SUBMISSION TO PRODUCTIVITY COMMISSION

INFRASTRUCTURE INQUIRY

APRIL 2014

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IMPORTANT INFORMATION

1 SUMMARY

This submission responds to the Productivity Commission's draft report Information Request 5.1 relating to the availability of bond financing for public infrastructure projects.

Infrastructure assets are usually best served by long-dated debt which reduces refinancing risk and matches their long-term nature. Many offshore infrastructure assets maintain average debt maturities of twenty years or more. However, this tenor of debt is not readily available for Australian infrastructure assets from our local capital markets. Australian infrastructure financing currently relies heavily on bank loans which are not available in tenors longer than seven years.

Australia's bond market is small relative to other markets, and is dominated by government bonds with little trading in corporate bonds. Australian superannuation funds allocate less to bonds and more to cash than similar funds in other countries. The Australian bond market is also limited by the absence of a well-developed pension / annuity market for retirees' savings. The rise of self-managed superannuation funds has exacerbated the low exposure to bonds, because currently SMSF's have negligible exposure to the bond market.

Offshore financing can provide some longer-tenor debt for Australian infrastructure companies, but long-term offshore debt is limited by the term of available currency hedges. Offshore financing also involves additional costs to Australian borrowers over domestic funding options in the form of both currency hedges and basis cost.

The result is that Australian infrastructure issuers are forced to use shorter-term debt financing than would be ideal. This leads to increased refinancing risk and reduces the value of infrastructure assets, with consequent reduction in the benefits to government of infrastructure privatisation and private investment in infrastructure.

Previous government reviews have supported establishing incentives for retirees to invest part of their superannuation payout in annuities. We believe that a stronger annuity market would also benefit the corporate bond market (and incidentally infrastructure financing) by boosting demand for low-risk long-duration assets. We also recommend that the government continue its program issuance of 20 year government bonds (and beyond) to support the development of a longer dated corporate bond market, and continue initiatives to support retail and SMSF access to bond investments.

2 BACKGROUND

2.1 Who is QIC

The Queensland Government created QIC in 1991 to serve its long-term investment responsibilities. QIC manages $11.2 billion of infrastructure assets across 24 global investments, including five Australian infrastructure assets. We focus on infrastructure projects in OECD countries exhibiting predictable cash-flows, sustainable competitive advantages and operating in well-defined regulatory environments. We have a sector centric approach and specialisation across transport, utilities and public private partnerships being especially strong areas of interest.

2.2 Submission focus

This submission focuses on Information Request 5.1 in the Productivity Commission's draft report:

> *The Commission seeks feedback on the availability of bond finance for public infrastructure projects in Australia.*

- *To what extent are there impediments to the development of the Australian bond market to support investment in infrastructure?*
- *To what extent are there barriers to Australian infrastructure firms accessing international bond markets?*

To address these questions, this submission compares the Australian corporate bond market with those found in other developed markets, and considers the implications of the differences for Australian infrastructure financing. This submission also discusses some of the difficulties found in practice when using off-shore financing to source the long-term debt that is not available in the Australian market.

3 INFRASTRUCTURE FINANCING

3.1 Introduction

Companies looking to utilise debt finance have two broad options to choose from: bank loans (in which a bank acts as a credit intermediary) or bond issuance (in which investors effectively lend directly to the company).

Bank lending and bonds have different strengths and weaknesses but can also compete with one another. The competition has the potential to create a more robust financial system than if either were a sole option for financing. In Australia, bank lending is particularly predominant for infrastructure financing. However, bank lending is generally limited to seven years or less in term and this is not ideal for long duration infrastructure with asset lives much longer than seven years.

3.2 Infrastructure companies prefer long-dated debt

While infrastructure financing is broadly similar to general corporate financing, infrastructure assets have some distinct features that influence their financing strategies.

Infrastructure assets tend to be:

- Long-lived (such as concession-based assets with 30-50+ year contracts, utilities with 50-100 years asset lives, essential service assets)
- Capital intensive
- Lower risk and return than the market as a whole (i.e. ungeared asset betas of less than one)
- Managed by a single-purpose business plan with very limited changes over time through acquisitions, divestments and strategic events.

As a result, the optimal financing tenor for infrastructure assets tends to be much longer than general corporate financing requirements. Shorter maturing debt equates to taking greater refinancing risk (i.e. risk arising from the unknown future cost of debt) and more exposure to future debt market appetite and economic conditions through time. This increased refinancing risk will ultimately be reflected in a higher cost of equity, and lower value for the project.

The appetite of infrastructure issuers for longer term local currency debt is evidenced by UK and Canadian infrastructure issuers. In these markets, where long-term debt is available, infrastructure issuers have taken advantage of this by building long maturity profiles.

For example, in Canada, the group that has the concession rights to Toronto's Highway 407, has a C$5.4bn debt portfolio, made up almost entirely of Canadian bonds with maturities up to 2053 and an average total

portfolio maturity profile of around 19 years. This long debt profile significantly reduces the concession's refinancing risk across the remaining 84 years of the concession agreement.

Canada also demonstrates that an active project bond market supports long-term financing of PPP projects. Recent Canadian PPPs have a weighted average maturity of 28 years (Table 4 in the appendix).

Likewise, UK water and electricity networks have shown strong demand for long term debt through corporate bonds. Thames Water, for example, has an average debt maturity of 27 years.

Table 1: Selected UK water utilities weighted average debt maturities

	Total debt (£ m)	Weighted average maturity (years)
Thames Water	4,808	27
Severn Trent	4,631	16
Kelda	4,411	18

Source: Annual Reports, Bloomberg

Where long-term local currency debt is available, infrastructure companies will use it. But Australian infrastructure companies do not have the same opportunity to use long-term debt as their overseas peers – correspondingly, we have seen Australian issuers seek this tenor from offshore markets.

4 CHARACTERISTICS OF THE AUSTRALIAN BOND MARKET

4.1 Corporate bonds a minor part of Australian market

For Australian companies looking to access the local bond market, the options are more limited than those available to their overseas counterparts.

