Considerations for State Infrastructure Funding

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Why is Credit Enhancement Necessary?

Strong credit ratings are critical to the economics of infrastructure projects

- Infrastructure developers require significant volumes of cost efficient finance
- Credit profiles determine funding availability and cost of finance
- Credit assessments have tightened up and even good credit profiles require substantial risk mitigation in development and operating phases
- Debt markets require good credit ratings (BBB+ and above) to finance large scale infrastructure projects in terms of volume and cost efficiency
- Lower credit profiles (i.e. BBB and lower) can have a substantial influence on the economics of infrastructure projects
- The project's credit rating is also highly influenced by the level of risk attached to the development or construction phase

Credit enhancement can improve ratings

- Infrastructure developers can mitigate many commercial risks but generally not enough to meet a >BBB+ risk criteria of rating agencies
- Funding structures can be credit enhanced via additional credit support from higher credit worthy parties
- Credit enhancement can for example be used during the construction period in isolation to provide a credit rating uplift before the project moves to a sustainable investment grade profile

Credit support can take a number of forms

- Principal guarantee
  - Limited % of project cost
  - Limited to defined period beyond construction and rampup
  - Can be used to enable junior ranking funding, thus enhancing senior debt position and cost
  - Can be used to create higher rated senior debt on blended basis by guaranteeing a portion of senior debt
- Servicing guarantee
  - Provides financial backstop or insurance in regards to financial debt servicing improving credit profile of debt funding
  - Can remove interest servicing risk during construction and rampup
  - Can improve interest servicing risk during operations via a top-up mechanism

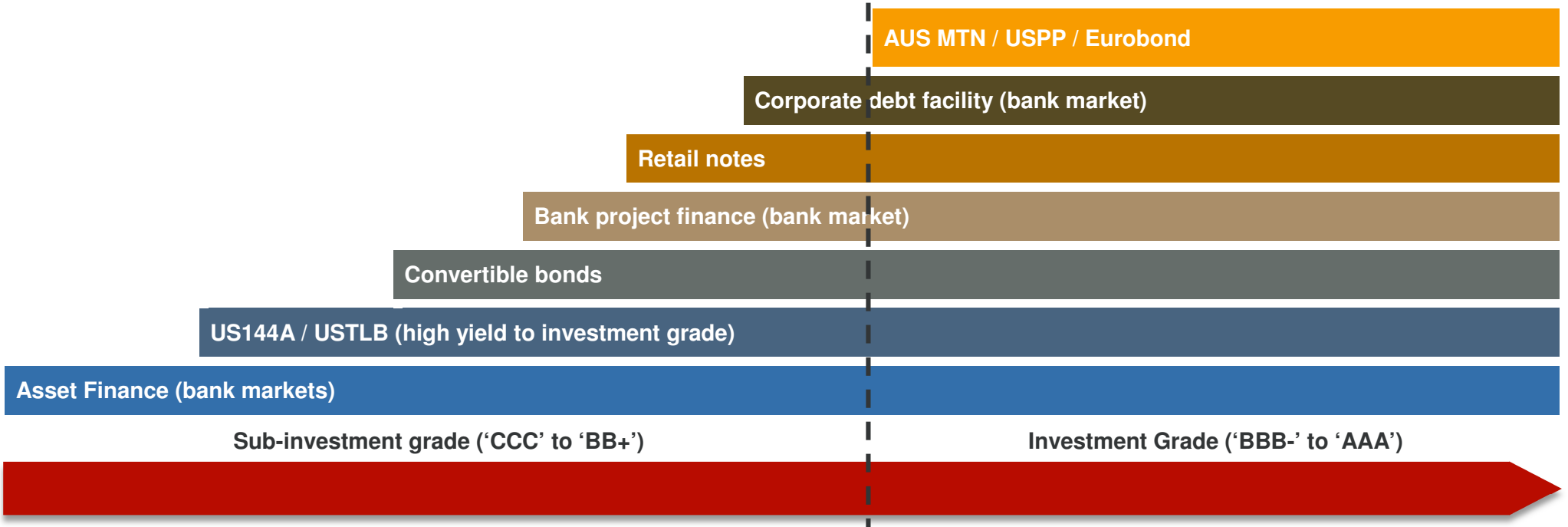
Strong credit ratings open alternative funding markets

- The domestic bank market will support quality infrastructure projects
- However, the domestic bank market is capital constrained beyond $2bn for single asset risk, which exacerbates funding costs, the term of debt and puts pressure on increasing the level of costly equity, thereby reducing economic returns for stakeholders
- A funding structure that is credit enhanced to achieve a credit rating of BBB+ or greater can source funding from other debt markets including domestic MTN, retail bonds and offshore capital markets

Strong credit ratings optimise economic returns

- With higher credit ratings, debt pricing naturally becomes more efficient
- Also, via access to different debt markets and volume of debt in excess of requirements, a level of competitive tension can be created across and within debt markets, leading to more efficient financing structures
- Further, strong credit ratings can deliver longer debt maturity profiles, improving the financial risk structure for stakeholders
- Credit enhancement during the construction period would also avoid the cost of refinancing that generally occurs between development completion and the operational phase

Infrastructure funding straddles sub-investment to low investment grade.



