goal of Infrastructure Australia that infrastructure funding decisions will be taken following careful planning and rigorous assessments that are based on sufficient evidence. A key role of Infrastructure Australia is to develop Infrastructure Priority Lists.

1.8 While previous iterations of the project had been submitted to Infrastructure Australia[3], WestConnex was first submitted to Infrastructure Australia in October 2012 and placed on the Infrastructure Priority List in June 2013. The categories assigned to the WestConnex project on successive priority lists have changed over time as a reflection of the project's progression (see Table 1.2).

Table 1.2: Progression of the WestConnex project on the Infrastructure Priority List

Date of assessment	Project name as per Infrastructure Priority List	Categorisation	Primary source documentation underpinning Infrastructure Australia's assessment
June 2013	WestConnex	Early Stage	High level project document
February 2015	WestConnex	Threshold	July 2013 Business Case
February 2016	WestConnex – Stage 3	High Priority Initiative	November 2015 Updated Strategic Business Case and supporting attachments.[a]
May 2016	WestConnex	High Priority Project	

Note a: Infrastructure Australia continued to work with NSW to obtain additional supporting information between receiving the November 2015 Updated Strategic Business Case (in November 2015) and publishing its May 2016 project assessment.

Source: ANAO analysis of Infrastructure Australia records.

1.9 Following a review of its assessment framework, Infrastructure Australia changed the categories for the reporting of the prioritisation results in January 2016. Figure 1.3 defines each category and identifies these changes.

3 The 2012 Infrastructure Priority List included the Port Botany and Sydney Airport Transport Improvement Plan at 'Early Stage', which encompassed both the M4 East and M5 East (parts of WestConnex Stages 1 and 2).

Figure 1.3: Infrastructure Australia's categorisations for the Infrastructure Priority list

Priority categorisations from 2012 to 2015		Priority categorisations from 2016	
Ready to Proceed	All of Infrastructure Australia's criteria have been met such that they are priority infrastructure proposals that will deliver real economic benefits.	**Projects:** potential infrastructure solutions for which a full business case has been completed by the proponent and positively assessed by the Infrastructure Australia Board.	High Priority Project[a]
Threshold	Proposals are well developed and present a detailed preferred option, or options. The initiative has strong strategic and economic merit and it is highly likely that the project will deliver economic benefits exceeding costs incurred.		Priority Project
Real Potential	Clearly addresses a nationally significant issues or problem and relevant.	**Initiatives:** potential infrastructure solutions for which a business case has not yet been completed. Initiatives are identified through a collaborative process between nominators and Infrastructure Australia Board, using Infrastructure Australia Board's Audit and other data as evidence.	High Priority Initiative[a]
Early Stage	Addresses a nationally significant issue or problem, but the identification or development of the right solution is at an early stage.		Priority Initiative

Note a: Initiatives and Projects which address major problems or opportunities of national significance are classified as 'high priority'.

Source: ANAO analysis of Infrastructure Australia records.

Audit approach

1.10 The objective of the audit was to assess whether appropriate steps were taken to protect the Australian Government's interests and obtain value for money in respect to the $3.5 billion in funding committed for the WestConnex project. The audit was undertaken as planned within the ANAO's 2015–16 forward work program, as well as in response to requests received from the Senate, individual Parliamentarians and citizens.

1.11 To form a conclusion against the audit objective, the ANAO adopted the following audit criteria:

- Was the decision to make a financial commitment to the project informed by appropriate advice and made through the processes that have been established to assess the merits of nationally significant infrastructure investments?
- Were the decisions to approve the commitment of $1.5 billion in direct funding, and make respective milestone payments to date, informed by appropriate advice?

- Was the decision to enter into a $2 billion concessional loan arrangement for the WestConnex project informed by appropriate advice?
- Do the terms of the concessional loan arrangements represent value for money?

1.12 The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of approximately $272 000.

2. Grant funding of $1.5 billion

Areas examined

The ANAO examined the advice that informed decisions to make an Australian Government financial commitment to the WestConnex project, as well as the subsequent approvals and payments of grant funding.

Conclusion

The WestConnex project had not proceeded fully through the established processes to assess the merits of nationally significant infrastructure investments prior to Australian Government funding being committed. This situation was identified in departmental advice to decision-makers prior to decisions being taken.

Funds have been paid in advance of project needs. Advice provided prior to the first payment of $500 million in June 2014 identified that a payment of that magnitude was not yet required. The ANAO estimates that as of November 2016, the total cost of amounts provided in excess of project needs since June 2014 has been approximately $20 million.

The May 2014 decision to make the $500 million advance payment led to the project being approved without there being any documented analysis and advice to Ministers that the statutory criteria for giving such approvals had been met. Advice seeking the necessary approvals for later payments (of $250 million in June 2015, $450 million in June 2016 and $300 million in November 2016) addressed those criteria. But those three milestone payments were designed and administered in a way that did not adequately protect the Australian Government's financial interests. This was because, in order not to delay payments, milestones were agreed to after the respective event had already occurred or amended shortly before the payment was due to be made where New South Wales (NSW) had not met the milestone.

What commitments were made in respect to the WestConnex project and when were they announced?

A $1.5 billion contribution towards the project was announced by the Coalition Opposition in June 2012, and reaffirmed prior to and following the September 2013 Federal election. Similarly, the Labor Government demonstrated its support for the project by providing $25 million towards the development of the business case in March 2013, as well as a commitment of $1.8 billion towards the construction of the project in the May 2013 Budget. The commitments announced by both the Coalition and the Australian Labor Party were made before NSW had finalised the July 2013 WestConnex business case. The business case was provided to the Department of Infrastructure and Regional Development (DIRD) and Infrastructure Australia in September 2013 and June 2014 respectively.

2.1 On 30 June 2012, the Coalition Opposition released a document stating that, if elected, it would work with the states and the private sector to ensure the acceleration of Sydney's M4 East[4]

4 The M4 East later became part of Stage 1 of WestConnex. WestConnex was announced by the NSW Government in October 2012, when Infrastructure NSW published its report *First Things First: The State Infrastructure Strategy 2012–2032*.

by providing a $1.5 billion contribution as part of its *Plan to Reduce Traffic Congestion*. The release further stated that the:

- timing of payments for specific projects would depend on construction progress and would be developed in consultation with the state governments; and
- first year of funding for the Plan to Reduce Traffic Congestion would be 2014–15.

2.2 At the time this commitment was announced, the Labor Government had already included a $25 million contribution for the project in its 2012 Budget. This amount was advanced to NSW in one instalment in March 2013, to be used for the development of the business case.

2.3 A further $1.8 billion commitment towards the project was included in the May 2013 Budget[5], but with the bulk of the funding profiled for provision beyond the 2018–19 financial year. The Labor Government also attached the following preconditions to that commitment:

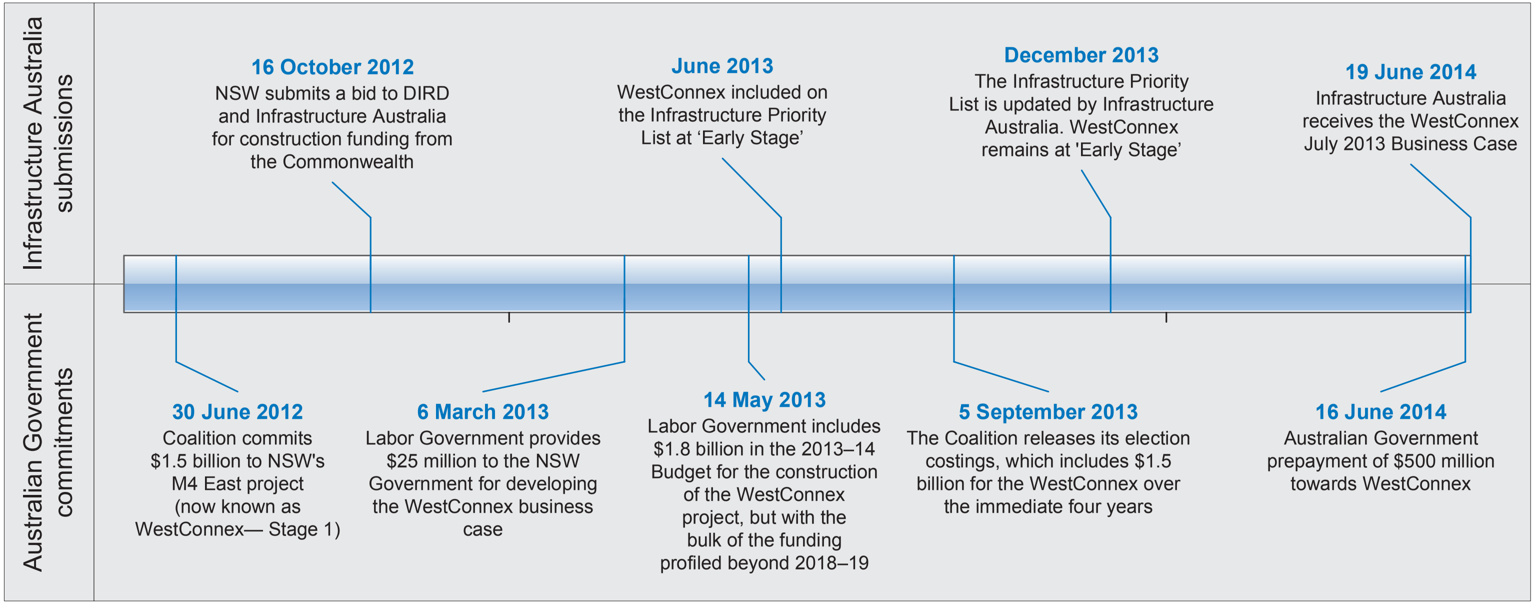
- development of a full business case and its submission to and assessment by Infrastructure Australia;
- that the design include suitable connections to the Sydney CBD and Port Botany; and
- that no tolls be imposed on currently untolled existing roads.

2.4 Following the September 2013 Federal Election, the incoming Coalition Government reaffirmed its $1.5 billion commitment by including its election costing profiles for the project in the December 2013 Mid-Year Economic and Fiscal Outlook (MYEFO) statement.

2.5 As illustrated by Figure 2.1, the various WestConnex funding commitments were made significantly in advance of a completed business case for the project being provided to Infrastructure Australia.

5 The project was identified within the 2013 Budget as the 'Sydney Motorways Program—M4 and M5 extension'.

Figure 2.1: Australian Government funding commitments



Source: ANAO analysis of DIRD and Infrastructure Australia records.

Were the decisions to provide significant support for the project consistent with the available advice?

> The decisions by both the Coalition and the Australian Labor Party to provide significant support for the project were inconsistent with the advice produced by both Infrastructure Australia and DIRD. At that stage, Infrastructure Australia had assessed the project as being at a formative stage of development. DIRD's advice consistently flagged that the project was in the very early stages of development and could not yet be recommended for Australian Government financial support.

2.6 A key feature of Infrastructure Australia's role is the transparency and public availability of its infrastructure project assessments. At the time the first commitment was announced, earlier iterations of the project had been submitted to, assessed and published by Infrastructure Australia.[6] The WestConnex proposal was first included on the Infrastructure Priority List in June 2013 at 'Early Stage'. The basis for this categorisation was not a business case but, rather, an October 2012 NSW Government 'Submission for Nation Building 2 funding' and the NSW Government publication *Westconnex - Sydney's next motorway priority*.

2.7 The NSW bid provided a high-level overview of the problems to be solved by the project including addressing poor service levels from existing roads (including for freight to Sydney's international gateways); poor urban amenity along Parramatta Road; and expected increases in demand for transport services provided by roads. The submission stated that the project had a preliminary benefit-cost ratio (BCR) of 1.5, a total estimated project cost between $10 and $13 billion ($2012), and required an Australian Government contribution of $1.6 billion. No patronage data was provided in support of this estimate. Infrastructure Australia's analysis was that:

> [b]ased on the material provided, the project is at a formative stage of development; without more detailed information it cannot be considered to have real potential when considered in the context of Infrastructure Australia's reform and investment framework. … [Infrastructure Australia] has raised concerns in respect of each core element of the framework: strategic alignment, problem evaluation and solution selection.

