Submission to Productivity Commission Inquiry into funding Australian Infrastructure

Assured Guaranty Services Australia Pty Ltd

Date : 20 December 2013

Submitted by : Assured Guaranty Ltd

Contact: Craig Lee

Assured Guaranty Ltd., and its operating subsidiaries (collectively referred to as "Assured Guaranty") is an active participant in the debt capital markets, specialising in providing financial guarantees for the benefit of public sector, infrastructure and project finance debt issuances around the world. In the US, our core business is to guarantee municipal bond issuances, but internationally our focus is infrastructure. We currently have A$6.3 billion par value of transactions guaranteed in the Australian market.

Assured Guaranty's business model is reliant upon debt capital markets execution, that is, the preferred funding strategy for infrastructure in the UK and US. Our funding solution is designed to create a win-win for issuers, investors and the Government. The financial guarantee provided by Assured Guaranty creates a number of benefits including: to help to reduce the borrowing costs of the issuer; support investors through a combination of credit enhancement, credit risk management and the origination of securities that offer attractive yields; and enable Government to deal with a highly-rated counterparty (AA- stable with S&P) that has extensive experience in structuring, managing and addressing issues that may arise in infrastructure related financings.

As an intermediary actively involved in the Australian market, we therefore welcome the opportunity to submit to the Commission our views on infrastructure funding and how the market could evolve to allow greater funding diversity and achieve best practices similar to highly developed markets.

This submission contains 4 sections, as follows:

Section 1 – An overview of Assured Guaranty and our expertise in the infrastructure debt funding market;

Section 2 – Our observations of the obstacles facing the domestic market;

Section 3 – A summary of our international experience and the lessons that may be applied in Australia;

Section 4 – Our recommendations to the Inquiry.

Appendix A provides additional information on the characteristics of financial guarantees.

Section 1: Assured Guaranty and Infrastructure Funding

Who We Are

Assured Guaranty's Bermuda-based holding company is listed on the New York Stock Exchange, and its principal subsidiaries are headquartered in New York. Through its subsidiaries, Assured Guaranty provides credit protection products to the US and international public finance, infrastructure and structured finance markets. Assured Guaranty applies its credit underwriting judgment, risk management skills and capital markets experience to offer financial guarantee insurance that protects holders of debt instruments and other monetary obligations from defaults in scheduled payments, including both scheduled interest and principal payments.

In the United States, Assured Guaranty currently supports around US$360 billion of public finance debt instruments. The bonds are purchased by institutional, retail and superannuant investors, who are attracted to the asset class for many reasons, including the support we provide through our irrevocable and unconditional guarantee. We understand that many of these investors would not be purchasing these assets if not for the support that Assured Guaranty provides. For example, retail investors do not have the capacity to undertake credit research and management tasks on their own.

Assured Guaranty's US business includes insurance and reinsurance on a number of different types of US public finance obligations, including:

- General obligation bonds, issued by States, their political sub-divisions and other municipal issuers, supported by the general obligation to pay interest and principal from general revenues;
- Tax-backed bonds, which are supported by the issuer from specific and discrete sources of taxation;
- Municipal utility bonds, including electricity, water and sewer utilities;
- Transportation bonds, Healthcare bonds, Higher Education bonds, Housing revenue bonds; and
- Infrastructure bonds, such as roads, airports, ports, social infrastructure and other physical assets delivering essential services.

Our presence in the market means that investors have been 'made good' even for their investment in bonds issued by entities in Detroit, Michigan; Jefferson County, Alabama; and Puerto Rico. While Assured Guaranty actively pursues redress from defaulting issuers, bond investors continue to receive principal and interest as and when due.

Global Activities

Outside the US, Assured Guaranty focuses on infrastructure projects and other projects essential for the delivery of public services (e.g., regulated utilities; economic and social PPPs). Section 3 will discuss two significant PPP projects in the UK in which Assured Guaranty has been involved.

In Australia, Assured Guaranty has approximately $6.3 billion of net par value debt instruments insured, which are held by institutional/wholesale investors. These include both primary guarantees for all bond investors in relation to a specific debt issuance and secondary market guarantees which provide specific individual investors who purchase credit protection on a specific holding within their investors portfolio.

