HERBERT SMITH FREEHILLS

GRANT SAMUEL

Peter Harris
Chairman
Public Infrastructure Enquiry
Productivity Commission
Locked Bag 2
Collins Street East
MELBOURNE VIC 8003

14 April 2014

by email infrastructure@pc.gov.au

Peter

Private financing of major infrastructure projects

We refer to the Commission's draft report on this topic. We wish to make a further submission in relation to it.

We note that the Commission recognises many of the challenges in arranging finance for greenfield infrastructure projects which we alluded to in our submission.

In our submission of 23 December 2013 we identified a particular gap in the market which we consider is materially contributing to the financing costs of infrastructure projects, which gap could be met by the establishment of a Fund to provide credit enhancement to elements of a project's debt capital structure.

In its draft report the Commission expressed reservations about whether it would be good policy for a state or Commonwealth to establish an infrastructure fund to provide financial support for infrastructure projects.

The Commission's principal reservations about this concept were:

- There may be avenues to de-risk greenfield projects such that wider pools of debt capital would be willing to support them without credit enhancement or similar support. The Commission has canvassed some of these in its report.
- Generally it is not the role of government to provide a service (including a financial service) which the private sector is capable of providing. If the role of providing financial support to infrastructure projects in the form of credit enhancement were a viable commercial strategy then the private sector would already to meeting this need. There are limited examples of this occurring internationally, with the principal player being Assured Guarantee, a AA rated entity which has already supported some mature Australian projects and might perhaps be able to support future greenfield projects.
- The Australian experience is that governments do not have a good track record of providing financial services. Even if the role we advocated made sense, governments should be cautious in taking it on.
- If, as the Commission recognises to be the case, the capital and operating costs of virtually all public infrastructure projects which the States and Infrastructure Australia have identified cannot be supported by direct user charges and require a public subsidy or financial support, then there are better ways to provide it. An up-front capital payment to meet part of the capital cost or availability charges over the life of the project will be the best avenues for governments to support projects financially where this is required.

101 Collins Street Melbourne Vic 3000 Australia
GPO Box 128A Melbourne Vic 3001 Australia
T +61 3 9288 1234 F +61 3 9288 1567
herbertsmithfreehills.com DX 240 Melbourne

Grant Samuel Debt Structuring & Advisory
Level 6, 1 Collins Street
Melbourne Vic 3000
T: +61 3 949 8800 F: +61 3 9949 8838
grantsamuel.com.au

We welcome the opportunity to address these issues.

Can greenfield project risk be ameliorated to the extent that wider pools of debt capital would be willing to support them?

Avenues to mitigate risk

The Commission has recognised that the risks which greenfield projects have presented in the past are such that many sources of debt finance are not willing to support them.

If the development risk issue can be mitigated, a funding structure that achieves a strong investment grade credit rating may broaden its funding sources, accessing other pools of liquidity including markets such as US144a, US Term Loan B, domestic MTN and Australian wholesale and retail debt markets.

At present, these markets are generally not available to support greenfield projects, which have had to rely on the Australian syndicated debt market led by the four major Australian banks and have needed to call on a greater role for equity, which is more expensive.

A range of factors conspire to prevent more cost efficient funding structures for Australian infrastructure projects including total volume capacity constraints, limited availability of debt sources for construction risk credit profiles, tightened global credit markets and increased capital requirements, limited domestic deposit base of major Australian banks leading to smaller individual commitment levels and for shorter tenors than international comparators, as well as the poor performance of a number of recent projects due to cost overruns or construction/ramp-up delays or revenue miscalculations.

The Commission has explored ways in which the risks associated with greenfield projects might be mitigated, including:

- reducing or removing patronage risk by having the state assume it and pay a fixed availability charge which does not vary with usage of the facility;
- reducing the cost of tendering processes by adopting more streamlined processes and potentially covering a portion of losing bidders' bid costs;
- reducing engineering risk by having the state undertake more preliminary work with respect to projects than it has done in the past – such as engineering studies; and
- reducing the risk of construction cost blow outs associated with labour market conditions by instituting labour market reforms.

Will these measures sufficiently impact project risk profiles?

In our submission, all of the above should be explored and may assist to enhance the appeal of greenfield projects to lenders (although we have a healthy scepticism for material improvements in labour markets in the construction industry, where previous attempts have made little progress in lifting the productivity of this sector).

