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The Frontier Line

Thought leadership and insights from Frontier Advisors

Productivity commission draft infrastructure report

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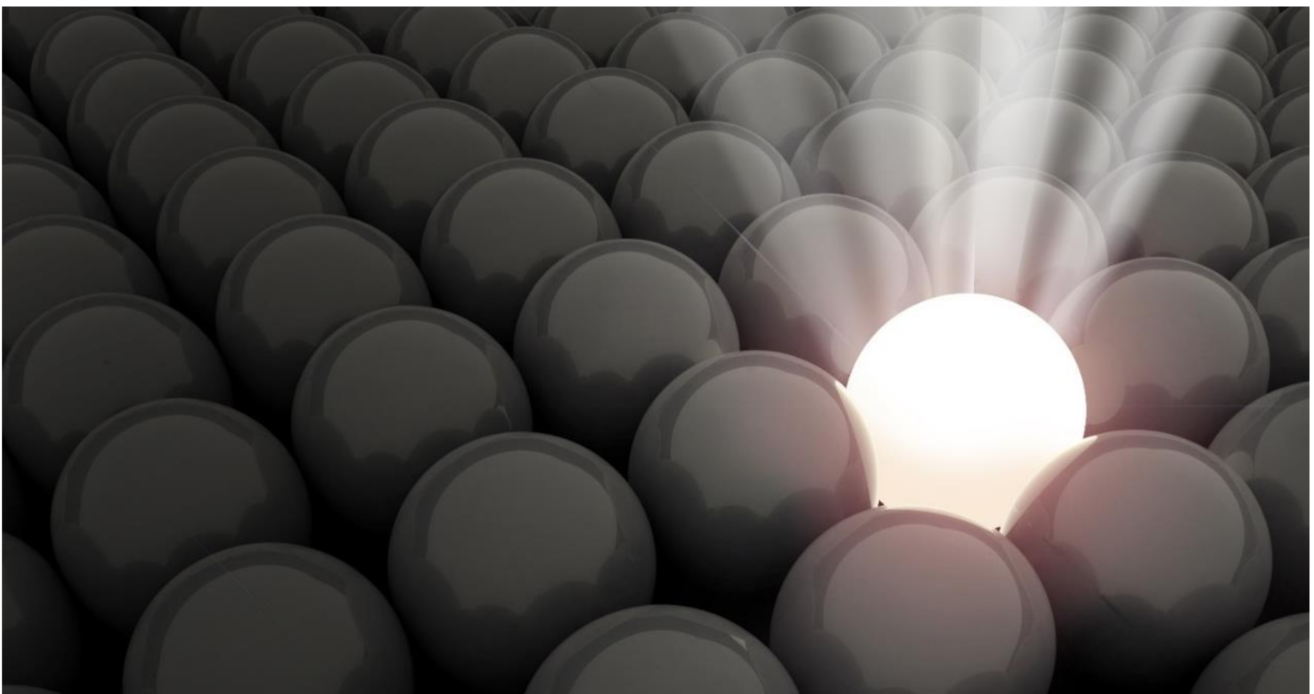

Michael Sofer joined Frontier in 2010 and works as an Associate Consultant within the real assets and quantitative solutions teams. He has worked as a financial modeller, developing financial models for large-scale infrastructure assets, specifically Public Private Partnership transactions. Michael completed a Bachelor of Commerce and Bachelor of Aerospace Engineering (Hons) at Monash University. He graduated Class Dux in his engineering class and received the University Medal for Commerce. Michael is a 2014 Level III CFA candidate.

Overview of the draft report

In 2013 the Federal Government asked the Productivity Commission (the Commission) to enquire into the various aspects of how Australia currently delivers infrastructure projects, and if innovations or improvements could be implemented nationwide to deliver superior outcomes to the public over the long-term. A draft report, dated 13 March 2014, has been prepared for public consultation and input, with a final report incorporating feedback to be provided to the Federal Government in May 2014.

The Commission draft report raises a number of limitations in the way public infrastructure is currently delivered in Australia. To respond to Australia's infrastructure deficit, the Commission recommends a comprehensive overhaul of the infrastructure delivery process.

The draft report calls for public input into all aspects of Australia's current infrastructure delivery process, ranging from how projects are initially scoped by the public sector, to financing solutions, to constructions costs. In this issue of *The Frontier Line* we summarise some of the pertinent investment considerations raised by the Commission. The intention is to provide an indication of the breadth of feedback sought and the potential reforms under consideration.

