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Infrastructure in Australia
Privatizations, partnerships, and investing alternatives

As Australia's resource boom grinds to a halt, the real question is whether infrastructure can come to the rescue and stimulate long term sustainable growth for the Australian economy. The Honourable Tony Abbott made clear his commitment to infrastructure during his election speech in Brisbane on 25 August 2013: "And we'll build the roads of the 21st century because I hope to be an infrastructure prime minister who puts bulldozers on the ground and cranes into our skies. We have a plan and we know how to pay for it." Against a backdrop of a reported infrastructure deficit of ~A$700 billion one thing is certainly clear – a strong committed pipeline of projects is essential in order to stimulate private investment in infrastructure in Australia.

The need to stimulate investment in Australian infrastructure, reduce debt and boost economic efficiency has seen privatizations make their way back onto the political agenda. A core element of the Federal Budget 2014/15 is the Federal Government's commitment of A$11.6 billion for the Infrastructure Growth Package, which includes a commitment of A$5 billion for the Asset Recycling Initiative. A key objective of the Asset Recycling Initiative is to incentive States and Territories to unlock funds by selling assets and reinvesting the proceeds into new infrastructure to support economic growth and enhance productivity. The categories of assets earmarked for sale include commercial property, public housing, bulk and commodity ports, and transmission and distribution networks. At the time of writing, the Asset Recycling Fund Bill 2014 (Cth) Asset Recycling Fund (Consequential Amendments) Bill 2014 (Cth) (which implements the Federal Government's infrastructure package) have not yet been passed. However, the stalemate in the Senate does not appear to have stalled progress, and deals have already been struck with the ACT and NSW which will see the Federal Government contribute > A$2 billion to proposed new infrastructure projects including the Capital Metro PPP Project in ACT and Sydney Rapid Transit and Parramatta Light Rail in NSW.

Privatization of assets in Australia is not a new phenomenon. Whilst the first privatization wave was very much UK / European focused, during the 1990s the value of privatizations in Australia ranked second after the UK relative to GDP according to the Organization for Economic Cooperation and Development (OECD). What distinguishes the current wave of privatizations from previous ones is the Federal Government's incentivation scheme – sell your old assets and we'll give you an incentive (in the form of Federal Government funding contributions) to build new assets.

The Federal and State Governments aim to raise a collective $100 billion through this asset sell-off scheme.

The asset sell-offs afford State and Territory Governments the ability to increase the speed and level of investment in new infrastructure projects whilst also maintaining a relatively healthy budget balance and credit rating.

Why private finance in the public sphere?

Privatization of Government assets can alleviate short and long-term budget pressures. As it stands the Federal Government sits on some A$13 billion of equity in Government business enterprises and the National Commission of Audit has recently identified a number of entities considered suitable for privatization (some of which are already subject to a sales process) including Australian Hearing Services, Defense Housing Australia, Showy Hydro, Australian Postal Corporation, Australian Rail Track Corporation and Royal

Australian Mint. By selling assets that may otherwise require continuing calls on a Government's budget over time and/or that already operate and compete in contestable markets, Government can focus on boosting economic efficiency by investing in new infrastructure.

There are various delivery methods that a Government can adopt in order to procure economic or social infrastructure projects, including design & construct or design, construct & maintain or public-private-partnerships (PPPs).

One of the reasons that the private sector is used in the public sphere is because of the efficiencies that it is seen to bring to the process including innovation, service quality, value for money drivers, increased transparency, rigor and discipline and the allocation of risks to the party best placed to manage them.

Roadblocks to private finance

There are a number of roadblocks to private finance in the public sphere including: achieving the appropriate risk / reward balance between the public sector and private sector; insufficient communication with the voting public about this risk / reward balance which leads to a Government that is susceptible to political pressure and manoeuvring; and the absence of a strong committed pipeline of projects.

One of the most important issues to address in any PPP is the allocation of risk between the public sector and the private sector, including demand risk – that is, the risk that demand or price for a service will vary from that initially projected so that the total revenue derived from the project over the concession term is lower than forecast.

Infrastructure represents one of the fastest growing real asset classes.

