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## Creation of a Sustainable Long-term Debt Funding Capability for Australian Infrastructure –

An alignment with national objectives for Australian retirement savings



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## 1. Executive Summary

This Paper recommends the establishment of a sustainable arrangement to provide long-term debt for the development of Australian infrastructure thereby filling a current void in the funding marketplace.

We propose to directly link Australian superannuation funds as the providers of funding with the infrastructure project bidders through the establishment of a low cost senior debt facility to meet the current shortfall of long-term debt for projects.

In order to efficiently and prudentially intermediate the lender-borrower relationship, we propose the establishment of a Government sponsored entity in the form of the Infrastructure Debt Authority (IDA).

We propose that the IDA sources relatively low cost capital from the superannuation funds with an institutional minimum investment of \$25million AUD. In return the investors are provided with a relatively stable source of income for their long-term (25 year) investment.

We recommend that the investments be fixed term and not tradeable, thereby allowing underlying capital valuations to remain at par throughout the life of the investment. As such this removes the unwanted capital valuation volatility which is less well matched to the objectives of the underlying investor for these types of investments. We propose an inflation index plus return in order to provide a constant real return to the investor.

We believe that the opening of a valuable new source of funding will provide an impetus to the development of Australian infrastructure projects. The availability of a stable long-term senior debt facility will provide greater certainty for project bidders and for equity investors.

A viable long-term debt facility will provide investors with a valuable addition to investing equity in single projects and potential alternative to current investments in northern hemisphere infrastructure debt.

Importantly, the proposed arrangements provide Australian Governments with a cost effective mechanism to accelerate the infrastructure projects pipeline with an additional flow on advantage for long-term Australian retirement savings. The arrangement provides the opportunity for the Australian Commonwealth Government with the opportunity to exert leadership in the creation of a needed facility/market whilst limiting its direct involvement in the funding of infrastructure project finance.

The infrastructure funding concept also already has parallels in terms of government co-ordination in an operating model in Europe and in a proposed mechanism in the United States.

## 2. Purpose

The purpose of this Paper is to recommend a structure which will facilitate the supply of an additional, alternative source of debt financing for the Australian Commonwealth and State Governments' infrastructure development programs.

The creation of a long term debt facility addresses a shortcoming in the current financing for Australian infrastructure projects.

The structure is designed to reduce the overall costs and challenges of infrastructure funding uncertainty whilst at the same time providing Australian superannuation funds and their members with a stable long-term investment opportunity.

### 3. Scope of Paper

The scope of this Paper is directly related to the establishment of a funding structure which will facilitate the investment for meaningful proportions of the sizeable Australian superannuation fund investment pools into the senior debt funding component across a broad range of Australian infrastructure projects.

Significantly, the purpose of the Paper is to create the case for the establishment of an investment structure which aligns the interests of Australian superannuation funds and their members as providers of long-term patient capital with the needs of Australian Governments in order to promote the successful operation and ongoing development of cost effective and valued infrastructure facilities.

This Paper does not establish or revisit the need for the ongoing privatisation and development of Australian infrastructure projects as this is assumed and has been amply illustrated in numerous other Papers and in submissions by and to Australian Governments. The future needs for infrastructure investment are cornerstones of the respective strategies of already established National and State level infrastructure entities.

For example, in the New South Wales State Infrastructure Strategy, eleven of the sixteen sections of their 2012 Strategy Report are devoted to setting out the breadth of the needs for long-term infrastructure investment across roads, transport, freight interchanges, energy, water, health and social infrastructure. These requirements are typical across Australia and are commonly agreed.

The Paper specifically includes funding for both existing brownfield infrastructure assets, which are wholly or partially transferred from Government operation to private ownership, and to the range of new projects to be offered under existing and future Public Private Partnership initiatives.

The Paper does not cover the infrastructure assets that will remain largely funded by the three levels of Australian Government as it is assumed that the cost of any debt used to fund these projects as part of Government outlays will be raised directly by Governments.

We have recognised that there is a clear trend to reduce overall Government balance sheet exposures to infrastructure projects where these can be satisfactorily developed and maintained in the private sector.

The Paper directly addresses the relatively high cost of private project finance which is often overlaid by complicated and expensive needs to involve multiple lenders, varieties of loan covenants and short-term arrangements. “Refinancing risk is a significant contingent risk issue for both governments and equity”<sup>\*1</sup>.