In summary the $6.3 billion of guarantees covers such issues as Adelaide, Sydney and Perth airports, utilities including Envestra and Electranet, and public use buildings such as the Melbourne Convention Centre and Orange Hospital. The guaranteed securities include both nominal and CPI-linked securities; fixed rate and floating rate bonds; some are amortising instruments, but many are bullet bonds.

Recently, we have also completed three landmark transactions in the UK, which we believe provide some helpful insights. These will be discussed in section 3 of this submission.

In Australia, the Assured Guaranty subsidiary that supports prospective transactions is Assured Guaranty Municipal Corp. (AGM), which carries a AA- (stable) credit rating from Standard and Poor's and A2 (stable) credit ratings from Moody's. The financial guarantee provided towards a transaction is irrevocable and unconditional and each transaction insured receives the benefit of AGM's credit ratings.

Benefits to Issuers and Investors

For issuers, who typically are rated at the lower end of the investment grade spectrum (BBB range), the purchase of a financial guarantee can expand the potential investor universe, enabling a total cost of borrowing that is below a non-guaranteed debt issuance. (The cost of borrowing is the interest rate paid to investors plus the guarantee fee paid to Assured Guaranty.)

For investors, guaranteed bonds provide comfort that scheduled payments will be received when due. Guaranteed bonds are also typically issued at yields that are competitive with the AA- universe of bonds. The existence of a guarantee often improves the market liquidity of a bond issue compared with an uninsured issue, enabling investors to more quickly and cheaply sell out of their holding if they choose or need to. Investors also benefit from the on-going surveillance of the debt issue, including credit risk monitoring of the metrics of the issuer's business and the guarantor's ability to serve as a single point of contact for the issuer (e.g., should a waiver be requested or a workout be required). In the event of a transaction default, the guarantor assures that investors receive full and timely payments without interruption, so the investors do not have the burden of seeking recoveries.

These benefits are particularly relevant for infrastructure issuers that have not yet matured or developed into on-going corporations and for whom the optimal funding situation is long-term debt covering the life of a government concession. While many fund managers have developed the credit skills to monitor and assess the risk of, say, a publicly listed airport, they do not necessarily have the ability to evaluate and monitor a project from development to maturity. Assured Guaranty has that

skill and the human resources to do the job well, with a global complement of approximately 300 employees.

The ability of Assured Guaranty to evaluate, manage and remediate complex infrastructure transactions (both greenfield and brownfield) is seen as a material benefit for a range of investors, including the rapidly growing Self-Managed Super Fund (SMSF) sector. These investors are typically unable to review the detailed due diligence information to accurately form a view on the credit. Furthermore, credit rating agencies (Moody's and S&P) will not support the publishing of their credit ratings for retail investors. In this regard, retail investors will likely need to rely on third party analysis for their investment decision. The financial guaranty provided by Assured Guaranty enables the establishment of an appropriate commercial relationship which supports superannuation contributions to this asset class and provides investment diversity.

Target Market

Assured Guaranty is actively seeking involvement in transactions in Australia. The main areas of new business focus are:

- Project finance or Public/Private Partnership bids for Greenfield/brownfield projects in the A$100-400 million range;
- Airports and regulated utilities refinancing maturing debt or additional capital expenditure;
- Replacement of other guarantors on existing PFI/PPP transactions; and
- Assisting issuers of and investors in PPP transactions with re-rating and refinancing issues.

The sectors that our business is best suited to supporting include: airports, hospitals, housing and university accommodation, public buildings, water treatment, regulated utilities, roads and schools.

Conclusion: Assured Guaranty is a global infrastructure credit specialist, whose activities have supported wider participation in bond investments than are possible without the credit risk assessment and surveillance capability that we offer. Already present in Australia, Assured Guaranty is keen to play an active role in the continued growth of local infrastructure funding, including facilitating wider investor participation, eg SMSF's.

Section 2: Observations of the Market in Australia

A significant volume of private sector infrastructure debt funding has been undertaken in Australia. As our existing portfolio illustrates, some of this has been borrowed with the support of a financial guarantee. In addition, there is a growing presence of fund managers who have established infrastructure debt funds so that their end clients can gain exposure to the sector.

In some ways, therefore, it could be thought that the domestic market is well served already. However, there are some significant issues to be addressed to enhance the market.

