Productivity Commission Inquiry: Public Infrastructure

SUPPLEMENTARY SUBMISSION

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Industry Super Australia

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
Phone: +61 2 6273 4333
Mobile: 0407 430 613
Level 3, 39 Brisbane Avenue,
Barton, ACT, 2600
mlinden@industrysuper.com

or

Jane McGill
Consultant
Phone: +61 3 9923 7105
Mobile: 0430 128 792
Level 39, 2 Lonsdale St,
Melbourne, VIC, 3000
jmcgill@industrysuper.com

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1. Key themes

The key themes in this submission are:

1. At least eight major infrastructure investors in Australia typically do not participate in greenfield PPP projects either as a bid sponsor or primary equity investor. Very high bid costs and long procurement processes with 'patchy' deal flow limit the number of parties who can afford to dedicate large teams for such projects. Long-term equity investors like superannuation funds do not see the relative value to divert resources away from pursuing brownfield infrastructure to greenfield PPP projects that involve such a costly, lengthy and uncertain processes. Their long term investment horizon and their appetite for illiquid assets make them ideal partners for such projects, however, the current process is biased towards short term financiers and contractors and requires reform to level the playing field.

2. The current PPP bid process produces a major misalignment of interests between the bid sponsors, who are short-term financiers and contractors and the equity investors who are brought into a deal by them. PPP bid syndicate leaders have been motivated by considerations other than the return to equity and the long term success of a project. Investment banks acting as bid sponsors have been compensated significantly towards the front end of the project and, in the absence of competition, are able to collectively seek to extract outsized fees tied to winning and financing a bid - so called fee leakage - which is ultimately borne by government and tax payers. In addition, construction companies generate their returns from project construction and have little or no exposure to the investment once operations commence.

3. Australia is not unique in facing a high cost bid process, long procurement timeframes and a lack of long term equity participation in partnership projects. In 2012, the UK National Audit Office stated: *"The PFI procurement process takes too long, costs too much and restricts the market. The time and cost involved do not serve investors or taxpayers well. The scale of procurement costs constitutes a barrier to market entry for financial investors such as pension funds and smaller contractors. Successful bidders recover their procurement costs in the contract price, which means the taxpayer foots the bill."* HM Treasury also observed in 2012 that "*the procurement process has been slow and expensive for both the public and private sector (and) this had led to increasing costs and reduced value for money."*

4. Industry SuperFunds believe that there is a better procurement process that satisfies both governments' need for a competitive process and value for money outcome, as well as investors' risk/return appetite, ultimately providing certainty and value for money for governments, patrons and investors. Under the proposed "inverted bid model" ("IB Model") the traditional bidding process is reversed by securing project financing through an equity funding competition prior to the construction and operation and maintenance (O&M) tender. In other words, the government tenders initially for the long term owner-operator followed by separate bids for construction, O&M and debt. The most effective models could involve the long term owner-operator bidding on their margin over the construction cost.

5. The critical benefit of the proposed "open book" inverted bid model is that it will level the playing field for genuine long-term equity investors who are seeking to make a reasonable return over the economic life of the asset, and not through the initial bidding, structuring and building of the asset. By separating the financing from the construction and O&M tender, the IB Model will increase the pool of banks and contractors available to the preferred owner-operator. This increased liquidity is expected to lead to more competitively priced fees and margins.

6. Governments expect PPP assets to be owned and maintained over their economic life. These demands are best met by long-term equity investors like superannuation funds that have an alignment of interest as they seek investments that deliver stable, reasonable returns over the long term.

2. Introduction

In our first submission to this inquiry in December 2013, we explored the co-existence of a significant infrastructure deficit in Australia alongside the large and growing pool of superannuation assets and explored the obstacles to investing those savings in the creation of public infrastructure.

This supplementary submission provides a brief recap on the issues faced by long-term investors such as superannuation funds participating in the delivery of new, greenfield projects in partnership with government and puts forward a new "inverted bid model" ("IB Model") that we believe could deliver a much better value for money outcome to governments and tax payers.

3. Issues with the current model

3.1 High bid costs and long procurement timeframe "barrier to competition"

At least eight major infrastructure investors in Australia, including Industry SuperFunds via IFM Investors ("IFM") typically do not participate in greenfield PPP projects either as a bid sponsor or primary equity investor. This submission examines how the current PPP bid model acts as a barrier to entry / competition from long term equity investors such as superannuation funds and the impact that we believe this has on value for money.