The recommendations directly address the need for cost effective alignment and sharing of risk/rewards between the Australian Governments as strategic planners, Project Operators as implementers of these plans and superannuation funds as both providers of cost effective capital and as direct participants in the creation of valued community resources.

The Infrastructure New South Wales 2011 State Infrastructure Strategy document “First Things First the State Infrastructure Family 2012-2032” makes the following key points in Section 16 (Funding), all of which are addressed by the recommendations in this Paper.

- “The current differential between public and private costs of capital, if sustained, requires an evolution of the PPP model to ensure value for money for government (S16.2.2, page 203).”

Response: ***The recommendations provide a sustainable source of cost effective long-term debt.***

- “Australian capital markets for infrastructure have historically lacked depth and liquidity compared with North America and Europe notwithstanding the world’s fourth largest pool of superannuation funds. As a result the ability of the private sector to provide a sufficient financing capacity for the largest Australian infrastructure projects continues to be a matter of debate (S16.2.4, page 203).”

Response: ***The recommendations open up a much broader opportunity for superannuation funds to participate in debt funding as well as through the provision of equity.***

- “Infrastructure NSW recommends that the Government continue to engage with the Australian superannuation industry regarding a risk transfer arrangement for greenfields investment that represents value for money to tax payers (S16.2.4, page 204).”

Response: ***The recommendations in this Paper directly take up this engagement to provide a substantial expansion of the opportunity for superannuation funds to participate in a mutually effective transfer arrangement.***

<sup>\*1</sup> Stephen Williams Business Council of Australia (2011) The Challenges of Financing Australian Infrastructure: Key Issues for Private Financing



## 4. The Objectives of the Parties

### 4.1 Australian Governments

The Commonwealth and State governments have the following requirements in the development of funding models for infrastructure projects:

- The development of a sustainable private Australian long-term debt market to reduce the dependence on Government funding.
- That the projects provide real long-term value to the respective communities and to Australian taxpayers.
- That the projects are developed cost effectively with the PPP model as the cornerstone for greenfields.
- Over time governments may reduce direct participation in the operation of infrastructure assets where this is in the interests of taxpayers and the community to do so. Effectively this removes assets and related debt from their balance sheets. Some infrastructure may remain under government control for strategic reasons.
- Ensure the effectiveness of the existing grant funding programs for infrastructure. The availability of a further lower cost, sustainable source of funding is likely to be an effective complement to the grant funding and shared funding approaches.
- Where existing assets are devolved into private operation, the optimal benefit to the community will be considered in terms of a combination of price received, the long-term economic viability of the asset, the reduction of the need to “rescue” assets or to insert additional future subsidies and the value add to the Australian community.
- The need to avoid guarantees on levels of investment return or financial viability for private infrastructure assets which would then be effectively underwritten by governments and future tax payers.
- Integration of micro tax reform as a way of encouraging long-term investment mechanisms.
- The opportunity and capability to accelerate the project implementation schedule for the long lists of infrastructure projects already identified.

### 4.2 Australian Superannuation Funds

Australian Superannuation funds have the following requirements in participation in Australian infrastructure projects, including infrastructure debt funding.

- Access to far broader participation opportunities in Australian infrastructure projects and development of National resources over and above providing equity as part of a consortium which is the somewhat restricted way in which only some large Australian superannuation funds can participate.

As a corollary to this current deficiency it is worth noting the continued growth in investment by Australian superannuation funds in northern hemisphere infrastructure opportunities is driven in no small measure by the lack of parallel opportunities in both debt and equity funding of infrastructure in Australia.

In fact Australian superannuation funds have a long and largely successful track record in investing in infrastructure, but predominantly offshore. We believe the appetite will remain, but that it would be advantageous to re-direct some investment into Australia.

- Access to a stable, long-term debt market as a supplier of funding.
- Reduction in the volatility of returns.
- Reduction in single asset risk arising from participation in single equity infrastructure investments.
- Alignment of investment objectives of fund members for retirement savings with lower risk debt level participation.
- Matching of asset return profiles with long-term retirement savings objectives flowing from long-term debt. The positioning of investment in infrastructure (and other similar yield based investments) as a cornerstone of post retirement strategies has largely been ignored to date but has considerable potential benefits.