Using Lane Cove Tunnel PPP project in NSW (which was a user-funded PPP) as an example, from an equity and debt perspective the project is often cited as a failed PPP. The project was completed in March 2007 but by 2010 the private sector party, Connector Motorways, was already in receivership after running into difficulties when the toll road only attracted a third of the forecast traffic volumes. As at the time of writing, a court case over the original traffic forecasting is still ongoing. From a Government perspective, it received a critical piece of road infrastructure at no additional cost and so perhaps not a failed PPP after all. There has been a marked shift away from user-funded PPP models in the market to Government-funded PPPs (e.g. Peninsula Link PPP, East West Link PPP). As to whether or not Government will continue to push the envelope on demand risk in future infrastructure projects and seek a more balanced approach remains to be seen.

With Government debt rising rapidly after the GFC and falling revenues caused by the commodities slowdown, the voting public is often nervous and apprehensive about significant funding commitments by Government with respect to PPP initiatives. And a nervous and apprehensive voting public often results in a Government whose primary concern is to not rock the boat and jeopardise its re-election prospects.

As such, another roadblock is to ensure that the efficiencies of private finance in the public sphere (as discussed above) and the risk / reward balance between the public sector and the private sector are communicated effectively and efficiently to the voting public. The recent privatization of Port Botany is often cited as an example as to how to successfully communicate Government risk and future infrastructure benefits of private sector involvement. The recent cancellation of the East West Link PPP by the Victorian Government and the South Australian Courts PPP by the South Australian Attorney General will no doubt be cited as failures by Government.

There has been increased interest of late in 'Greenfield' projects that use innovative risk-sharing models to ensure a more balance partnership arrangement.

Recent changes of Government in Queensland and Victoria have seen the newly elected Labour Parties cancel both proposed and committed infrastructure projects (both Brownfield and Greenfield). This may negatively impact Australia in its quest to attract global and domestic infrastructure players who have money to spend and want to put it to work in a relatively risk free environment. What is needed is a strong committed pipeline of infrastructure projects in Australia that is not susceptible to politicking.

Investment opportunities

Key players in the infrastructure space in Australia include pension funds, superannuation funds, sovereign wealth funds and insurance companies. These industries look towards long-term returns that seem well-matched to infrastructure investment. Their long-term liability profiles offer stability and confidence in the type of partnership that can be entered into.

Although considered an 'alternative asset class', infrastructure represents one of the fastest growing real asset classes. Institutional investors approve of direct investments in these projects because they typically offer stable, long-term and diverse investment opportunities. The major obstacle has been the availability of suitable infrastructure projects – something that Governments in Australia will need to address.

Brownfield and 'mature' assets often represent an attractive proposition because of where they are in their lifecycle (i.e. except in respect of asset enhancement projects, there is no exposure to initial stage construction risk). As such, they tend to be viewed by investors as a more stable investment and less likely to throw up surprises. The deal between the Government in NSW and Hastings Funds Management for a 98-year lease on the Port of Newcastle reinforces what superannuation investors are looking for: an established asset with a track record of strong performance. The financial multiples achieved through the recent 'mature' asset sales in NSW have also been very attractive to Governments with sales at multiples of up to 25 times Earnings Before Interest and Tax (EBIT). There has also been an increased level of interest in 'Greenfield' projects which adopt innovative risk-sharing models to ensure a more balance partnership arrangement.

Buying into Australian infrastructure

Clifford Chance Partner, Richard Graham and Counsel, Nadia Kalic, discuss who might benefit from the Australian Government putting private financial arrangements at the centre of its infrastructure roadmap.

As the Australian Government encourages private finance initiatives, what types of private financiers are most like to benefit from investing in these growing real asset sets?
The message from the Federal Government to Australian States is clear – sell your assets, invest the money in new assets and we will give you some money to help you out. The make-up of the bidding consortium, contractor groups and bank syndicates is becoming more diverse and international as investors seek to put their money to work in Australian infrastructure projects. Infrastructure, pension and superannuation funds are typically long term buy and hold investors, with a focus on cash yields as the primary driver of investment performance.

A long term lease of a strategic port asset (such as Port of Melbourne) or a 25 year availability based concession (such as Peninsula Link PPP toll road in Melbourne) presents a natural fit for these investors. We are seeing a significant amount of interest in Australian assets (both privatizations and Greenfield projects) from Korea, Japan and China.

What reasons still might make private investors in this area apprehensive about committing to this type of investment?
We find that interested parties often express apprehension about the complexity of the Australian regulatory regime for energy and infrastructure and the impact of macro- economic changes on a project's long term revenue profile.

This is particularly topical at the moment given the potential impact of the Australian Energy Regulator's draft decision that Ausgrid, Transgrid, Essential Energy and Endeavour Energy reduce prices by up to 36%, and the timing of the NSW privatization process for its poles and wires assets.