Very high bid costs and long procurement processes combined with 'patchy' deal flow, has limited the number of parties who can afford to establish and dedicate the necessary resources for such projects. Bid costs are estimated to average 1.5 per cent of the total project cost and the average length of procurement for PPP projects is 17 months.[1] With potentially only three or so PPP projects coming to market each year and a similar number of established bidding consortia, the barriers are high for new entrants.

Long-term equity investors have not seen the relative value in diverting resources away from pursuing brownfield infrastructure to pursue greenfield PPP projects that involve such costly and lengthy processes and which are infrequently brought to market. This is despite the fact that they are natural investors in such projects. Their extensive experience in brownfield infrastructure and their long term investment time horizon means they are well suited to own and manage greenfield infrastructure assets over their long life-cycle. They are motivated to price project risk on the basis that they will own the asset over the long-term as owner-operators and will make their returns through efficient asset management and operation.

The current PPP bid process has resulted in a major misalignment of interests between short-term financiers and contractors, and the equity investors. This has been perfectly illustrated by a series of failed toll road PPPs in Australia over the last eight years. PPP bid syndicate leaders have been motivated by considerations other than the actual return to equity and the long term success of a project. The investment banks acting as bid sponsors have been compensated significantly at the front end of the project and have extracted tens of millions of dollars in transaction and advisory fees – so called fee leakage - which is ultimately funded by government and tax payers.

In addition, the construction company generates its returns from project construction and has little to no equity exposure to the investment once operations commence.

Driven by these significant short term incentives, bidders have put forward aggressive patronage forecasts as, at the end of the day, this puts them in the winning position. Exacerbated by high levels of gearing, these overly optimistic traffic forecasts have led to the financial failure or significant stress of the projects. Ultimately, this risk is borne by the equity investors (who have been brought into the deal by the investment bank and

[1] KPMG (2010) PPP procurement review of the barriers and competition and efficiency in the procurement of PPP projects

contractor as bid sponsors), as the bid sponsors have extracted their returns upfront and have limited to no on-going equity exposure to the transaction. The ultimate outcome is a poor value for money outcome for government and tax payers, as well as a loss of shareholder value leading to risk aversion and scarcity of capital.

Whilst the limitations of the PPP procurement model have been best illustrated by the toll roads, similar issues exist for social (or availability based) PPPs where significant value capture and fee leakage occurs during the initial bid process and the achievement of financial close on a transaction.

3.2 Refinancing risk

In the absence of long term equity investors as bid sponsors who operate under more conservative assumptions, short term focused project sponsors are motivated to put forward aggressive financing assumptions to lower the cost of capital. This can result in a financing package heavily skewed towards debt: generally a financing package is comprised of 80-90 per cent debt and 10-20 per cent equity. Such finance packages may provide an upfront lower cost but they also have a latent cost because they may not be capable of refinancing. Ultimately, the risk is borne by equity or, in the case of reversion to the government, by the taxpayer. Debt will always be a significant source of finance for infrastructure projects, however, reform of the bid model would be expected to help foster more sustainable capital structures with reduced refinancing risk and, hence, a reduced likelihood in equity having to inject further capital or for assets to enter receivership.

3.3 Lack of innovation

Under a one-step bid model, financial terms, the business case, construction, operation and management contracts and project design are all fixed up front. A winning consortium may not include the 'best in class' of all of the project components and this may limit the extent of innovation and value for money achieved.

3.4 Under investment in assets

Governments may experience significant challenges over the medium term if they wish to change aspects of the asset and the services provided if the concession was awarded to investors with short term interests. The potential lack of alignment and resulting risk in not being able to negotiate changes in the future could be ameliorated if the procurement model motivated longer term investors to bid.

3.5 Poor value for money

In the UK, the PFI model has come under sustained criticism over its lack of transparency. Both the UK Treasury and National Audit Office have stressed the importance of greatly increasing the availability of public information and transparency of such projects, 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."