Looking at the Australian bond market generally, corporate bonds account for only a small part of the domestic bond market. The market-standard UBS composite bond index (against which many fund manager's bond mandates are benchmarked) is dominated by government bonds, with non-government bonds being only 15% of the index. Going deeper, financial issuers (banks and covered bonds) dominate the non-government bonds in the index, with infrastructure issuers accounting for less than 10 per cent of the non-government (i.e. corporate) bond market.

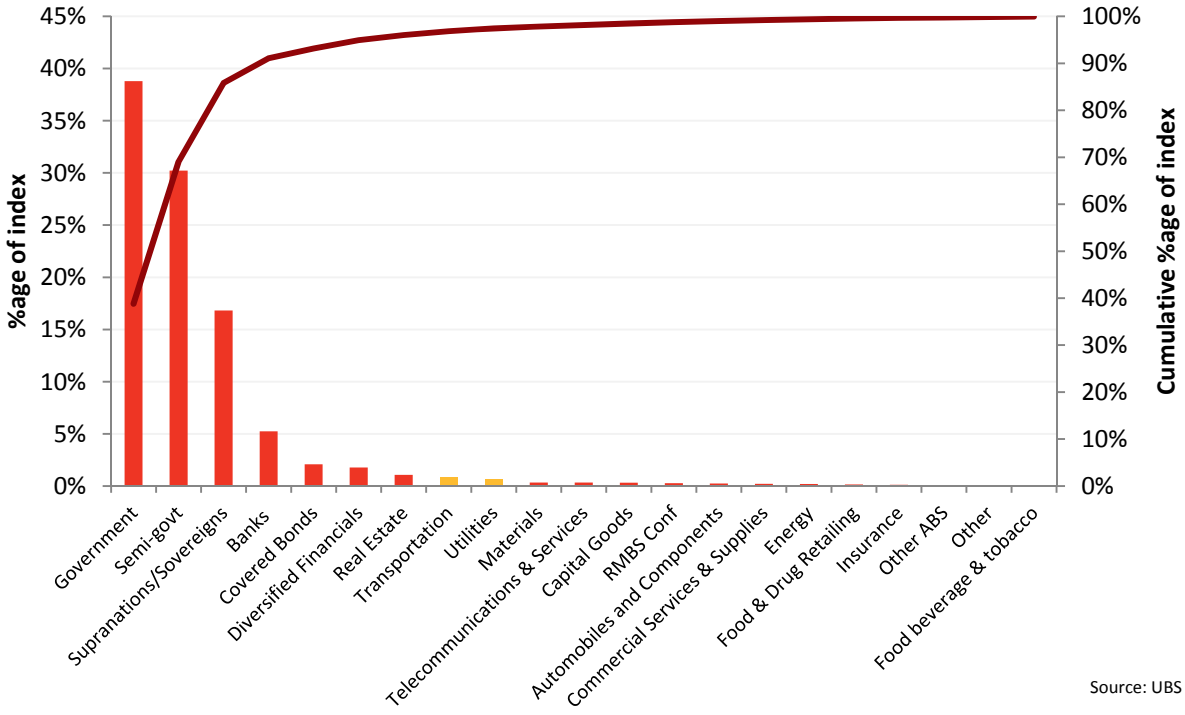


Figure 1: Composition of UBS composite bond index as of December 2013

As a result, Australian bond fund managers tend to focus primarily on strategies to trade government bonds and there is comparatively little focus on the credit skills necessary to trade corporate bonds. This particularly affects infrastructure issuers, which tend to have more complex structures that reward deeper credit understanding.

Liquidity is also a problem for Australian corporate bonds – with only a small share of the index, there is little trading in them which means that even for fund managers with strong credit skills, monetising that advantage by buying under-valued credits and selling over-valued can be difficult.

The infrastructure part of the UBS bond index had a face value of around $8bn as of December 2013, split equally between transport and utilities companies. Tellingly, only a small portion of these companies' debt is financed through domestic bonds. Infrastructure companies in Australia tend to be more exposed to bank debt as well as bonds issued overseas (chiefly in the US private placement market) as shown below (Table 2).

Table 2: Select Australian infrastructure companies' financing structure

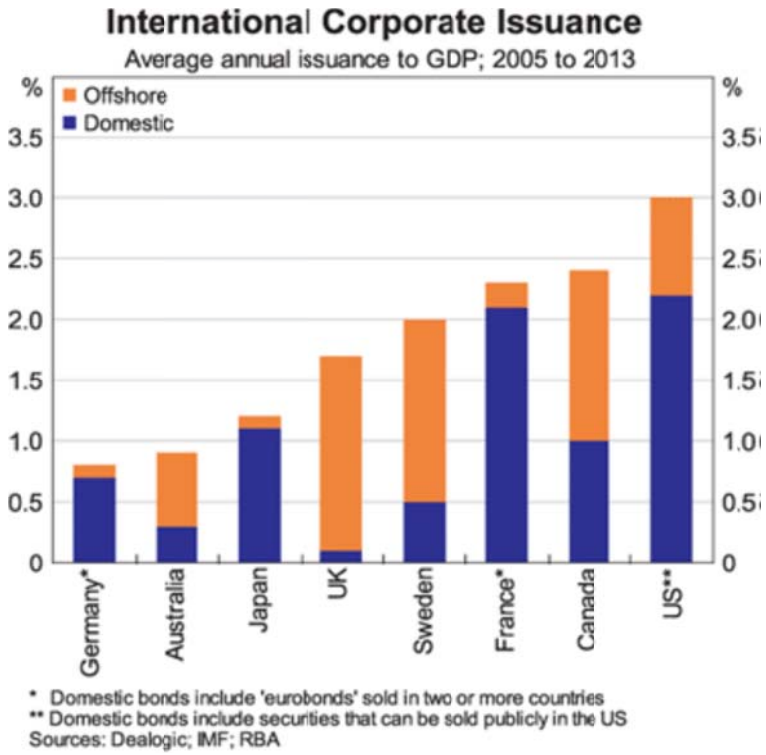
	Total debt (A$m)	Of which A$ bonds (A$m)	% of Total debt	Average total debt maturity	Average A$ bonds maturity
Transurban	8,523	1,050	13%	10	3
Sydney Airport	6,200	3,848[1]	62%	8	7
SP Ausnet	5,300	1,285	24%	5	8
APA Group	4,404	300	7%	6[2]	8

Source: Company presentations and annual reports

[1] This includes $2,578m of credit-insured bonds issued prior to the GFC. These would not be currently issuable under Sydney Airport's own rating.
[2] Excludes the $515m long-maturity ASX-listed subordinated floating rate instrument. Including this instrument, APA Group's average maturity is 13 years.