### **4.3 Asset Operators/Project Managers**

The development of a source of debt investment for Australian infrastructure projects, tapped from Australian superannuation funds, meets the following requirements and has the following benefits:

- Access to a substantial source of investment funds in Australia's superannuation system.
- Access to competitively priced debt as a base for financing projects. JANA's experience over the last two decades suggests that the establishment process for an appropriate debt package for both greenfield and brownfield investment opportunities is a major challenge for infrastructure investors. We observed this challenge again recently in the establishment of financing for the Sydney Desalination Plant project.



- This initiative directly addresses these pressures. As a way of reducing this risk, JANA's long-term investment strategy advice has involved reliance on investment in pools of diversified infrastructure assets. However, the marketplace is evolving with individual asset opportunities becoming more prevalent but not totally replacing the diversified pools arranged largely by investment managers.
- Reduction of time and effort spent on sourcing and refinancing senior debt.
- Ability to provide greater certainty to equity holders through long-term debt funding of projects.

## 5. New Debt Funding Model

The recommendation involves the establishment of a structure and mechanism to provide long-term debt funding for Australian infrastructure projects.

Infrastructure project financing invariably involves a level of debt funding. The level of debt funding varies according to the type of project and the risk-return objectives of investors with a usual range of 60 to 85% debt funding.

Australian superannuation funds have already participated in the provision of mainly equity funding for Australian infrastructure projects. The provision of equity has come with additional risks with some cases of total loss in single asset exposures. These have been isolated cases as the experience has generally been positive. However, any single poor equity investment can be disproportionately disadvantageous to a single asset investor.

The investment return expectations for superannuation funds for equity participation are commensurate with the respective risks, but generally within the range of 10-15% p.a with a moderate expected range of volatility in returns. These types of investments are well suited to diversified portfolios of growth assets although any large or total loss of equity capital in a large project would be significantly detrimental to investment returns received by fund members in any investment option.

The current need to commit meaningful amounts to individual medium-large projects provides a barrier to many superannuation funds and often poses a single asset risk to those which can participate.

We acknowledge that domestic and overseas banks will remain as significant providers of infrastructure debt notwithstanding emerging capital requirements under the Basel III regulatory environment.

However, the provision of an additional source of well priced debt funding can only be beneficial in an open and competitive market.

Whilst there is a clear natural link with the provision of lower risk/lower return debt funding, this opportunity has not been realised to any extent.

As Australian superannuation members move towards and into the retirement phase, for many there is an attraction of consistent “annuity-type” returns with a higher than cash real return. In recent times some of this requirement has been funded by the unusual investment premiums flowing from term deposit rates offered by Australian banks. However, these rates have been offered in response to circumstance specific events and are likely to be ephemeral at best.

There is a clear case for Australian superannuation funds to provide debt funding for infrastructure projects on a commercial basis within the current brownfields release and greenfields development programs flowing from the States and Commonwealth and perhaps even larger Regional projects where there are future infrastructure asset revenues associated with the identified projects. The type of investment and risk/return expectations are very different from the provision of equity.

This Paper recommends that a specific long term Senior Debt facility which taps into Australian Superannuation funds be established as a source of cost effective finance for Commonwealth and State released infrastructure projects.

In the Government-directed processes of the devolution of existing assets or in the creation of new assets, Project bidders/arrangers could be sourcing at least 20% and up to 40% of their total project bid funding from the Senior Debt facility. We recommend a cap of 40% on Senior Debt provided from this new source to reduce single asset risk to the lenders.

## 6. Co-ordination entity – Infrastructure Debt Authority (IDA)

The process of sourcing debt funding (from superannuation funds) and providing debt facilities through the issuance of senior debt-type bond instruments to infrastructure projects, needs to be co-ordinated with a mix of skills and experience.

The process could be undertaken by one or several proven market players which currently bid for projects and arrange/structure the underlying finance.

In the first instance we do not believe the co-ordination role should be dispersed and it would be difficult to “award” or even tender the role to just one current provider. The issue of unconflicted independence also comes into play. Initially a single Government sponsored entity would provide a simpler approach.

As such we recommend that a new Government sponsored entity is established to co-ordinate the intermediation.

