Norton Rose Fulbright Australia
ABN 32 720 868 049
Level 15, RACV Tower
485 Bourke Street
MELBOURNE VIC 3000
AUSTRALIA

Tel +61 3 8686 6000
Fax +61 3 8686 6505
GPO Box 4592, Melbourne VIC 3001
DX 445 Melbourne
nortonrosefulbright.com

Productivity Commission Public Infrastructure

Norton Rose Fulbright Australia

Reponses to Draft Report

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Contacts:
Jo Crew
James Morgan-Payler

1 Background

1.1 We refer to the Productivity Commission's (**Commission**) inquiry into various aspects of Australian Public Infrastructure (**Inquiry**) and the Information Requests and other commentary released in the Commission's Draft Report of March 2014 (**Draft Report**).

1.2 We acknowledge the Commission's Terms of Reference and the Inquiry's overarching aim to encourage private financing and funding for major infrastructure projects in Australia. We acknowledge the broad ranging nature of the Inquiry and wish to assist the Commission by focusing our submission on a number of discrete aspects relating to the Draft Report, namely:

(1) Information Request 5.1 (bond financing);

(2) Information Request 6.3 (inverted bid model); and

(3) the recommendations and commentary relating to tender processes and associated bid costs in section 11.2 of the Draft Report.

1.3 Norton Rose Fulbright has a significant history of involvement with Australian infrastructure projects. We act for for governments, financiers, sponsors and contractors and understand the financing and delivery of projects from all parties' perspectives. We provide legal advice across all areas of social and economic infrastructure including transport (ports, airports, road and rail), water, defence, prisons, schools, hospitals and social housing.

2 Bond financing

2.1 This section of our submission relates to Information Request 5.1 in the Draft Report, being:

(1) "The Commission seeks feedback on the availability of bond finance for public infrastructure projects in Australia:

(a) To what extent are there impediments to the development of the Australian bond market to support investment in infrastructure?

(b) To what extent are there barriers to Australian infrastructure firms accessing international bond markets?"

Overview

2.2 Bond financing offers many potential advantages for the funding of infrastructure projects in Australia, by connecting borrowers seeking to diversify their funding structures and access longer tenor debt with institutional investors seeking to invest in assets with yields higher than Government bonds that deliver stable, long dated cash flows which can match their liabilities.

2.3 As the Commission has noted, there are a number of infrastructure projects in Australia which have been or are currently funded by capital market issues. These include airports, roads, utilities, social infrastructure (such as hospitals and convention centres) and projects in the resources sector. Prior to the global financial crisis, bond financings for greenfield projects (including PPPs) were primarily credit wrapped. Since the global financial crisis and the exit of monoline insurers from the market, bond financings have tended to be restricted to refinancings of highly rated mature assets.

2.4 This submission considers some of the challenges facing borrowers or investors wishing to utilise the capital markets to fund infrastructure projects in Australia. Many of these challenges are simply practical challenges arising from the nature of a bond issue, which

can be overcome with additional time or money. However, given the competitive nature of the current market, a financing solution which requires additional resources may not be appealing to many borrowers. There are also some structural features of a bond financing which present challenges, especially when considered in the context of a greenfield project and the competitive nature of many Government procurement processes (particularly PPPs).

Advantages of bond financing

2.5 Bond financing offers a number of potential advantages (when compared to bank financing) in relation to the funding of Australian infrastructure projects:

(1) generally, bond issuances are available at longer tenors than bank debt, thereby increasing funding certainty, reducing refinancing risk and reducing the costs associated with multiple refinancings required over a project's term;

(2) bond issuances can provide fixed rate funding, minimising the need for interest rate hedging products;

(3) generally speaking (although depending on the type of bond issue), bond issuances have a more flexible covenant package when compared to bank debt;

(4) diversifying funding sources may have advantages in terms of the project's overall cost of capital, and also reduces refinancing risk and the project's exposure to movements or constraints in the bank debt market;

(5) the capital markets (and in particular the international capital markets) provide a deep and diverse source of funding, which could assist with the financing of large scale infrastructure projects which have debt requirements in excess of bank debt liquidity constraints; and

(6) for infrastructure projects which earn revenues in foreign currencies, capital markets issues in the international markets enable borrowers to mitigate currency risk.