3.6 High whole-of-life transaction costs

Transaction costs refer to the costs of establishing and maintaining a partnership. More specifically, they encompass legal, financial, and technical advisory costs incurred by both public and private sectors in the procurement and operational phases of a project. High transaction costs have the potential to erode the cost savings achieved through the PFI model[2]. Average transaction costs are estimated by the European Investment Bank at being over 10% of the project's value, with a cost of 3.5 % to the public sector, 3.8% to the successful bidder and a *combined* cost to the failed bidder of 5%.

[2] European Investment Bank (2005) Transaction costs in public private partnerships: A first look at the evidence

4. International Perspectives

Australia is not unique in facing issues with the complex and high cost of the bid process, long procurement timeframes and the desire for greater participation of long-term equity investors in PPPs.

4.1 Complex bid process

In its 2012 report, "A new approach to public private partnerships", HM Treasury described the complex process of infrastructure procurement in partnership with the private sector:

> *"Procurements of PF2 projects have a number of features that make them more complex than many other types of procurement. PF2 projects will be a long-term agreement for the design, construction, financing, maintenance, and sometimes operation, of a new asset; and their procurement needs, therefore, to address all these issues during the tendering process. Addressing these issues appropriately takes time. For instance, it will take many months to complete the detailed design development and obtain planning approval for the new asset. Additionally, agreeing how the PF2 project is going to be financed by a private sector partners will add further cost, complexity and time in procurement as financiers require time to conduct their own due diligence and to complete their separate financial negotiations."*
>
> **HM Treasury (2012)**
> ***A new approach to public private partnerships***

4.2 High bid costs and long procurement timeframes

The UK shares Australia's experience that high bid costs and long procurement timeframes present a barrier to entry to infrastructure procurement under the PPP model, and the absence of competition has added to bid costs and undermined the value for money outcome.

UK National Audit Office

The UK National Audit Office, in a 2012 report "Equity investors in privately financed projects" concluded: "Under the standard PFI model the deals have involved long procurements and high bidding costs. This has acted as a barrier to competition as only a small number of companies can afford to be regular bidders. The high bidding costs have also added to the cost of projects. The Treasury accepts lower procurement times are possible."

"The PFI procurement process takes too long, costs too much and restricts the market. The time and cost involved do not serve investors or taxpayers well. The scale of procurement costs constitutes a barrier to market entry for financial investors such as pension funds and smaller contractors. Successful bidders recover their procurement costs in the contract price, which means the taxpayer foots the bill.

Those negotiating contracts for the public sector too often lack the appropriate commercial and financial skills. The growing emphasis on localism makes this skills problem worse as all too often inexperienced local bodies undertake complex negotiations with experienced private sector counterparts. The Treasury, in consultation with investors, should identify and address the sources of cost and delay in the procurement process. The Treasury should consider whether best value would be secured by greater centralisation of the procurement of PFI projects."

The UK National Audit Office (2012)
Equity investors in privately financed projects

United Kingdom HM Treasury

The UK HM Treasury made similar observations in its 2012 report: *A new approach to public private partnerships* stating "the PFI procurement process has often been slow and expensive for both the public and the private sector. This has led to increasing costs and has reduced value for money for the taxpayer." It believes that procurement timescales for PFI have been excessive and is committed to reducing the time and cost of procurement of PF2 projects going forward.

"Average PFI procurement time frames, from initial tender to financial close, have stubbornly remained at around 35 months. This average, however, varied by sector; the average procurement time for schools was 22 months in 2008 whilst in sectors such as housing and waste procurement times have consistently been significantly longer.

The period from the initial project tender to the appointment of the preferred bidder is the most expensive phase of procurement, as this is when multiple bid teams are in competition. In the past, significant bid costs have been incurred by the private sector over this period which ultimately are borne by the public sector in the form of higher contract costs. On average this period took just under 2 years for past PFIs and in the worst PFI cases took over 60 months."

HM Treasury (2012)
A new approach to public private partnerships

European Investment Bank

The European Investment Bank examined the cost of projects in its report "Transaction costs in public-private partnerships: A first look at the evidence". "As regards the level of transaction costs in the procurement phase, it is estimated that the total costs amount on average to well over 10% of the capital value of the project. Transaction costs to the public sector and the winning bidder vary between countries (legal systems) and sectors, and they are significantly higher in small projects (below £25 million) and in projects that take long (over 50 months)."

