

Inquiry into Infrastructure Planning & Procurement

ISA SUBMISSION

11 April 2014

Submission to House of Representatives
Standing Committee on Infrastructure and
Communications



About Industry Super Australia

Industry Super Australia (ISA) is an umbrella organisation for the industry super movement. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

Matthew Linden

Director of Government Relations
Level 3, 39 Brisbane Ave
Barton, ACT, 2600
02 6173 1825 / 0407 430 613
mlinden@industriysuper.com

Robbie Campo

Deputy Chief Executive
Level 39, 2 Lonsdale St,
Melbourne, VIC, 3000
03 9657 4306 / 0400 565 760
rcampo@industriysuper.com

Table of Contents

| | |
|--|----|
| SUMMARY | 3 |
| 1. INTRODUCTION | 4 |
| 1.1 Structure of this submission | 4 |
| 2. THE PROVISION OF PUBLIC INFRASTRUCTURE IN AUSTRALIA | 4 |
| 2.1 What is public infrastructure? | 4 |
| 2.2 Definition of funding and financing mechanisms | 4 |
| 2.3 Trends in public infrastructure investment | 5 |
| 2.4 Alternative private financing models | 6 |
| 2.5 The use of PPP models in Australia | 7 |
| 3. SUPERANNUATION FUND CREDENTIALS, EXPERTISE AND RECORD IN PUBLIC INFRASTRUCTURE | 9 |
| 3.1 Credentials and expertise in public infrastructure investment | 9 |
| 3.2 Asset performance and member returns | 11 |
| 3.3 Economic benefits | 15 |
| 3.4 The growing appetite of superannuation funds for infrastructure investment | 16 |
| 4. FUNDING MECHANISMS | 17 |
| 4.1 Deficits and Debt | 17 |
| 4.2 User Charges | 17 |
| 4.3 Recycling brownfield assets | 18 |
| Greenfields or brownfields investment | 18 |
| 5. FINANCING MECHANISMS | 19 |
| 5.1 Conventional private financing mechanisms | 20 |
| 5.2 Advantages and disadvantages of alternative financing models | 20 |
| 5.3 Impediments to private financing | 21 |
| 5.4 Evolution of private financing models | 21 |
| 5.5 Costs and benefits of public versus private sector financing | 22 |
| 5.6 Issues with current private financing mechanisms | 23 |
| 5.7 Reforming the bid process | 25 |
| 5.8 Risk allocation | 25 |
| 5.9 Liquidity issues | 26 |
| 6. CASE STUDY: A BID MODEL FOR THE FUTURE | 27 |

SUMMARY

This submission seeks to explore the co-existence of a significant infrastructure deficit in Australia alongside the large pool of superannuation savings and explores the obstacles to the application of those savings to new public infrastructure. The submission is focussed on the following five themes:

1. Industry SuperFund credentials and expertise in public infrastructure investment

Industry SuperFunds have a long and successful track record in long-term investment in infrastructure with direct and unlisted investments in assets as diverse as energy, water, ports, roads, airports and property as well as social infrastructure such as aged care, hospitals and schools. By virtue of their scale, expertise and long-term focus they are able to access illiquid assets such as infrastructure not open to retail investors. Industry SuperFunds have the capacity to invest a further \$15 billion in new projects over the next five years to the benefit of both their members and the wider economy.

2. Asset performance and member returns

The innovative approach of Industry SuperFunds and their appetite for illiquid investment has paid dividends to members by delivering stronger investment returns and lower volatility. Over the last 18 years, IFM Investors has delivered after tax returns of over 12 per cent per annum, outstripping most other asset classes. Even over the past five years in the wake of the GFC, unlisted infrastructure returns have averaged 8.3 per cent per annum. Moreover, over the past 15 years, the volatility (standard deviation) of unlisted infrastructure was 6.5 per cent – one third of the volatility exhibited by domestic and international equities.

3. A trusted custodian of strategic assets

Independent research by Newspoll, commissioned by ISA, shows that superannuation funds have the potential to cut through community concerns about private sector ownership and potentially change the infrastructure game, unlocking billions of dollars for investment in new economic and social infrastructure. Almost four in five said they would be more supportive of private investment if it involved super funds. Industry SuperFunds have proven themselves to be responsible investors: they seek stable, income generating assets capable of delivering sound returns with an investment time horizon measured in the decades. In short, it makes sense for Industry SuperFunds to manage assets as the public desires – a sensible long-term employer, service provider and corporate citizen.

4. Debt equity rebalancing

The infrastructure financing package has generally been apportioned 80-90 per cent debt and 10-20 per cent equity (this is particularly true for the development of new assets). In the tighter post-GFC debt markets, the global equity contribution towards financing has crept towards the 30 per cent mark. In Australia, there has also been some increase in equity participation. Debt financing will always play a central role in financing infrastructure. However, there is scope for a further rebalancing towards equity as a means of better aligning the long life-cycle of investment projects with a long-term investment time horizon of participants, and in so doing, reducing refinancing risks.

5. Inverting the bid process

With a clearer pipeline of projects now emerging, reforms are required to the procurement process to encourage increased participation of long-term equity investors such as superannuation funds in greenfield infrastructure projects. Central to this is the need to reform or ‘invert’ the bid process. The current model is characterised by high up-front bid costs and long lead times which create “barriers to entry” to superannuation funds seeking to invest in new projects. Typical bid costs in Australia are around 1 per cent of the total project cost – for large projects the bid cost can be many millions of dollars. This is compounded by long procurement timeframes – an average of 17 months.

In this submission, we detail the issues with the current bid process for infrastructure projects and will propose a new “next generation” inverted bid model in a supplementary submission.

1. Introduction

There is a strong relationship between infrastructure development and Australia's long-term economic performance. However, Australian governments have limited discretionary funds available for infrastructure investment and will face an escalating infrastructure deficit unless they either significantly increase their debt or they utilise innovative funding and financing mechanisms. This is the central focus of this submission.

Industry SuperFunds are uniquely placed to be part of the solution given their expertise, appetite for illiquidity to secure a premium to members and commitment to long-term investment.

Australia's infrastructure deficit is conservatively estimated by Infrastructure Australia to exceed \$300 billion (and by other sources over \$700 billion¹). Infrastructure investment has become an increasingly critical driver of productivity gains as our population ages. There is the need for "new generation" funding and financing models that drives significant equity investment into infrastructure projects by Australia's superannuation funds. The issues with the current approach are set out in detail in section 4 and 5.

At the same time, so as to minimise the risks to the budget from an ageing population and secure living standards in retirement, there is a need to provide superannuation funds with viable and low-risk investment opportunities that deliver an attractive return to members commensurate with the risk of that investment. Based upon prospective allocations and underlying asset growth, there will be insufficient projects in which to invest if the private financing model maintains its high debt to equity ratios.

1.1 Structure of this submission

For the purpose of brevity, this submission addresses issues of particular significance to Industry SuperFunds.

2. The provision of public infrastructure in Australia

2.1 What is public infrastructure?

The National PPP Framework clarifies that 'public infrastructure' consists of physical assets and related services. Physical public infrastructure assets include both economic infrastructure (such as roads, rail, ports, and communication) and social infrastructure (such as correctional, health, educational, accommodation, public housing and court facilities).²

ISA recommends the definition of public infrastructure should explicitly include social infrastructure including schools, hospitals, prisons, courts and the range of other infrastructure through which public services are delivered.

Public infrastructure, whether economic or social infrastructure, exhibit shared characteristics: they both deliver essential services, have long economic lives, high capital costs, high barriers to entry, high levels of uncertainty and illiquidity and often involve governments as regulatory or funding counter-parties.

The IFM Investors infrastructure portfolio – the largest of its kind in Australia – spans the economy and touches virtually every aspect of our lives and other Industry SuperFunds, including Australia's largest, AustralianSuper, are also expanding their direct ownership of both economic and public infrastructure.

2.2 Definition of funding and financing mechanisms

It is worth noting the distinction between funding and financing of public infrastructure. The term funding refers to how infrastructure is paid for. Ultimately there are only two sources of funding for infrastructure –

¹ Citigroup (2008) Australia's Infrastructure Supercycle

² Commonwealth of Australia (2008) National PPP Policy Framework

government revenue raising (the tax payer) or direct user charges. This is opposed to financing, which refers to the way debt and/or equity is raised for the delivery and operation of an infrastructure project.³

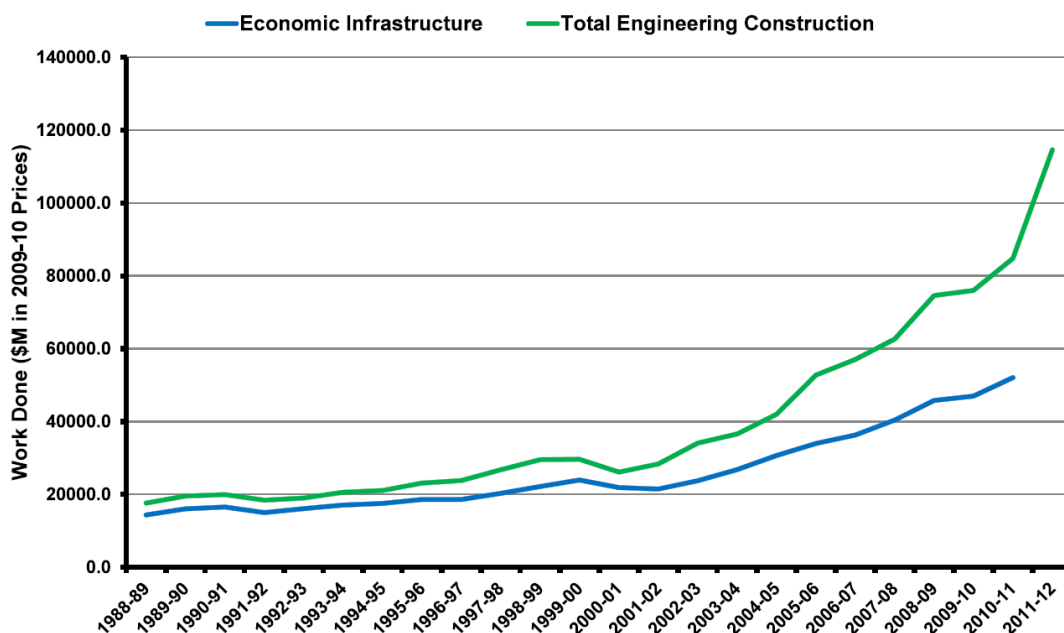
ISA recommends the recycling of capital from brownfields to greenfields projects to be considered as a funding mechanism.