4.2 Australian corporate bond market limited

Australia's total corporate bond issuance is less than 1 per cent of GDP, of which only half is domestic bonds. This is low by comparison to other countries -- US corporate bond issuance amounts to 3% of GDP and more than two thirds of corporate bonds are issued domestically (Figure 2). In Canada, the long-term corporate bond market is also well developed with corporate bond issuance reaching nearly 2.5 per cent of GDP and a strong market for infrastructure project bonds (Table 4 in the appendix shows some of the recent project bond issuance in Canada).



Source: RBA

Figure 2: Australia's corporate bond issuance compared to other developed markets

Taking the United States as an example, US entities have ready access to a range of capital markets alternatives for debt funding including:

- Public offer bonds
- US private placement bonds
- Public "144A" bonds
- Municipal bonds

The private placement market in particular has proven a popular and reliable debt market for issuers (including infrastructure issuers) that may not want the full obligations of a public-offer bond. The US private placement market also offers a wide range of debt maturities, including those stretching to 30 years. The US private placement market is discussed further in section 6.1.

The United States also has a municipal bond market, offering bonds issued by local governments and government agencies paying coupons that are exempt from state and federal income taxes; the municipal

bond market also includes project bonds (whose cashflows come from revenues specifically dedicated from particular projects). The municipal bond market is often used by US local governments to raise funds for infrastructure projects; no equivalent market exists in Australia.

The US's capital markets provide US companies with a broad spectrum of financing options, a competitive alternative to bank lending and an opportunity to access long-term financing. Australian companies, and the broader Australian financial system, would benefit significantly from any move towards this level of capital market capability.

4.3 Tenor of Australian corporate bonds

Most Australian corporate bonds are issued with three, five, or sometimes seven year maturities. Occasional issuers at the upper end of the credit spectrum have been able to obtain nine year funding but these have been the exception rather than the rule.

Issuers who want to issue offshore may have a variety of reasons: diversification of funding sources, match currency exposure of revenues or to access longer-term debt that is not available domestically. Around 40% of non-government debt securities are issued offshore (A$539bn). For non-financial corporations, this proportion is even higher, with 76% of their debt securities being issued offshore (A$179bn)

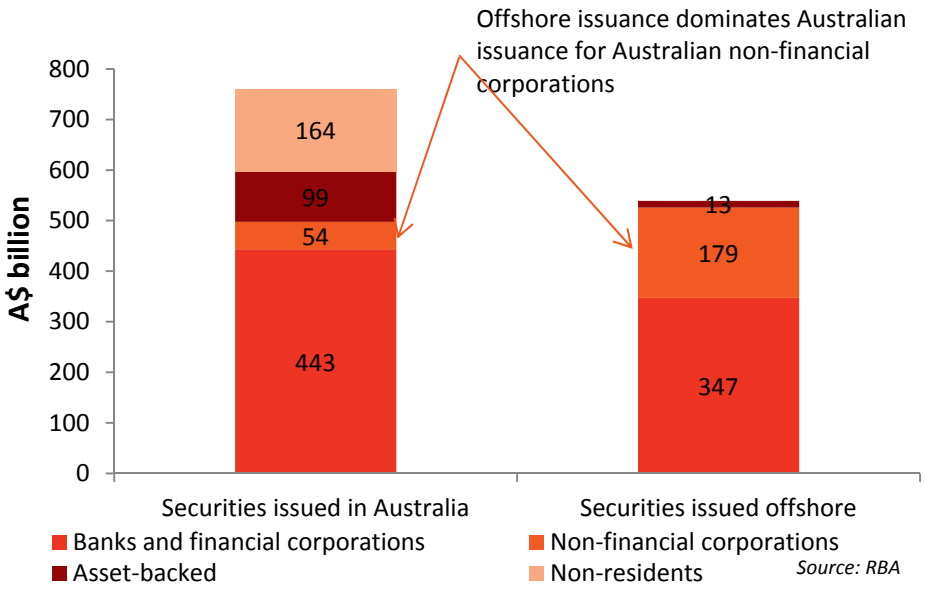


Figure3: Non-Government Debt Securities Outstanding

4.4 ASX listed bonds

A small number of corporate bonds in Australia are listed on the Australian Stock Exchange (ASX), providing an opportunity for retail investors to access the corporate bond market, but this list is largely dominated by debt issues coming from the financial sector (see Table 5). Within the infrastructure/utilities sector, only AGL Energy, APA Group, and Origin Energy are represented on the list of corporate bonds trading on the ASX. In addition, most of the bonds trading on the ASX tend to have short terms (median of 10 years), with a few exception such as the APA Group, Crown Resorts, and Origin Energy bonds which have a term of 60 years.

These longer-dated retail instruments represent an Australian innovation – long-dated (or perpetual), subordinated, listed, floating-rate instruments. These were originally developed for the banking sector, to

take advantage of retail investor's appetite for generous premiums to bank bill rates from 'name-brand' issuers and capital stability. These instruments also benefited from favourable equity treatment within bank's capital adequacy calculations.

Whilst listed perpetual subordinated instruments remain useful for issuers with strong retail brands but do not constitute a major source of financing for infrastructure issuers (many of which lack a retail name brand and for which the 4%+ premium to bank bills represents too high a cost compared to equity). Ultimately, these instruments are too expensive to provide core debt and have limited scope within the capital structure of infrastructure assets.