"There are several reasons why transaction costs in PPPs would be high, especially compared to traditional procurement of public investment projects. The main sources of higher transaction costs in PPPs are their long-term character, ownership and financing structures, and risk-sharing features. Due to all these reasons, the degree of contractual incompleteness is high in the case of PPPs, and attempts to reduce that contractual incompleteness give rise to correspondingly high transaction costs. Consequently, the search (tendering and bidding), contracting, and monitoring processes become more resource-consuming than in traditional short-term contracting aimed to supply assets, rather than services, to the public sector. Negotiating the contract is especially costly, not least due to the high cost of advisory services, and such costs are not limited to the pre-delivery phase, as renegotiation is almost inevitable in contracts that stretch over decades."

European Investment Bank
Transaction costs in public-private partnerships: A first look at the evidence

4.3 Long term equity investors

The UK Government is keen to see more long term investment by pension funds in infrastructure. It acknowledges the investors are not primarily interested in maximising returns. They typically invest on a long-term basis to earn long-term stable returns to match their maturing liabilities e.g. payments to pension holders. Typically, these types of investors have invested in projects during the operational phase of a project (following a sell down by the original bid sponsors) so as not to be exposed to bidding and construction risks.

"The Government is keen to see more investors with longer-term investment horizons, such as pension funds, investing in projects at an earlier stage. These longer-term investors have tended, historically, not to invest directly in projects. In part, this is because they have not developed the in-house skills and resources to manage these investments, but also because they have been averse to the time, risk and cost of bidding for projects.

HM Treasury (2012)
A new approach to public private partnerships

"The Government will, therefore, implement a mechanism to provide an investment opportunity for these investors. Where appropriate, it will require an equity funding competition after the preferred bidder stage for a proportion of the equity requirement. The timing of such a competition, when project documentation and commercial and financial arrangements are substantially complete, will keep the costs of participation in the competition down and so meet concerns expressed by long-term equity providers. It is also expected that widening access to different types of investor could be expected to increase competitive tension, with downward pressure on equity pricing in the longer-term."

HM Treasury (2012)
A new approach to public private partnerships

It does note that "The NAPF and PPF signed a memorandum of understanding to create the Pension Investment Platform (PIP) last year. It forms part of plans to encourage private sector finance for UK infrastructure. Seven of the largest UK pension funds have now signed up to the PIP (which is modelled on IFM Investors)."

5. The proposed inverted bid model

Industry SuperFunds believe that there is a better procurement process that both satisfies governments' need for a competitive process and value for money outcome, as well as investors' risk/return appetite, ultimately providing certainty and value for money for governments and investors.

This inverted bid model aligns the interests of government and long-term equity investors whose investment time horizon accords with the long life cycle of an infrastructure project. Such an alignment significantly increases the likelihood of the success of the project because equity investors are motivated to price project risk accurately on the basis that they will own the asset over the long term as "owner-operators". Unlike project sponsors under the current model, such investors make their returns through efficient operation and asset management not upfront fees and a subsequent sell down of their equity after construction.