2.8 The NSW Government provided DIRD with the same submission in October 2012 in response to the Infrastructure Minister's invitation to state and territory governments to submit funding proposals for assessment and consideration as part of the next five year Nation Building Program (now called the Infrastructure Investment Programme). DIRD's advice to the Minister for Infrastructure and Transport in November 2012, following the first stage of a two-pass assessment process was that:

> [s]ome very large projects, such as the East-West Link project in Melbourne and the WestConnex project in Sydney, will not be sufficiently developed by state governments for them to be adequately assessed by the Department prior to the 2013 budget. Further funding for these projects could be provided through future budget processes if the business cases for the projects

6 The 2012 Infrastructure Priority List included the Port Botany and Sydney Airport Transport Improvement Plan at 'Early Stage', which encompassed both the M4 East and M5 East (parts of WestConnex Stages 1 and 2).

demonstrate strong alignment with the key themes and productivity focus of [the Nation Building Program].

2.9 Having this assessment as context and recognising the incoming government's firm commitment to the project, DIRD recommended in March 2014 that its new Ministers amend the funding profile for the project so as to minimise the funding to be provided in 2013–14.

2.10 Both the Labor and Coalition Governments (in the May 2013 and May 2014 budgets respectively) decided to include funding for the WestConnex project over the forward estimates.

2.11 A Memorandum of Understanding (MoU) was signed on 16 May 2014. The MoU committed the Australian Government to:

- make a total payment of $1.5 billion to NSW towards WestConnex capital costs; and
- subject to agreement with NSW, provide a loan facility of up to $2 billion to be used to accelerate the delivery of Stage 2 (relative to the timeframes included in the business case).

Did sound advice inform the decision to make an advance payment of $500 million in June 2014?

> Ministers were provided with well-considered advice on the advance payment. The advice to Ministers clearly indicated that the payment was made in advance of project needs.

2.12 In November 2013, Ministers agreed the list of projects to be funded through the Infrastructure Investment Programme for the forthcoming five years, as well as the total funding envelope for the programme. An allocation consistent with the Coalition's election costings was included for WestConnex as part of that list.

2.13 In the lead up to the May 2014 Budget, a decision was taken by Ministers to amend the funding profile for WestConnex. This amendment doubled the planned 2013–14 funding, and extended the provision of Australian Government funding into 2016–17.

2.14 The advice provided by DIRD to its Ministers between November 2013 and June 2014, in respect to the Infrastructure Investment Programme was examined by the ANAO as part of the audit of the *Approval and Administration of Commonwealth Funding for the East West Link Project.*[7] The ANAO's analysis of that advice was consistent in respect to both the East West Link and WestConnex. Specifically, DIRD provided well-considered advice to its Ministers on a recommended funding profile for projects that were the subject of election commitments, including WestConnex. For example, DIRD's advice:

- took into account the nature of the election commitment announcement, as well as the funding profile identified in the election costings;
- identified payment profiles that were 'best for project' in that they aligned payments with anticipated project progress (see Table 2.1). In particular, based on its analysis of

7 ANAO Audit Report No.14 2015–16, *Approval and Administration of Commonwealth Funding for the East West Link Project*, Canberra, 14 December 2015, pp. 23–24.

information provided by the NSW Government in respect to WestConnex, DIRD identified that a contribution of $46 million was sufficient in 2013–14; and

- addressed whether making advance payments in respect to WestConnex and certain other projects would compound the existing problem with some states already underspent on their current infrastructure programmes.

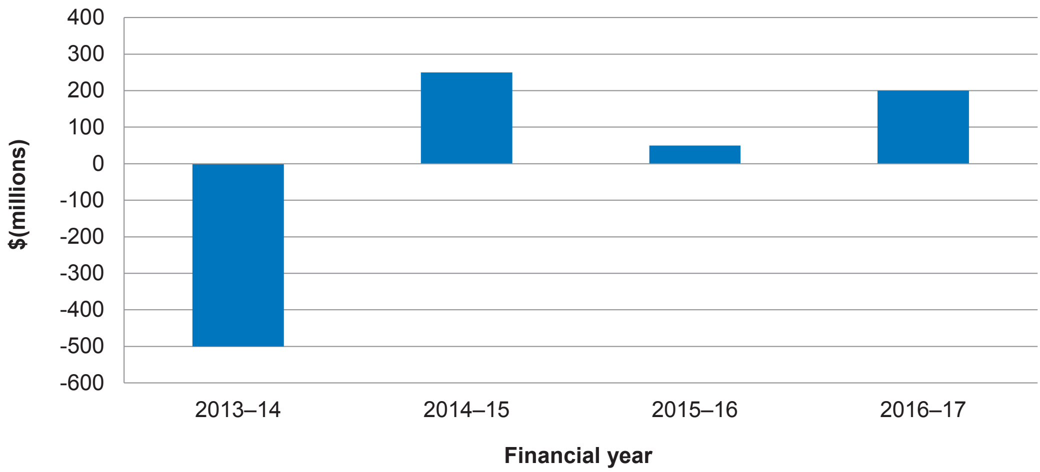
2.15 On 22 June 2014, a payment of $500 million was made to NSW for planning, development, procurement and construction costs. Based on the information within DIRD's Infrastructure Management System (IMS), the Australian Government incurred an additional cost of approximately $14 million[8] during 2014–15 as a result of providing that payment in advance of project needs. The ANAO estimates that as of November 2016, the total cost of providing amounts in excess of project needs since June 2014 has been approximately $20 million.

Table 2.1: Alternative project funding profiles

	2013–14	2014–15	2015–16	2016–17
Election costings	$250m	$600m	$650m	Nil
DIRD's preferred approach	$46m	$445m	$500m	$509m
NSW's preferred profiles	Nil	$500m	$500m	$500m
Actual payments	$500m	$250m	$450m	$300m

Source: ANAO analysis of DIRD records and *Fiscal budget impact of Federal Coalition costings*, September 2013.

Figure 2.2: Fiscal balance impact of actual payments compared with NSW's preferred profiles



Source: ANAO analysis of DIRD records and *Fiscal budget impact of Federal Coalition costings*, September 2013.

8 The ANAO notes that reported expenditure information within IMS for WestConnex may be unreliable (discussed at paragraph 2.39). In the absence of any other expenditure information, IMS data has been used to calculate the additional public debt interest costs incurred due to providing Australian Government funding in advance of the project's needs.

Was a robust process employed when the necessary statutory approvals were given for the project ahead of the advance payment?

The May 2014 decision to make the $500 million advance payment led to the project being approved without there being any documented analysis and advice to Ministers that the statutory criteria for giving such approvals had been met. This was because DIRD had not yet received the documentation it required from NSW to undertake an assessment against those criteria. DIRD was advised by NSW in mid-2014 that the state would not be in a position to provide this information until early 2015, once project planning had sufficiently progressed. Further, NSW had informed the Australian Government that it did not require an Australian Government funding contribution until 2014–15.

2.16 The legislative approvals that were prerequisites to the processing of the $500 million advance payment for WestConnex involved approvals under:

- the *Financial Management and Accountability Regulations 1997*;
- sections 10, 11 and 17(1) of the *Nation Building Program (National Land Transport) Act 2009*[9]*;* and
- the *Federal Financial Relations Act 2009*.

2.17 The advice provided and actions taken for each of these approval processes (as they relate to the Infrastructure Investment Programme projects approved in the 2014 Budget process) were examined by the ANAO as part of a performance audit of the East West Link project.[10] Reflecting the similarities with the concurrent approvals of the East West Link and WestConnex, the ANAO's findings were largely the same in respect to both projects. Specifically, the:

- Prime Minister approved the funding in accordance with the financial management framework for both projects sometime between 7 May and 12 May 2014[11];
- Assistant Minister for Infrastructure and Regional Development approved three projects, including both the East West Link and WestConnex[12], under the land transport legislation on 16 June 2014; and
- the Acting Treasurer signed a national partnership payments determination under the Federal Financial Relations Act on 24 June 2014, providing the final approval required to process the $500 million payment for WestConnex to NSW.

9 From 11 September 2014, the legislation governing the Infrastructure Investment Programme has been the *National Land Transport Act 2014*.

10 ANAO Audit Report No.14 2015–16, *Approval and Administration of Commonwealth Funding for the East West Link Project*, Canberra, 14 December 2015, pp. 24–29.

11 September 2015 legal advice to DIRD was that the approval had been given by the Prime Minister in undated correspondence that was sent sometime between those two dates.

12 The Assistant Minister signed four project approval instruments, which included one for WestConnex, two for each stage of the East West Link and one for the Gateway Upgrade North project.

Assessing Infrastructure Investment Programme projects prior to releasing payments

2.18 The administrative arrangements of the Infrastructure Investment Programme are set out in the *National Partnership Agreement on Land Transport Infrastructure* (NPA) and corresponding Notes on Administration. The NPA was most recently updated and agreed by the Australian and state and territory governments in October 2014. The NPA and notes set out the obligations and administrative processes that funding recipients must follow to claim payments, seek variations to project approvals and comply with the terms and conditions of approved funding. A key component of these arrangements is the submission of a 'project proposal report' (PPR) to DIRD by project proponents.

2.19 DIRD has created a PPR template for project proponents to populate with the information necessary for it to conduct a sufficiently rigorous assessment and make informed recommendations to its Ministers. In the audit of the East West Link, the ANAO found that the Victorian Government had worked with DIRD between February and April 2014 to develop a PPR in respect to the first stage of that project. But the timing of the decisions made in the 2014 Budget context concerning funding and advance payments for some Infrastructure Investment Programme projects meant that only some very limited departmental analysis of the PPR was undertaken.

2.20 In respect to DIRD's analysis of a PPR for the WestConnex project during that same timeframe, the ANAO's analysis was that a PPR had not been submitted by NSW ahead of the $500 million advance payment. DIRD was advised by NSW in early to mid-2014 that a PPR for the WestConnex project was not likely be available until early 2015. This advice was consistent with an April 2014 letter from the NSW Treasurer to the Assistant Minister for Infrastructure, stating that NSW did not require an Australian Government funding contribution until 2014–15.

2.21 NSW provided DIRD with a first draft of the PPR for WestConnex on 18 February 2015.

Was there a reasonable basis for making subsequent payments totalling $1.2 billion?

DIRD's approach to linking payments to the achievement of milestones was not effective as a control. While the payments referred to project milestones, some of those milestones were:

- agreed to after the respective event had already occurred; and
- amended shortly before the payment was due to be made where NSW had not met the milestone.

The purpose of the amendments was to ensure that payments would not be delayed.

2.22 An important control mechanism within the management framework for the Infrastructure Investment Programme is the provision of funding in accordance with the achievement of agreed milestones.[13] This control is intended to ensure that Australian Government funding is provided as it is needed; for purposes which it was intended; and to encourage timely project delivery.

13 It is a requirement of the NPA and related Notes on Administration that Australian Government funding for infrastructure projects is to be released only on achievement of pre-agreed milestones.

2.23 Project milestones are agreed upfront in writing between DIRD and project proponents during the development of the PPR, and are included as an attachment to that document. Agreed milestones are entered into DIRD's IMS, and may be varied. Since a PPR was not submitted prior to the June 2014 payment, project milestones for WestConnex had not been agreed between DIRD and the NSW Government.

PPR and agreed project milestones

2.24 In August 2014, DIRD advised NSW that no further Australian Government funding would be able to flow to the project until an acceptable PPR had been received and assessed; and ministerial approval granted for the next milestone payment.[14] Accordingly, the NSW Government worked with DIRD between February and May 2015 to develop a PPR in respect to the 'delivery phase' of the first two stages of WestConnex, and the 'scoping phase' of the third stage.