2.3 Trends in public infrastructure investment

There has been a strong and consistent growth in the number of infrastructure projects being undertaken across Australia. The National Infrastructure Construction Schedule (NICS) identifies a AUD\$920 billion pipeline of current and forthcoming Infrastructure Investments and the number of projects added to the 2013 National Infrastructure Priority List more than doubled from 2012.

The national total value of engineering construction is also currently at record levels, having steadily increased since 2005, and with a significant surge in construction activity within the resources and heavy industry sectors between 2010 and 2012 (figure 2.3.1). Specifically, engineering construction in the resources and heavy industry sectors increased from \$11.3 billion in 2005 to \$29 billion in 2010 (representing an increase of 157 per cent) and then to AUD\$56.4 billion (representing an increase of a further 90 per cent).

Figure 2.3.1: Australia – Trends in national expenditure on economic infrastructure and engineering construction



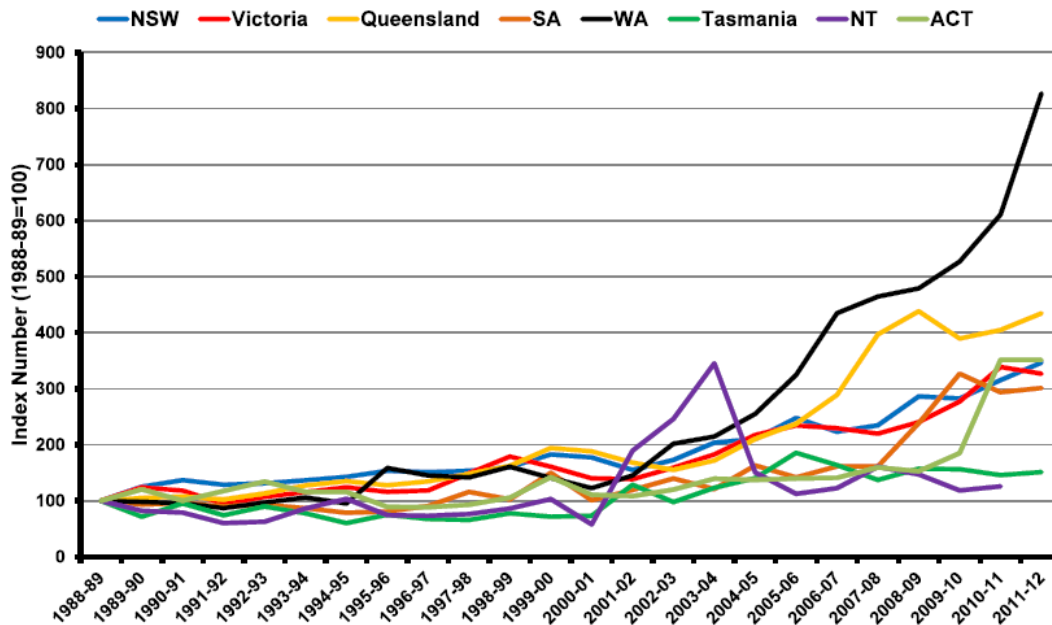
Source: Institute of Engineers Australia (2013) *Analysing Infrastructure Trends 2013: What has happened since the 2010 Report Card*

However, a large amount of this activity has been specific to the resources sector (namely transportation infrastructure such as ports and railways in both Queensland and Western Australia), obscuring the underlying wide variability in infrastructure investment across the various asset sectors and jurisdictions. As such, while investment in infrastructure might be at record levels, spending has not necessarily been spread evenly across all public infrastructure asset classes (refer to chart 2.3.2 for an analysis of growth in economic infrastructure by jurisdiction and 2.3.3 for an analysis of construction engineering spend by sector). For example, over the previous six years to 2013-14, the Australian Government has committed around \$36 billion to transport infrastructure – representing the largest Australian Government commitment to transport infrastructure ever made.⁴

³ Infrastructure Australia (2012) *Infrastructure Finance and Funding Reform*

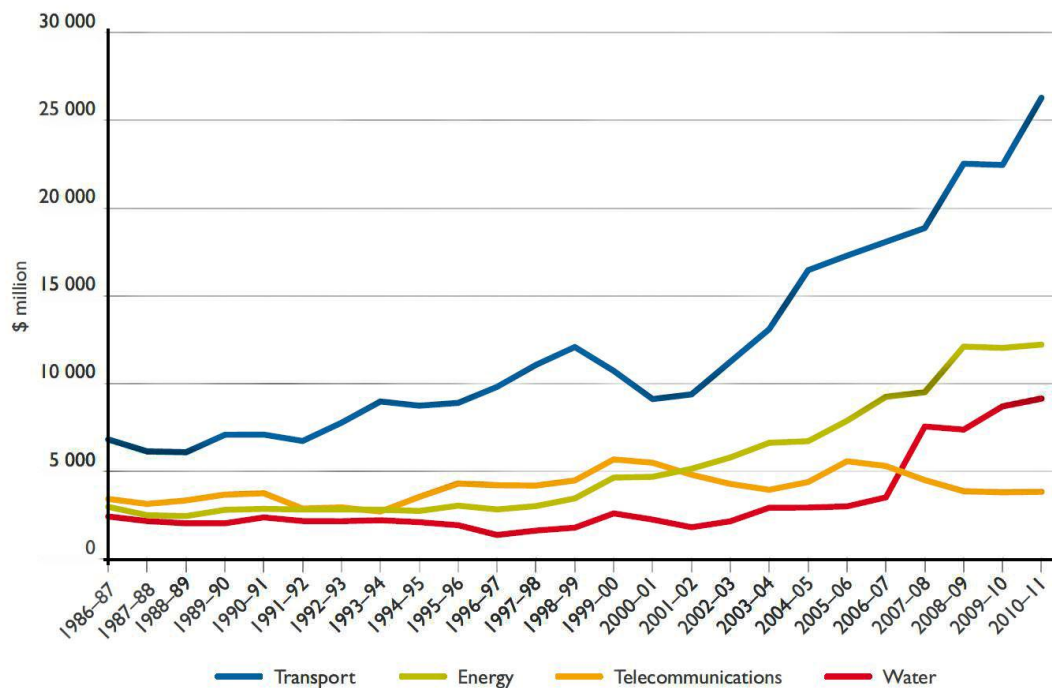
⁴ Infrastructure Australia (2012) *Infrastructure Finance and Funding Reform*

Figure 2.3.2: Australia – Economic infrastructure growth by jurisdiction



Source: Institute of Engineers Australia (2013) *Analysing Infrastructure Trends 2013: What has happened since the 2010 Report Card*

Figure 2.3.3: Australia – value of construction engineering by sector, 1986-2011



Source: Infrastructure Australia (2013) *National Infrastructure Plan: June 2013 Report to COAG: page 6*

2.4 Alternative private financing models

There are many public-private partnership (PPPs) models⁵. PPPs typically involve a partnership between the public and private sector where the private sector is contracted to design, build, operate and manage and, most importantly, finance new infrastructure or services and meet government obligations for a set period of time (typically 20 to 30 years). Included in the contract is the right to receive payments from the government and/or

⁵ Productivity Commission (2008) *Public Infrastructure Financing*

charge users of the facility a fee (a toll in the case of roads) in order to recover the costs of construction, operation and maintenance.

Table 2.4.1 Types of PPPs⁶ : Contract-type Characteristics

| Contract Type | Characteristics |
|--|--|
| Design Build (D&B) | The government specifies the asset it requires in terms of its functions and desired outcomes. The private sector is responsible for designing and building the asset and managing any related risks. The asset is transferred to the government to operate. |
| Operate Maintain (O&M) | An existing government-owned asset is managed by the private sector for a specified period. The private sector will be responsible for providing the services to the customer (retail or wholesale), maintaining the asset to a specified condition and ensuring that management practices are efficient. |
| Design Build Operate (DBO) | Effectively, this is a D&B and O&M contract rolled in together. The private sector is usually responsible for financing the project during the construction period. The government purchases the asset from the private sector for a pre-agreed price prior to (or immediately after) commissioning the asset and takes all ownership risks from that time on. The private sector retains the management function and related risks. |
| Build Own Operate Transfer (BOOT) | The private sector is responsible for design and construction, finance, operations, maintenance and all commercial risks associated with the project. It owns the project through the concession period and the asset is then transferred back to the government at the end of the term, often at no cost. Build Own Operate (BOO) Similar to BOOT projects, but the private sector retains ownership of the asset in perpetuity. The government also agrees to purchase the services produced by the asset for a fixed length of time. |
| Lease Own Operate (LOO) | Similar to BOO projects, but an existing asset is leased from the government for a specified period. The asset may require refurbishment or expansion but no 'new build' assets are necessary. |
| Alliance | An agreement between the private sector and the government to share the benefits or the costs associated with project risks. The parties agree to a benchmark price, time and service level. Any benefits (or costs) achieved are shared between the parties according to a pre-agreed formula. |

2.5 The use of PPP models in Australia

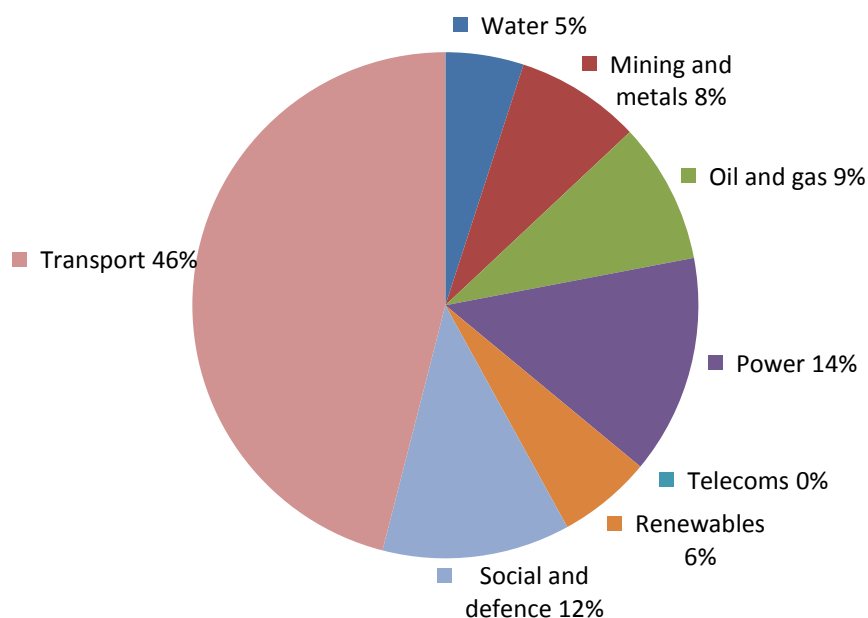
PPPs are being widely used by Australian, state and territory governments to deliver infrastructure projects across a range of sectors. Although initially focussed on economic infrastructure and full private provision of public services, over the last decade, Governments have used PPPs to procure social infrastructure assets and associated non-core services, with the public sector delivering core services such as health and education.