However, most of these measures are already being deployed on current projects such as Melbourne's East West motorway project.

Significant project development risks remain, including engineering risks, risks associated with design and construction activities, labour risks, weather risks, risks associated with the interface with other infrastructure (eg Spencer St Station) and contractual / counterparty risks.

Virtually every major infrastructure project in Australia, public or private and including the resources sector, has suffered major cost and time blow outs. In each case, the sponsors did everything they could to manage the risks. But they can't be fully mitigated.

Australian banks can accept these risks as they are close to the market, can readily analyse them and are in a position to demand margins and equity buffers which manage them to their satisfaction.

However, wholesale debt markets, even the domestic market featuring Australian institutional investors, are not willing to accept these risks. This market is only interested in investment grade credits. There is too little liquidity in debt extended to sub investment grade credits associated with greenfield development. Unless the credit can be enhanced, any exposures which institutions accept for this type of debt need to sit in an alternative asset portfolio rather than the much larger and more secure fixed interest category.

Specialist operators such as the monoline insurers have the capacity to analyse and accept these risks. In other markets, bodies such as the European Investment Bank and TIFIA have these capabilities. They are able to act as an intermediary between the project and the debt capital markets by accepting project risks and enhancing project credit to the point where the deeper pools of debt capital will be willing to support the project.

Our thesis is that the credit enhancement market has not yet recovered to the point where it can function effectively to support Australian infrastructure projects.

The Commission questions whether credit enhancement is necessary in order to access these deeper pools of capital. In our submission, credit enhancement is essential for this to happen.

The Commission notes that some projects which had been financed before the financial crisis with credit enhancement provided by monoline insurers have since refinanced their debt without this support (p187).

This is true, as we pointed out in our submission. However, by this stage, the projects had all been constructed and the development risk (as well as any revenue / patronage risk) had been removed.

The Commission also observes that there is evidence of the return of monoline insurers, noting some projects which have been supported by Assured Guarantee. This is also true - we mentioned some of those projects in our submission. Assured Guarantee have supported some mature Australian Projects (without development risk) to the extent of $6.3B in total and a small number of greenfield projects in the UK, such as bonds issued to finance the Sustainable Communities for Leeds hospital, Edinburgh University's student residences PPP and Brunswick Public Housing regeneration.

However, the fact remains that no monoline agency has supported an Australian greenfield project since the financial crisis.

In short, we do not think the sorts of risk mitigation measures mentioned by the Commission will be sufficient to enable infrastructure projects to attract markets such as the US144a bond market (the deepest capital market in the world), US Term Loan B or domestic capital markets.

Debt facilities will continue to be led by Australian banks at relatively high cost and for short tenors, presenting equity with re-financing risk which must be priced in.

How would an infrastructure Fund support the provision of finance to infrastructure projects?

Credit support need not apply to the whole debt stack - it can, for example:

- fall away when the project achieves certain hurdles and meets credit metrics which are considered suitable for stand-alone funding
- be limited to specific events or for a percentage of the project cost and to a defined period during and beyond construction and rampup

- support a junior debt position or senior debt via say a 'first loss' position
- provide additional construction period liquidity for the project or for debt interest servicing during construction and ramp-up
- improve the interest servicing risk profile during operations via a top-up mechanism.

Credit markets will typically apply a blend of the project's actual or assumed credit rating and the credit benefit flowing from the entity providing the enhancement depending on the level and limitations of that credit support.

Financial services with respect to infrastructure are better provided by the private sector

Over-riding principle

We agree with the Commission that it is not the role of government to provide a service (including a financial service) which the private sector is capable of providing.

Recently, there has been some evidence of a re-emergence of the monoline insurers as noted above. But no support has yet been given for greenfield projects. Our expectation is that the development risk associated with Australian projects combined with the limited capacity and extent of the monoline insurer market means that we will not see a great deal of activity in this space for some time.

It is possible that monoline insurers will re-emerge to the point where a Fund of this nature may no longer be required. At that point the Government which established the Fund could look to sell the Fund or wind it up, having assigned its obligations to other organisations of the same credit standing.

Assuming no calls have been made on the Fund, it should be worth considerably more than the initial seed funding through the investment of its capital and its credit support fees.

Crowding out

Another possible concern raised by the Commission is whether the existence of a publicly owned body providing financial support for projects would crowd out the private sector and act as a brake on its re-emergence in the greenfield project sector (p194).