2.25 On 1 June 2015, DIRD advised its Minister that it had completed its assessment of the PPR for WestConnex and considered that the project was eligible and appropriate for approval (in terms of the criteria set out in the land transport legislation), and recommended that the $250 million milestone payment requested by NSW be approved.[15] Also attached to the briefing was an agreed future project milestone schedule, which DIRD noted was 'subject to change based on project progress'. In this latter respect, DIRD advised its Ministers that the milestones would be reviewed and possibly renegotiated between the Australian and NSW Governments when separate PPRs for future phases were submitted.

2.26 The Assistant Minister for Infrastructure and Regional Development subsequently varied the project approval instrument on 11 June 2015 to allow for the $250 million payment. In respect to the approach taken to agreeing the PPR with NSW, the ANAO's analysis was that DIRD had:

- checked the details provided within the PPR to ensure compliance with DIRD's cost estimation standards set out within the Notes on Administration;
- queried inconsistencies observed within the documentation with NSW; and
- ensured that all details that were required from the proponent had been provided.

2.27 With one exception, the milestones used as the basis for the June 2015 payment were agreed by the parties in retrospect. Specifically, five milestone events were agreed on 11 May 2015, at which time four had already occurred. Those four had already occurred between October 2014 and January 2015 and involved the:

- receipt of planning approvals and the award of the contract for Stage 1A;
- close of tenders for Stage 1B;

14 The project approval instrument signed by the Assistant Minister in June 2014 provided approval for a maximum payment to NSW of $500 million. For additional payments to be made above this amount, a variation instrument needed to be signed. DIRD recommended that the funding cap be increased only by the $250 million profiled for 2014–15.

15 DIRD further advised that the payment was required by NSW to enable equity to be provided to the Sydney Motorway Corporation and was in accordance with the cash flow set out in the MoU. But this advice was inconsistent with NSW's reported monthly expenditure of Australian Government funding around the time the second payment was made (see Figure 2.3).

- receipt of planning approvals and the award of the contract the King Georges Road Interchange Upgrade; and
- completion of the Strategic Project Definition Plan for Stage 3.

2.28 The remaining milestone occurred one week after the schedule was agreed, on 19 May 2015. That milestone required the close of tenders for the New M5 (Stage 2).

2.29 DIRD advised the Assistant Minister in its June 2015 briefing that the remaining milestones for subsequent payments would be reconsidered in a PPR to be submitted in 2016 (see further at paragraph 2.33).

November 2015 update to the WestConnex business case

2.30 The NSW Government approved an Updated Strategic Business Case for WestConnex in November 2015. This business case was a significant advance on the detail within the previous July 2013 business case, including substantial changes to the project's scope and total cost. Table 2.2 identifies the changes made by the NSW Government to the overall project's scope in between business cases.

2.31 In the audit of the East West Link, the ANAO noted an increased level of detail within that project's 2015 varied project approval instrument as compared with the original 2014 instrument. Specifically, the ANAO's observation has been that the depth of planning and development for a project at any given time can be gauged by the level of detail contained within respective project approval instruments. The same has been observed in respect to each of the WestConnex project's approval instruments.

Table 2.2: Changes to the WestConnex scope between October 2012 and November 2015

	October 2012 Preliminary concept	July 2013 Business Case		Nov 2015 Updated Strategic Business Case		
	Core elements	**Stage**	**Project**	**Stage**	**Project**	**Detailed description**
Northern sector	M4 widening – Parramatta to Strathfield 9.5km	Stage 1: M4 Parramatta to City West Link 13.5km	M4 Widening (Church St to Homebush Bay Drive) 7.5km	Stage 1: M4 Widening M4 East 13.8km	M4 Widening (Parramatta to Homebush)	Widening the existing M4 Motorway from Parramatta to Homebush.
Northern sector	M4 extension – Strathfield to Taverners Hill area (Petersham) 6.2km		M4 East (Homebush Bay Drive to City West Link) 6km		M4 East (Homebush to Haberfield)	Extending the M4 Motorway in tunnels between Homebush and Haberfield via Concord. Includes provision for the future connection to M4 – M5 Link.
Northern sector	Tunnel – Taverners Hill to St Peters area via Camperdown area 5.3km	Stage 2: M5 East & Airport Link 12.5km	M5 East Duplication St Peters to Beverley Hills (King Georges Road) 11km	Stage 2: New M5 & KGRIU	New M5 (Beverly Hills to St Peters)	Duplicating the M5 East from King Georges Road in Beverly Hills with tunnels from Kingsgrove to a new interchange at St Peters. The New M5 tunnels include provision for a future connection to the proposed Southern Connector and the M4 – M5 Link.
					King Georges Road Interchange Upgrade (Beverly Hills)	Upgrade of the King Georges Road Interchange between the newly widened M5 West and the M5 East at Beverly Hills.
Southern sector	Sydney Airport Access Link 4.6km		Airport Link 1.5km		Sydney Gateway (St Peters to Sydney Airport and Port Botany)	A high-quality, high-capacity connection between the new St Peters Interchange and the Sydney Airport and Port Botany precinct.
Southern sector	M5 East Duplication 7.2km	Stage 3: M4 City West Link to St Peters 8.5km	M4 East (City West Link to St Peters) Connections at Parramatta Road and Camperdown	Stage 3: M4-M5 Link 9.2km	M4-M5 Link (Haberfield to St Peters) Connections at Rozelle and Camperdown	Tunnels connecting the M4 East and New M5 via Rozelle and Camperdown. Includes ramps connecting to the St Peters Interchange and an interchange at Rozelle with provision for a future connection to the Western Harbour Tunnel.

Source: ANAO analysis of WestConnex project documents.

Final project approval instrument variation

2.32 In April 2016, DIRD advised the Minister for Major Projects[16] on the need to vary the WestConnex project approval instrument to allow for future milestone payments to be made and for formal approval of the remaining $750 million of the Australian Government's $1.5 billion grant commitment for the project. Specifically, DIRD outlined that:

- additional funding was required to further progress construction for Stages 1 and 2, as well as planning for Stage 3;
- while the entirety of the commitment would be approved, DIRD would only release the Australian Government funding on the achievement of agreed project milestones; and
- the approval was consistent with the requirements of the land transport legislation.

2.33 Although having previously advised its Minister in 2015 that an updated PPR would be required for WestConnex, DIRD's April 2016 advice to the Minister was silent on whether this had been received or why it was no longer necessary. DIRD advised the ANAO in November 2016 that:

> The Department had a copy of the full updated business case for the WestConnex project, which, building on the PPR previously submitted, provided ample detail on the project to make an assessment as presented in the brief to the Minister. It was considered that requiring NSW to produce a separate PPR document on this occasion would have created an unnecessary administrative burden given the additional information available to the Department through the full business case.

2.34 Shortly after the acceptance of the PPR and processing of the June 2015 payment, NSW and DIRD discussed and made minor amendments to the milestones for the 2015–16 period. In May 2016, DIRD and NSW made further amendments to the milestone schedule.[17] This was in order to ensure that NSW was able to provide the evidence necessary for the $450 million milestone payment to be made before 30 June 2016 (it was made on 22 June 2016). Specifically:

- Stage 1A was amended from 'Duck River Bridge complete and open to traffic' to 'Final design certificates issued for construction and all eight major girders installed for Duck River Viaduct'; and
- Stage 2 was amended by removing the achievement of 'environmental studies and documentation complete'.[18]

2.35 On 11 October 2016, NSW Roads and Maritime Services (RMS) wrote to DIRD advising that the remaining agreed milestones had been achieved, and requested that the remaining $300 million be paid. DIRD approved this request on 19 October 2016, and the final payment was provided to NSW by the Department of the Treasury on 1 November 2016. The milestones relating to that amount were to be achieved throughout the first seven months of the 2016–17

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16 The change in ministerial approvers reflects the change in ministerial responsibilities that occurred in September 2015.

17 Milestones for the 2016–17 year were not reviewed or amended at that stage.

18 The timing of the 2016 Federal Election, and Australian Government caretaker conventions being in place, meant that the Minister for Environment was not able to grant the necessary approvals under the *Environment Protection and Biodiversity Conservation Act 1999* for WestConnex once NSW was in a position to seek the approvals.

financial year (see Table 2.3 for specific milestones and dates). The ANAO's analysis of the final payment was that:

- there was a large difference between the milestones that had been approved in June 2015 and the milestones submitted by RMS with the payment request. Specifically, the new milestones indicated that that none of the 2016–17 milestones agreed in 2015 had been met;
- according to the June 2015 schedule, $120 million was being provided to NSW sooner than had been originally agreed (this amount was linked to milestones that were to be achieved in December 2016 and January 2017); and
- the final milestone payment was approved by DIRD the day after it had reviewed and accepted the monthly expenditure report for October 2016 from RMS, which indicated that:
  - the previously reported expenditure of the Australian Government grant funding contained significant errors[19] (over a period of up to 25 months); and
  - of the $1.2 billion DIRD had already paid to NSW, $319.4 million remained unspent.[20]

Table 2.3: Comparison of the approved and actual WestConnex milestone payments for 2016–17

Sub-project	Milestones approved by the Assistant Minister in June 2015	Estimated completion date	Milestones approved by DIRD for payment in November 2016	Completion date
M4 Widening	Stage 1A: New viaduct complete.	July 2016	Stage 1A: Production of 200th bridge girder complete.	Not advised
	Stage 1A: Separable portion 1 complete.	August 2016		
	Stage 1A: Contract complete and Stage 1A open to traffic.[a]	December 2016		
M4 East			Stage 1B: Completion of Underwood Road tunnel access shaft and commencement of tunnelling at Contra Park.	August 2016

19 For example, the reported expenditure for September 2016 was overstated by at least $319.4 million (discussed further at paragraph 2.39).

20 The IMS monthly reporting for November 2016 indicated that of the $1.5 billion that had been paid to RMS, $479 million remained unspent.

Sub-project	Milestones approved by the Assistant Minister in June 2015	Estimated completion date	Milestones approved by DIRD for payment in November 2016	Completion date
New M5			Stage 2: • Completion of St Peters Interchange remediation works and; • Commencement of initial site establishment activities at Commercial Road and Garema Circuit, Kingsgrove.	February 2016 August 2016
KGRIU	Stage 2 King Georges Road Interchange: Cooloongatta Bridge complete and open to traffic.	September 2016		
	Stage 2 King Georges Road Interchange: Completion and Final Milestone—contract complete and open to traffic.[b]	January 2017		
M4-M5	Stage 3: Finalisation of procurement & delivery strategy	July 2016	Stage 3: Completion of Stage 3 Concept Design Report.	September 2016

Note a: As at 1 December 2016, Stage 1A was reported as 75 per cent complete.

Note b: As at 1 December 2016, the King Georges Road Interchange Upgrade was reported as 85 per cent complete.

Source: ANAO analysis of DIRD records.

How has the grant funding been spent?

Expenditure of the grant funding was minimal (as a proportion of the Australian Government funding already provided to NSW) until mid to late 2015, once construction activity had commenced for the M4 Widening and King Georges Road Interchange Upgrade sub-projects. Based on NSW's expected spending patterns and the actual expenditure reported by NSW to DIRD, the funding has been largely front-loaded into Stage 1 to allow for it to be the first section completed and privatised, with those proceeds to be used for the construction of Stage 3.