Impediments to bond financing

2.6 Despite the potential advantages, there are also a number of impediments to utilising bond financing for infrastructure projects in Australia:

(1) **market risk**: bond issuances are exposed to volatility in the capital markets, and until the date of issuance there will be uncertainty as to volume, pricing and tenor. The timetable for a bond issuance can also be unpredictable. This is contrasted with bank debt, where it is customary for banks to sign a commitment letter and the pricing and volume will be certain (at least for a defined period of time). Market risk associated with bond issues can be partially mitigated by an underwriting, although an underwritten bond issue is not always available (and of course adds to the cost of the process);

(2) **credit rating**: investors will require the bonds to be rated, and the price and source of funds will depend on whether that rating is investment grade (and what level of investment grade it is). Institutional investors will typically require a rating of at least A-, and that may not be possible without credit enhancement of some sort. In addition, obtaining a rating can be an expensive and time-consuming process, and we are aware of examples of rating agencies requiring certain provisions in documentation which are not commercially achievable in the current market;

(3) **construction risk**: bondholders will generally not accept construction risk, making unwrapped bond issues for a greenfield infrastructure project very uncommon;

(4) **cost of carry on bond proceeds**: unlike bank debt for a greenfield project (which can be drawn on a periodic basis as and when required over the construction period), the bond proceeds are drawn in full in a single issue and invested until they are required. This can result in negative carry as the interest received by the borrower over the construction period is less than that paid to bondholders in the same period;

(5) **prepayment**: bondholders are typically focussed on long term yield and, as such, prepayment is often viewed negatively by bondholders and either restricted or subject to high prepayment fees or make-whole premiums (when compared to bank debt);

(6) **communications and decisions**: depending on the type of bond issue (and whether the bonds are traded through a clearing system) there may be a large number of bondholders (and in many cases they may be accustomed to being passive investors). This can result in greater difficulty (and additional time and cost) in obtaining bondholder decisions (including consents and waivers). In the absence of a single controlling creditor, the level of decision making and oversight required of financiers in the construction phase of a project is generally regarded as incompatible with the cumbersome voting process of bondholders; and

(7) **additional time and cost**: there are some aspects of a bond issue which can add additional time and cost to the financing process. For example, complying with strict disclosure standards in some jurisdictions (e.g. US securities laws), marketing costs (including roadshows and investor presentations), obtaining a rating and complying with ratings agency requirements, and negotiating and documenting potentially more complex intercreditor arrangements (particularly for large infrastructure projects where there are multiple sources of funding).

2.7 As the Commission has noted, an additional challenge for Australian borrowers seeking to access international bond markets is the ability to access long-dated cross currency swaps to hedge their currency exposure.

Particular challenges of bond financings for greenfield projects, including PPPs

2.8 The drawbacks of a bond financing (as highlighted above) are particularly acute in a greenfield project (including PPPs) (and have been exacerbated in the period since the global financial crisis by the exit of monoline insurers who previously provided credit wraps). In particular:

(1) an unwrapped bond issue for a greenfield project would require investors to take construction risk, which is generally not done except in special circumstances;

(2) a greenfield project has no operating history and as such, the bonds are unlikely to receive a sufficient investment grade rating to enable a bond solution to be utilised (without credit enhancement);

(3) government procured projects often have bid requirements which are incompatible with a bond financing solution, including:

(a) a requirement for highly committed financing proposals (with pricing held for a fixed period of time), which are assessed by the Government as part of assessing the overall bid; and

(b) documents that assume bank debt solutions will be used (for example, requirements that financiers have a certain rating or that the identity of financiers be disclosed to the Government). Given that bidders are required to mark up documents and the departures are assessed as part of the overall bid, this may make departures which are required to

accommodate a bond financing seem undesirable when compared to bids that are financed with bank debt;

(4) the increasing trend for government contributions to be provided post-completion (including as a debt pay down) will be viewed negatively by bondholders;

(5) as bond pricing is subject to market risk, there will be an issue as to which party will take the risk of price fluctuations between the final bid date and financial close; and

(6) PPP's involve complex, lengthy and expensive bidding processes with extensive due diligence requirements. Bond investors may not have the specialist skills or resources necessary to participate in such processes and in any event may prefer opportunities to deploy capital more immediately.

2.9 In addition, for those borrowers seeking to access the capital markets for a refinancing, the State consent process in PPPs (particularly in relation to documentation and timetable requirements) can present similar challenges. Although not insurmountable, these challenges require infrastructure borrowers to invest additional time and money into the refinancing process.

3 Inverted bid model

3.1 This section of our submission relates to Information Request 6.3 in the Draft Report, being:

(1) "The Commission seeks feedback on the advantages and disadvantages of alternative procurement processes focussed on long term equity, such as an inverted bid model. In particular, the Commission is interested in how an alternative procurement process should be designed to maximise efficiency gains and the likely benefits and costs of such an approach."

3.2 Our understanding of the 'inverted bid model' (based on the description in the Draft Report and the submissions of others) is that:

(1) the government tenders initially for the long term owner-operator and the government and the bid sponsor agree an equity rate of return; and

(2) this is followed by a separate bid for construction, O&M and debt finance.