5.1 Inverted bid model

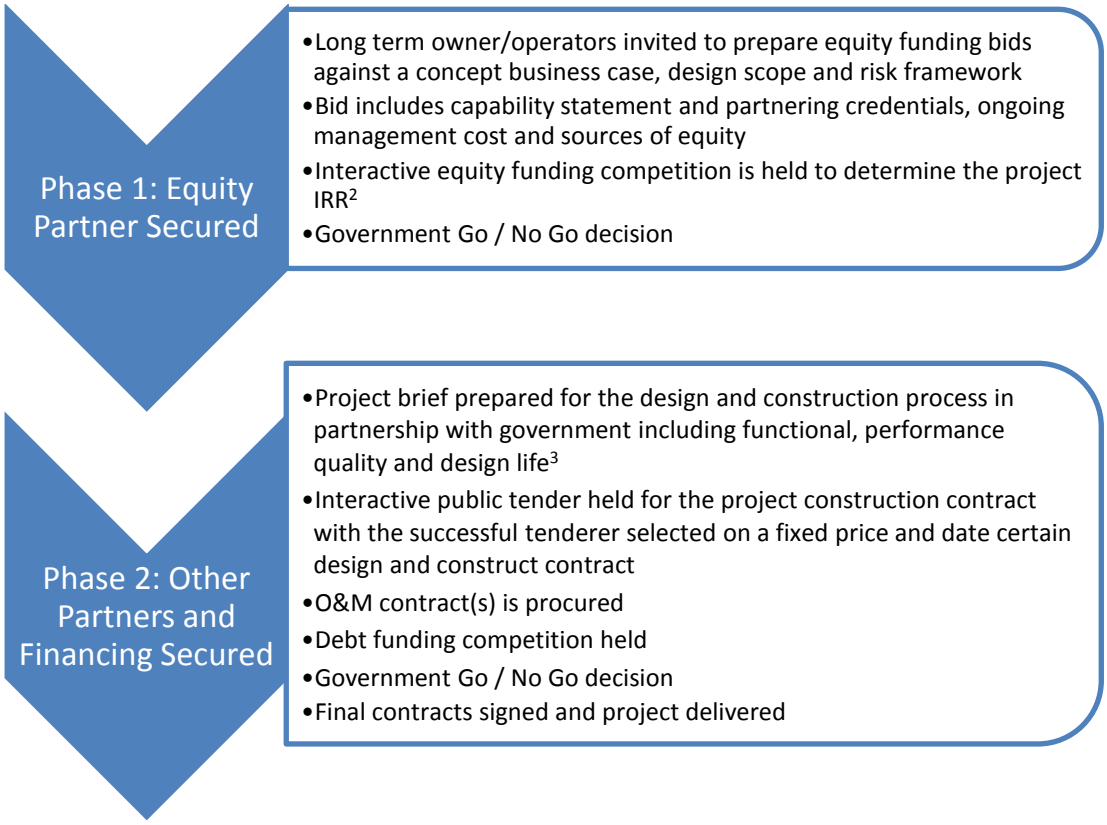
Under the proposed inverted bid model, the traditional bidding process is inverted by securing project financing through an equity funding competition prior to the construction and O&M tenders and raising of debt. [3] In other words, the government tenders initially for the long term owner-operator followed by a separate bid for construction, O&M and debt finance. This effectively inverts the bid process relative to current PPP procurements that typically only see long term equity after an initial sell down by project sponsors.

The most effective models could involve the long term owner-operator bidding on their margin over the other project capital, operating and financing costs.

An inverted bid process would more effectively align the interest of all parties, significantly reduce fee leakage and deliver a better value for money outcome.

[3] This process is focussed on greenfield projects rather than government privatisations of existing assets.

Chart 1: The inverted bid model[1]



1. For a more detailed description of the workings of the inverted bid model see Appendix A
2. This process is competitive for the majority of projects. For unsolicited bids where there is only one natural partner, the IRR is benchmarked against the market/other similar projects. This has occurred on a number of road partnership projects in Victoria and NSW.
3. The project requirements will also include any constraints on the design, such as land acquisition, environmental approvals and the like.

International experience with inverted bid models

There are two international examples that approximate the inverted bid process in that they separate the procurement of financing from the tendering for construction: The Education Funding Authority (EFA) "Aggregator" Model in the UK[4] and to a lesser extent the NPD model in Scotland.[5] Under the first, a separate structure called the Aggregator is established to secure debt finance. A manager is appointed for the Aggregator. Multiple bundles of projects are competitively tendered. Contractors have to provide equity funding that is matched by the EFA with the majority of debt funding coming from the aggregator. Projects are PFI based for a set term. The model has a somewhat different motivation to the inverted bid model: achieving scale by grouping the financing of a series of small projects but also similarities: centralising financing through an interactive tender process to achieve time and cost savings, and achieving greater competition amongst contractors since they are not tied to a single consortium and are able to tender for multiple contracts. The NPD model also separates financing from construction.

[4] Education Funding Agency (2013) Aggregator: Introduction and program overview

[5] Scottish Futures Trust (2011) NPD Model Explanatory Note

5.2 Equity funding competitions

The preferred owner-operator would be secured through an equity funding competition (EFC). The objective of the EFC is to efficiently test the appetite of long-term equity investors including but not limited to superannuation funds, establish the terms of equity finance and ensure that equity investors are selected in open competition with appropriate selection criteria.