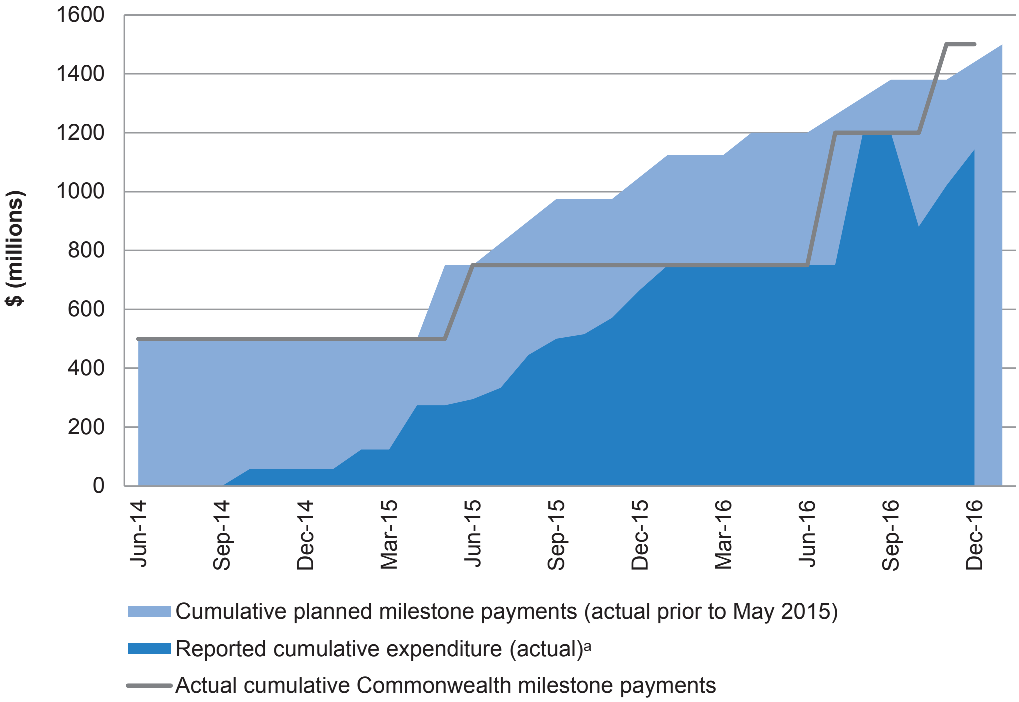
2.36 The financing strategy for WestConnex was set out by NSW within the 2013 business case. This strategy has been amended over time, but the following key factors have remained consistent:

- the NSW Government has established a new company (the Sydney Motorway Corporation Pty Limited, SMC) to manage the state's financial interests in WestConnex;
- the viability of WestConnex is linked to the implementation of a toll regime;

- approximately $3.3 billion of combined NSW and Australian Government grant funding was flagged as being required to get the project underway. SMC was to be capitalised with seed capital of $2.65 billion in shareholder funds from this grant funding[21]; and
- the balance of the funding for the scheme will come from debt and privatisation proceeds raised against tolls on the individual stages of the project, with government capital (the original grant funding) invested into the initial stages of WestConnex recycled into Stage 3.[22]

2.37 Part of the usual administrative processes for managing expenditure of Infrastructure Investment Programme funding is project proponents' reporting of monthly expenditure through DIRD's IMS. Responsibility for this reporting for the WestConnex project sits with NSW RMS. Figure 2.3 illustrates this reported expenditure.

Figure 2.3: Cumulative expenditure against milestone payments (planned and actual)



Note a: DIRD advised the ANAO in December 2016 that the decrease in cumulative expenditure in October 2016 was due to an error within the information reported by NSW (discussed at paragraph 2.39).

Source: ANAO analysis of DIRD records.

2.38 The ANAO's analysis of the reported use of Australian Government grant funding is that:

21 NSW advised DIRD in March 2015 that it intended for the profiled Australian Government funding to be invested either into the Sydney Motorway Corporation as equity (on a fixed and contracted monthly profile) or via budget allocation to RMS for land and delivery costs.

22 NSW originally intended to sell Stage 1 to fund Stage 2, and sell Stage 2 to fund Stage 3. The provision of the concessional loan has meant that the delivery of Stage 2 has been de-linked from the sale proceeds of Stage 1.

- it has been allocated to and expended largely on the delivery of the first stage of WestConnex. While construction work for some of Stage 2 commenced in July 2015, most of the construction work—and therefore expenditure—has been for Stage 1; and
- the reporting of expenditure through DIRD's IMS is by NSW RMS, rather than by the entity responsible for delivering the project. This approach decreases the visibility DIRD has over incremental expenditure of the Australian Government grant funding, as spending by RMS relates to the passing on of grant payments in full to SMC as equity injections rather than reflecting expenditure by SMC on delivering WestConnex. In this respect, in November 2016 DIRD commented to the ANAO that:

  > Reporting on the Australian Government grant funding is required to be completed by RMS in the IMS system. This is the case for all NSW road projects in the Infrastructure Investment Programme, including projects that are ultimately delivered by other entities, including local government agencies. The Department disagrees with the statement that "this approach decreases the visibility DIRD has over incremental expenditure".

2.39 In December 2016, the ANAO requested an update to the IMS monthly reporting information from DIRD for October and November 2016. The expenditure reported by RMS in October 2016 indicated that there had been a decrease in the cumulative expenditure of Australian Government funding of $319.4 million (26 per cent) when compared to the previous month (see Figure 2.3). In respect to this decrease, DIRD explained to the ANAO that it had raised this issue with NSW, and was advised that:

> the initial reporting did not reflect the correct split between state and federal, and this was only picked up through a recent financial audit process. [DIRD has been] advised that SMC has now modified its reporting systems to allow for a more accurate split of funding source, and that the October and November reports reflect these changes, which is why the cumulative amounts appear to have dropped and then risen again. There should be consistency in the figures now moving forward.

2.40 In the context of this explanation, it is expected that the reported expenditure of the NSW Government funding would increase by the amount that the expenditure of Australian Government funding had decreased. But rather, the ANAO observed that the monthly reporting for October 2016 indicated that:

- the expenditure of NSW Government funding had increased by $75 million;
- funding from 'other sources' had increased by $15 million; and
- total cumulative expenditure across all funding sources had decreased by $229 million.

2.41 In the following month, the reported cumulative expenditure for funding from other sources decreased by $1.48 billion, and NSW expenditure increased by $1.52 billion.

2.42 This situation highlights the need for DIRD to review the process it employs for the collection and validation of reported expenditure by project proponents. It is important that DIRD is able to rely on the information it collects through IMS. The ANAO notes that the risk of inaccurate information is increased in situations where DIRD is relying on information from secondary sources (such as the information being reported by SMC to RMS, then from RMS to DIRD).

2.43 A September 2016 draft DIRD Internal Audit report of the Infrastructure Investment Programme highlighted the unreliability of the information stored within IMS and made a 'Management Improvement Suggestion' that the 'the [responsible] Division undertake a functional review of the IMS to determine whether it adequately supports the [Infrastructure Investment Programme] and identify any risks associated with the current approach of automated and manual processes.' Therefore, the ANAO has not made a recommendation in respect to reporting information held by the IMS, but notes that the validation of project proponents' expenditure reporting should be considered as part of that review.

3. The $2 billion concessional loan

Areas examined

The ANAO examined whether the decision to commit to and enter into a $2 billion concessional loan arrangement for the WestConnex project was informed by appropriate advice, and whether the loan arrangements represent value for money.

Conclusion

Departmental advice to Ministers focused on the benefits of providing a concessional loan to the WestConnex project. The key benefits identified were the:

- lower net financial impact on the presentation of the Federal Budget of a loan compared with further grant funding (due to the differences in the accounting treatment of loans and grants, and because a loan would earn interest income and be later repaid);
- expected increase in construction activity between 2015–16 and 2016–17 from accelerating the second stage; and
- potential to reinvigorate the private sector lending market in relation to demand risk toll roads.

But the advice to Ministers did not adequately identify or quantify the costs and risks associated with providing a concessional loan. Key issues that detract from the loan providing value for money include:

- there is evidence that the loan was not needed to accelerate the second stage of WestConnex and, in any event, the project has not been accelerated to the extent projected by DIRD (by up to two years); and
- the interest rate on the loan was set well below comparable market rates with no margin included to cover the Australian Government's loan administration costs or risks.

Area for improvement

The ANAO has recommended that DIRD improve the advice that is provided to decision-makers on future loans for major infrastructure projects by:

- developing a more robust and tailored administrative framework to govern the possible provision of concessional loans to infrastructure projects;
- clearly identifying and quantifying the impact of all key aspects of the proposed commercial arrangements; and
- seeking Ministerial agreement to the parameters within which the department is authorised to negotiate on the key terms of the loan.

Why was a concessional loan recommended for supporting the WestConnex project?

A concessional loan for the WestConnex project was recommended as a preferred alternative to further grant funding. This was because concessional loans have a smaller impact on the presentation of the Australian Government Budget than grant funding. A loan to accelerate Stage 2 of the project was also expected to increase construction activities between the 2015–16 and 2016–17 financial years and to reinvigorate the private sector lending market when it comes to demand risk toll roads.

3.1 A concessional loan for the WestConnex project was first recommended to the Australian Government by the Department of Infrastructure and Transport in March 2013. This was in the context of a broader recommendation that approval be given to the department to commence formal negotiations with relevant state governments to use alternative funding options for three 'megaprojects'[23] being supported by the Australian Government. This approval was granted.

3.2 The options suggested were concessional loans, guarantees and phased grants. The department identified the impact of each option on key Budget figures (see Table 3.1), and advised that the various options would have a number of benefits, as well as some negative impacts on the Budget. Among the listed benefits was the potential to:

- attract private sector (including superannuation fund) investment in major Australian infrastructure by providing the sector with secure low risk investment opportunities; and
- reduce the overall reliance on Australian Government grant funding, allowing scarce funds to be targeted in a more effective manner.

Table 3.1: Budget impacts of alternative financing options considered

Funding model	Impact		
	Underlying cash balance	Fiscal balance	Net debt
Grants or phased grants	Yes	Yes	Yes
Commonwealth Guarantee—not called upon	No	No	No
Commonwealth Guarantee—called upon	Yes	Yes	Yes
Concessional loan	No	Yes	Yes
Equity injection	No	No	Yes

Note: The advice outlined that no attempt had been made to identify the relative impacts of the models within the table, and the impacts that were outlined did not include the cost of public debt interest to fund each model.

Source: DIRD records.

3.3 While both grants and concessional loans negatively impact the fiscal balance, the relative impact of a concessional loan is far less than that of a grant. This is because the full value of grants payments are recognised as expenses in the years they are provided. In the case of concessional loans, the impact of the loan drawdowns is offset by the recognition of a loan asset. A loan's

23 The two other megaprojects were the Melbourne Metro project and Brisbane Cross River Rail.

impact on the fiscal balance is the net effect of public debt interest expense, accrued interest revenue and the value of the concession on the loan.[24] By way of comparison, Table 3.2 shows the fiscal balance impact of the concessional loan as reported in the May 2014 Budget papers alongside the impact had the drawdowns been accounted for as grant funding.

Table 3.2: Comparison of the fiscal balance impact between a grant and a concessional loan

	13–14	14–15	15–16	16–17	17–18
	($ million)				
Grant	0	3.8[a]	226.4	854.5	831.3
Concessional loan	0	3.8[a]	96.6	344.5	314.9

Note: The $3.8 million allocation in 2014–15 was for DIRD's due diligence expenses.

Source: ANAO analysis of 2014 Budget documents, MYEFO documents and DIRD records.

3.4 In November 2016, DIRD advised the ANAO that the loan also achieved two Australian Government policy goals:

- to increase construction activities within the 2016–17 and 2017–18[25] financial years (years that central agencies identified requiring stimulus to counteract the drop-off from the mining construction boom) through the acceleration of the Stage 2 project[26]; and
- to reinvigorate the private sector lending market when it comes to demand risk toll roads. Before the project, there had not been a greenfield toll road financing by private sector debt since before the Global Financial Crisis.