⁶ Productivity Commission (2008) Public Infrastructure Financing. Adapted from AusCID

Infrastructure Australia also identifies a number of speculated projects.⁷

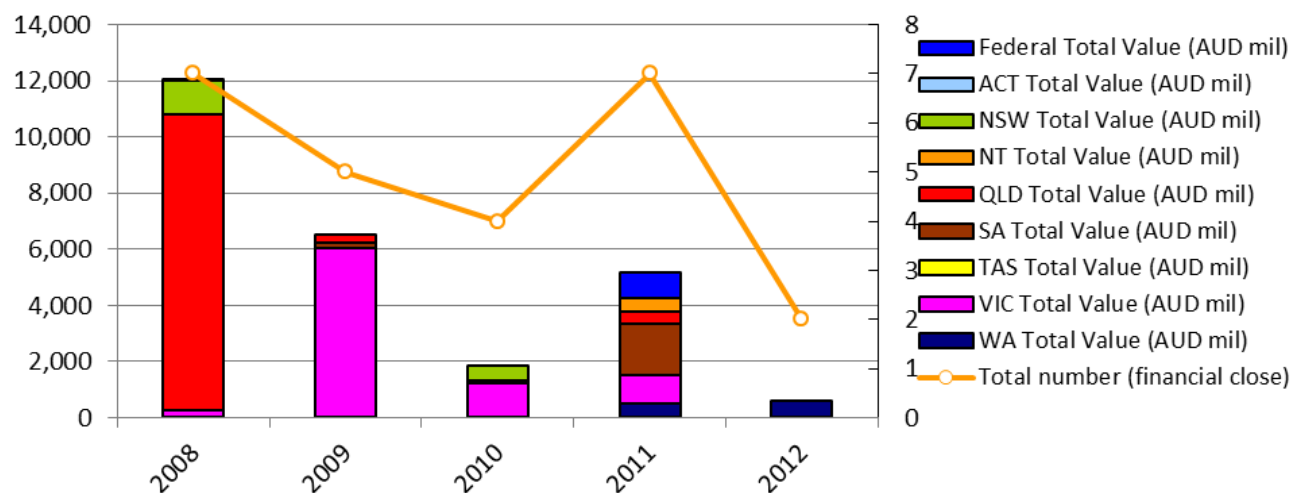
Overall, PPPs account for a relatively small share of the total investment in Australian public infrastructure and the share fluctuates from year to year and by state and territory. The market in Australia is characterised by a volatile and at times geographically dispersed deal flow. .

Figure 2.5.1: Australia – sector breakdown of PFI projects, 2006-2011



Source: Infrastructure Australia

Figure 2.5.2: Australia – total number and value of PFI projects, 2008-2012



Source: Infrastructure Australia

A combination of the Australian Government's commitment to spending on infrastructure, a resilient banking sector, the appeal of infrastructure assets as a stable long term investment option – particularly for Industry SuperFunds, has enabled the Australian project finance market to recover quickly from the GFC.

Economic infrastructure has been dominated by large toll roads, for example Victoria's AUD\$2.6 billion Eastlink; NSW's \$2.3 billion Westlink M7; and Queensland's AUD\$4.8billion Airport Link.

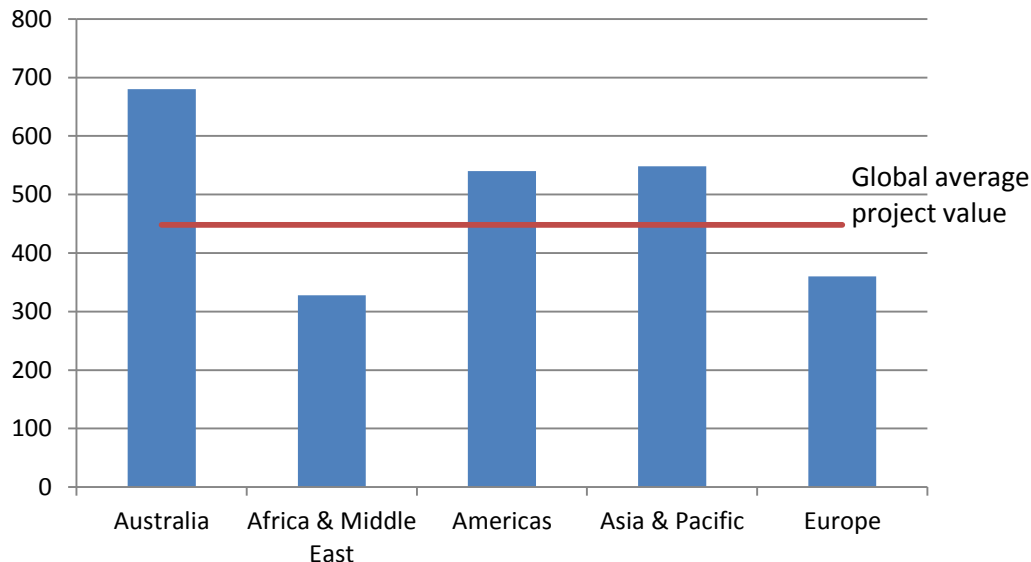
The development of roads is an ongoing priority area but developing roads as PPPs presents challenges in the

⁷ Infrastructure Australia (2013) Potential PPP Projects as at May 2013

Australian market – overly aggressive traffic forecasting on a number of toll road projects led to the underperformance of project financed roads, for example, the 2007 Sydney Cross Tunnel bankruptcy.

In Australia, economic and social infrastructure projects have tended towards being larger in terms of capital investment and more complex than in other PFI markets (figure 2.5.3).

Figure 2.5.3 Regional versus Australia average PPP Project Value



Source: Infrastructure Australia

3. Superannuation fund credentials, expertise and record in public infrastructure

3.1 Credentials and expertise in public infrastructure investment

Superannuation assets now top \$1.75 trillion and are on a growth path that will see the savings pool increase to around \$6 trillion in the next 15 years. As the savings pool continues to expand so too do the opportunities for innovative long term investment in real assets – like infrastructure – that in a post-GFC environment offer strong and stable returns for members as well as supporting a virtuous economic cycle of growth and jobs.

Industry SuperFunds manage around \$150 billion of assets for nearly six million Australians. By virtue of their scale they are able to access investments otherwise unavailable to retail investors. In particular, they are more likely than retail superannuation funds to invest in unlisted assets such as infrastructure.

Investment in economic infrastructure is integral to driving productivity and economic growth against the background of an ageing population, however such investments also deliver strong, predictable cash flows to members. Investment in such alternative assets is now more important than ever given the volatility of listed assets.

The Industry SuperFund investment model

Superannuation funds have a long and successful track record of investment in public infrastructure and have developed a deep pool of expertise in this specialist investment class.

Soon after the legislation of the Superannuation Guarantee (SG), Industry SuperFunds recognised the opportunities presented by direct investment and sought to build internal capability and expertise. The OECD has recognised that these steps were at the leading edge of direct infrastructure investment by pension funds

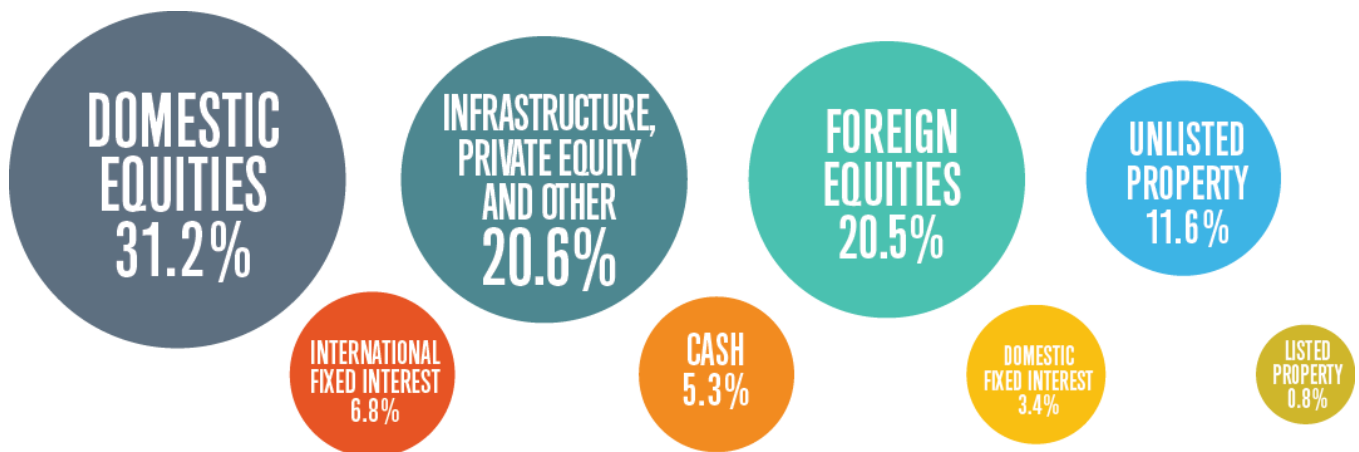
globally.⁸

Unlisted investment through pooled vehicles or direct ownership is often able to achieve better long-term returns for members by eliminating the costs of intermediaries and allowing more control over the performance of assets. Unlisted investments are intended to be long-term in nature and seek to capture an illiquidity premium to compensate for the fact that they are not liquid and cannot be redeemed for cash readily.