However we do believe that the framework of ASX listing of bonds is an important one that can help the domestic bond market evolve over time to include retail investors. Retail access to bond products is important to allow self-managed superannuation funds to access a full range of investments.

4.5 Outcome for Australian infrastructure companies

As a result of the limitations of the Australian corporate bond and bank lending, Australian infrastructure companies tend to have much shorter average debt maturities than their overseas peers. Unlike their US, UK, and Canadian counterparts, Australian infrastructure companies are unable to secure long-term domestic debt to match their asset lives and reduce refinancing risk.

Sydney Airport for example has a weighted average debt maturity of 8 years, even though the Sydney Airport concession doesn't end for 87 years, while the Canadian Highway 407 (with 84 years remaining on its concession) has a 19 year average debt maturity.

This kind of greater mismatch between asset lives and debt maturity is a common theme in Australia -- the Australian bond and bank loan markets do not provide long-duration financing in the context of 30yr+ asset lives. The absence of long-term financing burdens infrastructure assets with significant refinancing risk. In turn, pricing this risk reduces the value of projects and thus reduces the efficiency benefits available to government from privatisation or private sector financing of infrastructure.

So what contributes to the Australian bond market's more limited offering of financing options?

5 FACTORS LIMITING THE AUSTRALIAN CORPORATE BOND MARKET

5.1 Superannuation asset allocation disfavours bond investment

The superannuation system dominates Australia's pool of savings but has a lower allocation to fixed interest than the comparable pension systems of other markets. This institutional allocation away from fixed interest is likely due to a range of factors including:

- The predominantly defined contribution (vs. defined benefit) nature of the Australian superannuation system
- Super fund choice / portability
- The Australian superannuation system assigning investment risk and choice to the individual beneficiary, creating an institutional preference for liquidity and a low allocation to bonds.

With US$1.6 trillion in assets, Australia's superannuation system is the fourth largest pension system in the world[3]. However, Australia's pension system is not like other large systems. Australian superannuation is a defined contribution scheme and, because it holds 81% of total pension assets, this means that Australia's savings for retirement are dominated by defined contribution schemes. On the contrary, Canada only has 4% of its pension assets coming from defined contribution pension plans, the rest coming from defined benefit pension plans.

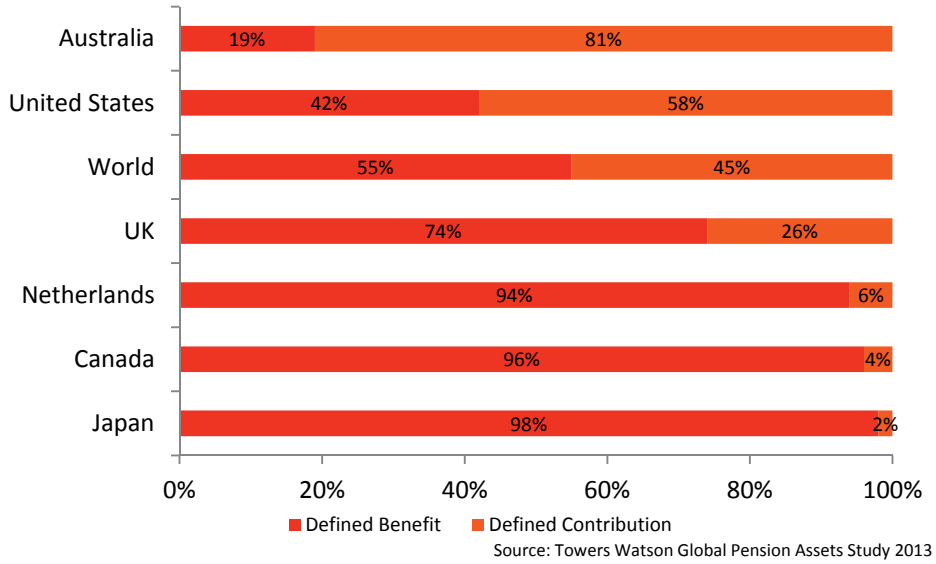


Figure 4: Split of defined benefit vs defined contribution plans by country

The implications for asset allocation of this split between defined benefit and defined contribution plans are significant. Defined benefit plans place the risk of meeting the obligation to pay a specified pension on the plan sponsor and its fiduciaries. Defined benefit plans are therefore much more likely to drive asset allocation to match anticipated future pension plan liabilities with assets. This asset-liability matching favours bonds (particularly longer-term bonds) whose duration and low cashflow risk provide good matches with the liability profile of pensions and other long-dated assets.

Defined contribution plans, by contrast, push the risk of investment performance down to the individual saver; typically individual savers have the right (albeit often unexercised) to manage their portfolio in some way. In Australian superannuation, this right is in the form of choice of fund and choice of investment. In other words, superannuation funds in Australia are characterized by their portability (both by asset allocation and provider); any superannuation fund beneficiary can transfer his or her funds to another investment strategy or another superannuation fund. This right incentivises superannuation funds to invest in more liquid assets than in countries where pension savings are not portable. As Figure 5 below shows, Australian funds hold significantly more cash than funds in other countries, and significantly less in bonds – resulting in the largest pool of savings in Australia having only a limited allocation to bonds.

[3] Global Pension Assets Study, Towers Watson (January 2013)