3.5 In this latter respect, the ANAO notes that the demand risk for Stage 2 is primarily borne by the NSW Government (as equity owner); until such time that the project vehicle is sold. Additionally, Stage 2 of the project is not a greenfields toll road. Rather, it involves a mix of greenfield (parts of the New M5) and an expansion of existing roads (widening of the M4 and duplication of the M5 East). Therefore, there is some history of established traffic demand to draw on.

Advice provided to the incoming Australian Government

3.6 Following the September 2013 Election, DIRD provided Ministers with a number of briefings related to WestConnex, and the implementation of the Australian Government's commitment to it. In respect to a potential loan for the project, Ministers were advised over the following few months that:

24 This value represents the value of the gap between the concessional loan interest rate and the market interest rate that would have applied to the borrowing entity without the Australian Government loan. The value of the concession is proportionally recognised as an expense at the time respective drawdowns occur.

25 According to April 2014 advice to Ministers, the period targeted for increased investment in infrastructure so as to overcome the forecast downturn in the mining industry investment was between 2015–16 and 2016–17.

26 The Australian Government's objective in providing the loan was to accelerate delivery of Stage 2 by up to two years. As of September 2016, Stage 2 is less than six months ahead of the originally scheduled completion date (see paragraphs 3.62 to 3.65).

- a request for further funding for the WestConnex project from NSW was likely to be forthcoming, and that no further grant funding should be agreed until a broader range of financing options, including concessional loans, had been considered;
- the indicative Infrastructure Investment Programme—based on the Government's election commitments—contained a funding shortfall of $4.73 billion, which had the potential to be reduced by the use of alternative financing options for key projects, including WestConnex; and
- a proposal had been received from the NSW Government that aimed to accelerate the completion of Stage 2 of WestConnex by up to two years through the provision of a concessional loan of up to $2 billion.[27]

3.7 The acceleration proposal was consistent with, and designed within the context of, the Government's intent to create economic stimulus in the construction industry through the Infrastructure Growth Package between 2015–16 and 2016–17.

3.8 In November 2013, DIRD advised Ministers that the Government's capacity to continue to fund infrastructure through traditional grants was no longer sustainable given the changing economic climate and the size of the infrastructure task. As a solution to this issue, DIRD suggested the use of a range of potential alternative financing options, including concessional loans.

Was the loan administered within an effective framework?

> The approach recommended by DIRD provided a convenient legislative mechanism for loan drawdown. But a tailored approach, similar to that subsequently adopted for the Northern Australia Infrastructure Facility, would have provided a more effective framework.

3.9 DIRD, in consultation with the Department of Finance, examined the legislative options available for the administration of the WestConnex concessional loan, and infrastructure financing more broadly (for future projects). DIRD advised the Assistant Minister for Infrastructure and Regional Development that the *Financial Framework (Supplementary Powers) Regulations 1997* provided the most convenient mechanism to draw down the loan amount. Accordingly, 'Infrastructure Investment' was included in Schedule 1AB from June 2015.

3.10 The department provided a proposal on innovative funding and financing to the previous Australian Government for consideration in early 2013. As part of this proposal it committed to coming back to Government with additional advice on risk management strategies and proposed governance arrangements to administer the 'new model'.

3.11 In February 2016, the Minister for Major Projects released the Australian Government's Principles to support the use of innovative financing in the delivery of critical transport infrastructure. These principles indicated an intention to increase the use of alternative financing mechanisms.

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27 NSW's proposal was not unsolicited. DIRD had sought and received Ministers' approval in early November 2013, to negotiate the use of alternative financing mechanisms with jurisdictions in respect to seven major infrastructure projects (including WestConnex) that had been committed to by the new Government.

3.12 The new framework that was put in place for the new Northern Australia Infrastructure Facility (NAIF) in May 2016 differs from the WestConnex approach in significant respects. The facility is led by an independent board and is to offer up to $5 billion over five years in concessional finance to encourage and complement private sector investment in infrastructure that benefits Northern Australia. The *Northern Australia Infrastructure Facility Investment Mandate Direction 2016*[28] contains the criteria that must be met in respect to 'investment' decisions made by the NAIF board. The criteria include:

- a financing mechanism (for example, concessional loans and debt guarantees) must not be provided unless the board is satisfied the project would not otherwise have received sufficient financing from other financiers;
- projects must meet mandatory financing eligibility criteria;
- the development of a risk appetite statement to guide the board's investment decisions; and
- returns must cover at least the facility's administrative costs, and the Australian Government's cost of borrowing.

3.13 DIRD advised the ANAO in November 2016 that it did not agree with an ANAO suggestion that the NAIF approach merits consideration by DIRD for future land transport infrastructure arrangements. Specifically, DIRD commented to the ANAO that:

> The Department's position has long been that each major infrastructure project is unique, and that a one-size fits all approach to infrastructure funding and financing is not appropriate. It is the Department's preferred approach that projects with the potential to be financed through methods other than grants are discussed between the Australian Government and the partner state government, with an appropriate approach agreed between the two. The Department provided advice along those lines to government in *[respect to the WestConnex project].*
>
> The Northern Australia Infrastructure Facility (NAIF) is not relevant to this audit as the audit criteria refer to the decisions and processes that led to the decision to offer the loan.[29] As the legislation governing the NAIF was only passed on 3 May 2016, five months after the WestConnex concessional loan was executed, and some two years after the Australian Government agreed to provide the loan, we consider this to not be a relevant comparison. We would also note the NAIF is yet to finalise a loan and would consider it better practice to wait until loans have been issued by NAIF to compare the two approaches.

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28 The *Northern Australia Infrastructure Facility Act 2016* was passed by Parliament on 3 May 2016.

29 As outlined at paragraph 1.11, the audit criteria address both the decision to enter into a $2 billion concessional loan arrangement as well as whether the terms of the concessional loan arrangements represent value for money.

Was the $2 billion loan needed to deliver Stage 2?

There is evidence that Stage 2 could have progressed towards construction as planned without the concessional loan. The concessional loan was used as a replacement for the financing that could have been obtained from private sector lenders and through the privatisation of Stage 1 in 2019–20.

3.14 When briefing the Assistant Minister on the acceleration proposal in December 2013, DIRD advised that it had not yet determined whether further additional funding (above the $1.5 billion grant commitment) was required in order to accelerate Stage 2. This was due to the more immediate profiling of funding to NSW as compared with the previous Government's profiles (see Table 3.3). Subsequent advice did not provide a conclusion in respect to this.

Table 3.3: Funding profiles for WestConnex announced in 2013 by political party

	13–14	14–15	15–16	16–17	17–18	18–19	19–20 onwards
Labor	$0m	$0m	$0m	$200m	$100m	$100m	$1 400m
Coalition	$250m	$600m	$650m	$0m	$0m	$0m	$0m

Source: ANAO analysis of DIRD records.

WestConnex financing strategy

3.15 The NSW Government engaged a financial adviser in late 2012 to develop the financing strategy for the delivery of all three stages of WestConnex. This strategy was finalised in July 2013, along with the project business case, and informed the way in which each of the WestConnex projects were scheduled for delivery.

3.16 The financing strategy report was an attachment to the 2013 business case. But it was not provided to DIRD until mid-March 2014. Had this document been accessible at an earlier stage, DIRD would have been able to take it into account when advising its Ministers about the acceleration proposal.

3.17 The financing strategy outlined that the entire scheme could be delivered over a 10 year period and set out the estimated cashflows (including funding sources and uses) involved in delivering the project.[30] A key part of this was the reliance upon privatisation proceeds from the sale of the earlier stages in order to fund the construction of later stages. Stage 2 was reliant upon Stage 1 privatisation proceeds of up to $1.5 billion in its final year of construction (2019–20). The financing strategy concluded:

> It is important to note that in the current case, **no further State (or Commonwealth Government) financing is required to deliver WestConnex**, based on the financial forecasts generated by SMPO for the Business Case and current market conditions. All required private sector financing can be delivered through either proven financing markets (e.g. project financing based on proven toll revenues) at market based leverage multiples or potential hybrid products

30 The strategy was in accordance with how the project had been scoped and designed at that point in time and was consistent with the most up-to-date project documentation when the MoU was signed in May 2014.

that are expected to be able to be structured in a manner that will resonate with investors [emphasis in original].

3.18 As noted at paragraph 3.12, the NAIF framework requires that financing not be provided unless the board is satisfied the project would not otherwise have received sufficient financing from other sources. An international example of stronger governance arrangements in this regard is the United States of America's Transportation Infrastructure Finance and Innovation Act (TIFIA) Program. The key objectives of the TIFIA Program are to:

- facilitate projects with significant public benefits;
- encourage new revenue streams and private participation;
- fill capital market gaps for secondary/subordinate capital;
- be a flexible, 'patient' investor willing to take on investor concerns about investment horizon, liquidity, predictability and risk; and
- limit federal exposure by relying on market discipline.

3.19 An important aspect of the TIFIA Program is that it aims to fill a capital market gap where one exists. Analysis in this regard was not undertaken by DIRD for WestConnex, and the advice available to NSW in July 2013 indicated that a gap did not exist (see paragraph 3.17).

When were the commercial principles for the loan agreed?

Negotiation of the loan terms commenced in November 2013. A Memorandum of Understanding (MoU) signed with the NSW Government in May 2014 set out the key commercial principles for the Australian Government loan.

3.20 Negotiation of the loan terms commenced in November 2013. Negotiations were conducted in phases, with the results from each phase culminating in key documentation including:

- an MoU signed by the Prime Minister and NSW Premier on 16 May 2014 outlining the agreed delivery arrangements for all three stages and an agreed approach to the Australian Government's funding contributions (including both the $1.5 billion grant component and the $2 billion loan);
- the WestConnex M5 Project Subordinated Concessional Loan Term Sheet, approved by the Assistant Minister for Infrastructure and Regional Development on 17 November 2014—providing a document sufficient for use by NSW when approaching private sector lenders to secure the senior debt component of the project's finance; and
- execution of the final contract on 20 November 2015 by an appropriately delegated senior DIRD official. The Acting Prime Minister provided the required approvals under the financial management framework five days prior on 15 November 2015.

Key commercial principles for the loan were agreed in May 2014

3.21 The signing of the MoU was a significant event as the MoU established the key commercial principles for the loan. The Ministerial decision to sign the MoU was informed by April 2014 advice from DIRD. DIRD's advice included that:

- construction of Stage 2 could be completed by up to two years ahead of schedule and the nominal cost of the project potentially reduced from $4.7 billion to $4.5 billion;
- a private sector equity and delivery partner had been introduced to the delivery model, to 'inject a strong private sector influence and discipline to the project'[31]; and
- the Australian Government's interests were to be protected by the security of revenue from tolls.

3.22 The MoU signed on 16 May 2014 outlined that, subject to agreement with NSW, the Australian Government would provide a loan facility of up to $2 billion to be used to accelerate the delivery of Stage 2 (relative to the timeframes included in the business case). An attachment to the MoU set out the commercial principles for the loan, including:

- a tenor of 19 years comprising the period from the date of financial close to the hard maturity date of 1 July 2034;
- the loan would be structurally and contractually subordinated to senior debt with no common security shared with the senior debt. There would also be limited events of default (being acceleration of senior debt by the senior lenders, non-payment of principal or interest at hard maturity date or insolvency);
- a fixed interest rate, being the applicable Australian Government Bond Rate at financial close;
- a 12 year interest capitalising period commencing at the date of financial close. Interest during this period will add to the outstanding loan balance. During this period, senior debt service obligations will be met and distributions may be made to equity; and
- the interest capitalising period to be followed by an interest only period ending on the soft maturity date (30 September 2029).

Department's engagement of advisers

3.23 DIRD's April 2014 advice (see paragraph 3.21) outlined to Ministers that, in order for the department to effectively protect the Australian Government's interests when negotiating the concessional loan arrangements, appropriate private sector expertise would need to be procured. Accordingly, a $3.8 million allocation was included in the May 2014–15 Budget for DIRD's due diligence activities.[32] In this context, six expert advisers were procured between late 2013 and late 2015 (see Table 3.4).

