Westpac GROUP

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Submission to the Productivity Commission Inquiry into Public Infrastructure

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SUMMARY

Westpac Banking Corporation (Westpac) welcomes the opportunity to make a submission to the Productivity Commission's inquiry into Public Infrastructure.

Westpac is an active participant in promoting dialogue on an appropriate national response to Australia's infrastructure challenge. Westpac indeed recognises that Australia has a significant infrastructure challenge ahead. The linkages between the efficient delivery of major infrastructure, productivity, international competitiveness, economic growth and our country's standard of living are all well understood. Also, and as outlined, in the terms of reference for the Inquiry, access to reliable and affordable public infrastructure has an important role to play in meeting social and environmental objectives.

Westpac views infrastructure financing as a core part of our business offering. Westpac has a long history and a strong track record in delivering financing solutions for infrastructure projects. We offer a full product suite and our ability to deliver solutions includes, amongst others, the following product areas: bank debt, debt capital markets products, risk management and derivative products, and transactional banking services.

In addition, Westpac's subsidiary Hastings is a specialist fund manager which only invests in infrastructure assets on behalf of institutional investors. Hastings was launched in 1994 and has been a subsidiary of Westpac since 2002. Its infrastructure equity track record over that time has seen it produce returns after fees in excess of 12% per annum for its investors. Today, Hastings has more than A$7 billion in funds under management and services around 70 institutional investors with over 90 staff located in five offices around the world, making it a world leader in the sector.

The Productivity Commission Inquiry is broad ranging. Given our role in the industry, we have focused our input on the financing of infrastructure. We note the Inquiry is also considering the cost of construction of major infrastructure projects. In this area, we would support any efforts to streamline regulatory processes which will reduce the regulatory burden and approval times for major infrastructure projects.

In terms of the financing of public infrastructure, Westpac has focused its comments on:

- Australia's infrastructure challenge and the private sector's financing appetite;
- Infrastructure funding, in particular as it relates to user charging and recycling of capital;
- Alternative sources of infrastructure finance, with a particular focus on the $A corporate bond market and the superannuation sector; and
- Public Private Partnerships.

This submission draws upon the bank's considerable experience in the financing of major infrastructure projects, both domestically and internationally. We continue to be engaged with governments, their advisers as well as with the key investors in infrastructure, both from an equity and debt perspective covering both brownfield and greenfield projects.

SUBMISSION

Westpac is strongly committed to supporting the delivery of public and private infrastructure in Australia, primarily by providing financing solutions required to deploy major infrastructure projects.

Westpac has sought to play a constructive and responsible role in the ongoing discussion on the most effective means of addressing challenges such as the provision, funding and financing of infrastructure. In doing so, Westpac has always sought to provide practical feedback on the market and business implications of proposed solutions, while supporting our customers to manage risk and pursue emerging commercial opportunities.

This submission does not address all of the terms of reference of the public inquiry, but seeks to provide feedback on key considerations which we believe will assist the Commission in making recommendations to the Australian Government.

Australia's infrastructure challenge and the private sector's financing appetite

It has been widely noted that Australia has a significant infrastructure challenge. Major investment is required to meet demand from a growing population, particularly in major urban centres, and support future economic activity. The Business Council of Australia's recent report *Infrastructure Funding and Financing* estimates the demand for infrastructure investment may be $760bn over the next ten years and possibly more. A key focus of this Inquiry is how to boost private sector investment in infrastructure to meet this future demand at a time when governments are seeking to reduce debt and manage other challenges such as the ageing population.

There is a concern that commercial banks and other investors lack the appetite to increase support and financing of long term infrastructure projects as a result of tighter prudential regulation. This concern is unfounded. As the Commission has identified in the Issues Paper, it is important to draw a distinction between the "financing" and "funding" of infrastructure. Currently in the market, there is generally sufficient appetite from both the equity and debt markets to "finance" the deployment of productive public infrastructure at a reasonable rate of return reflecting the risk in the project. The issue is really the "funding" of infrastructure; i.e. who will pay for the cost of constructing, operating and maintaining this infrastructure, as ultimately this source of payment will service the required equity and debt capital.