In the draft report, the Commission makes the distinction between funding solutions – how infrastructure is paid for – and financing solutions – the debt and equity arrangements.

Focus on long-term benefits

Expenditure on public infrastructure has historically been significant at more than 2% of GDP since 2008. Yet there are numerous examples of failed infrastructure projects (e.g. toll roads) and of those which are expensive and fail to deliver enhanced productivity or quality of life over the long term.

The Commission seeks improvements in how infrastructure projects are selected, funded, financed and costed.

Limited risk transfer historically achieved

The Commission questions whether Public Private Partnerships (PPPs) have delivered superior outcomes in Australia. It cites failed toll roads, and the requirement of the Government to step-in when growth or efficiency assumptions are not met (e.g. CLEM7 motorway, Latrobe Regional Hospital). In these instances, the Commission believes a key contributor is inappropriate risk allocation to parties not best placed to manage them, and implicit Government guarantees that are not costless.

As a result, the Commission points out a need to consider innovative funding solutions (e.g. patronage risk), more robust governance arrangements, and clearer rights and responsibilities.

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Overview of the draft report

Poor public sector decision making

The Commission finds Governments sometimes are poor at scoping and project development, and can fail to fully consider all project risks, which has led to deficiencies in design and pricing. The report highlights the need for this to be significantly improved along with more transparent decision making processes and frameworks.

Limited appetite for patronage risk

A preference is shown for user charges where appropriate (as opposed to availability-based infrastructure), and in this regard encourages consideration of innovative funding solutions (i.e. how infrastructure is paid for). This does not necessarily mean demand risk is passed to the private sector. The impetus is partly because, in general, unless a Government is able to remove the obligation for future payments to the private sector (by shifting the funding burden to the user) then a liability is created on its balance sheet – one which ratings agencies take into consideration.

While this reduces the ultimate cost to Government, it can increase risk by introducing patronage risk. Interestingly, this desire for user charges was criticised by the Federal Government. Specifically, in relation to distance and location charging of vehicles, Prime Minister Tony Abbott stated that "…this new form of user-charging, I suspect, is unlikely to ever be adopted by any Government" (ABC News, 13 March 2014).

Strong demand limits innovation

The Commission notes there is no shortage of private capital for good projects. This is consistent with the amount of capital Frontier has seen flowing into Australia, driven by increasing allocations to infrastructure from pension and sovereign wealth funds globally, combined with their currently low cost of capital. In particular, we believe this strong demand limits the need to consider innovative financing models.

This is more likely to gain traction when there is insufficient private finance available or where Governments believe they can facilitate better value for money outcomes.

Nonetheless, the Commission still cites some perceived impediments to increased financing: small corporate bond market; limited private sector appetite for greenfield projects; superannuation liquidity requirements; lack of tax incentives; lack of a clear project pipeline; and high transaction costs.

Cost of bidding is high

The cost impost of submitting a bid for an infrastructure project is very high (but not just in Australia). Bid costs up to, and in excess of 1% of the project value, are not uncommon. The Commission advocates taking steps to minimise costs to encourage competition and attract high quality bids.

This includes having the vendor conduct key initial design work available to all bidders, contribute to bid costs where aspects of the bid can be used to improve project innovation, and limiting the scope of due diligence required pre appointment of a preferred bidder.

Construction costs are not excessive

Market concentration in the construction sector – namely the duopoly of Leighton Holdings and Lend Lease Group – is cited as possibly contributing to high infrastructure prices. However, the recent entrance of global contractors (e.g. Samsung, Bouygues, Acciona and Ferrovial), bring global experience and competitive dynamics. No evidence has been found that competition is being diminished in Australia, but increased use of pro-competitive procurement policies such as project packaging – breaking major projects into smaller parts, is encouraged.

Industrial relations reform required

The Commission is concerned union and employer behaviour is restricting productivity and increasing costs. It calls for a discussion over industrial relations reform noting many industry participants are lobbying for the regulator to be given more power.

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Involvement of superannuation

According to the report Australian superannuation fund investment in Australian infrastructure has been material, but has typically focused on brownfield infrastructure assets.

It suggests funds could invest further, particularly in greenfield infrastructure.

We support this aspiration however there are some key challenges constraining more involvement from funds.

Liquidity

Superannuation funds are required to maintain sufficient liquidity to facilitate member switching and redemptions. This constrains their ability to commit to illiquid investments such as infrastructure.