Investors Preference for Short Term Debt

Investors in Australia have shown a clear preference for relatively short dated bonds. There are several reasons for this, including the limited relative size of life insurance portfolios; the fact that superannuation funds are increasingly defined contribution, market linked schemes rather than defined benefit schemes; and the reality that the most commonly used bond indices are much shorter in duration than their global counterparts. Until recently, there has also been little by way of long-dated government bond issuance.

In the capital markets, SPI Electricity and Gas Australia is the only BBB and/or infrastructure issuer in the domestic nominal market (i.e., included in the commonly used bond indices such as UBS) that has bonds maturing beyond 7 years – and this issue was originally executed when they were more highly rated at A-.

Fund managers have upskilled in relation to credit risk assessment, but maintain a preference for non-government debt with maturities in the 5 – 7 year region, rather than longer term. Bank funding, which is currently quite aggressively priced, is also very short term in nature, largely because of the regulatory environment for banks.

This isn't a major issue for those infrastructure entities which have matured into on-going businesses with well established credit ratings, stock exchange listing and an experienced Treasury department that can manage their term and refinance risk (e.g., SPI, Sydney Airport).

However, many projects involve a government concession over a specified time period, such as 20 to 30 years or more. The equity investors in these assets value certainty of costs such as interest expenses over the full period of the concession; borrowing short term adds to economic uncertainty due to refinancing risk. Through reducing a project's exposure the refinancing cycle, longer term debt reduces the potential shocks to the system from credit and market events.

Typically, these are the projects that expand Australia's infrastructure rather than simply privatising existing assets, so the importance of enabling suitable funding regimes goes beyond the needs of equity participants.

There are a small number of existing issues in the inflation-linked bond (ILB) and floating rate note markets that are longer term (maturing in 10 years or more), but no new deals are being done in this space. The ILB market is not supported by many asset consultants, who advise investors not to mix

credit risk management and inflation risk management. This leads them to the conclusion that investors should only use government ILB rather than corporate or infrastructure issues.

Assured Guaranty has a role to play in supporting long term funding solutions. Bond insurance gives investors an unconditional and irrevocable guarantee of all interest and principal payments as and when due. Exposure to an underlying infrastructure issuer rated, say BBB, can be taken for a longer time period if supported by a AA- rated financial guarantee.

Conclusion: the short term nature of fixed interest (debt) investing in Australia needs to be addressed. Financial guarantees by well rated companies such as Assured Guaranty have a role to play in enabling investors to invest in first time issuers and take a longer term view on infrastructure projects.

Government Requirements at Bid Stage of Projects

One of the reasons for the prevalence of bank funding in infrastructure transactions is that governments in Australia have required bids to be fully funded up front. While this leads the government to simply seek the cheapest form of debt, it doesn't necessarily produce the best risk-reward profile for the project itself. One of the reasons is that banks are really the only financial intermediaries in the position to commit at such an early stage to pricing and tenor debt funding. As already noted, their regulatory environment and their own balance sheet management leads them to provide short term funding.

This introduces refinancing risk into the valuation process. While it is currently true that short term debt can be issued at lower yields than longer term debt, it is incorrect to conclude that this means that short term borrowing is the best solution. The positive slope of the yield curve reflects a market implied view that short term rates will be higher in the future. Therefore, for a project involving say a 30 year concession to prefer short term debt is a speculative position against the current market forward curve – a bet, if you like, that short rates won't be higher in the future.

Equity investors need to include an allowance for refinancing risk in their valuation of a project's expected cash flows, potentially reducing the price they will pay. Therefore, governments may do better from Public Private Partnerships (PPP) that have longer term funding solutions that remove the refinancing risk element. The goal should be to achieve the best value-for-money funding outcome over the life of the project, rather than merely achieving a short term cost saving. This is the preferred funding model for US, UK and Canadian markets.

This needs capital market solutions. As these are more difficult to lock down as early as the bid stage of the PPP, we believe that a different approach is needed to broaden the potential funding opportunities.

Conclusion: a new approach to the funding incorporated into bids for infrastructure assets is needed to facilitate longer term, capital market solutions.

One possible alternative approach has been taken in the UK where Assured Guaranty has been involved in some significant PPP transactions recently. Section 3 of our submission summarises those deals to illustrate the different approach.