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31 Following the approval of the term sheet for the Australian Government loan in November 2014, NSW decided it would not include a private sector equity and delivery partner in the delivery model.

32 As at 30 June 2016, DIRD's recorded expenditure for consultancies directly related to the WestConnex concessional loan due diligence was $1 289 224 (of which $5 000 was reimbursed under an indemnity clause in the loan contract).

Table 3.4: Advisory services procured by DIRD for the development of the loan arrangements

Service	Service provider	Date commenced	Location	Expenditure (between September 2013 and July 2016)
Commercial and financial	PwC	December 2013	Melbourne and Sydney	$322 000
Traffic patronage	RBConsult	April 2014	United Kingdom	$184 000[a]
Legal	Allens Linklaters	July 2014	Sydney	$668 000[b]
Cost estimate review	AECOM	July 2014	Sydney	$60 500
Risk advisory	Broadleaf Consulting	April 2015	Canberra	$27 000
Risk workshop	SMEC	April 2015	Sydney	$6 000
Engineering	SMEC	October 2015	Sydney	$21 600

Note a: This contract did not incur GST.

Note b: This figure includes $5 000 which was reimbursed by NSW under an indemnity clause in the loan contract.

Source: ANAO analysis of DIRD records.

3.24 The ANAO's analysis was that by the time legal advisory services were procured, the fundamental financing arrangements for Stage 2 had already been negotiated and agreed with the NSW Government. This situation was reflected by the few substantive changes made to those arrangements between the MoU and final contractual arrangements.[33] Less than five per cent of DIRD's expenditure on advisory services for WestConnex related to periods before the signing of the MoU in May 2014 (see Figure 3.1). The ANAO's analysis was that the:

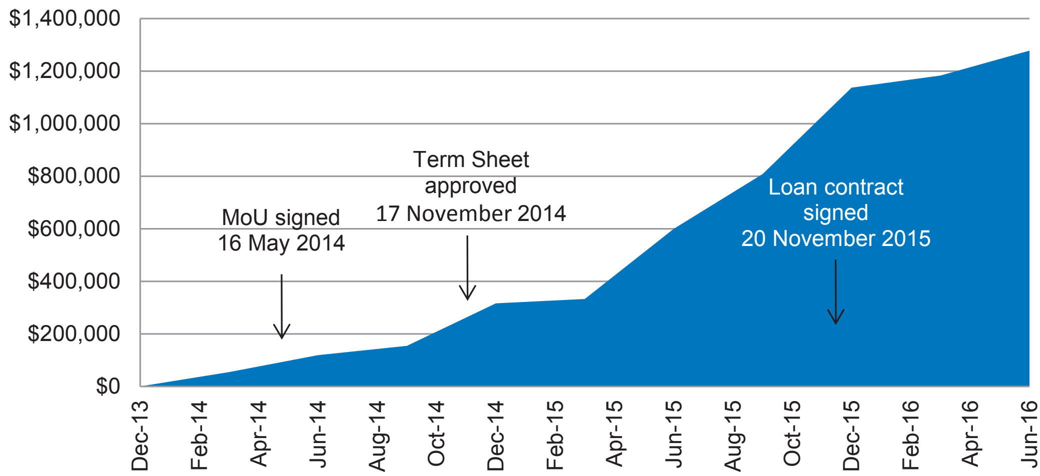
- commercial and financial advice could have been better used between January and February 2014. In this respect, in November 2016, DIRD commented to the ANAO that:
  - commercial advisors were engaged in December 2013 and were immediately put to work analysing the information we had been provided to date. NSW were slow to release information to the Commonwealth for analysis;
- legal advisers were engaged too late—had legal advice been available to DIRD during the development of the MoU, the Australian Government may have been in a stronger starting position (as the department's own lessons learned workshop finalised in July 2016 recognised)[34]; and

33 In the context of reviewing a proposed concessional loan for another project, in July 2016 DIRD recorded in relation to the WestConnex loan that: 'the signing of the MOU froze the term sheet (which is generally a live document, amended as negotiations progress) at a particular point in time, well in advance of financial close. This reduced the flexibility and negotiating power of the Department through the due diligence process.'

34 Having commenced some seven months into the negotiations and two months after the MoU was signed, DIRD's legal advisers noted that it became apparent during the course of negotiation of the term sheet that it was the WestConnex Delivery Agency's intent that the loan was to be a concessional loan affording minimal rights to the Australian Government.

- risk workshop was conducted too late—risks would have ideally been identified prior to the signing of the MoU and public announcement of the loan, then reviewed periodically.

Figure 3.1: Timing of DIRD's expenditure on advisory services for WestConnex



Source: ANAO analysis of DIRD records.

3.25 DIRD conducted a post-implementation review of the loan development in early 2016. The findings of the review were communicated to DIRD's Secretary in a brief in July 2016, which made similar observations about the timeliness of the engagement of advisers.

Was the risk of the loan not being repaid adequately managed?

There are relatively few features built into the loan contracts for the benefit of the Australian Government in its role as subordinated lender. Nevertheless, the risk that the Australian Government loan will not be repaid was adequately addressed by DIRD.

3.26 A key risk to the Australian Government in respect to the concessional loan is the risk of non-repayment. DIRD focussed on this risk throughout the negotiation of the loan terms and conditions.

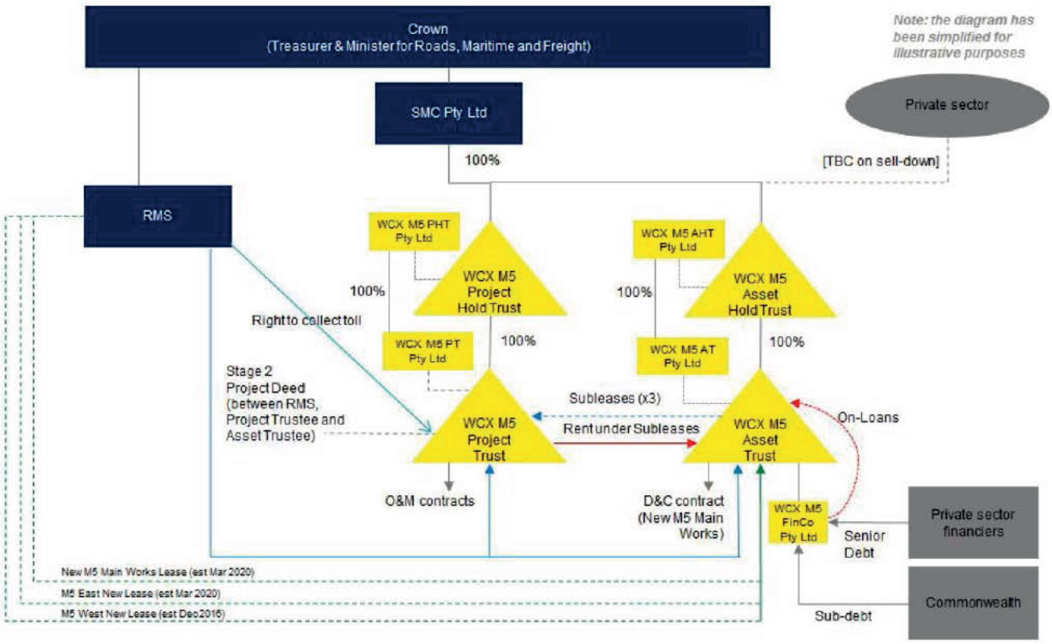
3.27 There are relatively few features built into the loan contracts for the benefit of the Australian Government in its role as subordinated lender. Rather, the risk of the loan not being repaid was addressed by linking repayment of the loan to NSW's ability to generate sufficient income through toll revenue.

Entity to which the loan has been provided

3.28 The WestConnex M5 Commonwealth Subordinated Loan Agreement was executed by the Australian Government and WCX M5 FinCo Pty Ltd (FinCo) on 20 November 2015. FinCo is a special purpose vehicle (SPV) incorporated under the *Corporations Act 2001*. It is currently wholly owned by the NSW Government through the Sydney Motorway Corporation, but has been designed and established by NSW with the end goal of a future privatisation, in order to recycle its original seed capital into Stage 3, or other NSW projects (as discussed at paragraph 3.17).

3.29 Figure 3.2 illustrates the complex nature of the stapled trust structure into which the concessional loan is being paid. Of particular note is that while the drawdowns are being advanced to FinCo, the entire value of the concessional loan (as well as that of the senior debt) is being on-loaned by FinCo to M5 Asset Trust (FinCo's parent and lessee of the M5 concessions). This arrangement limits the recourse (to the State Government) available to the lenders in the event of financial distress or default. In November 2016, DIRD commented to the ANAO that '[t]his is a standard project finance vehicle, as advised by our legal advisers.'

Figure 3.2: The commercial structure supporting the delivery of WestConnex Stage 2



Source: NSW Treasury, Financial Advice for Roads and Maritime Services, 18 November 2015. Contained within DIRD records.

3.30 It was originally the NSW's Government's intention that the senior and subordinated lenders would enter into contractual arrangements with separate entities within the SPV structure for the provision of the respective loans. In this respect, DIRD's legal adviser provided the following advice in August 2014:

> This borrowing structure reflects the concept of 'structural subordination' which is designed to minimise concerns for the senior lenders, and usually avoids the need for subordination or intercreditor agreements. It is commonly used for 'deeply' subordinated loans which are akin to equity … This means that, in addition to being subordinated to the Senior Lenders, the Commonwealth ranks behind unsecured creditors … for any claim against the project assets.

3.31 While the MoU that was signed in May 2014 reflected this arrangement, DIRD and its legal advisers were able to negotiate an agreement with the NSW Government that the senior and subordinated loans would be paid to the same entity, and that a single security package would be held by a security trustee for the benefit of both the senior banks and the subordinated lender. This provided a resolution to the structural subordination issue and was reflected in the approved subordinated loan term sheet, in November 2014.

What is the cost of the concessional interest rate?

> Interest on the Australian Government loan is charged on the loan at 3.3637 per cent per annum, being the yield on the 2033 Australian Government Bond at the time of financial close for the loan. This rate is well below comparable market rates, with the cost of this concession estimated to be at least $640 million. The interest rate on the loan is fixed, meaning the Australian Government is exposed to interest rate risk as the cost of borrowing to finance loan drawdowns will vary over time. The rate includes no margin to cover Australian Government loan administration costs and risk.
>
> The ANAO's analysis was that DIRD should have provided more comprehensive advice to Ministers on the size and cost of the interest rate concession (relative to a comparable market rate), and obtained specific Ministerial agreement to the loan interest rate including no margin to cover Australian Government loan costs and risk.

3.32 The MoU signed on 16 May 2014 set out a process for determining the interest rate on the concessional loan. Specifically, it required that the interest rate be the applicable Australian Government Bond Rate at financial close. Interest is charged on the loan at 3.3637 per cent, being the yield on the 2033 Australian Government Bond.

Advice to decision-makers

3.33 The size of the interest rate concession was a decision that would have a significant impact on the cost to the Australian Government of providing a loan to the WestConnex project.

3.34 In January 2014, the Department of the Treasury advised the Treasurer that the estimated cost of the concession (for the $1.5 billion loan being considered at that stage) was $1 billion.

3.35 In late March 2014, estimates of the cost of the concessional interest rate prepared by the Department of Finance for the purposes of the May 2014 Budget were based on a market interest rate of 7.24 per cent and an interest rate for the Australian Government loan of 4.5 per cent. The interest rate concession was estimated to be 274 basis points.[35]

3.36 Advice to DIRD in early April 2014 from its commercial adviser was that the loan would not be straight forward to price as, whilst it would be subordinated to senior debt (suggesting higher pricing), its size relative to other capital was such that the risk profile would not be consistent with a normal subordinated loan (suggesting lower pricing). A rate somewhere in the range of between 8 per cent and 11 per cent was suggested to be used for estimating purposes.