There is a cost in the establishment and operation of the entity or the new Infrastructure Debt Authority (IDA) which would be met within the related pricing of the Senior Debt facilitation activities. The establishment costs would also be a debt from IDA to the Commonwealth Government to be recovered from future business revenues.

In this respect IDA would be operating as one of the potential providers of debt alongside of the banks and specialist manager pools.

We envisage that the Infrastructure Debt Authority (IDA) will essentially be an intermediary/co-ordinator of only senior debt funding for infrastructure. Depending on the type of project, debt will generally constitute 50 to 85% of the overall funding with senior debt making up the highest ranked portion.

The overriding purpose of the Infrastructure Funding proposal is to promote a mechanism to provide long-term senior debt infrastructure funding for projects whilst also providing superannuation funds with an investment match for relatively secure, stable retirement-phase oriented returns for their members.

Equity investment in infrastructure projects is higher risk/higher return with greater market price volatility and is less well suited to the provision of more secure annuity-type returns for the investors. Superannuation funds already have the opportunity to provide equity into infrastructure projects directly, as part of bidding consortia or through investment manager infrastructure pools. Listed infrastructure also provides a further equity entry point for superannuation funds.

We do not envisage IDA as an intermediary for equity or as whole of project funding. We cannot see significant additional advantages for equity investors using IDA as an intermediary (and additional cost layer). We also do not see IDA as the de facto total funder/approver of infrastructure projects.

We suspect this arrangement would also be less palatable to the project bidders. We believe the IDA Funding concept would be more effective if it is a simple structure as an ancillary aspect of the current structures.

IDA would not need to be a large or complex entity as the envisaged activity is specialised and narrowly focused. IDA could also seek and receive external expert advice from the industry on an ongoing or project basis.

IDA would form the role of a specialised market intermediary for providing Senior Debt sourced from Australian superannuation funds into Australian infrastructure projects.

In the July 2011 Australian Government Infrastructure Financial Reform Issues Paper there is specific reference to the potential place and value of an infrastructure intermediary such as IDA. In reference to the establishment of an infrastructure fund the Issues Paper suggests **“it could play a role as a provider of concessional loans or raise funds on capital markets in respect of eligible projects”**. (page 14).

Significantly, the Issues Paper referred to above notes that the concept is already being applied overseas and we again quote from the same Paper.

**“Infrastructure banks are one kind of infrastructure fund that has been used in international jurisdictions. The European Investment Bank (EIB) is one example. The EIB raises funds on the capital markets and lends them on favourable terms to eligible projects. The EIB’s current three-year operational plan allocates €160 billion to infrastructure projects consistent with the bank’s strategic objectives.**

**For example, as part of the Trans-European Networks initiative to modernise Europe’s key value-added transportation corridors, EIB has provided favourable loans to the Port of Barcelona to help update its facilities and practices.”**

**“In the United States, the concept of an infrastructure bank is topical. As part of the fiscal year 2012 budget proposal, the Obama Administration proposed the creation of a national infrastructure bank that would invest US\$30 billion over a six-year period. The bank would provide loans and grants for transportation projects. However, it is unclear at this stage exactly how the bank will operate.”**

However, the recommendation to establish IDA is narrower and simpler than the overseas examples cited above. IDA would fulfil the role of a long-term debt intermediary rather than the far broader roles required in the European and US examples. In the Australian setting this would mean that the infrastructure project strategy/prioritisation would remain with Governments supplemented by the facilitator of a senior debt source supplied from the Australian superannuation funds.

The deep project arrangement/implementation roles would remain with the current skilled infrastructure managers/facilitators where Australian firms are to the fore on a global basis.

The debt access arrangement will also assist superannuation funds in terms of reducing the complexity associated with participation in infrastructure funding.

At the end of a proving period of say ten years, the Infrastructure Funding Debt Authority could be sold and transferred into private ownership albeit with operating controls firmly established. This would also provide the Commonwealth Government with a future return. IDA should be established with a modest level of capital backing from the Commonwealth Government commensurate with statutory capital requirements of financial organisations, albeit IDA's area of operations will be narrow and impacting only on large institutional investors.

As such IDA should also operate within the broad regulatory provision related to the providers of a wholesale financial product in the Australian marketplace including oversight by the Regulators.