The recent decline in Australia's resources and energy commodity export earnings and delay in start-up of the liquefied natural gas facilities in Queensland may also impact the timing for various proposed assets (including Port of Darwin, Utah Point bulk handling facility at Port Hedland port and Kwinana bulk terminal south of Perth) and their forecast sales price. While changes in Government and changes in Government policy in a number of states has resulted in either the cancellation or the delay of privatisation programmes and projects, Australia remains an attractive option for infrastructure investors looking to put their money to work. It will also prompt some interesting conversations with Government, financiers and sponsors in the next round of PPP projects to come to market, particularly with respect to default, termination and termination compensation.

There are investors who will always prefer to enter an infrastructure project via a secondary equity trade post construction completion because of internal views about construction risk. Government may also take a view that it is a better use of its funds to construct the infrastructure asset itself and then privatise it following completion rather than procure the design, construction and operation of the asset using a traditional PPP delivery model. Whilst demand risk has become less of an issue recently given the move away from user-funded PPP models in Australia, the pendulum is likely to swing back again and we may see some hybrid models emerge.

Investors have been, at times, wary of investing in 'Greenfield' projects, preferring the "whole of life" potential of mature assets. FTI Consulting's Senior Advisor John Corbett discusses this issue.

What risk sharing models can be introduced to encourage potential investors that many of the risks associated with these projects can be mitigated?
There have been a number of different "risk sharing" models considered across the Victorian, New South Wales and Queensland Governments. One that is often pointed to is the "Availability Payment" model whereby the PPP owner is paid a fixed annual (indexed) payment over the life of the asset in compensation for constructing, maintaining and operating the asset. This model has been successfully used in Victorian new build toll roads and appears to have achieved consensus agreement across the political divide as an appropriate model delivering benefits. Notably, the Availability Payment model underpins just about every social infrastructure PPP undertaken in Australia

Another model actively considered by the Queensland Government to help offset Greenfield risk was to include revenues from a Government owned brownfield asset – in that instance, the existing revenues from the Gateway bridges to support the potential use of a PPP model to fund the Gateway Upgrade North project. This was ultimately discarded in lieu of selling the Gateway bridge assets to the private sector. A hybrid tolling plus capacity payment model has also been considered in a number of projects – most recently for the Toowoomba Range Crossing. That project is now under further review following the change of Government in Queensland.

The bottom line here is that each project needs to be assessed on their merits and the potential solutions to mitigate Greenfield risk and encourage the private sector to participate should be developed on a case by case basis.

Public negativity also plays a crucial role in any potential public/private partnership. How might these models be better communicated in the future?

I believe the answer to this question lies in the trade-off between a State selling assets and recycling the capital into new build infrastructure and the alternative of a PPP model to fund new build infrastructure. We have seen two State Governments lose office largely on the back of privatization proposals and incoming administrations very quickly pronouncing they will go the PPP route rather than sell assets.

As a consequence, we are seeing less public controversy attached to PPP's. This is particularly the case when their costs are "invisible" to the public as is the case with social infrastructure PPP's or those involving assets where the cost is not directly seen by the public.

Encouraging private investment and looking to the future

All of the roadblocks identified above can be overcome but it will take time and a commitment from Government to invest in the necessary resources to ensure that a long term sustainable plan is adopted with respect to closing the infrastructure gap in Australia. A plan that looks beyond the next election cycle.

Notwithstanding the recent cancellations of projects in Queensland, Victoria and South Australia, Australia is likely to remain an attractive option for infrastructure investors in the region. There may be an increased level of focus on the termination and termination compensation provisions under the concession agreements for any new PPP projects that come to market, and perhaps a heavier burden assumed by advisors (particularly when acting for international financiers and sponsors) in explaining the legislative framework which governs the rights and obligations of Government and the private sector in a default / termination scenario, but the investment tap is unlikely to be turned off.

The establishment of Infrastructure Australia, and similar State / Territory Government departments associated with infrastructure delivery will no doubt continue to facilitate an increased level of sophistication and transparency when procuring infrastructure projects using a PPP delivery model. And the voting public will ultimately demand it, particularly if there is no alternative plan that is proposed by Government to reduce debt and stimulate economic efficiency.

Post-GFC much of the investment environment is about mitigating risk – infrastructure more than most. Ensuring that the public-private models used are balanced when it comes to risks and potential gains is essential to providing long-term solutions to Australian infrastructure demand.

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