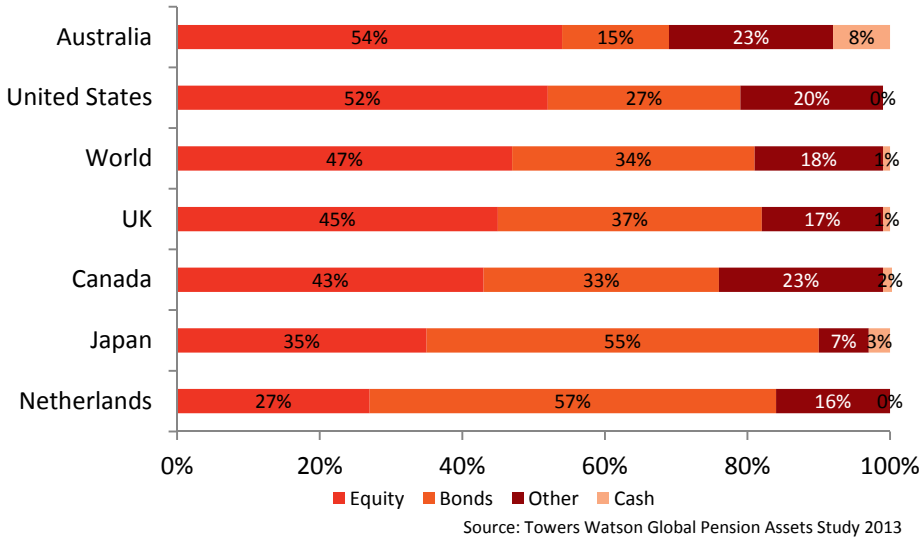


Figure 5: Pension fund asset allocation

5.2 Self-managed superannuation funds tend not to allocate to bonds

Self-managed super funds (SMSFs) play an important part in the pension fund landscape in Australia. According to APRA, SMSFs have grown at 15 per cent in 2013 to reach $543bn in December 2013, or 30% of total superannuation assets in Australia. Over the last nine years, total assets managed by SMSFs have grown at 17 per cent per annum, as opposed to 11 per cent per annum for superannuation total assets.

As Figure 6 shows, SMSFs asset allocation tend to be allocated to cash, equity, and property, with less than 1 per cent exposure to debt securities. This means the fast-growing SMSF sector is actually contributing to an overall reduction in fixed interest allocation in Australia superannuation savings.

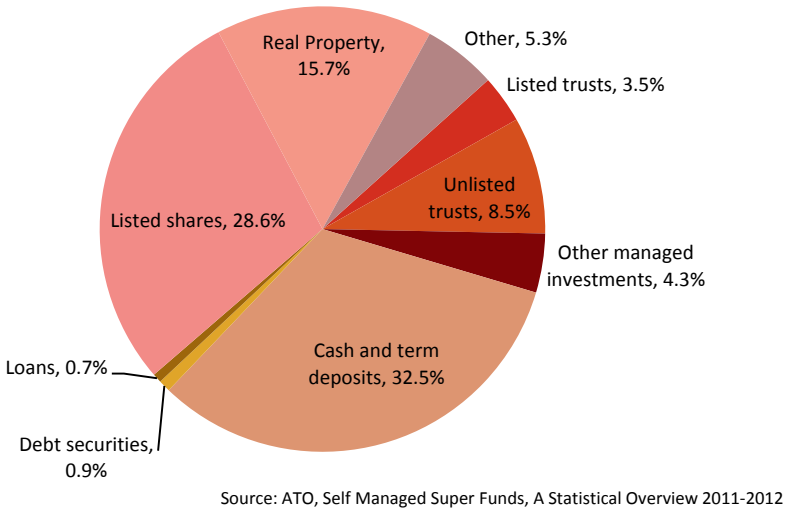


Figure 6: SMSF's asset allocation

This lack of investment in debt securities could be due to a number of factors:

- **Government bank deposit guarantee**: The government guarantee of bank deposits of less than $250,000 means that most retail depositors can access an effectively risk-free investment at rates

above actual government bond rates. This reduces the attractiveness of bond products that do not have such a guarantee.

- **Accessibility**: Retail investors also have limited access to retail bonds – the ASX trading of Australian government bonds has helped but monthly turnover on this market has remained in the single digit millions of dollars. As mentioned in section 4.4, there is a limited range of listed corporate bonds (30 bonds with a face value of about $15bn), most issued by the financial entities. Most corporate bonds trade "over-the-counter" in wholesale markets rather than on the ASX.
- **Attention**: Fixed income may also suffer from a lack of popular media coverage compared with shares. This may be associated with retail investors valuing the potential for capital growth more than the potential for capital preservation and security that bonds offers.

5.3 Life insurance companies not major fixed income investors

In the US, Canada, and the UK, life insurance companies are major investors in fixed income to back their portfolio of life insurance policies and annuities. In fact, US life insurance companies dominate the US private placement market (which provides much long-term financing for Australian corporates). The dominance of superannuation as a form of long-term saving in Australia means that these natural buyers of corporate bonds are proportionately less significant. Without the demand coming from life insurance companies looking to match long-term liabilities, the Australian market has a lower propensity to invest in bonds.

Given these limitations, Australian companies look offshore to issue longer-dated debt.

6 OFFSHORE FINANCING OPTIONS

6.1 Case Study: US private placement market

Australian bank loans are not meaningfully available for terms over seven years. Infrastructure issuers in Australia have therefore turned to off-shore markets to attempt to satisfy their requirements for long tenor debt. The most popular off-shore market has been the US private placement (US PP) market, although there are also other markets that can be accessed by Australian issuers (including Europe, the UK, Canada, and Japan). This discussion focuses on the US PP market as the largest and most popular of the off-shore markets for Australian infrastructure issuers but the same conclusions would apply more broadly to other off-shore financing markets.

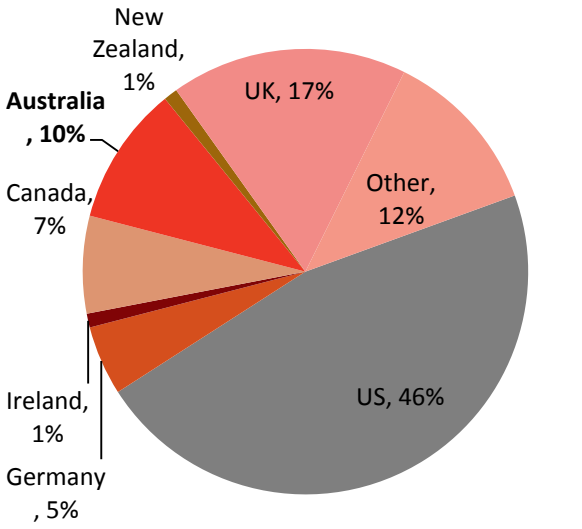
Table 3: Recent US private placement by Australian and New Zealand infrastructure companies