The general roles of the Infrastructure Debt Authority (IDA) would be to:

- i) Establish the rules and operating standards for IDA as a long-term debt provider to Australian infrastructure projects facilitating funding from Australian superannuation funds. The IDA funding source should not be seen as an automatic source of funding to otherwise poorly constructed financial/operating arrangements for sub-optimal infrastructure projects. It should be seen as one source of Senior Debt funding in the marketplace.
- ii) Assess Commonwealth and State government infrastructure projects for their suitability for providing the Senior Debt facility including any lending conditions for each project.

We acknowledge that the funding and related pricing mechanisms differ significantly from the arrangements currently on offer from the major debt providers.

We recommend that the pricing points are discussed with the major infrastructure project equity holders and project arrangers to ensure that the business case is enhanced by the availability of stable long-term debt funding.

- iii) Manage the funding mechanisms and flows to the infrastructure operators.
- iv) Responsibility for all issuances and the associated legal, tax compliance and record keeping requirements.
- v) Facilitation of coupon payments/distributions to investors.
- vi) Agree the level of senior level debt afforded to each infrastructure project through liaison/negotiation with the project bidding consortiums.



- vii) Establish guidelines/rules for participation in the long-term debt facility. For instance it could be considered that where Project arrangers/managers or related investment managers are expected to receive ongoing management fees from the infrastructure project that minimum levels of equity holding apply (as a multiple of the level of recurrent fees to be received) as a condition of participation in the IDA long-term senior debt facility.
- viii) Select and manage long-term debt exposures to a diversified range of infrastructure projects that collectively form a “pool” of investments in order to minimise any single asset default risk.
- ix) Determine the level of participation (ie. provision of Senior Debt by IDA) made available to borrowers in each project with the bands of 20% to 40% of the total project bid price. In most cases there will be a need for further debt financing over and above the IDA sourced Senior Debt. This would be provided by the market as a form of lower ranked debt.

The providers of the additional debt may suggest that IDA, as Senior Debt holder, has taken their place and that the subordinated debt they then provide would come at a higher price due to the existence of the IDA Senior Debt.

In the first instance we indicate that there is currently no long-term debt financing of any substance for Australian infrastructure projects. As such it is a new source of funding. It is also currently the case that the provision of debt facilities at various levels in the capital structure results in different levels of pricing. The introduction of a new type of long-term facility provides an additional market player to the existing providers.

We suggest that the considerable scope to expand the size of the infrastructure development market through the provision of long-term senior debt will expand both the subordinated debt and equity opportunities for all current players.

We believe that the proposal has suitability to both Greenfield and Brownfield projects. We are aware that the risks/returns and cash flow patterns are quite different in a Greenfield project. There are two significant ways in which the proposal addresses the construction risk/income flow issues.

Firstly, we propose that the IDA arrangement be limited to the provision of senior debt with the need for the project operator to repay interest as investment funds are drawn. This is a usual construction cost and would be drawn from the project balance sheet which itself would include project equity supplied by equity holders

Equity holders usually bear a range of project costs including the repayment of debt before the onset of regular income flows or capital appreciation from the infrastructure asset.

We would anticipate that the level of debt funding, including senior debt, to be lower in a Greenfield project and that IDA would make the assessment of how much senior debt/debt was appropriate for the individual asset before allocating senior debt commitments.

Conversely with a higher level of equity in Greenfield projects there are more construction type costs (including debt repayment) to be initially allocated against drawn equity.

Secondly, we envisage that IDA would aggregate groups of infrastructure projects according to “vintage” in the establishment of the debt funding arrangements. The bond holder (ie. the superannuation fund) would hold an investment across a number of infrastructure projects (ie. the equivalent of a pooled investment) in relation to the general period or vintage of approval/funding. The “pool” would include different types of projects in order to reduce single asset exposure risk for the bond holder investor.

Competition will apply to the debt outside of the IDA Senior debt (as well as for the IDA Debt itself) and the market players will continue to determine the terms (and returns) for these facilities. Subordinated debt commands higher returns/pricing as it does in current financial structures for infrastructure development. On a net/net basis we see scope for lower overall costs of financing stimulated by the IDA long-term debt facility and an expanded market for infrastructure project debt and equity finance.

In terms of the establishment of IDA we recommend the following to ensure there is an existing source of available “committed” funds on commencement.