35 The cost of the concession in dollar terms was not quantified (as analysing the size of the concession was not one of the purposes of the Department of Finance's analysis).

3.37 Further estimates prepared by the Department of Finance on 3 April and 7 May 2014 used a market rate of 8.5 per cent and a rate of 4.25 per cent for the Australian Government loan. That is, the interest rate concession was estimated to be 425 basis points.[36]

3.38 In April 2014, DIRD advised its Minister that the loan would involve a targeted return of 'at least' the long term bond rate with a $121 million negative impact on underlying cash within the forward estimates period and a positive Budget impact of $292 million over the life of the loan. Similarly, the May 2014 Budget Papers stated that:

- loan drawdowns would commence in 2015–16, with $756 million to be drawn down over the forward estimates period (that is, to 2017–18);
- the value of the concessionality of the loan, on a fiscal balance basis[37], was estimated to be $728.1 million over the forward estimates; and
- on an underlying cash basis, the impact of the loan was estimated to be $96.2 million over the forward estimates.

3.39 The Budget Papers did not set out the value of the concessionality of the loan over its life, on either a fiscal balance or underlying cash basis.

3.40 The April 2014 advice from DIRD to its Minister had stated that the interest rate on the Australian Government loan would be 'at least' the respective long term bond rate (equivalent to the 17 year tenor that DIRD had already agreed with NSW). But Ministers were not advised of the extent of the concession that was proposed to be provided (as the advice did not identify a market rate for the loan) and were not asked to specifically endorse or otherwise decide upon how the size of the interest concession would be arrived at, or the acceptable cost of that concession to the Australian Government.

3.41 DIRD also did not brief its Minister on options or seek a Ministerial decision on an acceptable range in which the department should negotiate. Departmental records did not evidence that the rate was the subject of negotiation between NSW and Australian Government officials.

3.42 In relation to whether there was any substantive engagement by DIRD on the choice of interest rate with the Australian Office of Financial Management, the Department of the Treasury or the Department of Finance, DIRD advised the ANAO in November 2016 that:

> Agreement was sought in relation to the pricing methodology from Treasury and Finance. Their Ministers expressed support for the proposed concessional loan terms and conditions (including the interest rate) prior to the MoU being signed.[38]

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36 The cost of the concession in dollar terms was not quantified (as analysing the size of the concession was not one of the purposes of the Department of Finance's analysis).

37 The calculation of this amount is required by the Australian Accounting Standards (AASB 139 *Financial Instruments: Recognition and Measurement*) and the Department of Finance's Resource Management Guide No. 115 (November 2014).

38 That support was not unqualified. For example, the Treasurer and the Finance Minister in separate correspondence in April 2014 each noted that further due diligence would be undertaken by DIRD prior to recommending the execution of a legally binding agreement and that a number of important details still needed to be negotiated.

Interest rate risk

3.43 The analysis underpinning the May 2014 Budget calculations was on the basis that the interest rate at which the Australian Government would borrow funds to enable the loan drawdowns would be the same (4.25 per cent) as the rate at which interest payable on the loan would be calculated (also 4.25 per cent). But while the interest rate payable by NSW on the loan was to be set at the yield on the 2033 Australian Government Bond for the term of the loan, the cost of borrowing the funds necessary for each loan drawdown are not fixed. Rather, they are determined by the interest rate available to the Australian Government when the revenue required for each drawdown is raised through the issue of Australian Government bonds.[39]

3.44 Advice from the Department of the Treasury to the Treasurer in early April 2014 identified that the Australian Government would be exposed to interest rate risk as:

> By providing a fixed interest rate, the Australian Government takes all the risk that interest rates on Commonwealth Government securities move in future. Interest rate risk can only be mitigated either by charging a premium for offering a fixed rate or setting a variable interest rate that tracks a relevant Commonwealth Government Security benchmark.

3.45 DIRD did not similarly advise its Ministers that the structure of the arrangements exposed the Australian Government to interest rate risk. DIRD did not seek Ministerial agreement to the Australian Government either accepting the risk or seeking to manage the risk, for example by negotiating loan terms that included a variable interest rate to be paid on the loan or including a margin on a fixed interest rate to try to cover the risk.

Margin to be added to the bond rate removed during negotiations

3.46 In March 2014, DIRD's commercial adviser proposed that the rate payable on the Australian Government loan include a margin to be added to the long term bond rate. Accordingly:

- in April 2014, DIRD advised its Minister that the loan would involve a targeted return of 'at least' the long term bond rate; and
- early drafts of the MoU proposed that the interest rate be equal to the 10 or 15 year Australian Government Bond Rate plus 0.25 per cent. How this quantum of margin was arrived at was not documented in DIRD records.

3.47 This margin was removed by DIRD on 28 March 2014. Instead, the process set out in the MoU signed on 16 May 2014 for determining the interest rate on the concessional loan required that the interest rate be the applicable Australian Government Bond Rate at financial close. Ministers were not advised that the proposed margin had been removed, or the reasons for this. The ANAO estimates that, had the 0.25 per cent margin been retained, interest on the loan would have been $87.5 million higher.

3.48 The ANAO sought advice from DIRD on the reasoning for the department removing a margin. The department's advice did not set out the reasoning, but simply stated that:

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39 Australian Government bonds are issued by the Australian Office of Financial Management on a whole-of-government basis, as and when required to support the Government's financial commitments. The interest rate attached to the bonds is determined at the time of each issue.

The margin was removed following negotiations with NSW.

3.49 By way of comparison, the rate payable on the senior debt includes a margin to cover profits, risks and costs.

3.50 DIRD has advised the ANAO that the policy rationale for the loan did not include creating a profitable financial instrument for the Australian Government. This is recognised. But the loan arrangements expose the Australian Government to interest rate and other financial risks, as well as to administrative costs.

Estimated cost of the concession

3.51 For the purposes of estimating the fair value of the loan to include in its financial statements, in February 2016 DIRD obtained advice that that a lender in the market providing a comparable loan would expect a rate of return in a range between 4.65 per cent and 5.44 per cent with a mid-point of 5.05 per cent. On that basis, the cost of the concession over the term of the loan will be $640 million.

3.52 Although the Commonwealth loan is subordinated to senior debt and therefore has a higher risk profile, the mid-point figure being used by DIRD is less than the senior debt rate. Using the senior debt rate (for the construction phase), the cost of the concession would be over $700 million.

Comparison with other concessional loans

3.53 The terms of the WestConnex concessional loan are relatively unique when compared to those of other Australian Government concessional loans. It is one of the largest in value, but has been provided on more concessional terms than the loans provided under two substantially smaller concessional loans programs that have been audited by the ANAO recently.[40]

3.54 A variety of other concessional loans are administered by the Australian Government. Those with publicly available terms and conditions are typically programs aimed at individuals, farms and other small businesses. In addition to the WestConnex loan, DIRD also administers concessional loans to three other jurisdictions—the Northern Territory, Norfolk Island and the Australian Capital Territory (as at September 2016). Of those three, the loan to the Australian Capital Territory is the most recent and was provided on broadly similar terms to the WestConnex loan.

3.55 In respect to the smaller programs aimed at individuals and businesses, the terms vary greatly from program to program, and are generally not as concessional as the larger loans that have been provided to the states and territories. For example, the smaller programs have not offered fixed low interest rates for more than 12 months, nor have they allowed interest to be capitalised.

40 ANAO Audit Report No.11 2015–16, *Indigenous Home Ownership Program*, Canberra, 3 December 2015; and ANAO Audit Report No.28 2015–16, *Administration of Concessional Loans Programs*, Canberra, 18 April 2016.

What are the benefits provided by the interest capitalisation period?

In addition to providing a $2 billion loan at below market interest rates, the Australian Government has reduced liquidity risk for the NSW Government and senior lenders on WestConnex. This was done by the Australian Government agreeing that no interest will be paid on the loan until 2027. Rather, interest will be accrued and added to the loan balance for the first 12 years. This is a more generous concession than was provided by senior lenders, who agreed to capitalise interest for the first three and a half years (that is, for the period of construction only).

The estimation of the impact on the fiscal balance of the concessional loan incorporated the effect of the interest capitalisation period. But advice to Ministers did not specifically canvas the merits of agreeing to an extended interest capitalisation period, rather than requiring interest to be paid as it was accrued, or from when construction is completed (as occurs with senior lenders).

3.56 In addition to providing a loan at well below market interest rates, the Australian Government agreed to a 12 year interest capitalisation period starting from financial close (20 November 2015). This meant that, while the Australian Government would be paying interest on the borrowings necessary to finance the drawdown of the loan (there are 41 monthly drawdowns between July 2016 and December 2019), it would not be receiving any interest income on the loan until 2027. Rather, a total of $791.66 million in interest during the 12-year capitalisation period is added to the outstanding loan balance.[41]

3.57 By way of contrast, the senior loan terms included a significantly shorter interest capitalisation period of approximately three and a half years (ending upon the completion of construction). The extended period of capitalised interest for the Australian Government loan provided a major reduction in liquidity risk for the project. This was of benefit to both the NSW Government and the senior debt providers (as debt servicing risks are significantly reduced during that period).

3.58 The estimation of the impact on the fiscal balance of the concessional loan incorporated the effect of the interest capitalisation period. But advice to Ministers did not draw attention to the specific cost of agreeing to an interest capitalisation period (rather than requiring interest to be paid as it was accrued) or why DIRD considered the Australian Government should help to reduce liquidity risk on the project in addition to providing finance at below market interest rates.

41 Total interest on the loan is expected to be $958.68 million, with $167.02 million in interest accruing between November 2027 and September 2029 to be paid to the Australian Government each quarter.

Was the effect of the loan on taxation revenue identified and advised to decision-makers?

Notably absent from the advice prior to the Budget, and subsequently, was analysis of whether the concessional loan would impact upon the Australian Government's finances for portfolios other than Infrastructure and Regional Development. Specifically, due to the concessional loan being provided by the Australian Government rather than a taxpaying entity, there will be no assessable income from the interest paid on the loan on which company tax will be paid but capitalised interest on the loan as well as capital works depreciation will be available to be claimed as tax deductions.

3.59 Taxation considerations formed an important consideration in the NSW Government's structuring of the financial arrangements for WestConnex. Part of the work conducted by NSW's commercial adviser was to recommend how to optimise the amount generated on the refinancing of the project company. This included maximising the tax deductions available to the future private sector equity owner, making the project company more valuable to the private sector, and leading to a better sale price upon privatisation for the NSW Government.

3.60 This work resulted in a successful private tax ruling application for the tax deductibility of the capitalised interest applied to the Australian Government loan. The rulings obtained from the Australian Taxation Office outline that the capitalised interest and capital works depreciation are both deductable and transferable when the planned privatisation of WestConnex occurs. But those benefits were not estimated and advised to Ministers by DIRD so that they could be aware of the corresponding reduction in taxation revenue that could be expected.

3.61 In this latter respect, DIRD advised the ANAO in November 2016 that:

- 'the Department's legal advisers in their letter of 19 November 2015 confirmed that the structure that NSW put in place during negotiations was typical of project finance transactions of this nature, suggesting the taxation costs would occur if the project went ahead with this structure regardless of who financed it'[42]; and
- it is not responsible for providing advice on taxation revenue policy and that 'the Treasury and the Department of Finance were both significantly involved in the negotiation of the loan agreement.'

Is construction of Stage 2 expected to be completed two years ahead of the business case schedule?

According to the data held by DIRD, Stage 2 is currently less than six months ahead of its originally scheduled completion date. The 13 May 2014 announcement of the accelerated project stated that the project would be completed up to two years earlier than planned.