In addition to capturing higher risk adjusted returns, unlisted investments allow greater control over assets, including the ability to take a more active role in manager compensation and investor protections. On average, Industry SuperFunds allocate almost 21 per cent⁹ of funds under management to alternative assets which include direct and pooled infrastructure investments and private equity (PE).¹⁰ Retail super funds allocate less than one quarter of this amount at the whole of fund level to similar assets.¹¹

Source: Australian Prudential Regulation Authority (APRA)

Figure 3.1.1: Industry SuperFund asset allocation (average of default strategies of Industry SuperFunds)



Source: Australian Prudential Regulatory Authority

Appetite for illiquidity

Industry SuperFunds are uniquely placed to sustain relatively illiquid investments such as infrastructure: their members' long-term investment time horizon aligns with the long term life-cycle of such investments.

APRA has found that not-for-profit funds, such as Industry SuperFunds have characteristics¹² which can sustain a relatively high level of illiquid investment due to scale, member demographics and strong cash flows. Importantly, the structure of Industry SuperFunds provides additional flexibility to make strategic investment decisions on behalf of members. Such flexibility is diminished in the retail super fund and SMSF environment because investment decisions are normally left up to individual retail level financial advisers and their clients.

Nevertheless, if other sectors of the superannuation industry invested to the same extent as Industry SuperFunds in infrastructure, an additional \$100 billion would be available for investment.

In addition to capturing higher risk adjusted returns, unlisted investments allow greater control over assets, including the ability to take a more active role in manager compensation and investor protection.

Pooled investment

⁸ Inderst, G. (2009), "Pension Fund Investment in Infrastructure", OECD Working Papers on Insurance and Private Pensions, No. 32

⁹ APRA 2012, Superannuation Fund-level Profiles and Financial Performance

¹⁰ Among Industry SuperFunds approximately three quarters of 'other' investments are exclusively infrastructure with most individual funds maintaining allocations between the range of 10-16%

¹¹ Cummings and Ellis, 2011, APRA Working Paper, Risk and Return of Illiquid Investments

¹² Ibid

The use of pooled investment vehicles has allowed a broad group of industry funds to aggregate expertise, access scale cost savings and diversify their investment allocation adequately. Pooled investment vehicles are used to invest in a diverse range of assets including commercial property, energy, water, ports, roads, airports and social infrastructure including aged care, hospitals and schools.

Industry super funds, through IFM Investors, have been investing in the expansion and upgrade of Australia's infrastructure for almost two decades. IFM Investors is wholly owned by 30 industry super funds and is a multifaceted investment manager holding assets worth over \$48 billion for domestic and offshore institutional investors.

Some large industry super funds with specialist investment teams also invest directly in key assets where they have the scale to do so.

An example is AustralianSuper which has over \$6.5 billion invested in infrastructure assets, with just over half in Australia. In 2013, the NSW Ports consortium, led by IFM Investors and including AustralianSuper, QSuper and Tawreed Investments Limited, a wholly owned subsidiary of the Abu Dhabi Investment Authority, was named by the NSW Government as the successful bidder for the 99-year leases of Port Botany and Port Kembla. The consortium partners have paid a consideration of A\$5.1 billion to acquire the 99-year leases for the ports, with AustralianSuper taking a 20 per cent direct holding. Investing directly provides funds such as AustralianSuper with greater control over the deployment of capital into infrastructure assets, both in timing and for portfolio construction.

Infrastructure investment can take the form of equity or debt. However, unlike listed investments, unlisted infrastructure assets are illiquid and require a greater focus on shareholder arrangements and valuation metrics. All infrastructure assets, regardless of whether they are greenfield or brownfield, need strong boards and an alignment of interest between management performance and long-term shareholder value.

3.2 Asset performance and member returns

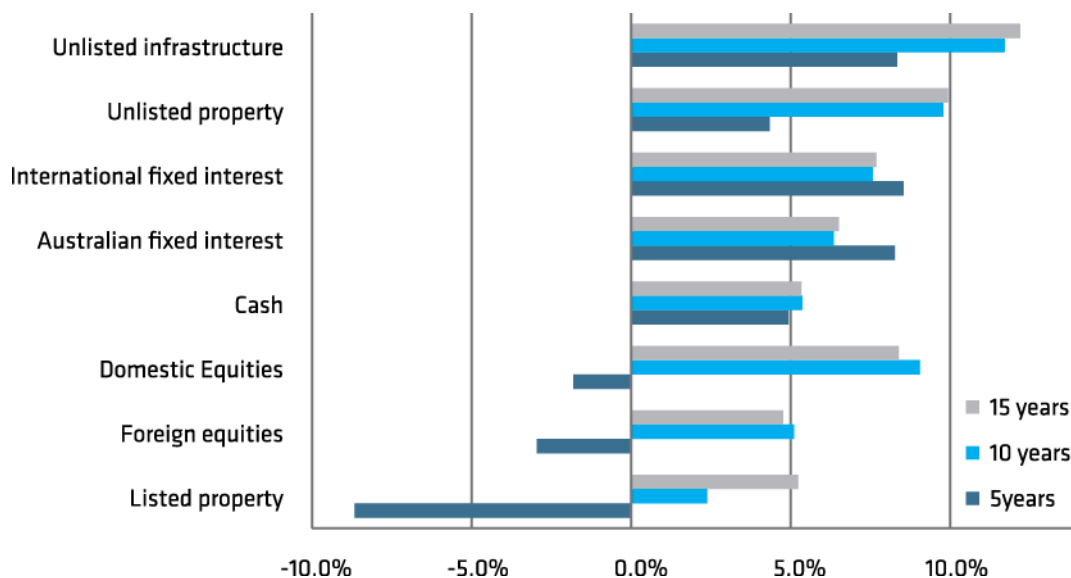
Unlisted assets including infrastructure have delivered superior returns to member over the short, medium and long term relative to other asset classes.

Infrastructure in particular has a number of features which underpin its strong performance:

- Infrastructure assets typically have stable and predictable cash flows by virtue of their monopoly characteristics and inelastic demand curves;
- They tend not to be highly correlated with other asset classes whose performance can be heavily influenced by financial market dynamics and investor sentiment;
- Strategic ownership of the assets reduces the costs associated with financial intermediaries that would otherwise be integral to an asset being offered through a listed financial instrument;
- Strategic ownership gives more control over the management and development of the asset thereby maximising its economic value.

Over the last 18 years IFM Investor's unlisted infrastructure portfolio has delivered after-tax returns averaging over 12 per cent per annum outstripping most other asset classes. Even over the past five years through the unprecedented turmoil of the GFC, unlisted infrastructure returns have averaged 8.3 per cent per annum.

Figure 3.2.1: Five, 10 and 15 year investment returns to Dec 2012 by asset class



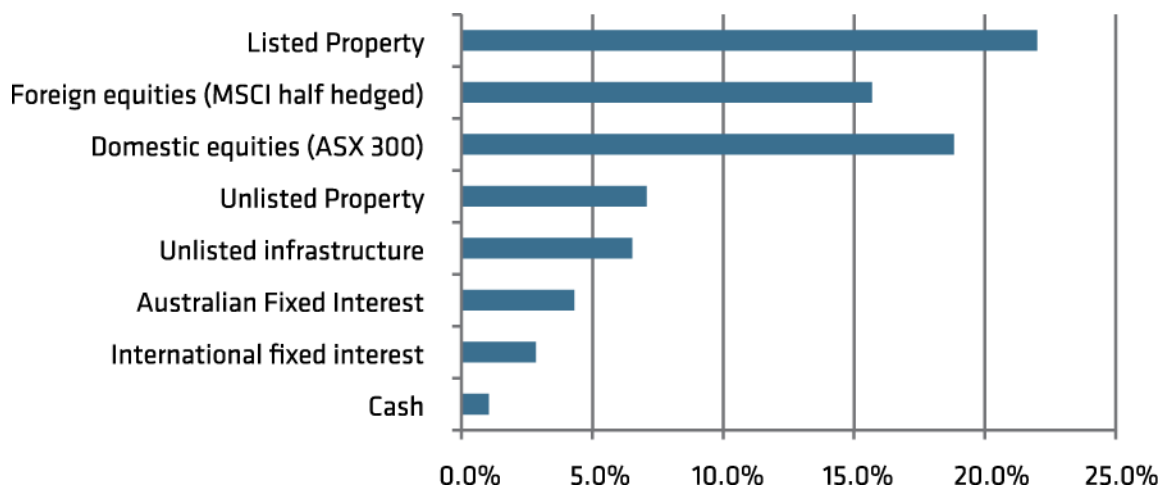
Source: Proprietary data, Frontier Investment Consulting, ISA calculations

As well as delivering stronger average returns, both unlisted infrastructure and property have exhibited lower volatility than other asset classes with the exception of cash and fixed interest.

Over the past 15 years volatility of unlisted infrastructure (measured the standard deviation of annual returns) was 6.5 per cent – one third the volatility exhibited by domestic and international equities.

Table 3.2.1: Cumulative 15 year Investment returns to Dec 2012 by asset class expressed in current dollars

| Asset Class | \$100 invested 15 years ago worth: |
|------------------------------|------------------------------------|
| Unlisted Infrastructure | \$562 |
| Unlisted Property | \$414 |
| International Fixed Interest | \$304 |
| Cash | \$218 |
| Domestic Equities | \$335 |
| Foreign Equities | \$201 |
| Listed Property | \$215 |

Figure 3.2.2: Volatility of common investment classes 1997-2012 (std. dev. of annual returns)

Source: Proprietary data, Frontier Investment Consulting, ISA calculations

Member benefits

The capacity for exposure to illiquid assets has demonstrably contributed to investment outperformance by Industry SuperFunds to the benefit of members.