- i) Expressions of interest be canvassed from large Australian Superannuation funds (eg. Those with assets in excess of \$2 bil) together with indicators of likely levels of initial and subsequent commitment.
- ii) The Commonwealth Government seeds the IDA debt facility with \$200 mil available for immediate funding with a view to superannuation funds replacing this investment over the first 24 months of operation of IDA. In terms of Commonwealth Government support for infrastructure projects this could be viewed as either a supplement or part replacement for some future grant funding.

## 7. Pricing and Conditions for Long-term Senior Debt

### 7.1 Pricing Level

The level and conditions of pricing for infrastructure debt are critical to both the superannuation fund and its members and to the project arranger/manager.

The level of return for the superannuation funds must meet the objectives of the fund and its members for the type of investment and level of risk expected with debt funding of infrastructure.

As the investment is long-term and the return expectation is relatively modest, investors would also expect some further concessions/advantages from this form of investment. These are covered in subsequent sections of this Paper. The recommendation of CPI plus 2.5% return to investors with a 3.0% borrowing cost seems a reasonable start point in 2013.

Whilst we would expect stability in returns for investors, market factors and tensions may require periodic reviews in order for these returns to remain competitive and reasonable for the lenders and borrowers. If there is a sound financial case for variance to the commencing rates/relativities this would be reflected in the expectations of lenders/borrowers at the time.

As such participation in IDA could be in accordance with “vintages” offered in any particular year in order to accommodate market variations/tensions. These arrangements would not affect the underlying term of the investments (25 years). The individual investments and liabilities would remain “matched” according to vintage.

In terms of individual investors (superannuation funds) and even their underlying members in “matched” investment options, there would still be a “lock in” to the return/period of investment.

Given the long-term period envisaged we recommend that the investment return received by superannuation fund investors be CPI index linked rather than fixed. We recommend that the interest rate to be received by superannuation fund investors be based on the Consumer Price Index (CPI) plus 2.5%. This level provides for a modest real return to the superannuation funds and their members consistent with the long-term return for a higher grade bond investment.

We also recommend that the long-term senior debt loans are offered at the rate of CPI plus 3% to infrastructure project borrowers which we believe to be extremely competitive particularly considering the long-term nature of the loans. Whilst we believe that this level is commercially competitive, the pricing should be subject to periodic review ideally on an annual basis.

The 0.5% difference between the return rate received by the superannuation funds as providers of debt and the rate charged for the loans to the infrastructure project managers/operators would support the operating of the Infrastructure Debt Authority (IDA) with a margin.

Over time this would build equity in the IDA which could also be deployed to repay initial establishment costs and to provide a contingency provision for any unforeseen circumstances where asset realisation in any failure did not result in full payment to Senior Debt holders. Whilst this reserve was accumulating, the Commonwealth Government would ensure the stability of the IDA. The overall level of risk however is reduced by only offering Senior debt and up to determined levels on a project by project basis.

If we assume CPI at the middle of the current Reserve Bank target range ( i.e 2.5%) for now the recommended pricing level is above current Commonwealth 10 year bond rates by around 1.0 to 1.5%. However, Government long bond rates are currently towards the low end in real yields and in comparison with rates across longer periods.

In any case the Commonwealth Government is not expected to be a direct player or guarantor in the Infrastructure long-term loans. The recommended pricing is also above the current States 10 year bond rates by 0.5% to 0.75%. Again these yields are towards lower points on the historical scale and again the States would not be directly involved in the provision of funds or acting as guarantors.

The recommended pricing levels to borrowers appear competitive and the loans come with the additional advantage of being long-term, further enhancing their value. Given the scale of the institutional investment for large infrastructure projects we recommend that an appropriate minimum level of investment applies. We also do not envisage the IDA providing a facility for smaller or retail investors. As such an appropriate minimum level of investment for the target market should be around \$25 million.

## **7.2 Long-Term Duration**

Given the long-term nature of Australian infrastructure projects and Australian superannuation fund/fund member expectations we recommend that the Senior Debt instruments issued by the IDA be of 25 years duration. This would not necessarily mean that all infrastructure projects held their Senior Debt for 25 years as there would be arrangements and conditions for early repayment in individual projects.