Bid sponsors should be principals acting on behalf of their own equity or manage long term orientated investment funds. If developers, contractors and investment banks wish to bid, they must bring meaningful balance sheet equity to invest, for example 50% or more of the total equity required for the project, and be restricted in selling down that equity for a meaningful period of time after construction.

The EFC would be based on the bidding of an investment IRR. This could also include variants such as risk sharing above and below certain IRR thresholds particularly where there are risks that cannot be appropriately estimated during the bid process e.g. toll road PPPs with patronage risk.

Funding competitions in the UK

- Debt funding competitions have been extensively used throughout the UK for a decade[6]
- A UK Audit Office review found that funding competitions had successfully delivered value for money and recommended their further use on all PFI projects[7]
- The UK HM Treasury now requires all senior debt over £50 million to be subject to competition.[8]
- More recently, the UK HM Treasury PF2 initiative facilitates equity funding competitions for a portion of private sector equity to enable long term equity providers to invest in projects before financial close[9]

Internal rates of return

There is a body of international evidence dealing with windfall profits.

A UK Audit Office report into the role of equity in PFI projects found that since the cash flow of a PFI project generally only provides investors with returns towards the end of the contract operations period, primary equity investors seek to accelerate returns by debt re-financing and selling equity.[10]

The UK, Australia and Scotland have each experienced high profile PFI projects where equity investors have made significant profits on the secondary market and have initiated policies to stop PFI equity investor from selling their equity for set periods after project completion as well as the sharing of profits.

For example, the Scottish Futures Fund has a policy where all project returns above a threshold amount are returned to the Government.[11] DTF in Victoria has recommended that the Government should have the pre-emptive right to purchase debt if sold in the secondary markets.[12]

[6] UK Audit Office (2001) Innovation in PFI financing

[7] UK Audit Office (2001) Innovation in PFI financing

[8] UK HM Treasury (2006) Preferred bidder debt funding competition

[9] UK HM Treasury (2012) A new approach to public private partnerships; UK Audit Office (2012) Equity investment in privately financed projects

[10] UK Audit Office (2012) Equity Investment in privately financed projects

[11] Scottish Futures Fund (2012) NPD: Model explanatory note

[12] Victorian Department of Treasury and Finance (2012) Future directions for Victorian PPP

6. Benefits

6.1 Well aligned partnership

The critical benefit of the proposed "open book" inverted bid model is that it allows long term equity investors to compete along with other investors to deliver significant greenfield infrastructure projects and better value for money outcomes. This is made possible by the likely reduction in bid costs and shorter project time frames anticipated under this model. This will result in the alignment of interests between government, the long term owner-operator of these assets and the long lifecycle of infrastructure project. Decisions made will be in the long-term interest of the project and its users. It will also result in the significant reduction of fee leakage through the removal of short term interests and intermediaries.

6.2 Faster procurement and lower bid costs

The proposed inverted bid model is expected to reduce project procurement timeframes and lower bid costs due to the following:

- Removes the need to have a fully-detailed design and costing plan developed at the start of the project
- In traditional, fully financed bids, bid costs and advisory costs are duplicated across multiple bidding groups as well as for the government - these are avoided
- Increases the pool of contractors available to the preferred bid sponsor
- Enables construction contractors to tender based upon more precise project specifications, leading to reduced tender costs.

6.3 Lower financing costs

In an inverted bid model, the preferred bidder will have access to a greater number of banks than would a bidder in a competitive bid. In a competitive bid, large banks typically run multiple teams to cater to multiple bidders, however, smaller banks unable to run multiple teams are only available to a single bidder. In an inverted bid model, the entire pool of banks, large and small, will be available to the preferred bidder. Based on market soundings, we believe that the greater availability of bank capacity is likely to improve liquidity and lead to more competitively priced fees and margins than may otherwise be the case. Banks are also likely to be more responsive when there is bidder certainty.

6.4 Incentive to invest in assets

As long-term owners and operators of infrastructure assets, the owners are motivated to invest heavily in those assets over their lifetime to enhance facilities and services. For example, approximately $4.9 billion has been invested by IFM Investors in their Australian airports – more than double the $2.4 billion in distributions paid to shareholders of those same airports. IFM Investors has also committed to further enhancements of its assets, estimated to require a further $6.8 billion over the next ten years for their five largest assets. This includes a significant commitment to the development of a new parallel runway at Brisbane airport – the first major runway in the world to be built by the private sector.[13]

6.5 Transparency

With an agreed rate of return on equity and an open book approach, projects under the IB Model will withstand the highest levels of scrutiny.