As noted in section 2.1, Industry SuperFunds invest differently to other sectors by maintaining higher asset allocations to unlisted assets, particularly infrastructure. On average these higher allocations have historically resulted in less exposure to equities and fixed interest. APRA recently tested the investment performance of funds over the period from 2004 to 2010 to determine if illiquid assets made a difference to fund performance and member returns.¹³

The study found that among 139 retail and not-for-profit funds, not-for-profit funds achieved an average net risk adjusted investment outperformance of 144 basis points per annum, of which around one quarter could be attributed to a higher share of illiquid assets. As the APRA analysis did not disaggregate Industry SuperFunds Investments from the not-for-profit sector, further analysis is necessary to determine if the higher allocation to unlisted assets in Industry SuperFunds further affects returns.

Benchmark analysis

Determining the impact of different asset allocations over time can be assessed by constructing different asset portfolios and then utilising time series benchmark returns to determine the annual weighted returns for each portfolio.

For this analysis four different asset portfolios are considered:

- (A) Average Industry SuperFund;
- (B) Typical listed retail portfolio;
- (C) Typical SMSF portfolio;
- (D) Infrastructure.

¹³ Cummings and Ellis, 2011, APRA Working Paper, Risk and Return of Illiquid investments

Table 3.2.2: Portfolio detail, returns and volatility

| Asset Class (Benchmark) | A) Industry SuperFund | B) Typical listed retail portfolio | C) Typical SMSF | D) Infrastructure |
|---|--------------------------|---------------------------------------|-----------------|-------------------|
| Cash | 4.9% | 14% | 40% | 5% |
| Domestic equities (S&P ASX/300) | 32.3% | 30% | 44% | 25% |
| Foreign Equities (MSCI World) | 22.7% | 27% | 1% | 22% |
| Unlisted infrastructure & Private Equity | 17% | - | - | 25% |
| Listed property trust | 2.6% | 10% | 5% | - |
| Unlisted property trust | 10.1% | - | 5% | 13% |
| Domestic fixed interest | 6% | 14% | 5% | 5% |
| International fixed interest | 4.5% | 5% | - | 5% |
| Average Annual Returns (15 yrs) | 7.12% | 5.94% | 6.44% | 7.51% |
| Volatility | 9.3% | 9.9% | 8.2% | 8.1% |

Industry SuperFund assets are rebalanced to actual asset allocations identified in APRA fund level statistics (2006-2012). The allocations shown above are the average for the period. Other portfolios have fixed asset allocations that are rebalanced annually.

Summary of investment outperformance

For the purpose of the analysis all returns are net of tax and a common 0.5 per cent administration fee. Accordingly returns only reflect the differences in asset allocation. The results show that the asset allocation of Industry SuperFunds have underpinned higher investment returns over much of the last 15 years and allowed members to better ride out recent market turmoil arising from the GFC.

Key outcomes:

- Industry SuperFund asset portfolio achieved average after-tax investment returns around 118 basis points per annum higher than a typical retail listed portfolio;
- These returns have led to a cumulative after tax investment outperformance of 18 per cent from 1997-2012 relative to a typical listed retail portfolio;
- Industry SuperFund asset portfolio reduced volatility by 70 basis points compared to a typical listed retail portfolio over the last 15 years;
- Increasing Industry SuperFund unlisted infrastructure and PE allocations to 25 per cent would have:
 - increased annual returns by a further 28 basis points per annum,
 - increased cumulative after-tax returns to 25 per cent above the level achieved by a typical listed retail

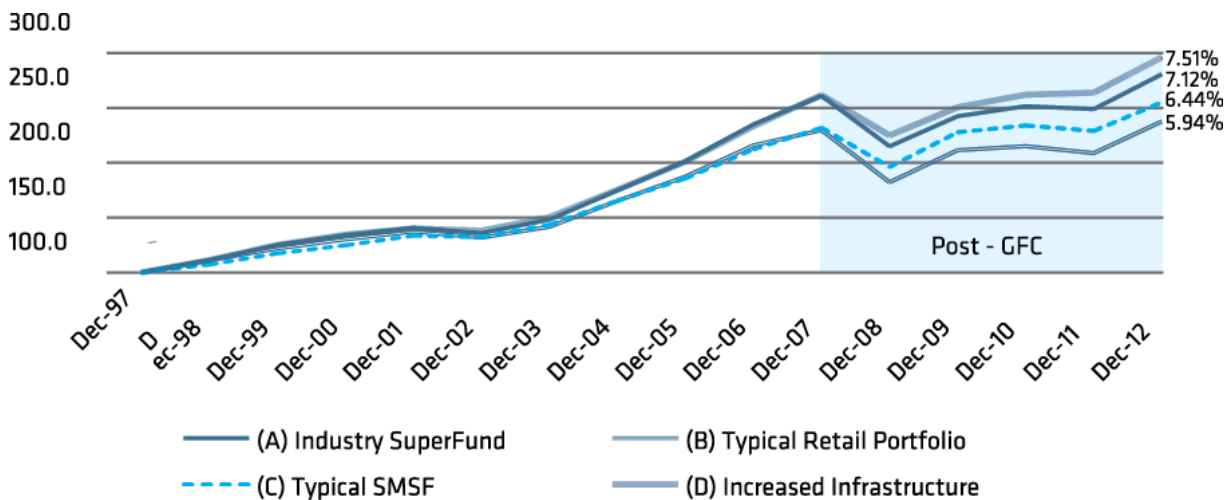
portfolio from 1997-2012, and

- reduced volatility by 110 basis points compared to a typical listed retail portfolio.

These outcomes are consistent with APRA research which found not-for-profit fund returns were less volatile than for-profit funds over the last five years coinciding with the GFC. What is especially evident from the benchmark analysis above is the extent to which an increased allocation to unlisted infrastructure would have further protected members during the GFC¹⁴ from the effects of negative returns in listed markets.

The analysis also shows that while the higher weighting in SMSF portfolios to cash helped reduce volatility during the GFC, it did so at the expense of long-term returns where it trailed the Industry SuperFund allocation by a cumulative amount of 10 per cent over the 15 years.

Figure 3.2.3: Cumulative return index 1997-2012



3.3 Economic benefits

Infrastructure investment improves the quality and quantity of our nation's capital stock which keeps the wheels of the economy moving despite the ageing of the population.

An example is the construction or upgrade of a road which relieves congestion – allowing goods to be transported more rapidly – yielding cost savings for business and households. Such investments also yield dynamic productivity gains which arise from the better integration of markets.

At a macroeconomic level, infrastructure investment contributes to capital deepening in the Australian economy which in turn leads to economic growth and higher real wages.

Capital deepening in the economy has a powerful effect on productivity and GDP growth. The Productivity Commission has estimated in Australia's recent economic history, capital deepening accounted for 52 per cent of productivity growth in the economy.¹⁵

The Productivity Commission has also estimated infrastructure investment, coupled with market reforms to achieve best practice in energy, transport, and other activities could, increase GDP by nearly two per cent.¹⁶

OECD research¹⁷ has also suggested investment in physical infrastructure can boost long-term economic output by more than other types of investment.

¹⁴ APRA, June 2011, Annual Superannuation Bulletin (See Figure E page 13)

¹⁵ DCITA, 2006, Forecasting Productivity Growth 2004-2024

¹⁶ Productivity Commission, 2006. Potential Benefits of the National Reform Agenda, Report to the Council of Australian Governments

¹⁷ OECD 2009a, Economic Policy Reforms: Going for Growth, Organisation for Economic

Co-operation and Development

Some tangible examples of Industry SuperFund investment in transport assets and indicative economic benefits are shown below.

There are important dynamic benefits that accrue to super fund members from productivity gains resulting from the improvement in capital stock of the economy. Improvements in productivity have the capacity to improve the operating environment for other investments. Additionally productivity growth increases real wages, which enhance purchasing power and lift contribution rates to superannuation thus further bolstering retirement incomes.

Higher productivity growth rates also reduce an inflationary pressure which protects and enhances the purchasing power of members' accumulated savings.

Table 3.3.1: Selected IFM Australian infrastructure investments

| Asset | Investment | Economic Benefits |
|-------------------------------------|--|--|
| M5 Toll Road (NSW) | \$400m to be invested in widening the road in the vital Botany economic precinct. | 5th busiest toll road in Australia will have capacity of road increased 50%. |
| Southern Cross Station (VIC) | Construction of Southern Cross Station provided a new interchange for 5 transport networks in Melbourne's CBD. | Passenger numbers have increased 110% from 55,000 to 115,000 per day. |
| Port of Brisbane | \$1.2b in planned capital expenditure over the next 10 years. | Capital expenditure will support increased trade volumes. |
| Australian Airports | \$2.9b in capital investments between 2002 and 2010. Support for further additional investments including \$1.3b in a new parallel runway at Brisbane Airport and \$1b over the next 5 years at Melbourne Airport. | Capital expenditure supported an increase in passenger volumes from \$36m per year to \$64m per year including through expanding runways terminals and access roads. Investments have generated over 13,000 additional jobs - FTE employment at Melbourne Airport increased 22% alone contributing \$850m p.a to Victoria's Gross State product. |

3.4 The growing appetite of superannuation funds for infrastructure investment

There are a number of factors relevant to superannuation which means its appetite for infrastructure investment will only grow.

Ongoing population and wage growth, along with the scheduled increase in the SG will provide funds with strong cash flows and increase flexibility to invest in illiquid assets such as infrastructure.

Additionally as the system matures and further regulatory reforms progress there will be an increasing influence on the system from the retirement phase. While this can bring some uncertainty in respect to redemptions it is most probable that there will be increased take up of income streams which have predictable investment

horizons and cash flows. Government policy settings may have a role in hastening this transformation.