High Risk

- Small scale and private
- Limited track record
- Construction / development risk
- Minimal / nil revenue

Low Risk

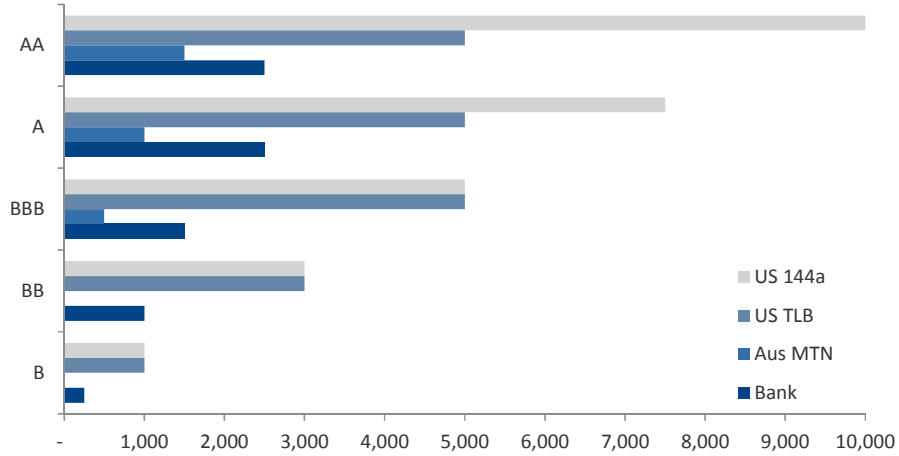
- Large scale and public
- Proven business model
- Diversified revenue sources
- Established market position

Overview of Infrastructure Project Debt Market Options

	Bank Market – Corp	Bank Market – PF	US Private Placement	Australian MTN	US Term Loan B	US 144A Market
Market description	■ Bank facilities on revolving or term structures on bilateral, club or syndicated structure	■ Non-recourse bank facilities raised to finance the development of specific assets	■ Mutual funds and insurance company investors under non-public offerings	■ Institutional buyers in Australia plus some foreign buyers	■ US Term Loan market, comprising bank and institutional lenders	■ Public bond market issuance to QIBs
Liquidity	■ >$1bn	■ $2bn	■ >$1bn	■ $150 – $1.5bn	■ $250m - $5bn	■ $250 – $10bn
Tenor	■ 3 – 5 years ■ 7 & 10 possible	■ 3 – 12 years	■ 5 – 12 years ■ Sometimes up to 20 yrs	■ 5 – 10years	■ 5 – 7 years	■ 5 – 30 years
Technical Considerations	■ Non-standard documentation	■ Non-standard documentation	■ Model document	■ MTN format	■ Standard documentation	■ Standard documentation
Rating	■ No	■ No	■ NAIC only	■ Yes, one	■ Yes, typically two ratings	■ Yes, typically two ratings
Pricing	■ BBSY +	■ BBSY +	■ US Treasuries +	■ BBSY +	■ LIBOR +	■ US Treasuries +
Pros	■ Structural flexibility ■ No redemption penalties ■ May re-price with spread contraction	■ Longer dated facilities available	■ Longer tenor ■ Private ■ Only rating requirement is NAIC ■ Speed of execution	■ Scope for no maintenance covenants	■ No redemption penalties ■ Minimum 1% p.a. amort.	■ Most liquid market ■ Unsecured market ■ Longer tenor ■ No amort. requirements
Cons	■ Shorter term than bond market ■ Terms and conditions are tighter than in bond markets ■ Maintenance covenants	■ Highly restrictive terms and conditions ■ Post construction, necessitates costly refinance	■ Typically require covenant alignment to senior lenders ■ Maintenance covenants ■ Redemption penalties	■ A$ market ■ Redemption penalties ■ Upper investment grade market but BBB band issues have increasedd	■ Typically secured ■ Longer execution ■ LIBOR floor ■ Maintenance covenants ■ Similar to bank market	■ initially high documentation requirement ■ Redemption penalties
Observations	■ More flexible than Bank market - PF	■ Struggles to absorb sub-IG risk ■ Volume limitations above $1.5bn	■ Limited AUD issuance	■ A market to consider on the back of strong rating ■ Limitations over $500m	■ Bank market – Corp will generally outperform this market ■ Covenant light ■ Significant volume	■ Attractive long dated uncovenanted market ■ Regularly accepts junior creditor risk