The concept we have been advocating is that financial support would be provided only on commercial terms. Hence, the publicly owned body would not preclude privately owned bodies from competing in this sector if they wished to. And, in any event, the Fund would only be active in public infrastructure, not private infrastructure.

Given the narrow remit of the Fund, we do not think its existence would be a material brake on the emergence of privately owned entities offering the same sort of service. And, as indicated above, as soon as the market is sufficiently developed, the State could seek to dispose of the Fund to the private sector and recycle the capital involved.

Australian governments do not have a good track record in providing financial services

Track record

The Commission raises the example of the state banks, which proved to be disastrous in some cases, particularly the State Bank of Victoria, the State Bank of South Australia, VEDC and WADC.

These are certainly good examples of disasters, although disasters can just as readily be found in the private sector (RBS and Lehman Brothers spring to mind but there are, of course, many others).

There are also positive examples of public sector financial institutions. Commonwealth Bank is certainly one and the Future Fund is another, contemporary example, along with VFMC and QIC, to name two others involved in funds management.

Governance

The model we are advocating would include strong governance arrangements such as those adopted by the Future Fund. The board would be entirely independent of government. Its members would face significant reputational risk if they deviate from the clear principles established for the Fund to provide financial support on a prudent and commercial basis – the same basis that the monoline sector would adopt if it were fully recovered and operational today in a similar way to that in which it operated before the financial crisis.

The flood gates theory

One view expressed by the Commission about the provision of guarantees by a state owned entity is the potential for this to lead to other demands from the private sector for similar support. Qantas is the obvious example – where support was requested as a "national icon".

It is possible that businesses like Qantas and others could argue that their sector is just as important as infrastructure and should be supported in a similar manner.

However, the clear differential here would be that the support is confined to very narrow circumstances enshrined in legislation. It follows in some key respects infrastructure funding models adopted by many OECD countries.

International models

The European Investment Bank was formed in 1958 and is backed by the 27 EU member states. It provides relatively small but important elements of a greenfield project's debt requirements by way of subordinated loan or cost over-run facility. This reduces the risk and cost of senior facilities. The Bank has also issued guarantees such as the recent GBP46m guarantee of bonds issued by Great Gabbard Offshore Transmission Link.

The EIB has a AAA rating and a strong technical and financial analytical capability. It raises funds from its own bond issuance. Various European countries have established their own funds which operate in a similar manner.

The US Transportation Infrastructure Finance and Innovation Act established TIFIA in 1998, administered by the Federal Department of Transportation. While it is empowered to issue guarantees it has largely simply made low interest loans to transport infrastructure projects with tenors up to 35 years.

Each year DOT determines its "subsidy" of such loans by estimating non-recovery and operating costs. These must lie within boundaries authorised by Congress ($750m for 2013 and $1b for 2014). However, the full amount of the loans (up to $7b in 2013 and $9b in 2014) are made by DOT. The loans are only ever part of a project's needs but are often subordinated to other lenders.

TIFIA is widely acknowledged to have facilitated projects which would not otherwise have been viable. Australian companies such as Transurban have been involved in some projects supported by TIFIA.

TIFIA is not authorised post 2014 and the Obama administration has been considering whether to extend it or replace it with an "infrastructure bank" concept which would be a stand-alone entity the obligations of which could be off the government's balance sheet. The bank could be capitalised by government initially ($10-25b has been canvassed) but it could also issue its own bonds which could potentially be tax advantaged.

Around 30 US States already have "infrastructure banks" however they have not been well capitalised and are yet to make a major contribution to the national infrastructure.

task. Yet the fears of the federal "infrastructure bank" include the traditional federal vs state funding control battleground and political favouritism. The same concerns in Australia might tend to favour the establishment of state based Funds.

How would an Australian infrastructure Fund differ from other international models?

The Fund advocated in our submission is similar to the "infrastructure bank" model but would clearly be non-recourse to government. It would have its own seed funding. Like the EIB it would establish an analytical capability but it would provide support principally in the form of guarantees or critical elements of the debt stack which are difficult to place in the market.

The Fund's financial support would not reflect any degree of "subsidy" like much of the support provided by TIFIA. It would simply be the provision of a commercial service on commercial terms. But the important point is that this service is not presently available in Australia. It is badly needed in our view.