3.62 NSW originally intended to sell Stage 1 to fund Stage 2, and sell Stage 2 to fund Stage 3. The provision of the concessional loan has meant that the delivery of Stage 2 has been de-linked

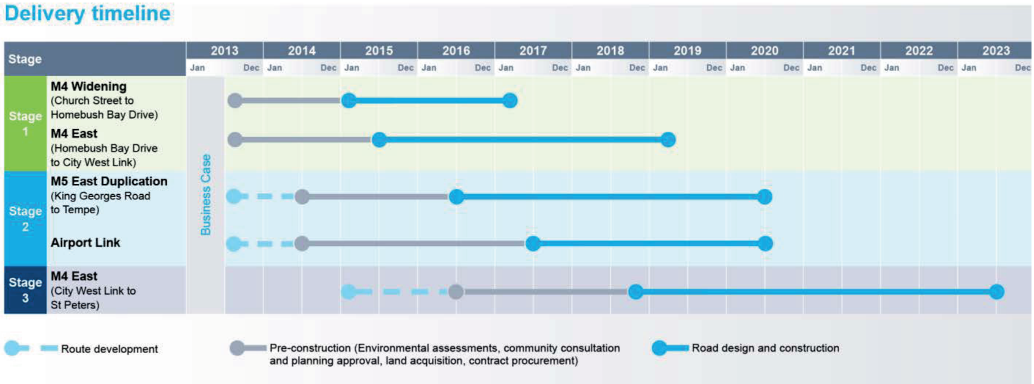
42 In this respect, due to the concessional loan being provided by the Australian Government rather than a taxpaying entity, there will be no corresponding assessable income from the interest paid on the loan on which company tax will be paid.

from the sale proceeds of Stage 1. DIRD's April 2014 advice to Ministers indicated that, by providing a loan, construction of Stage 2 could be completed by up to two years ahead of schedule.

3.63 On 11 May 2015, the Assistant Minister for Infrastructure and Regional Development and the NSW Minister for Roads jointly announced the commencement of Stage 2 construction 18 months ahead of schedule with work starting on the King Georges Road Interchange Upgrade (a Stage 2 sub-project). The Australian Government loan was credited with this acceleration.

3.64 The Stage 2 main works (the M5 East Duplication) were originally scheduled for commencement in July 2016, with completion in mid-2020. This is reflected by Figure 3.3. On 16 September 2016, NSW had reported to DIRD that the Stage 2 main works were not expected to be complete until early 2020. This timing indicates that Stage 2 is less than six months ahead of the delivery schedule outlined in 2013.

Figure 3.3: WestConnex sub-project delivery timelines in the 2013 Business Case



Source: NSW Government, WestConnex Business Case, July 2013.

3.65 In the context of the lengthy approvals, compulsory acquisitions of property, and consultation processes that must be undertaken in respect to an infrastructure project of this size, committing to an accelerated delivery of up to 24 months was too optimistic. In this respect, DIRD advised the ANAO in November 2016 that:

> The claim of "up to two years" was based on the best available information at the time. If ANAO were to seek NSW Government views on the acceleration, it is clear the acceleration compared to what would now be expected would be more than 6 months.

Recommendation No.1

3.66 Department of Infrastructure and Regional Development improve the advice on any future loans for major infrastructure projects by:

(a) developing a more robust and tailored administrative framework to govern the possible provision of loans;

(b) clearly identifying, and quantifying the impact of, all key aspects of the proposed commercial arrangements; and

(c) providing Ministers with a range of options on the key terms for agreement on the parameters within which the Department is authorised to negotiate.

Entity response: *Agreed*

3.67 *The Department agrees with the recommendation and notes that, as acknowledged by the ANAO in this audit report (refer 3.25), the Department conducted its own 'lessons learned' workshop in relation to the concessional loan in early 2016 in order to continually improve its due diligence processes.*

Grant Hehir
Auditor-General

Canberra ACT
14 February 2017

Appendices

Appendix 1 Entity responses

The formal responses received by ANAO following circulation of the draft report from the Department of Infrastructure and Regional Development; Infrastructure Australia; and the Department of Finance have been reproduced on the following pages.

Australian Government

Department of Infrastructure and Regional Development

Secretary

PDR ID: EC17-000065

Mr Grant Hehir
Auditor-General
Australian National Audit Office
GPO Box 707
Canberra ACT 2601

Dear ~~Mr Hehir~~ Grant

ANAO Audit of the Approval and Administration of Commonwealth Funding for the WestConnex Project

I refer to Ms Michelle Kelly's letter of 20 December 2016 seeking a response to the proposed audit report on the Approval and Administration of Commonwealth Funding for the WestConnex audit pursuant to sub section 19(1) of the *Auditor-General Act 1997* and to Mr Brian Boyd's subsequent advice by email of 1 February 2017.

The Department's revised summary response, response to the recommendation and full response on the proposed report, in light of the follow up advice from the ANAO on the basis of our first response, are provided at Attachment A.

Please contact Mr Mark Thomann, Executive Director, Infrastructure Investment Division on 6274 7631 if you would like to discuss this response.

Yours sincerely

Mike Mrdak AO

2 February 2017

GPO Box 594 Canberra ACT 2601 Australia • Telephone: 02 6274 7573 • Facsimile: 02 6274 8166
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Attachment A

Summary of Department's response

The Department of Infrastructure and Regional Development (the Department) notes the ANAO's findings and agrees with the recommendation in relation to the Department's involvement with the WestConnex project. The Department has concerns in relation to a number of the audit findings and has provided further comments in its full response.

Response to Recommendation No.1

The Department agrees with the recommendation and notes that, as acknowledged by the ANAO in this audit report (refer 3.25), the Department conducted its own 'lessons learned' workshop in relation to the concessional loan in early 2016 in order to continually improve its due diligence processes.

Department's full response

The Department of Infrastructure and Regional Development (the Department) notes the ANAO's findings and agrees with the recommendation in relation to the Department's involvement with the WestConnex concessional loan. The Department has concerns in relation to a number of the audit findings as outlined below.

National Partnership Payment

In relation to the National Partnership Payment of $1.5 billion, the Department disagrees with the statement that the grant administration did not adequately protect the Australian Government's financial interests.

The grant funding was provided to help facilitate the delivery of all three stages of the project. There are mechanisms in place that enable the Australian Government to seek a return of a portion of the grant funding if all three stages are not ultimately delivered. The ANAO fails to adequately recognise this in its report.

The ANAO notes that the initial payment was provided ahead of project need, but does not recognise that the *Federal Financial Relations Act 2009* provides the legal means to recover any payments should a project not proceed or not be completed. The ANAO previously recognised this point with the East West Link payment examined in an earlier audit. This Act and the Department's own legislative frameworks protect the Commonwealth's interest in the unlikely circumstance that such a major project, in which the NSW Government was already investing, did not proceed.

The Department ensured that all milestone payments following that initial payment were only made if sufficient work had been undertaken and there was sufficient evidence of project progress. Milestones for all projects are discussed and agreed between the Department and the relevant proponent, and are subject to change based on project progress. At no time were milestone payments made for WestConnex based on work that had not been completed at the time the payment was made.

In addition, the Department ensured that the Australian Government's interests are met through actively monitoring progress on the WestConnex project, including both Commonwealth and State expenditure, through the Department's Infrastructure Management System. The NSW Government reports monthly on the project through this system. Regular teleconferences are held with the NSW Government at the project officer level and the Department has senior management oversight of the project through its representation on the WestConnex Interdepartmental Steering Committee.

WestConnex concessional loan

In relation to the WestConnex concessional loan, as the ANAO noted, the Department conducted a 'lessons learned' workshop after the concessional loan was executed and is continually strengthening its processes as a result.

The Department stands by its earlier comments that the framework for the Northern Australia Infrastructure Facility (NAIF) is not directly relevant to this audit as the NAIF was developed well after the concessional loan was considered. The use of the NAIF sets a standard after the event.

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Additionally, the NAIF framework was developed to enable an independent board to assess proposals for up to $5 billion over 5 years in concessional finance to encourage and complement private sector investment in infrastructure. The WestConnex concessional loan made by the Australian Government was a one-off, tailored loan. However, in respect of the WestConnex concessional loan, the NAIF criteria as set out in the audit report (refer 3.13) were mostly addressed.

As the ANAO acknowledges (refer 19), the concessional loan was recommended as an alternative to grant funding and was intended to increase construction activity in the 2015-16 and 2016-17 financial years as well as reinvigorate the private sector lending market. The Australian Government chose to bring forward construction at a lower cost compared to providing a National Partnership Payment of the same amount. While the Department acknowledges that providing a concessional loan incurred a greater cost to government than providing a market loan, as the ANAO acknowledges (refer 3.54) the intent of the concessional loan was not to create a 'profitable' financial instrument for the Australian Government.

The Department disagrees with the ANAO's assertion that the concessional loan was not needed to accelerate the second stage of WestConnex. The initial strategy required Stage 2 construction contracts to be executed before sale proceeds from Stage 1 had been secured. The Department considered that this approach carried an unacceptable level of risk. The provision of the concessional loan enabled Stage 2 to be fully financed at contractual close, allowing Stages 1 and 2 to proceed in parallel resulting in significant time savings.

The second feature of the concessional loan that the ANAO claims detracts from the concessional loan being value for money is that the interest rate is set below a comparable market rate with no margin to cover the Australian Government's loan administration costs or risks. The Department disagrees with this assessment as it is not in the business of providing market loans, and that the more appropriate comparison is with a National Partnership Payment. A National Partnership Payment does not recover the administration costs of the Australian Government, nor does it provide features that would cover the Australian Government's risks. When compared against a National Partnership Payment, a concessional loan offers greater value for money, as the funds will be repaid and there is an income stream that goes some way towards offsetting the Australian Government's cost of borrowing in a way a National Partnership Payment does not.

The Department appreciates the ANAO's acknowledgement that the Department has adequately addressed the risk that the loan will not be repaid.

The Department acknowledges that the interest capitalisation period reduces the liquidity risk on the project and results in income to the Australian Government being delayed. The modelling provided to the Department by NSW indicated that the debt service coverage ratio required by Senior Debt would not be achieved without the interest capitalisation period on the Commonwealth loan.

Australian Government
Infrastructure Australia

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24/01/2017

Michelle Kelly
Group Executive Director
Performance Audit
Australian National Audit Office
GPO Box 707
Canberra ACT 2601
AUSTRALIA

Dear Michelle,

Thank you for the opportunity to review the proposed audit report on the Approval and Administration of Commonwealth Funding for the WestConnex Project, prepared by the Australian National Audit Office (ANAO).

Infrastructure Australia notes the report and believes that it accurately reflects Infrastructure Australia's role in the analysis of the WestConnex Project.

Yours sincerely,

Philip Davies
Chief Executive Officer

Australian Government

Department of Finance

Stein Helgeby
Acting Secretary

Our Ref: SEC0014145

Ms Michelle Kelly
Group Executive Director
Australian National Audit Office
GPO Box 707
CANBERRA ACT 2601

Dear Ms Kelly

Thank you for your letter of 20 December 2016 providing the Department of Finance with an opportunity to comment on the proposed Australian National Audit Office audit report on the "Approval and Administration of Commonwealth Funding for the WestConnex Project".

The Department of Finance notes the audit report and its recommendation.

The following comment is for inclusion in the report summary:

The Department of Finance notes the findings of this report and that the recommendation in the report is consistent with the current Budget Process Operational Rules (BPORs). The BPORs, which took effect from October 2016, strengthen the information requirements to Government on the costs and financial risks associated with loans.

If you have any queries on this matter, please contact Mr Richard Bartlett, First Assistant Secretary, Industry, Education and Infrastructure Division on (02) 6215 3580 or Richard.Bartlett@finance.gov.au.

Yours sincerely

Stein Helgeby
Acting Secretary
19 January 2017

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