Based on existing asset allocations and underlying growth, Industry SuperFunds will be seeking opportunities to invest a further \$5 billion in new money into infrastructure over the next five years. A modest increase in infrastructure allocations by five percentage points would increase available new investment to \$15 billion over the next five years. With no shortage of interest from Industry SuperFunds in new infrastructure investment opportunities the key challenge is how to make it happen.

4. Funding mechanisms

4.1 Deficits and Debt

Unlike superannuation funds, there are real capacity constraints on the ability of the Australian public and private sectors to fund Australia's infrastructure deficit.

- Australian Government budget funding: a major constraint on the delivery of social and economic infrastructure is the funding capacity of Australian governments. In order to overcome Australia's infrastructure deficit over the next decade (based on total revenue in 2012-13 of \$376 billion), the Australian Government would need to either increase its revenue by \$37 billion (representing an increase of 10 per cent) or reduce other expenditure by the same amount. Given current GDP growth projections of 2 per cent per annum and the trajectory of budget deficit, neither is realistic.
- Government debt financing: there is capacity for the Australian Government to take on additional debt to fund infrastructure projects by way of issuing generic long dated government bonds (this is preferred to the issuance of infrastructure bonds as the greater liquidity in generic bonds offers lower funding costs). However, while the Australian Government does have the balance sheet capacity to take on some additional debt based upon its AAA credit rating, it is unlikely to rely on this option given the current upward trajectory of government debt and commitment to return the budget to surplus and repay debt.
- State and territory government funding: there is limited budget and balance sheet funding capacity for state and territory governments to fund significant investments in infrastructure. There is a widespread reluctance to increase net debt positions that will affect AAA credit ratings (typified, for example, by the recent downgrade in Western Australia's credit rating to AA+.) Infrastructure assets (particularly energy assets) are regarded by credit rating agencies as adding to balance sheet risks and regarded as requiring longer term capital funding commitments¹⁸

In the debate around optimum debt levels, it must be acknowledged that even bonds that raise funds for a specific purpose – such as infrastructure bonds – are merely government debt by another name.

4.2 User Charges

The key impediment to levying user charges on public infrastructure, at a level sufficient to deliver on investor return expectations, has been reluctance by government to make the case for their imposition. Governments' must continue to make the case to the public – in the appropriate circumstances – to fund infrastructure projects by including in the procurement contract the right to charge users of the facility a fee (a toll in the case of roads) in order to recover the costs of construction, operation and maintenance. The benefit of doing so is based on grounds of intergenerational equity – similar to the case for prudent long-term government borrowing. The project should be paid funded and maintained over its long life-time by the users / beneficiaries of that asset.

¹⁸ Infrastructure Australia (2012) Infrastructure Finance and Funding Reform

4.3 Recycling brownfield assets

There is reluctance amongst many to consider the sale of existing public infrastructure to finance the construction of new assets, which may not otherwise be immediately suitable for private sector investment. Superannuation funds have the capacity to cut through public concerns about private ownership to facilitate the privatisation of state government-owned infrastructure assets by virtue of public confidence in them as custodians of strategic economic assets.

Greenfields or brownfields investment

Industry SuperFunds have financed a number of greenfields investments, however new greenfields projects are not always suitable for super fund investment.

Bid processes, construction risk, investment lags, and the lack of suitable user charge or availability payment mechanisms can make new infrastructure unsuitable for super fund investment.

In contrast, brownfields infrastructure investments can be more attractive because of absence of investment lags, and construction and patronage risk.

An alternative financing mechanism for public sector greenfields infrastructure investment exists if a way can be found to effectively recycle the capital from public brownfields infrastructure.

Funding new infrastructure from the sale of old

There may be infrastructure projects that are of strategic importance and that may not pass a private cost-benefit analysis; perhaps because the costs and benefits need to be amortised over too many decades or for other reasons.

Very often these factors may not diminish the need for such infrastructure, but in the absence of a workable private sector financing model the only option is for Governments to fund the construction themselves.

With constrained balance sheets, a workable option is to raise the funds from the sale of existing assets which are more suitable for private sector investment – so-called recycling of infrastructure.

Privatisation of key infrastructure assets does, however, raise significant public concerns which must be addressed including continued amenity from the asset, pricing, service and employment impacts.

While many of these issues can be effectively dealt with by structuring a deal with appropriate contractual or regulatory arrangements to ensure access and pricing remains within public expectations, others go to the motivations of the new owner.

The public has been rightly concerned by public sector asset sales where new owners have been motivated by short-term incentives to slash costs, cut jobs, gear up and bail out without regard for the long-term needs of the business or community.

Unfortunately, public sentiment has been damaged by the perception that private investment in government-owned core infrastructure has been driven by financiers with a motivation to increase wealth as quickly as possible. In order to ensure ongoing public support for private infrastructure investment, it is critical to deal with the potential for a lack of alignment between the public and the buyer.

Addressing concerns about private ownership

Superannuation funds as buyers have the potential to cut through community concerns about private sector ownership and potentially change the game. Research commissioned by ISA and conducted by Newspoll shows 77.8 per cent would be more supportive of private investment if it involved super funds. Other key takeouts of the research are:

- 97.8 per cent of respondents thought governments should be investing more in building new or improving old infrastructure;

- Only 30.3 per cent thought governments should tax more and 32 per cent cut services to pay for it (2/3rds opposed);
- 74.8 per cent believe investment from super funds (which nearly everyone has a stake in) would provide more benefits to the community than short-term investors like investment banks (12.9 per cent).

Industry SuperFunds have proven themselves to be long-term responsible investors and they seek stable, income-generating investments capable of delivering sound returns with an investment time horizon measured in decades.

When acquiring an asset, Industry SuperFunds take into account environmental, social and governance factors rather than looking at financial factors alone.

Unrealistic growth expectations, mergers that make no sense, high leverage, high remuneration packages that incentivise risk-taking are just a few examples of short-termism or ‘irresponsible’ behaviour.

Responsible investment is the opposite. Industry SuperFunds recognise that short-termism introduces unacceptable risks that are inconsistent with realising the long-term value of assets. In short, it makes sense for super funds to manage infrastructure in exactly the manner the public desires – with a responsible approach to employment, service provision and government relations.

Also because super funds and fund managers invest for the long term they are also likely to make available additional capital to future proof assets to improve their amenity. An example of this includes Industry SuperFunds’ investment in airports, where over \$4.9 billion was injected into capital investment compared to \$2.4 billion in distributions over the period 2002-2010.

When it comes to improving the quality of assets, super funds won’t hesitate in making the necessary investments. In contrast cash-strapped governments will often fail to invest or defer decisions for as long as possible.

Finally, this ownership model also ensures the public continue to have direct stake in the asset providing a unique alignment between the owners and users of an asset (as they will often be one and the same). So the toll a member might pay for using a road will be paid back with interest when they retire.

The risk return profile

The other key ingredient to deliver better participation is a convergence of expectations on the risk return profile of projects on both the government and super fund side.

Traditionally super funds have set risk adjusted rates of return hurdles of 10-15 per cent on greenfields infrastructure investment. Existing PPP models often expose equity investors to all the risk but returns as low as eight per cent.

Alternative deal structures which reduce or eliminate leakage by investment banks may result in the risk return profile converging towards a range that is acceptable for both governments and super funds.

Alternatively, governments have also recognised they can de-risk projects through the use of availability payments. An example of this is the Peninsula Link toll road, which the Victorian Government is structuring to remove patronage risk by providing availability based payments instead of usage based payments.

5. Financing mechanisms

Private financing mechanisms provide an alternative to public funding of public infrastructure projects.

5.1 Conventional private financing mechanisms

Infrastructure projects may be financed through conventional private means if the project can generate sufficient cash flows over its lifetime to meet a risk-adjusted threshold rate of return to investors. In theory, conventional infrastructure finance can be secured through two channels:

- Bank based funding where investments are intermediated by financial enterprises such as banks through their lending
- Market based funding where there is a direct exchange of funds from investors to enterprises or projects such as the equity market, bond market, intermediated by underwriters and dealers

In practice, only a limited number of smaller infrastructure projects can be delivered as “private goods” paid for by those who utilise the asset. However, public infrastructure, by definition, generates wider economic indirect benefits for the economy that cannot always be captured or turned into revenue by the private investor. There are other constraints on the use of conventional private financing models:

- It is suggested that the offshore appetite in Australian bank debt is limited to AUD\$150 billion per annum.¹⁹
- The RBA estimates that the cost of funding their aggregate loan book has now increased by 140 to 150 basis points relative to the cash rates since mid 2007.²⁰
- Bank loan terms are shorter in than that available elsewhere in the global project finance market. Australian banks are generally unwilling to fund projects beyond five to seven years.²¹
- The Australian Financial Markets Report showed equity capital raising fell 42.6 per cent in 2012. There were 99 IPOs with total capital raisings, including scrip-for-scrip, of \$50.6 billion.
- Equity markets are increasingly focussed on trading. In 2012 for every \$28 of trading there was \$1 of public capital raising, compared with \$10 of trading for every \$1 of capital raising in the later 1990s.²²

5.2 Advantages and disadvantages of alternative financing models

The advantage of private financing models is the ability to achieve value for money in the delivery of public infrastructure and related services through the effective transfer of risk to those parties best able to manage that risk. The limitations of the current model are addressed in detail in section 5.6 of this submission but at a high level, the current PFI model has demonstrated the following disadvantages.

Transparency and value for money

The existing PFI model has come under sustained criticism over its lack of transparency and governance. Both the UK Treasury and Audit Office have stressed the importance of greatly increasing the availability of public information and transparency of PFI projects²³ – indeed stating “there is no clear data to conclude whether the use of PFI has led to demonstrably better or worse value for money than other forms of procurement.”²⁴ Infrastructure Australia has addressed this issue through guidelines ensuring that financial models are robust and tested for sensitivity to critical assumptions.