This long-term period addresses a significant weakness and frustration in current debt funding arrangements in infrastructure projects where shorter term loans need to be “rolled” and re-negotiated more frequently. This rolling creates additional uncertainty through the life of the infrastructure project and also impacts on the investment outcomes for equity investors. A stable long-term source of funding will potentially contribute to greater certainty and confidence across all investors in infrastructure projects.

Investors would invest in the open-ended pool of investments managed by IDA rather than into any single infrastructure investment in order to diversify participation and risk.

### **7.3 Senior Debt Designation**

It is recommended that the long-term debt issued through the IDA be classified as the most Senior Debt in each project and therefore would rank ahead of other debt holders and equity holders in the infrastructure project investments.

As such, in the event of any single infrastructure asset encountering financial difficulties, the IDA Senior long-term Debt holders, through the IDA, would have first access to available assets to meet debts. This designation affords an additional level of security to the long-term debt holders.

The Senior Debt designation is also consistent with the modest “high grade” type investment return commitment.

### **7.4 Fixed Term/Non Tradeable/Valuation Methodology**

Given the purpose and characteristics of the long-term debt investments, we recommend that these debt investments are for fixed terms and that they are non-tradeable in terms of the existence or operations of active secondary markets other than at par value.

As a corollary we further recommend that these investments be valued in accounting terms at par throughout the life of the investment. This approach is consistent with the non-tradeable characteristic and absence of an active secondary trading market for these loans.

As such there would technically be no capacity to apply the “Mark to Market” accounting standard to adjust the par price in any way. Therefore rather than needing to seek any exemption from Mark to Market accounting requirements, the standard approach would be to value the capital component of the long-term debt instrument at par.

We believe that liquidity in this type of investment is not necessarily an essential requirement for large superannuation funds as the pool of superannuation assets is continuing to grow.

Australian Superannuation funds are growing assets through mandated contribution levels and the appetite for further moderate yielding, low volatility infrastructure debt investments is likely to increase over time, particularly as their memberships skew further towards retirement phase.

Naturally, the illiquidity of the senior debt instruments would need to be factored into the overall liquidity policies and practices of the individual superannuation funds in line with APRA standards.

In the event of unanticipated and unmanageable impacts of an individual fund continuing to hold IDA long-term bonds, we recommend that the IDA would buy back and reallocate the debt. However, we do not recommend the availability of immediate liquidity for such redemptions, but that liquidity be provided on the basis of a period of up to 12 months from the date of notification of intention to redeem. Any buyback from IDA from superannuation fund investors would be at par to discourage arbitrage activity.

The notification period would allow IDA to reallocate the debt into a growing pool of investment rather than providing any immediate guarantees on redemption.

In order to apply for such liquidity relief we recommend that the individual superannuation fund seeking liquidity would be required to have a clear case that it was unable to hold the infrastructure debt anywhere within its asset allocation in the event of the clear need for liquidity.

## **7.5 Taxation Implications**

The taxation of income within superannuation funds, as derived from fixed interest type investments, is nominally at a rate of 15% for accumulation phase investments. However the current relevant taxation provisions also provide for a zero tax rate where segregated groups of investments (supported by Actuarial certificates) are specified to meet pension phase entitlements.

The long-term, low volatility income stream associated with the long-term Infrastructure Senior Debt is well matched to the investment objectives of many superannuation fund members in the post-retirement phase of their superannuation investment as well as for significant numbers of fund members approaching retirement.

The taxation implications for superannuation fund members in retirement phase would be unchanged where the IDA Infrastructure bonds formed part of their investment asset allocation. As such no further new tax concessions would be required for participation.

However, we recommend that consideration be given to a reduced level of nominal taxation on ILA Infrastructure debt bonds for fund members not yet in the pension phase, with a concessional tax rate of 7.5% for these investments. If the initial scale of the IDA operations were \$10 bil for Senior Debt Loans ( we can see this figure growing quickly from this point) , with half in retirement phase linked investments, the cost of the concession in “foregone” taxation to the Commonwealth would be \$15 mil on current valuations/estimates. This would be offset by an equity build (and/or distributions) from the IDA to Government together with some reduced pressure on Government Infrastructure Project Grant Funding.

## **7.6 Security and Guarantees**

We have not expressly advocated a government guarantee of returns in the Paper. Currently the Commonwealth Government can borrow long term funds at levels close to historical lows and if inclined could undertake massive cheap borrowings for virtually any purpose.