Repo Eligibility

As part of its open market operations, the Reserve Bank of Australia may enter into repurchase agreements with the banking system. The only corporate securities that are eligible for an RBA repo are required to be rated AAA/A1 – the highest credit quality. The exception is that securities maturing beyond 1 year issued by an Approved Deposit-taking Institution (ADI) that are rated as low as BBB+ may be eligible[1].

Infrastructure bonds are, therefore, not eligible securities for RBA Repo. Typically, infrastructure debt securities as stand-alone issues are rated in the BBB ratings band. This reflects the two key financial features of such issues: the relative stability of cash flows once a project is established; and the level of gearing typically built into these projects.

Infrastructure bonds that are issued with a financial guarantee are, however, assigned the rating of the guarantor. Is previously noted, AGM's rating is AA- (Standard & Poor's)/A2 (Moody's).

The market for infrastructure bonds would be significantly enhanced if securities issued to fund PPP's in Australia, carrying a financial guarantee from a well-rated institution, were to be included as repo eligible securities. It would make infrastructure bonds a more attractive investment for many market participants, including longer term issues.

One avenue for this enhanced attractiveness would be improved market liquidity. Many superannuation funds are reluctant to invest heavily in longer dated infrastructure debt because of a perceived lack of liquidity and the belief that Member Choice means that funds need to be highly liquid.

Assured Guaranty recognises that there are other policy factors that have priority for the RBA in determining what type of securities it will provide liquidity against. However, we do not believe that our suggestion would detract from the RBA's monetary policy and financial system liquidity goals. The following arguments support this contention:

1. As already noted, much lower rated ADI securities are already accepted, so there is a precedent for securities rated less than AAA being repo eligible.

2. In particular, the inclusion of PPP related assets, which though carrying credit risk still have a degree of government involvement and backing, would easily be thought of as an extension of the existing range of assets such as semi-governments and ADI debt securities.

[1] See http://www.rba.gov.au/mkt-operations/resources/tech-notes/eligible-securities.html for details.

Conclusion: The infrastructure debt funding market would benefit from securities issued with a financial guarantee being included for RBA repo eligibility.

Section 3: Recent UK transactions

During July 2013, Assured Guaranty announced the successful close of a £101.8 million wrapped public bond issue to finance social housing in Leeds and a £63 million wrapped public bond issue to finance the construction of postgraduate accommodation and associated facilities for Edinburgh University. These transactions represent the first two wrapped public bond issues for U.K. PPP transactions since 2008. A third such transaction was executed in December 2013, a GBP 73.5 million wrapped bond to finance the regeneration of a public housing estate in central Manchester.

The inclusion of a capital market funding option, including a financial guarantee, was actively encouraged and supported by the national Treasury, in which they specifically required Assured Guaranty's involvement for a transaction to enable a debt capital markets funding solution.

In contrast to the current practice in Australia, in the UK the successful bid is first determined and then the project is subject to a competition for funding. Treasury requires a range of funding models to be included, each of which makes the case for its value proposition. The goal has not been to reduce bank funding per se, but to encourage complementary financing sources.

Transaction 1: Little London, Beeston Hill & Holbeck (Leeds) social housing PFI

> This project is a 25 year DBFMO (design, build, finance, maintain and operate) concession for 400 new council houses and refurbishment of 1,300 existing houses.
> GBP 101 million of debt was issued, with a 19 year maturity. The single tranche was taken up by a mix of life insurance companies and fund managers.

Transaction 2: Holyrood Student Accommodation PLC

> This project is a 50 year DBFMO concession for student accommodation at Edinburgh University in Scotland.
> GBP 94.5 million of debt was issued, in two tranches, both with 35 year maturity.
> Tranche 1 was GBP 63 million of nominal bonds.
> Tranche 2 was GBP 31.5 million of inflation-linked securities.
> These bonds were acquired by a mix of life insurance companies and fund managers.

These bonds provided welcome diversity and duration for institutional investors and cost-effective long term stable financing for the infrastructure projects.

As a result of these benefits, Assured Guaranty is currently working towards financial close or in the process of performing due diligence on of other PFI transactions..

Conclusion: moving the bid evaluation process to something similar to the UK approach would encourage a wider range of funding models for infrastructure projects in Australia, thus enhancing the value proposition for potential equity investors compared with largely obtaining short term bank funding.