Above market returns

¹⁹ www.fidelity.com.au/insights-centre/investment-articles/australia-big-four-banks-post-the-gfc

²⁰ Reserve Bank of Australia (2012) Submission to the Inquiry into the Post-Global Financial Crisis Banking Sector

²¹ Furber (2012) Australia PF Outlook: Banking opportunities with few caveats. Infrastructure Journal Online

²² ISA calculations

²³ United Kingdom HM Treasury (2010) PPP Technical Update; United Kingdom National Audit Office (2011) Lessons from PFI and other projects; United Kingdom National Audit Office (2012) Equity Investment in privately financed projects

²⁴ United Kingdom National Audit Office (2011) Lessons from PFI and other projects

There is evidence in the UK of equity investors requiring significant above market returns under the existing PFI model.²⁵ Investors take on and are paid to accept a range of specific risks, however these risks either had not materialised or had already been mitigated by investors, for example being passed on to contractors using fixed price contracts. There are also examples where risk transfer has been ineffective.

Complexity

The PFI model is contractually complex and requires well-resourced and highly competent public sector teams to manage both the procurement process and the contract on an ongoing basis. This complexity is reflected in the high transaction costs and long lead times associated with PFI projects. It is generally acknowledged that state governments could benefit from additional specialist expertise to construct deals and offer them to market.

5.3 Impediments to private financing

A challenge for the Australian infrastructure market is that new domestic investment opportunities have been very limited. This applies to both new (greenfields) projects and the sale of existing (brownfields) infrastructure into the market. The reason for the lack of deals is complex but it is best summarised by a failure to offer and structure investment opportunities in a workable way having regard for market conditions and the characteristics of the project or asset.

Public private partnership (PPP) models have yet to evolve in a workable way in the post-GFC environment to attract long-term investors. Prior to the GFC such deals were characterised by steep upfront fees stripped out by the bid sponsors, presenting dubious value for residual equity players, and high levels of debt financing.

Very high bid costs and long lead times limit the number of parties who can strategically afford to dedicate the large teams required for such projects. Typically bid costs are around one to two per cent of the total project cost – for large projects the bids can cost tens of millions of dollars. With only three to four projects a year and a similar number of established investment bank and construction consortia, the barriers to entry have been high and chances of success for new entrants were limited.

In recent times Infrastructure Australia has made useful progress in identifying a pipeline of projects and exploring alternative financing models, though all the issues have not yet been resolved. The issues associated with current private financing mechanism are addressed in.

5.4 Evolution of private financing models

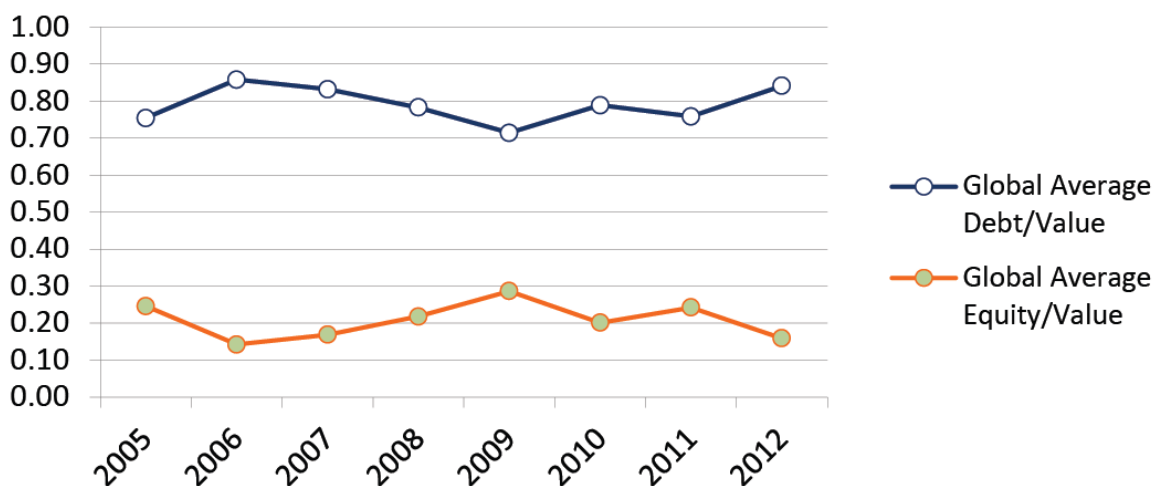
The PPP financing package has generally been apportioned as 10 to 20 per cent equity and 80 to 90 per cent debt (refer to Figure 5.4.1). However, the tightening of domestic infrastructure investment markets in most countries post-GFC has caused some key changes to this existing PFI model²⁶:

- Debt has become more constrained and expensive in many markets, leading to an increase in equity contributions by institutional investors (up to 30 per cent);
- Debt competitions after the selection of the preferred tenderer have been introduced;
- Governments are accepting demand and refinancing risks;
- Governments are increasingly supporting projects through equity contributions, debt guarantees, and IRR guarantees.

Figure 5.4.1: Global PPP market – average equity and debt as a percentage of project value, 2005-2012

²⁵ United Kingdom National Audit Office (2012) Equity Investment in Privately Financed Projects

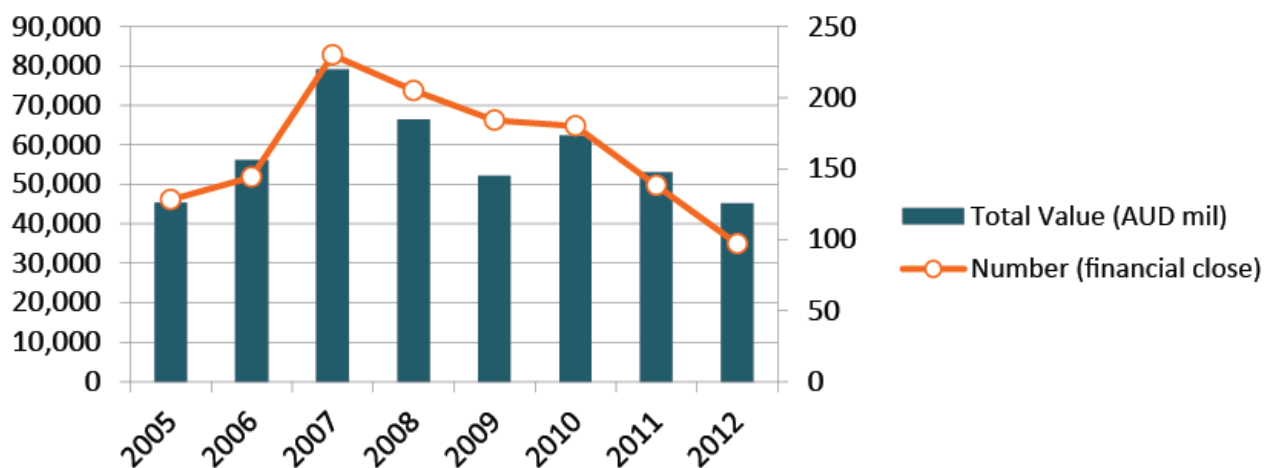
²⁶ United Kingdom HM Treasury (2012) *A new approach to public private partnerships*.



Source: Infrastructure Journal Online

However, the effect of these developments in amending the existing PFI financing model has not resulted in a significant increase in the number or volume of PFI deals internationally - these amounts steadily decreased over 2009-2012 (refer to Figure 5.4.2). Meanwhile, the global infrastructure deficit continues to rapidly escalate.

Figure 5.4.2: Global PPP market – total value and number of PPP projects reaching financial close, 2005-12



Source: Infrastructure Journal Online

This highlights the need for a new approach to PFI in the Australian market that attracts Australian Superannuation Funds. The PFI approach is biased towards deal promoters and contractors, whose debt-based deals are generally based on overly optimistic outcomes that do not properly account for medium and long-term risks. Alternatively, superannuation funds are long-term investors who price risk more accurately, since they are long-term owners and operators of infrastructure. This bias of optimism falsely makes debt appear cheaper than equity - meaning that superannuation funds cannot compete on a bespoke project basis with promoters and contractors. It is the responsibility of the Commonwealth Government to establish a national system where superannuation equity investment in infrastructure can price for long-term risk and receive a commercially reasonable rate of return.

5.5 Costs and benefits of public versus private sector financing

As outlined in section 4, there are real capacity constraints on the ability of the Australian Government and state and territory governments to fund Australia's infrastructure deficit. The key benefit of private financing,

particularly if it incorporates user charges, is that it eases the constraint on the provision of public infrastructure. That said, as examined in detail in section 5.6, there are significant issues with the current PFI model which need to be addressed.

5.6 Issues with current private financing mechanisms

There are a range of deficiencies in the current structure of private financing mechanisms which limit the Australian governments' abilities to deliver and support investment in critical infrastructure. These are:

- **No unified National infrastructure funding or procurement process**

Australia has nearly 600 different local, state and territory governments that, together with the Australian Government, fund and plan infrastructure projects. This multitude of government stakeholders makes infrastructure funding and development fragmented and slow, when compared to other benchmark countries.

- **Poor project governance**

Poor project governance in Australia is a major reason why infrastructure projects fail to meet their timeframe, budget and service delivery objectives. Australian governments must improve the project procurement and transaction management processes to: reduce tender, construction and operational cost; increase schedule reliability; eliminate fees leakage; eliminate windfall operational profits, and promote innovation.

- **Capital locked into brownfield infrastructure**

As noted in section 3.3, Australian governments need to recycle the capital that is locked into existing brownfield assets, so as to finance new infrastructure. Recycled brownfield assets can include airports, roads, water services, ports, freight rail, and electricity generation, transmission and distribution.

- **Inability to address Australia's infrastructure gap**

The current debt-based PFI model has a limited funding capability that can only support a limited number of bespoke projects – the vast majority of projects identified for PFI do not proceed. According to Infrastructure Australia, despite Australia's recent significant investment, there still remains a national infrastructure deficit of at least \$300 billion.

- **Inflexible single bid model**

PFI projects generally use a "single bid model" where a consortium of investment banks, developers and contractors propose a design and service delivery model for an infrastructure asset, supported by a financing package. This one-step approach to infrastructure investment requires all costs to be met upfront, with no subsequent scope for project flexibility or innovation.