The Commission references a number of dangers where a state directly provides financial support such as guarantees. It can be seen as a form of backing for the project upon which a range of stakeholders may rely in supporting it, such that, if the project fails, the State may feel obliged to step in and provide support beyond that which it had committed to (pp 187 and 188). One international example of this was provided.

However, we submit that this risk would not arise where the support is provided by a separate, dedicated body and is confined to very specific financial instruments associated with a project.

If greenfield projects need state support to be viable, there are better ways for the states to provide that support

Models which have so far been developed to assist private sector financing of infrastructure include:

Government develops the project and then seeks to sell the asset to the private sector when complete - eg the $10 billion WestConnex tollway project and $1.9 billion Sydney desalination plant	Potentially lower cost to government	Increases state debt and potentially impacts credit rating State retains construction and revenue risk
Capital contributions by governments to meet part of the construction cost and reduce the need for debt funding - eg the Sunshine Coast University Hospital ($1.8 billion construction cost, $820 million capital contribution), Victorian Comprehensive Cancer Centre ($1 billion construction cost, $300 million capital contribution)	Can be used where insufficient economic private finance available	Increases state debt and impacts credit rating State may also retain an element of construction and revenue risk
Direct provision by government of all or a portion of project debt, subordinated to senior lenders - eg $1.1 billion South East Queensland Schools Project (70% of the debt funding at the operations phase)	Still passes construction risk to private sector, but takes advantage of Government's ability to raise debt at lower	Increases State debt Introduces intercreditor complexities and potentially reduces

A variant of this is where the State provides the debt but receives credit guarantees with the loan repaid on termination of the concession agreement - eg £230m hospitals in Leeds (bank guarantee) and £225m hospital in Portsmouth (with credit guarantee provided by a monoline insurer)	cost than private sector	ability of private sector to introduce financing innovations HM Treasury are not planning further use, due to the lack of credit guarantee providers in the market
Provision by government of project loans on attractive terms such as those provided by the US TIFIA programme or European Investment Bank. Used for Capital Beltway Hot Lanes, Miami Intermodal Centre, Intercounty Connector Other government programmes can also guarantee project debt - the UK Infrastructure Guarantee Fund allows Treasury to provide guarantees to support infrastructure project debt (as well as loans or other commitments) up to £50 billion. Used for Drax conversion to biomass and earmarked for Northern Line extension, Thames Tideway Super Sewer and Mersey Gateway toll bridge Swedish Debt Office can also guarantee infrastructure project debt (eg Oresund Bridge between Sweden and Denmark)	Reduces financing cost and may provide access to capital which is not otherwise available	All structures mentioned are fully funded or are recourse to government and therefore usually increase state debt and would be taken into account in sovereign ratings
Assumption by government of revenue risk by making availability payments or guaranteeing project revenue – eg Peninsula Link tollroad	Can be useful where the private sector is reluctant to take revenue risk. Up-front capital commitments are funded by the private sector so do not increase State debt and private sector bears construction risk	Revenue support can leave the government with substantial ongoing commitments

We think there is a role for all of these models in Australia, save that generally we think governments should be reluctant to provide loans, as these directly contribute to state debt and place pressure on credit ratings. Guarantees also impact credit ratings, which is

why we think an off balance sheet vehicle, capitalised by government, would be a better model.

At the end of the day, the simple question which governments need to address is what is the cheapest way to support projects. The answer could be:

- Make up-front government grants (one off hit to the budget and one off addition to state debt).
- Make availability payments to underpin project revenue (larger ongoing demands on budgets unless other revenues can be found such as congestion charges or local government rates).
- Make loans or give guarantees (impact debt in the first case and credit ratings in both).
- Capitalise a Fund to provide credit enhancement without recourse to the State (will tie up the capital required to capitalise the Fund until the Fund can be sold or wound up).

Of course, a combination of these is possible.

Conclusions

While the Commission has raised a number of reservations, we think each can readily be addressed. We remain of the view that a Fund of the nature proposed has the potential to become an important pillar in the delivery of infrastructure investment in Australia.

Yours sincerely

Robert Nicholson
Josh Sgro
Partners
Herbert Smith Freehills

+61 3 9288 1749
+61 419 383 119
robert.nicholson@hsf.com

Scott Killingbeck
Managing Director
Grant Samuel

+ 61 3 9949 8835
+61 410 439 304
skillingbeck@grantsamuel.com.au