Section 4: Summary of conclusions and recommendations

Assured Guaranty is a global infrastructure credit specialist, whose activities have supported wider participation in bond investments than are possible without the credit risk assessment and management experience that we offer. Already present in Australia, Assured Guaranty is keen to play an active role in the continued growth of local infrastructure funding, including facilitating wider investor participation.

1. Preference for short-term fixed interest investing in Australia

A key issue with the infrastructure funding market in Australia is the short term horizon of most fixed interest portfolios. Ways of encouraging investors to take a longer term view need to be explored. Financial guarantees by well rated companies such as Assured Guaranty have a role to play in enabling investors to invest in first time issuers and take a longer term view on infrastructure projects.

2. Eligibility for RBA Repo facility

While Assured Guaranty recognises that there are other policy factors that have priority for the RBA in determining what type of securities it will repo, it is true that the infrastructure debt funding market would benefit from repo eligibility. Infrastructure debt standing in its own right is typically rated too low to be considered, but eligibility for bonds issued with a financial guarantee from a company with a similar rating to the Australian banks would be consistent with the RBA criteria.

3. The bid process for PPP transactions

The current bid process for PPP’s appears to create an in-built bias towards short-term bank funding, which is to the detriment of achieving the best solution for the projects and the Government. It exposes them, for example, to refinancing risk. A new approach to the funding incorporated into bids for infrastructure assets is needed to facilitate longer term, capital market solutions.

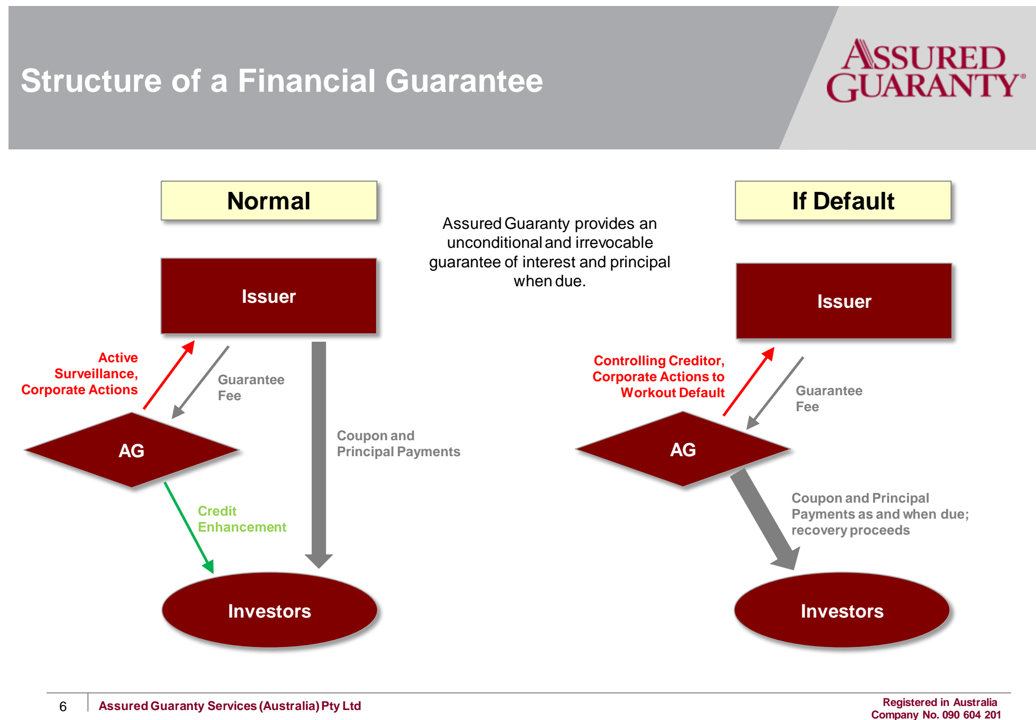
The UK approach may be an appropriate model for Australia to follow. The inclusion of a capital market funding option, including a financial guarantee, was actively encouraged and supported by the national Treasury, in which they specifically required Assured Guaranty's involvement for a transaction to enable a debt capital markets funding solution.