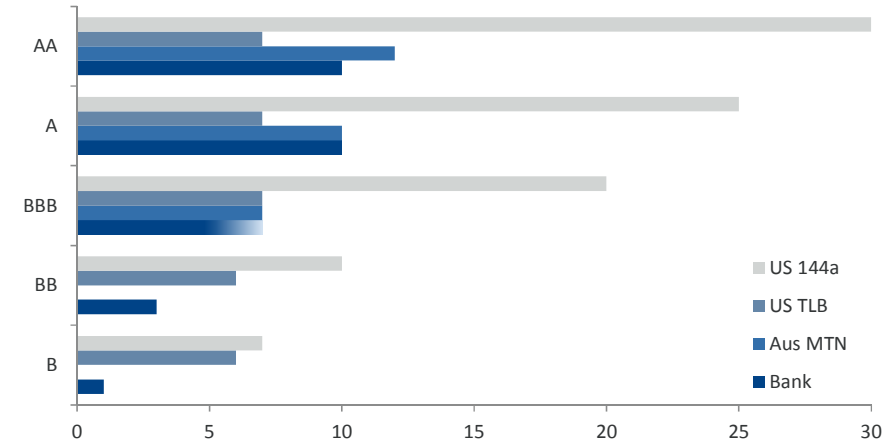
Opening Access to Additional Credit Markets, Debt Volume and Longer Tenor

DEBT MARKET RISK CAPACITY ($ million)



Source: Grant Samuel

DEBT MARKET TENOR RISK (years)



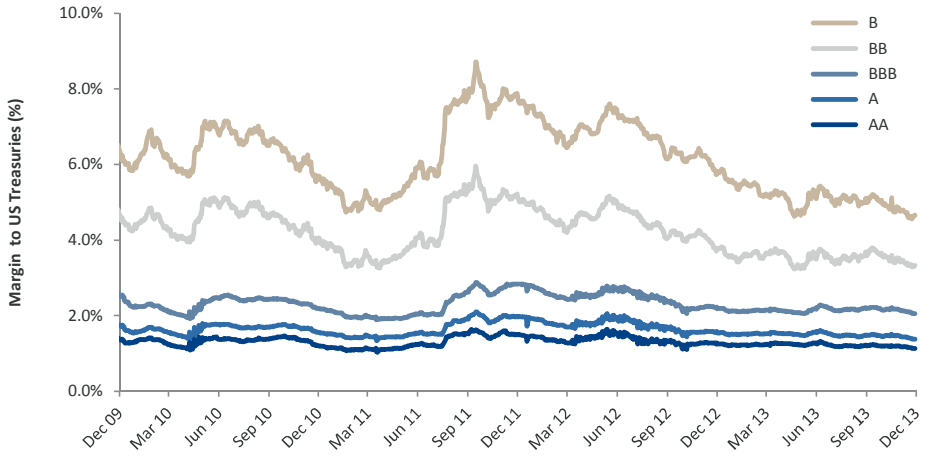
Source: Grant Samuel

COMMENTARY

- A higher credit rating yields substantial benefits in particular for projects requiring large volumes of long term debt funding through the ability to:
  - access a greater variety and deeper funding markets such as US144a, US Term Loan B ("US TLB"), Australian Medium Term Notes ("Aus MTN")
  - raise larger volumes of debt (> $5 bn)
  - secure loans with longer tenors (> 10 years)
- This generates a number of benefits for an infrastructure project:
  - ability to run competitive, multi-track funding processes which typically result in more favourable terms (pricing and other financial terms, tenor, covenants)
  - increased ability to optimise the capital structure through the use of both shorter and longer term debt allowing the debt holders to refinance certain components of the debt as the project's characteristics and market conditions evolve
  - decreased reliance on single debt markets / providers thereby reducing third party and refinancing risks

Potential Pricing Benefits for Infrastructure Projects

DAILY CREDIT SPREADS



Source: Standard & Poor's

AVERAGE CREDIT SPREADS (bps)

	Last 12 Months	Last 24 Months	Last 36 Months	Last 48 Months
A – AA	28	34	34	34
BBB – A	65	70	67	67
BB – BBB	140	171	181	192
B - BB	158	195	196	193

Source: Standard & Poor's

COMMENTARY

- There is a significant pricing differential between sub-investment grade and investment grade risk.
- Credit enhancement during the construction phase through the provision of guarantees could provide a 75-200bps improvement in cost of debt.
- Subject to the commercial and legal characteristics of the project, credit support could generate savings to the State of c.$300-600m over the construction period for a c.$5bn project reflecting:
  - lower cost of debt during the construction period
  - revenue generated by the State through the provision of guarantees
  - removal of the need to refinance the facilities post construction to capture lower funding costs as a project transitions to its operational phase and a stronger risk profile

Potential Cost Benefits to State[1]		
		$m
Infrastructure project debt	-	5,000
Credit enhancement	20%	1,000
Construction period	5 years	
Funding cost savings	0.75% – 2.00%	188 - 500
State revenue from guarantee	1.50%	75
Refinancing cost savings	0.5%	25
Cost Benefits to State	**-**	**288 - 600**

[1] This reflects a hypothetical scenario without regard for the credit impact of specific commercial and legal project characteristics. Additional analysis and due diligence is required to determine the appropriate level of credit enhancement to achieve desired cost benefits.