	Date	Principal (USD m)	Maturity (years)
Origin Energy	Feb-14	150	7Y / 10Y
AquaSure	Jan-14	310	10Y
Newcastle Coal Infrastructure	Oct-13	150	7Y / 10Y
Wellington Electricity Distribution Network Ltd	Aug-13	120	7Y / 9Y
Contact Energy	Jun-13	240	7Y / 10Y / 15Y / 10Y / 12Y / 15Y
Brookfield Rail	Mar-13	700	7Y / 9Y / 10Y / 12Y
Electranet	Feb-13	410	4Y / 12Y / 15Y
Powerco Limited	Oct-12	105	12Y / 15Y
Newcastle Coal Infrastructure	Oct-12	325	7Y / 10Y / 12Y
Brisbane Airport Corporation	Jul-12	215	10Y / 12Y
Envestra	Jul-12	200	10Y / 15Y
Port of Brisbane	Jun-12	550	7Y / 10Y / 12Y

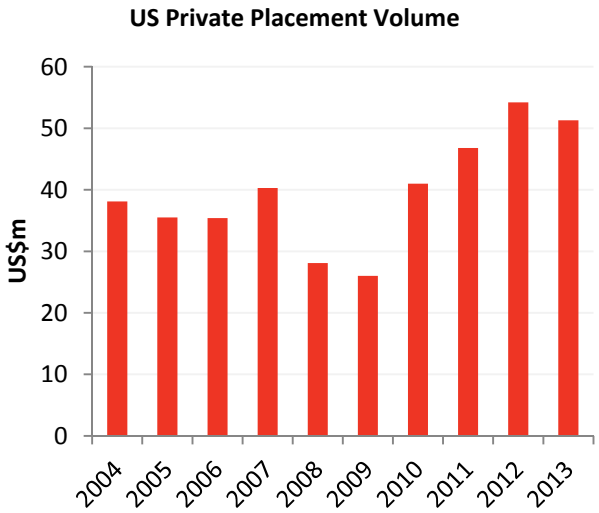
	Date	Principal (USD m)	Maturity (years)
Perth Airport	May-12	300	10Y / 12Y / 15Y
TRUenergy	Mar-12	400	5Y / 7Y / 10Y / 12Y / 15Y
Transpower NZ	Sep-11	380	10Y / 12Y / 15Y
Unison Networks Ltd	Aug-11	100	10Y / 12Y
Melbourne Airport	Jun-11	600	10Y / 12Y / 15Y
Powerco Limited	May-11	245	9Y / 12Y / 15Y

Source: Westpac Weekly Bond Wrap

The US PP market has been a reliable provider of financing over the past ten years, providing more than US $20bn per annum even during the global financial crisis. In 2013, the US PP market raised US$51 billion of debt, of which 14% came from infrastructure assets. Issuance from Australian companies represented 10% of total issuance in the US PP market.



Source: NAB

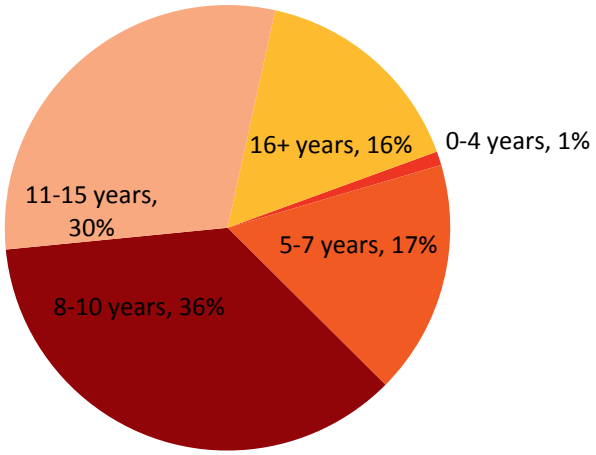


Source: BAML

Figure 7: US Private Placement Issuance by region

CFOs of Australian infrastructure issuers mention the long tenor of debt available and the need for diversification of funding sources away from Australian banks as the main reasons to issue debt in the US PP market[4]. Figure 8 shows that the tenor of the US PP issuance in 2013 was heavily weighted to more than 10 years.

[4] *"Debt markets roundtable: Trends and opportunities In US borrowing"*, AFR, 12/03/2014



Source: NAB

Figure 8: US Private Placement Issuance by tenor

6.2 Limitations of off-shore financing

While off-shore bond markets (in particular the US PP market) have been a reliable source of funding for Australian companies in general and infrastructure companies in particular, there are a number of limitations on the ability of Australian issuers to access long-term debt from offshore markets:

- Requirement for cross-currency interest rate swaps
- Limitations in concession deeds
- Not available to all issuers.

Of these three limitations, only the third would apply to Australian domestic bond issuance.

6.2.1 Cross currency swaps

Any Australian borrower using off-shore funding must hedge the currency risk arising from any mismatch between the currency of borrowing and the currency in which the borrower receives its cashflow. Without this hedging, the off-shore loan has embedded foreign exchange risk – a risk few borrowers would choose to take on. Almost all Australian infrastructure borrowers have cashflows entirely in Australian dollar, meaning hedging is required for any foreign-currency borrowing.

Hedging should match the cashflows of the underlying borrowing; this means that the combination of foreign-currency borrowing plus hedging is equivalent to an Australian currency borrowing (no residual currency risk). Typically, this is accomplished by way of a cross-currency interest rate swap.

There are three potential issues with cross-currency interest rate swaps:

- **Pricing**: Cross currency interest rate swaps come with a cost (the "basis") which is essentially the difference between the supply for these swaps and demand for them. As the Australian economy requires consistent investment of foreign capital, the basis swap typically increases the cost of an off-shore loan once converted back to Australian dollars. This basis can vary significantly over time, and would be expected to increase if the amount of offshore borrowing by Australian companies increases. Without an effective long-term Australian bond market (which does not require a basis swap for Australian issuers) there is effectively no alternative to cross-currency swaps (and paying the basis) for Australian borrowers needing long-term debt.