[13] IFM Investors (2013) Submission: Productivity Commission inquiry into public infrastructure

The separation of the construction tender from financing means the most capable and best value contractors and lenders can be selected without compromise as each will not be tied to a particular consortium. Similar to debt, the ability to obtain a more competitive bonding arrangement over construction becomes more likely under our proposed model. Similarly, the separation of the O&M selection from funding means that the most capable and best value operator and maintainer can be selected without compromise.

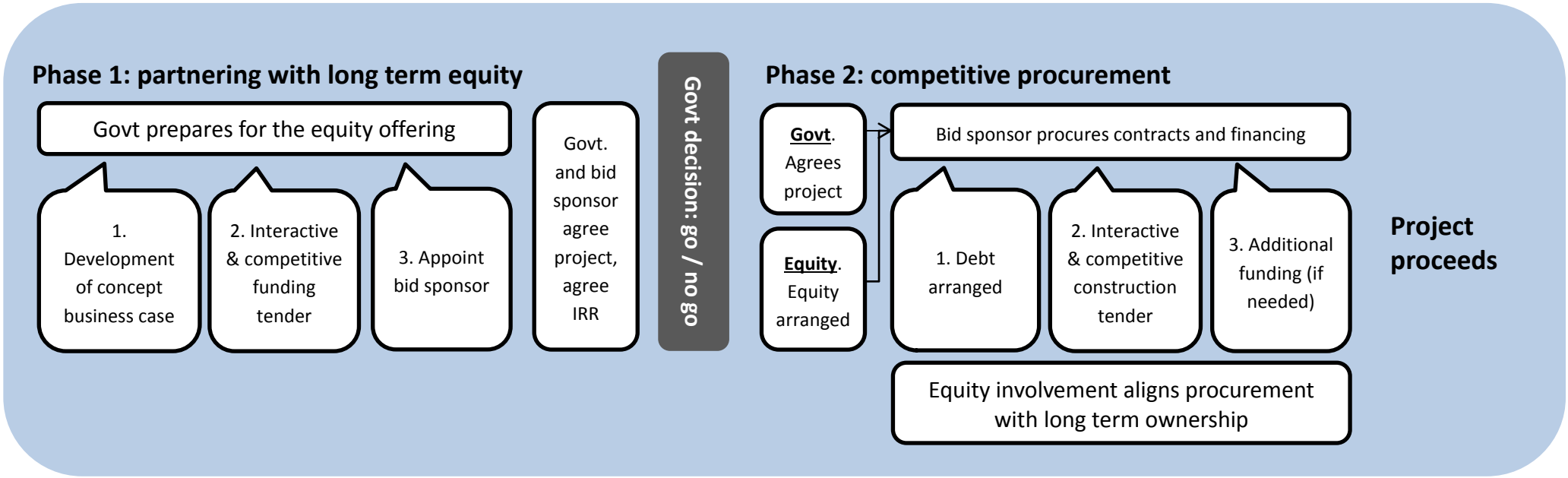
6.6 Better value for money

The inverted bid model is designed to deliver value for money for government, tax payers and long term equity. In the absence of short term interests and intermediaries it will address the leakage of tens of millions of dollars in fees during the early stages of a project. It will maximise transparency and competition. Every aspect of the project will be open to competitive and interactive tendering. Financing will be secured through an "open book" funding competition, first for equity and then for debt.

Sell down and change in ownership would be permitted only after a material period following construction completion and only with the consent of the government. All purchasers would need to meet the same criteria as the original bid sponsors.

The above will ensure that infrastructure is built, owned and operated by genuine long-term investors seeking to make a reasonable return over the economic life of the asset, not through the initial bidding, structuring and build of the asset.

Appendix A: Inverted bid model



Advantages

1. Increases availability of bank capacity and, hence, liquidity
2. Increases the pool of contractors leading to more competitive pricing
3. Avoids duplication of bid costs across multiple bidders
4. Eliminates intermediaries, conflicts and misalignment of interests
5. Operates under a transparent, 'open-book' arrangement
6. Promotes ownership by genuine, long-term investors