There is, however, a difference in the level of appetite investors have for "brownfield" assets when compared with "greenfield" assets. Investors, in particular the funds management and superannuation sectors, generally have a stronger interest in brownfield assets. In saying that there is no shortage of investor appetite evident for well-structured greenfield assets (e.g. "availability" Public Private Partnerships where payments are made based on the asset being "available" to use under quality or service levels agreed to in the contract rather than revenue based on patronage levels).

A key risk that investors, including banks, will consider on all projects is patronage risk. Patronage risk is particularly challenging for greenfield projects where there is no proven patronage. This risk has been evident in the toll road sector where in some cases patronage forecasts have been overly optimistic, resulting in a number of toll roads going into receivership.

As a result of these issues, we do not expect that debt or equity financiers will accept full exposure to patronage risk for new toll road projects. If these are to be financed, there may need to be greater sharing of this risk with government, and there are a number of mechanisms through which this could be achieved. This is not typically an issue with brownfield assets which have proven patronage.

Infrastructure funding

When governments are considering new public infrastructure assets there are predominantly four distinct funding options; i.e.:

- Taxation
- Debt
- Recycling of capital (i.e. privatisation of assets); and
- User charges (i.e. tolls).

With limitations in governments' appetite to take on more debt and increase taxation, user charging will need to become an important method of funding infrastructure. There are also substantial opportunities to privatise some major State Government assets.

User charging

We would expect Australia to embrace user charging more fully as a source of funding. In the US, roads are being charged dynamically, depending on the time of day, and Time of Use Metering through Smart Meters is increasingly being used in the electricity markets.

We would encourage governments to adopt user charging as a more common feature of infrastructure projects. It is also important to continue to highlight to all governments and the broader community the benefits of user charging in enabling major infrastructure to be built.

Recycling of capital

Most large infrastructure assets are held by State Governments. While many assets have already been privatised, there are still opportunities for States to privatise productive assets to release capital for reinvestment in other infrastructure projects. Victoria's privatisation of its electricity generation and distribution assets in the 1990s remains the strongest historical example of how privatisations of the right assets, when well executed, can successfully recycle important government capital and also add value through private sector innovations, disciplines, and efficiencies.

We note at their meeting in November 2013, the Federal and State Treasurers discussed incentives for States to privatise assets, potentially including grants to replace lost revenue. This type of cooperation between the States and the Commonwealth is welcome and we look forward to these discussions progressing in early 2014.

Alternative sources of infrastructure finance

There are a number of alternative sources of finance which may, in the right environment, be able to make a greater contribution to infrastructure financing. These include the corporate bond market and the superannuation sector. If the potential of these sources is fully realised it could provide an additional boost in private sector infrastructure investment.

$A Corporate bond market

The $A corporate bond market is a possible alternative source of financing. Over the past two years, the volume of corporate bond issuance has almost doubled to $11.5 billion from $6.0 billion. In addition, it is also encouraging that average tenor has widened to 6.5 years from 4.7 years over this period. More importantly, for infrastructure assets, tenors of 7 years and greater are readily achievable.

While the corporate bond market in Australia continues to develop there is limited evidence in improving appetite for “greenfield” project bonds, with all new greenfield projects since the Global Financial Crisis (GFC) financed by banks. This primarily reflects a more cautious investor appetite, the significant credit deterioration of monoline insurers that previously supported project bonds, and that the financing task is now often significantly larger than was typical pre-GFC.

In the absence of a material credit enhancement to infrastructure projects during the construction period there is currently limited potential for the development of a project bond market in Australia. Credit enhancement during the construction period may potentially be provided by well rated financial institutions or potentially by government. Beyond the construction period we generally view most well-structured operating infrastructure assets to likely be of an investment grade profile and for which there is less of a requirement for credit enhancement.

Superannuation sector

Superannuation funds under management are now $1.7 trillion and this is likely to grow to $3.3 trillion by 2020 and $4.6 trillion by 2025. Approximately 5% of current funds are invested in infrastructure. While we do not support any mandatory requirement to invest in infrastructure, this represents a considerable untapped opportunity that could be allocated to infrastructure over time provided there are ways for superannuation funds to invest at appropriate levels of risk.

The ‘Stronger Super’ reforms are likely to drive further consolidation of the industry. Funds therefore, will become larger in size which may pave the way for the establishment of specialist

infrastructure teams – a critical need for the industry and certainly a prerequisite for assessing the risk profile of the proposed infrastructure investment. Superannuation funds, depending on their individual objectives, have an opportunity to choose what risk they feel most comfortable with; i.e. equity investment and/or debt investment.