- **Long procurement timeframes**

It is internationally accepted that the average PFI procurement timeframe for new infrastructure, although varying internationally²⁷ - is too long:

United Kingdom - 35 months²⁸;

Australia - 14 to 19 months (average 17 months)²⁹;

Canada - 16 months;

Portugal - 12 months³⁰;

²⁷ KPMG (2010) *PPP Procurement: Review of the Barriers to Competition and Efficiency in the Procurement of PPP Projects*

²⁸ United Kingdom HM Treasury (2012) *A new approach to public-private partnerships*: at page 38.

²⁹ Infrastructure Australia (2012) *Efficiencies in Major Project Procurement (Volume 1)*: at pages 8-9.

Spain - 8 months.

- **High bid costs**

The high upfront bid costs emerging from the current bid model create a “barrier to entry” for superannuation funds seeking to participate in PFI infrastructure projects. Estimations for average PFI bid costs in Australia range from one to two per cent for successful bidders, and 0.8 to 1.2 per cent for unsuccessful bidders³¹ (refer to Table 5.6.1).

Table 5.6.1: PPP winning tender costs for Australia, Canada and the United Kingdom

| Country | Low | High | Average |
|----------------|------|------|---------|
| Canada | 0.5% | 1.5% | 1% |
| Australia | 1% | 2% | 1.5% |
| United Kingdom | 2% | 3% | 2.5% |

- **High whole-of-life transaction costs**

High transaction costs have the potential to erode the cost savings achieved through the PFI model³², with average transaction costs estimated by the European Investment Bank at being over ten per cent of the project's capital value – with a cost to the public sector of 3.5 per cent, a cost to the successful bidder of 3.8 per cent (although this varied from 3.0 - 5.7 per cent depending upon the sector), and the total cost to the failed bidders at five per cent. Where data is available, the split between bidding costs and contract negotiation costs has been shown to be approximately equal.

- **Lack of transparency and value for money**

The existing PFI model has come under sustained criticism over its lack of transparency and governance. Both the United Kingdom Treasury and National Audit Office have stressed the importance of greatly increasing the availability of public information and transparency of PFI projects³³ – indeed stating “there is no clear data to conclude whether the use of PFI has led to demonstrably better or worse value for money than other forms of procurement.”³⁴

- **Lack of Innovation**

Existing PFI approaches stifle innovation – projects need input from long-term equity owners into the way that the deal is structured, procured and managed.

³⁰ Spain and Portugal are not directly comparable to the Australian market - in Spain, projects are typically fully designed before entering into the procurement process, leaving little room for innovation and resulting in bidders effectively bidding based on lowest price: The Conference Board of Canada (2013) *Delivering value through PPP at home and abroad*.

³¹ KPMG (2010) *PPP Procurement: Review of the Barriers to Competition and Efficiency in the Procurement of PPP Projects* pp.36

³² European Investment Bank (2005) *Transaction Costs in Public Private Partnerships: A First Look at the Evidence*. pp.14

³³ United Kingdom HM Treasury (2010) *PPP Technical Update*; United Kingdom National Audit Office (2011) *Lessons from PFI and other projects*; United Kingdom National Audit Office (2012) *Equity Investment in privately financed projects*.

³⁴ United Kingdom National Audit Office (2011) *Lessons from PFI and other projects*: at page 6.

5.7 Reforming the bid process

In this submission, we detail the issues with the current bid process for infrastructure projects and will propose a new “next generation” inverted bid model in a supplementary submission.

Without a preparedness of governments to bring more deals to market and explore different models for major domestic infrastructure deals the risk return profile for superannuation fund equity investment will remain marginal.

Existing PPP models involve a major misalignment of interests:

Syndicate leaders have a range of motivations, only one of which is return to equity. This partly stems from the fact that investment banks are generally compensated toward the front end from outsized fees tied to winning and financing a bid.

The construction company generates its returns from the construction of the project, completed and paid for before usage patterns emerged or refinancing is required.

Although construction companies generally provide some of the equity, it is typically limited (around five per cent) and potentially a loss leader to the construction contract. Typically equity investors are exposed to significant risks and single digit returns.

The difficulties of this model are now well understood by investors leading to a thinning of capital and increased reliance on debt. Debt financing is more expensive post-GFC and ratings agencies are placing a higher premium on risk. In these circumstances some Australian governments are finding structuring such deals is much more difficult than in the past.

If governments wish to accelerate the number of projects being brought to market, increase competition and obtain better value for taxpayers it should explore alternative bid arrangements.

Inverting the bid process

To better align stakeholder interests, governments should consider tendering initially for the long-term owner operator followed by separate bid for residual finance and construction. This would effectively invert the bid process.

The most effective models could involve the long term owner / project manager bidding on their margin over the construction contract. Such contracts can even be structured to recover construction cost overruns from the margin.

Such an approach would suit changes in the economic climate but still sustain the continued need for governments to partner with the private sector to deliver infrastructure projects.

This type of approach could invert the process and select fit for purpose operators on each project and subsequently invite construction companies to bid against each other under terms set by the providers of funding. This would effectively align the interests of all parties on a long term basis and eliminate the huge fee leakage of investment bank led syndicates. In particular, our approach would ensure that the bid process is conducted in a manner which ensures adequate consideration and control of the risks and interests of long term owners and users. An indicative bid model (see overleaf) demonstrates how project deals could operate in practice, which will be further detailed in our supplementary submission to this enquiry.

5.8 Risk allocation

Risk sharing arrangements

Post-GFC there has been an evolution in risk sharing arrangements between governments and private partners.

- **Risk allocation**

The objective of PFI is their capacity to allocate risk between contracting public and private parties to ensure infrastructure and related services are delivered at best value for money. There are instances where risks are unquantifiable and while they have notionally been transferred to the private sector, in reality they continue to reside with government. In these cases it may be appropriate for these risks – and costs – to be shared between the two parties. More recently, the tightening of domestic infrastructure investment markets in most countries post-GFC has caused some governments to share demand and refinancing risks. For example new models have developed to share demand risk replacing a direct user charge model with availability payments (section 3.2).

- **Minimum IRR**

Governments are increasingly supporting projects through IRR guarantees.³⁵ A case can be made for providing a minimum IRR guarantee on PFI projects to ensure that superannuation funds can access a low risk alternative to volatile asset classes such as unlisted property and Australian and international shares. The first public policy benefit of guaranteeing a minimum IRR is that it provides superannuation funds with a viable and safe investment, which assists in mitigating the Commonwealth Government's risk exposure to pension entitlements for an ageing Australian population. The second public policy benefit is that it provides superannuation funds with an acceptable rate of return to deliver a pipeline of infrastructure projects needed to close Australian's infrastructure deficit and deliver the productivity gains necessary to maintaining the standard of living as the population ages.

5.9 Liquidity issues

Supported by mandatory contributions, preservation requirements and a degree of member inertia, superannuation is a long-term investment which allows trustees to invest in assets, like infrastructure, which are relatively illiquid. Investing in illiquid assets can secure an illiquidity premium which improves long term returns for members.

As noted in section 3.1, APRA requires funds to have in place detailed liquidity management policies, with the degree of exposure to illiquid assets subject to fund specific cash flows and member demographics. Trustees are confronted with a trade-off between redemption risk (the likelihood a member may switch funds or investment option) and long-term returns which can be bolstered through exposure to illiquid asset classes.

It is vital that future regulatory changes fully appreciate the impact they may have on the balance between redemption risk and long-term returns. Subject to appropriate prudential oversight these decisions are best left to trustees.

It is vital that ongoing regulatory changes to superannuation and financial advice laws don't have unintended impacts on the capacity of the system to deliver long-term returns to members.

Indeed to support higher levels of investment in infrastructure across the superannuation sector it may be desirable to remove impediments to the provision of inter fund liquidity mechanisms, or providing external facilities such as the RBA currently provides to the banks. Subject to maintaining prudent levels of liquidity such arrangements could occur on commercial terms and as a backstop only if exceptional market conditions transpire. ISA will make further submissions to the Financial System Inquiry on this matter.

³⁵ The Internal Rate of Return (IRR) on a PFI project is generally accepted as that rate which, when applied as a discount rate to a stream of projected cash flows, produces a Net Present Value (NPV) of zero. As an alternative, a firm may calculate the NPV with a discount rate set equal to its cost of capital. A positive NPV project increases the value of the firm.

6. Case study: a bid model for the future

1. The government (State or Federal as the case may be) would carry out due diligence and appoint a fund manager or a consortium (e.g. Fund Manager, Offshore Investor, Global Institution, Bank(s)) to work with it on an asset sale/lease and/or project. Alternatively, the Government could pre-qualify a number of such managers as approved infrastructure superannuation partners and rotate deals. The manager must agree to a cap on fees (e.g. 0.5 per cent p.a. or less) and no other benefit. Related party transaction fees, re-financing fees or other sources of income would be expressly prohibited.
2. The parties would then seek to negotiate – on an open book basis – an agreed base case internal rate of return (IRR) to the investor, which determines the price paid. The parties may also attempt to agree a floor level return and ceiling return (i.e. a range around the base case IRR, with taxpayers/government sharing in any under or over performance). Government could use its regulatory powers, structuring powers, and sometimes its role as a customer to strongly influence the risk/return matrix at this stage. Also the manager/consortium can use its technical and creative capabilities at this stage to influence the shape and even the size of the deal.
3. If agreement is reached on a transaction price and terms, the manager must then offer the deal by way of a wholesale unit trust via a pooled fund. The manager will be responsible for marketing the deal.
4. If the deal is oversubscribed, units should be issued pro rata to the super funds based on their asset size or their number of members or on a formula incorporating both asset and member size. If the deal is undersubscribed, the manager may seek to introduce offshore and/or non-super interests at the same fee, or the Government may withdraw the deal, downsize the deal by providing its own capital, or improve the terms of the deal for re-offer to all super funds.

The advantages of this model include:

- It can be completely transparent at all stages;
- Bid costs are reduced;
- If outperformance occurs, the benefit is widely spread to the workforce and retirees;
- There can be no windfall profit to financial intermediaries, including the manager;
- The manager holds and develops the asset long-term for a fixed fee – it can sell the management rights but the set fee remains and all performance goes to the investors;
- Full opportunity for private sector innovation at negotiation stage;
- It gives the first opportunity to Australian investors through their super funds.