- **Impact on issuer's bank credit capacity**: The impact of cross-currency interest rate swaps on a borrower's ability to borrow also creates problems. While they are generally matched to the cashflows of the underlying loan, the swaps can experience, from time-to-time, very large mark-to-market movements prior to maturity. This does not affect cashflows but, in the event that the Australian dollar has appreciated against the borrowed currency, the swap will have a large negative mark-to-market value; from the perspective of the banks that provided this swap, this value will represent a credit exposure to the borrower and will reduce the extent to which those banks can lend to that borrower in Australian dollars. To put it another way, a foreign-currency bond with a cross-currency swap could actually reduce a borrower's ability to borrow from banks.
- **Tenor**: A further issue with cross-currency interest rate swaps is tenor. While banks are sometimes willing to write swaps with a tenor of more than 10 years, they will typically require a break right at 10-12 years. This requires the borrower to pay any mark-to-market value of the swap after ten years. While this requirement reduces the bank's potential credit exposure, it creates the potential for a dramatic liquidity problem for the borrower, because (depending on movements in exchange rates) a borrower may be forced to find a substantial payment to the swap provider. The ability to issue long-term debt is therefore restricted by the length of cross-currency swaps available without break rights.

6.2.2 Concession deed limitations

Some infrastructure concessions in Australia, such as tollroads, may enforce certain restrictions on refinancing or issuing additional debt. For example, each refinancing may require state government consent. In addition, a concession deed issuer may be restricted from issuing bonds in domestic and/or international debt capital markets.

Offshore debt capital market issuance provides the greatest concern for governments because of the need for cross currency swaps and the potential volatility caused by negative mark-to-market valuations on the swaps if a concession is terminated and a termination payment is required to be paid.

6.2.3 Minimum size

Offshore financing is not available to all infrastructure issuers. In particular, companies with greenfield assets or in construction phase are unlikely to be able to access these markets (although this is likely to be true for Australian domestic bonds as well). Companies with credit ratings below investment grade (or no credit rating) will find their access significantly curtailed. Small issuers with bond requirements of less than US$500m won't have the ability to create long-term supply of bonds into the US PP market and may find accessing this market difficult.

7 CONCLUSION

7.1 Motivation for changes

The RBA has identified the corporate bond market as an important fall-back option for the economy (in the event of a banking crisis) as well as a useful institution in its own right[5]. Furthermore, by offering an alternative to bank intermediation of financing, a domestic corporate bond market provides competition to the bank loan market.

For an infrastructure borrower, the development of this alternative is overdue – the bank loan market does not typically provide loans of more than seven years tenor and offshore financing has certain limitations

[5] Philip Lowe (Deputy Governor, RBA) speech to ASIC Annual Forum 2014, 25 March 2014.

that prevent it from being a complete solution to the problem. Infrastructure issuers need longer duration domestic debt to lower their refinancing risk and cost of equity.

This lack of long-term debt is not merely a problem for infrastructure investors -- by limiting the ability of infrastructure companies to reduce their refinancing risks, equity risk and required return increases. This reduces the value of infrastructure assets and the benefits available to governments from privatisation or private sector involvement in delivering much needed infrastructure.

7.2 Recommendations

This section presents our recommendations. In making recommendations, we have been conscious of the Commission's draft report, and also of the narrow nature of our concerns within the broader financial system.

We do not recommend any compulsion on investors or limitation on the rights of superannuation funds and their investors to invest their superannuation savings as they choose. Nor do we believe it is within the scope of our submission to consider changes to the superannuation system. We also recognise that any government support for infrastructure financing (for example via explicit guarantees or government contribution to private infrastructure) would have to have a strong justification in the current fiscal environment.

Whilst we recognise that no one factor can "develop" the Australian domestic bond market, we set out below a number of considerations that we believe will assist this over time.

7.2.1 Increase incentives for individuals to seek annuities

Previous reviews have suggested that there might be broad policy benefits to increasing the uptake of annuity products upon superannuation rollover. The Henry tax review highlighted the issue of longevity risk and the need for longevity risk management products in Australia. Longevity risk refers to the risk that an individual will outlive its retirement savings coming from defined contribution accumulations, therefore creating a fiscal burden for governments providing pensions.

Incentives for retirees to take up annuity products upon superannuation rollover would decrease the risk that they outlive their retirement savings and thereby decrease the need for government assistance.

The US and UK have well developed annuity markets where life insurers offer different types of annuities. In the UK, 350,000 annuities were sold by British insurers in 2013, worth £11.9bn[6]. In Australia, the demand for annuities has been falling over recent years. One of the reasons why the demand for annuities remains low is that annuity products are usually perceived as poor value and inflexible.

In addition, the annuities market would benefit from incentives to purchase of life annuities because this would provide a larger pool of annuities, generating economies of scale for insurers and decrease the cost of providing annuities products[7].

Clearly, the implications of incentives for retirees to take up annuities extend much more widely than just into the corporate bond market and infrastructure financing. Nevertheless, we believe that the experience from other markets (cited in section 4) suggests that there would be meaningful ancillary benefits for the development of financial markets in Australia to greater uptake of annuities by retiring Australians which could be considered on the benefits side of any assessment of annuity incentives. In other words – increased take-up of annuities would deliver public policy benefits (ensuring that superannuation savings

[6] Association of British Insurers

[7] John Evans & Michael Sherris, *"Longevity Risk Management and the Development of a Life Annuity Market in Australia"*, The University of New South Wales Australian School of Business, 2010

are used to support retirees throughout the rest of their lives), reduce retiree longevity risk and may assist in the development of the Australian corporate bond market. With the aging profile of the baby boomer generation, we believe also that this generation will increasingly seek greater annuity product as it enters a de-accumulation phase of retirement.

From the narrower perspective of this submission, the main benefit would be that annuity products would generate a meaningful demand for liability-matching assets. This should lead to an overall increase in the demand for bonds, including corporate bonds, as well as an increasing demand for long-duration (>10yrs) bonds. Finally, annuity-products would not be subject to the liquidity requirements of superannuation funds (driven by choice of fund and choice of investment requirements), so would be in a good position to harvest any potential illiquidity premium from longer-dated corporate or infrastructure bond issuance.