Interestingly, the draft report put forward several potential solutions aimed at overcoming the liquidity constraint. These included: a Government liquidity guarantee similar to that provided to authorised deposit-taking institutions (suggested by Industry Super Australia and Cbus); a Government-backed liquidity pool that would allow funds to access liquidity if risk thresholds were exceeded (suggested by Industry Super Australia and Cbus); and an infrastructure debt authority, which would source debt capital from superannuation funds and provide a guaranteed inflation-linked return (suggested by JANA/MLC and Maritime Super).

Bidding process

The current bidding process for greenfield infrastructure is lengthy and expensive and this precludes many funds from direct involvement. Further, the involvement of short-term focused consortium members can create a misalignment of interests with super funds, which typically aim to be long-term equity holders. The draft report notes the suggestion of Industry Super Australia for an inverted bid process. Under this proposition, an equity funding competition is held prior to construction, operations, and maintenance and debt tenders with the aim of reducing equity bid costs, aligning stakeholder interests, and reducing fees.

Risk and return profile

Super funds invest mainly in brownfield assets, rather than greenfield assets as they are more suitable for those portfolios from a risk and return perspective.

The draft report suggests Governments be more active in recycling capital, through the privatisation of Government owned infrastructure assets. It is thought this could facilitate an efficient mechanism of delivering key greenfield infrastructure investments. However, the draft report notes that, above all, privatisations are only appropriate if they are able to demonstrate a long-term benefit to the community.

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Agenda of reform

The draft report proposes improvements to the way of delivering infrastructure projects across all levels of Government. In general, we believe the suggested reforms make sense and could improve the ability of infrastructure to deliver superior outcomes to the public over the long-term.

However, historically it has been challenging to achieve the wide-ranging reforms currently called for in this draft report. We note prior reviews of the sector conducted by the Productivity Commission.

In relation to the procurement of infrastructure in Australia, delivery mechanisms vary by asset and there is a lack of coordination at the different levels of Government. We believe it will be challenging to achieve the degree of consistency of reforms targeted by the Commission.

Further, we cite the Canadian experience where the uniqueness of the different provinces and territories has proved a considerable challenge to the implementation of consistent infrastructure delivery methods.

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Conclusion

Australian superannuation funds have a long established history of successfully investing in Australian infrastructure projects. However, in the past few years, and looking forward, the dynamics of the industry support increased participation in the infrastructure asset class.

First, as the superannuation pool grows, these funds are required to make increasingly large commitments to infrastructure projects to maintain their allocations.

Second, as consolidation of superannuation funds continues, and as these funds become increasingly more sophisticated (i.e. investing independently or alongside, rather than via, fund managers) their ability and willingness to fund large projects increases.

And third, as the membership base of the superannuation funds matures and moves into retirement, there will be an increasing demand for investments that exhibit stable long-term and inflation-protected cash flows, to better match the underlying risk-return profile of the member. Such cash flow profiles are aptly described by infrastructure assets.

However, as flagged in the Commission's draft report, Australia's current method of delivering infrastructure poses some challenges and barriers for superannuation funds.

These include: the cost and complexity of bidding; achieving optimal risk allocations to appropriate parties; liquidity and tax considerations; complying with increasingly complex legislative requirements; and an unclear investment pipeline of projects with suitable risk and return characteristics.

The draft report indicates a desire for a nationwide reform of the way in which infrastructure projects are currently delivered in Australia.

It is suggested this could bring about a more robust, transparent and innovative delivery process, which could encourage a strong pipeline of key infrastructure projects in Australia.

Importantly, it is hoped amendments to the current delivery process will prompt further demand for Australian infrastructure, both by domestic and foreign investors.

Reform of this nature certainly offers the potential to meet the changing requirements of a growing and evolving superannuation industry.

In particular, a more efficient bidding process, in terms of both cost and time, could encourage greater involvement in greenfield infrastructure from Australian superannuation funds.

However, to encourage increased superannuation investment in Australian infrastructure, reform needs to address the long-term requirements of superannuation members. That is, investments need to offer: the right asset characteristics; a good risk and return profile; appropriate structuring and consortium partners; and a complimentary nature to their existing portfolio.

Superannuation funds, and all investors for that matter, will always be attracted to good projects.

Level 16, 222 Exhibition Street

Melbourne, Victoria 3000

Tel: +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv

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