3.3 We note that the Draft Report refers to the government "guaranteeing" an initial rate of return to the long-term equity provider, although it is unclear to us from the Draft Report and the submissions of others how this guarantee might be structured.

3.4 We agree with the Commission that there are a number of factors to consider in assessing this proposal, and we agree that the Commission's preliminary assessment in the Draft Report raises a number of important issues in relation to the proposal. In addition, we believe issues that would need to be further considered by governments, equity investors, contractors and financiers would include the following:

(1) how will equity investors be able to bid a rate of return in the equity funding competition in the absence of due diligence in this phase?

(2) does the proposal over-emphasise the importance of the cost of equity at the expense of other important aspects of the bid, namely design and risk allocation?

(3) how does this proposal enable equity investors to overcome the other challenges of investing in greenfield projects (namely, taking construction risk)?

(4) from the government's perspective, any such model would need to be carefully structured to ensure that wholesale project and financing risk is not passed to the government (as well as the risk of changes in economic conditions), given equity's traditional place in project cash flow waterfalls. Only discrete risks resulting in decreasing equity returns should be identified as appropriate for such risk transfer and we suggest it may be difficult to isolate such risks and quantify notional or actual impacts on returns;

(5) what is the appropriate level of importance that should be placed on the equity investor's ability to execute and deliver the project at the agreed rate of return, and to what extent should this be considered at the equity funding competition stage?

(6) if the successful equity investor is required to run multiple tenders for construction, O&M and finance, will this not increase their bid costs?

4 Tender process

4.1 We refer to the Commission's Terms of Reference regarding processes that reduce the costs of public infrastructure projects and measures that would help ensure the effective delivery of infrastructure.[1] We acknowledge the discussion in the Draft Report addressing these Terms of Reference, particularly with respect to design processes and the timing of design work in the tender process, as well as government ownership of design.[2] We comment below on some additional factors which we believe may have a beneficial impact on tender costs.

Delays in tender

4.2 The overall efficiency of a project can be improved by reducing delays in the tender process. Such delays compromise an overall project as they represent unnecessary transaction costs. In Australia, the average time from the Expression of Interest (**EOI**) phase to financial close for social infrastructure PPP projects is in the order of 14 to 19 months, with health projects at the higher end, and 18 months for transport infrastructure projects.[3]

4.3 Additionally, protracted bidding phases, such as 'best and final offer', may encourage bidders to strategically avoid placing their best bid at earlier stages in the tender process. The prevalence of delays during tender may also contribute to a hesitancy by private parties to engage in a tender process, given the prospect of incalculable tender costs.

Excessive documentation

4.4 It is our experience that it may be possible to reduce the costs of the tender process by easing the requirements for comprehensive, but sometimes unnecessary, documentation to be provided during the early stages of a tender. It is not uncommon for bidders to be required to provide documents such as fully detailed communication plans, site management plans and OH&S plans, as well as other environmental, technical and operational documentation and ancillary commercial information that is not relevant to price or risk allocation.

4.5 We note similar concerns in relation to the comprehensive legal documentation that is often required of bidders. We query whether it is necessary for bidders to provide, for example, fully developed and negotiated letters of commitment from subcontractors and certain types of downstream subcontracts, when the pricing and risk allocation issues arising from

[1] Report, p 4.
[2] Report, Chapter 11.2 and 11.4.
[3] KPMG, "PPP Procurement: Barriers to Competition and Efficiency in the Procurement of Public Private Partnerships" (2010), pp 27, 28.

these could be sufficiently addressed through so-called “Terms Sheets.” This is also the case with certain licensing arrangements and user agreements. Additionally there are a number of schedules to the concession or project agreements on many infrastructure projects (for example, state security agreements) that are rarely commercially contentious and, we would suggest, could be deferred for comment until the preferred stage. We also note the duplication and costs associated with the requirement that departures from proposed legal documentation be presented in the form of “Departure Tables,” where marked-up versions would, we would suggest, suffice.

Duplication of process

4.6 The efficiency of the tender process could be enhanced by reducing the duplication of due diligence required by each of the bidders and their engagement with authorities and third party bodies. For example, where bidders are responsible for the provision of utilities to the site, each bidder may be required to engage with relevant utilities during the bidding process in order to determine the scope and price of this obligation. As these requirements will generally be expected to be consistent across bids, efficiency (and therefore time and cost savings) could be enhanced by removing such duplication.

We would be pleased to further assist the Commission in respect of any of these submissions or any other query that it may have in relation to the Inquiry.