Incentives for annuity could come in the form of both positive and negative incentives. This could include tax incentives for retirees to take part of their superannuation payout as an annuity or a straight compulsion for a percentage of a payout to be invested in an annuity product. The key point from the perspective of this submission is that any consideration of such incentives should include the likely benefits to the corporate bond market and the overall robustness of the Australian financial system.

7.2.2 Maintain and increase government long-term bond issuance

The initial issuance of the 20yr Commonwealth government bond in November 2013 was for $5.9bn and was considered well-received by the market. The further issuance of a 2026 bond in March 2014 was also encouraging. The Commonwealth government bonds outstanding with a tenor of more than 10yrs are now 14% of total bonds outstanding.

We would encourage the government to continue its issuance program of longer term debt (including potentially lengthening the curve further beyond the recent 20yr issuance) to build a range of maturities greater than 10yrs to the $10bn level of outstanding that the AOFM's CEO has previously said represents a liquidity benchmark[8].

Liquid government bonds of greater than 10yrs maturity provide a crucial benchmark for the issuance of longer term corporate bonds. Without government issuance, investors will not be able to readily assess the extent to which a longer-term corporate bond is offering a premium credit margin for its lower credit status (compared with the AAA-rated Commonwealth government) or is simply reflecting a rising yield curve. In this sense, a liquid longer-term government bond market is a necessary (but not sufficient) pre-condition to the existence of a longer-term corporate bond market.

7.2.3 Retail bond market development

Self-managed superannuation funds are of growing importance and they should have equitable access to defensive investments (like bonds). Consequently, we support government incentives to develop the retail bond market, including by listing government bonds on the ASX, ensuring bond prospectus requirements are not unnecessarily onerous, and supporting educational efforts to help SMSFs manage their asset allocation with due care (including an appropriate investment in long-term defensive assets like bonds).

[8] Rob Nicholl, Australian Office of Financial Management, speech to ABE Forum, June 2013.

APPENDIX 1: PPP PROJECT FINANCING IN CANADA

Table 4: PPP project financing in Canada

Issuer	Credit Rating	Maturity (years)	Amount (C$)
Acces Recherche Montreal LP (CHUM Research Centre)	A(low)/A3	3.0	59
Acces Recherche Montreal LP (CHUM Research Centre)	A(low)/A3	33.0	332
CSS FSCC Partnership (Forensics)	A(low)/A-	32.0	190
SNC-Lavalin Innisfree McGill Finance Inc.	A(low)/A	34.0	764
Plenary Health Hamilton (St. Joe's Hamilton)	A/A	5.0	115
Plenary Health Hamilton (St. Joe's Hamilton)	A/A	33.0	255
Plenary Properties LTAP LP (CSEC)	A/A	4.8	167
Plenary Properties LTAP LP (CSEC)	A/A	33.0	840
Integrated Team Solutions SJHC Partnerships (St. Joe's London)	A(low)/A-	31.8	212
Health Montreal Collective LP (CHUM Hospital)	BBB(high)/Baa2	38.3	1,371
Hospital Infrastructure Partners (NOH) Partnership (Halton)	A(low)/A-	33.5	544
Plenary Health Care Partnerships Humber L.P.	A/A	3.7	482
Plenary Health Care Partnerships Humber L.P.	A/A	27.7	375
Plenary Health Care Partnerships Humber L.P.	A/A	33.2	149
Capital City Link General Partnership (Henday)	A(low)/A-	34.0	535
407 East Development Group	A(low)/A-	4.6	451
407 East Development Group	A(low)/A-	33.1	120
Plenary Health Kelowna L.P.	-	32.0	73
ABC Schools Partnership (ASAP 3)	A-	31.3	87
Rainbow Hospital Partners	A(low)	1.2	52
Rainbow Hospital Partners	A(low)	30.7	71
Arctic Infrastructure LP (Iqaluit)	A-	33.8	142
Integrated Team Solutions PHC Partnership (ITS) (Providence Care)	A-	3.0	154
Integrated Team Solutions PHC Partnership (ITS) (Providence Care)	A-	32.5	171
InPower BC General Partnership (John Hart)	BBB(high)	19.1	299
Plenary Justice Okanagan Limited Partnership	A(low)	32.1	115
Weighted Average Life		**28.0**	

Source: TD Securities

APPENDIX 2: CORPORATE BONDS LISTED ON THE ASX

Table 5: Current corporate bonds listed on the ASX

Issuer	Sector	Term
Heritage Bank Limited	Banks	10
Heritage Bank Limited	Banks	5
Pentagon Capital Limited	Diversified Financials	10
Pentagon Capital Limited	Diversified Financials	10
AGL Energy Limited	**Utilities**	**27**
AMP Limited	Insurance	10
Australia and New Zealand Banking Group	Banks	10
APA Group	**Utilities**	**60**

Issuer	Sector	Term
Amp Group Finance Services Limited	Insurance	10
Australian Unity Limited	Diversified Financials	5
Bendigo and Adelaide Bank Limited	Banks	3
Bendigo and Adelaide Bank Limited	Banks	Perpetual
Commonwealth Bank of Australia	Banks	5
Colonial Holding Limited	Diversified Financials	25
Caltex Australia Limited	Energy	25
Crown Resorts Limited	Consumer Services	60
ALE Property Group	Real Estate	4
Macquarie Group Limited	Banks	Perpetual
National Australia Bank Limited	Banks	Perpetual
National Australia Bank Limited	Banks	10
Nexus Bonds Limited	Diversified Financials	10
Origin Energy Limited	**Energy**	**60**
Primary Health Care Limited	Health Care Equipment & Services	5
Suncorp-Metway Limited	Insurance	Perpetual
TABCORP Holdings Limited	Consumer Services	5
TABCORP Holdings Limited	Consumer Services	25
Tatts Group Limited	Consumer Services	7
Westpac Banking Corporation	Banks	10
Westpac Banking Corporation	Banks	10
Woolworths Limited	Food & Staples Retailing	25
Average term		**17**
Median term		**10**

Source: ASX