One of the other drivers for the super sector to focus more on the infrastructure sector as an investment class is the changing demographics. Over the next 10 years or so, baby boomers will move into retirement phase and there should be greater demand for annuity style returns in superannuation. The infrastructure sector is ideally placed to deliver that as the long dated nature of these assets aligns with the long dated nature of super funds' liabilities.

Superannuation funds have recognised that the infrastructure asset class is capable of producing predictable long-term cashflows with strong consumer price index linkages, and as such, is a good investment hedge to support the payments to its members. In our experience, there is no shortage of equity support from superannuation funds for good infrastructure projects. Ongoing support from these superannuation funds, as well as other offshore pension funds, remains critical to the private sector funding of infrastructure projects.

Public Private Partnerships

Public Private Partnerships (PPPs) have been used widely across Australia to finance both economic and social infrastructure. While there have been issues with the implementation of PPPs, they typically deliver superior value for money for government than any alternative delivery model when applied to appropriate projects. This includes lower construction cost over-runs, less construction phase delays, and greater "whole of life" cost certainty.

We recognise and support that States are becoming more innovative in deploying PPPs. A good example is the multi-billion dollar East-West Link project in Victoria, where the infrastructure (road and tunnel) will be delivered by the private sector but the traffic risk is retained by the Victorian Government. This mitigates the potential patronage risk. Once the traffic is proven, the State could easily monetise the right to toll the road.

Although the present pipeline of PPPs is high by historical standards, more could be done, in particular if a more standardised framework could be developed. A National PPP Policy and Guideline Framework for PPPs was developed and endorsed by the Council of Australian Governments in 2009. However, this policy continues to allow differences between jurisdictions on a range of issues and every state has a slightly different approach towards PPPs. A consistent framework would reduce bidding costs.

In addition, there is a high degree of financing required in Australia as each bidder has to lodge fully financed bids. In other markets (e.g. UK), bidders often bid the solution and the preferred bidder will subsequently seek funding from the banking market. This may lower financing costs on some projects, particularly larger projects where market capacity may be more stretched. However, this financing model is more easily considered when there is a high degree of standardisation, and there is limited potential to enhance project value through financing innovation.

There are currently inconsistencies amongst States in how they apply government contributions to PPPs, however, there is an increasing trend in a number of States for large government contributions to be provided post construction. While there are obviously merits to this approach, we note this results in limited opportunity to develop a market which offers longer tenor project bond solutions. More broadly it also makes the PPP market less attractive to financiers given the significant origination and structuring effort required for relatively short term relationship opportunities.

Concluding comments

Westpac will continue to work with Government, with other market participants and with our customers to deliver practical products and services to facilitate the provision, funding and financing of public infrastructure in Australia.

At present, there is no shortage of private capital to finance the delivery of major infrastructure as long as the right investment environment for private investment is put in place and not disrupted over time. There is an opportunity for governments and the private sector to work together and agree on the allocation of risks and policy settings which, combined, will all assist in developing more efficient infrastructure markets.

APPENDIX A

About Westpac

Westpac Banking Corporation (Westpac) was founded in 1817 and was the first bank established in Australia. Today, Westpac provides a broad range of retail, commercial and wholesale banking services to over twelve million personal, business, corporate and institutional clients.

- Westpac Group has branches and controlled entities throughout Australia, New Zealand and the near Pacific region and maintains offices in key financial centres around the world.
- As at 30 September 2013, the Westpac Group employed approximately 36,000 people (full time equivalent basis) in Australia, New Zealand and around the world, and had global assets of $697 billion.
- As at 30 September 2013, market capitalisation was $102 billion.
- For the 12 months to 30 September 2013, the Westpac Group's reported net profit after income tax was $6,816 million.
- About 570,000 people and institutions in Australia and overseas are Westpac shareholders.

Westpac Institutional Bank (WIB), a division of Westpac Banking Corporation, manages the financial needs of corporate, institutional and government clients that are based, or have interests in, Australia and New Zealand. WIB are a leading provider of wholesale banking services in the region and are consistently recognised as a leading bank for Australian and New Zealand dollar-denominated financial products and risk management. WIB is located in Australia, New Zealand, London, New York, Singapore, Hong Kong, Beijing, Shanghai and Mumbai.