Recommendation: Moving the bid evaluation process to something similar to the UK approach would encourage a wider range of funding models for infrastructure projects in Australia, thus enhancing the value proposition for potential equity investors compared with largely obtaining short term bank funding.

Appendix

What does an investor actually get when they purchase a Guaranteed Bond?

The structure of a guaranteed debt instrument is represented visually in the following diagram:



From the investor's point of view, a Guaranteed Bond is in most ways a corporate bond like any other, with the interest and principal payments on the bond being paid by the Issuer. However, as guarantor, Assured Guaranty is the controlling creditor in relation to corporate actions under the terms of the bond. Investors are kept fully informed of all credit issues, but are relieved of the need to devote resources to determining matters such as covenant waiver requests.

The key difference from an unguaranteed corporate bond is in the event of a default by the Issuer. If that happens, Assured Guaranty continues all payments to be made to investors and undertakes all work out activities to deliver the optimal remedy to the default. In this way, the credit quality of the bond is higher than that of an unguaranteed bond of the same issuer. Investors in Guaranteed Bonds therefore not only receive the cash flows from the investment, with the enhanced credit protection of the guarantor, but also have an active, involved partner in the management of the Issuer's credit risk and performance.

What, then, are the main benefits for investors of a Guaranteed Bond?

A Guaranteed Bond provides investors with a range of benefits that enhance their credit risk management of underlying exposures. Not only are there the direct structural benefits of the credit enhancement that Assured Guaranty provides, but the range of monitoring, corporate action and workout services and activities undertaken represents a significant reduction in the resourcing requirements for investors.

Specific benefits include:

- Capital and income protection:

  - A Financial Guarantee is an irrevocable and unconditional guarantee of scheduled periodic interest and principal at maturity.
- Credit enhancement:
  - A Financial Guarantee typically guarantees payments on debt instruments that would otherwise be rated below the Financial Guarantor's financial strength rating, and rating agencies then assign the Financial Guarantor's higher financial strength rating to the Guaranteed Bonds.
- Credit selection:
  - Financial Guarantors apply strict underwriting criteria;
  - Experienced professionals:
    - Conduct credit analysis of relevant obligors;
    - Conduct due diligence;
    - Evaluate documentation, financial models and specific risks; and
    - Work with relevant technical experts and independent advisers (legal, technical, insurance, tax, audit).
- Independent negotiation of transaction terms and covenants appropriate for the Financial Guarantor:
  - Legal structure;
  - Security agreements;
  - Financial structure;
  - Control rights; and
  - Inter-creditor position with third parties (e.g., commercial banks and US private placements).
- Ongoing surveillance by a dedicated team of surveillance specialists (separate from origination/underwriting team):
  - Covenant monitoring;
  - Early identification and rectification of problem credits; and
  - Processing of consents and waivers in capacity as controlling party, which relieves investors of the need to make decisions or reach consensus about such requests. If an event of default occurs, investors receive scheduled bond payments without interruption and are insulated from any recovery process.
- Dealing with a highly rated counterparty:
  - Assured Guaranty's core infrastructure direct insurance entity relevant to the Asian and Australian markets is AGM, which has financial strength ratings of "AA-" (stable outlook) by Standard and Poor's Ratings Services ("S&P") and "A2" (stable outlook) by Moody's Investors Service, Inc. ("Moody's").
- Potential increased capacity and / or liquidity:
  - By purchasing a Guaranteed Bond, investors may be able to increase their respective exposure to a particular issuer and still satisfy regulatory counterparty limit requirements;
  - May facilitate additional wholesale investor acceptance and secondary trading opportunities; and
  - May provide additional flexibility to satisfy rating and portfolio mandates.

Additionally, investors have certain embedded information rights which enable them to monitor the performance of the transaction. This includes the receipt of periodic transaction reports in a format agreed with the Issuer and the bond trustee.

What motivates issuers to bring Guaranteed Bonds to market?

A Guaranteed Bond also provides significant benefits to issuers, including enabling access to a broader investor group, potential pricing benefits and potential additional market liquidity relative to other funding sources. It also allows the Issuer to negotiate commercial terms with a single counterparty, the Financial Guarantor. On an ongoing basis, it allows the Issuer to channel consents and waivers solely through the Financial Guarantor, reducing the execution risk of dealing with many end investors, who generally require a consensus view.