The cost of such borrowings would currently be considerably less than the proposed cost of senior debt under IDA so it is difficult to come to reconcile how the Commonwealth Government might guarantee a higher rate of return when it could borrow the funds itself for less. However, in order to not increase Government balance sheet liabilities direct additional government borrowing is currently not occurring nor likely to occur.



The “security” of returns is more related to the structure of financing and bond issuance arrangements. We have proposed that the investment be senior secured debt which is at the top of the capital structure. In other words in return for a modest investment return of CPI plus 2.5% we recommend that the investment be senior debt thereby ranking ahead of other debt holders and ahead of equity holders in the event of project difficulties or failures. The risks to the senior bond holders would be the lowest of the funders of infrastructure debt projects.

As previously indicated where asset projects are Greenfield or potentially riskier the level of senior debt and debt overall should be less thereby exposing the equity holders to greater risk.

We note that in recent project failures in toll road infrastructure assets the equity holders have been wiped out as have parts of the debt holdings. However the assets have not been valueless to the most senior debt holders.

The further spread of risks achieved by combining a number of project assets in a “vintage” also affords greater security to the senior debt holders with the overall risk being low and not single asset specific.

We would therefore not expect that there is an over-whelming need for an explicit Government “guarantee” given the inbuilt security offered by the structures. However, the additional advantage in structuring IDA initially as a Government entity would impose an implied responsibility on the entity (and Government) to provide secure returns to senior debt bond holders and to address any significant failures.

## 8. Interaction with Existing Structures

The introduction of a long-term debt facility under the aegis of the Infrastructure Debt Authority does not result in the need to change existing structures or preferred processes for bringing either “brownfield” or “greenfield” infrastructure projects to the market.

The existing Commonwealth, State and Regional Infrastructure Planning entities charged with identifying strategic directions and in prioritising projects, are unaffected. However the availability of a new substantial long-term funding source is likely to assist accelerating overall schedules.

Whilst there are some challenges for the current PPP type tendering processes, including the high actual costs of putting tenders together, we do not recommend any direct changes as a result of the introduction of the alternative long-term debt facility.

The complexity of changing how the system promotes individual projects is also beyond the scope of this Paper. We also do not think that an overhaul of the system is necessary in order to introduce IDA as a preferred senior debt funding facility into current arrangements.

We contend that the availability of a source of competitively priced long-term senior debt funding, which is currently largely absent in the marketplace, will assist in bringing more infrastructure projects into play. However, IDA funding is not intended to extend to less viable or “wish list” projects which do not otherwise stack up financially.

We believe that a sufficient number of pipeline projects have been identified by the various Commonwealth and State Infrastructure Strategy/Planning organisations to ensure a flow of investable assets.

Whilst asset project offerings may stipulate that senior debt funding be sourced through IDA, a better approach may be to ensure that IDA sourced funds are competitively priced. We believe that the suggested CPI plus 3% funding cost to project bidders sits very competitively against the offerings of alternative providers of debt. The introduction of a low cost intermediary in IDA would effectively replace some current commercial providers where their funds/profit margins would be higher than for IDA unless they were prepared to dramatically reduce margins.

The IDA long-term loan arrangement provides superannuation funds with an alternative option to equity participation (but without the associated tender bid costs). Superannuation Fund participation in the long-term senior debt side of investment will not entail the same costs as bidding for overall projects.

This does not preclude Superannuation Funds from participation in the higher risk/higher reward equity side (or for that matter, lower ranked debt participation) of infrastructure projects. We would expect that the availability of a debt funding option for superannuation funds would be additive to overall participation levels in infrastructure investment.

## 9. Reduction in Risks

The capacity for Australian superannuation funds to directly participate in medium to large infrastructure projects as an equity holder/consortium bidder is currently restricted by scale and the ability to absorb upfront costs which will not be recoverable where the bids are not successful.

Given the “chunky” nature of many projects, the single asset failure risk can potentially be very high for superannuation fund investors particularly as equity holders. Australia has experienced total loss outcomes for equity holders and even substantial loss for debt holders in some single infrastructure asset projects in recent times. The capacity for superannuation funds to invest in senior debt across a selected and diversified range of infrastructure projects diversifies the risks substantially.

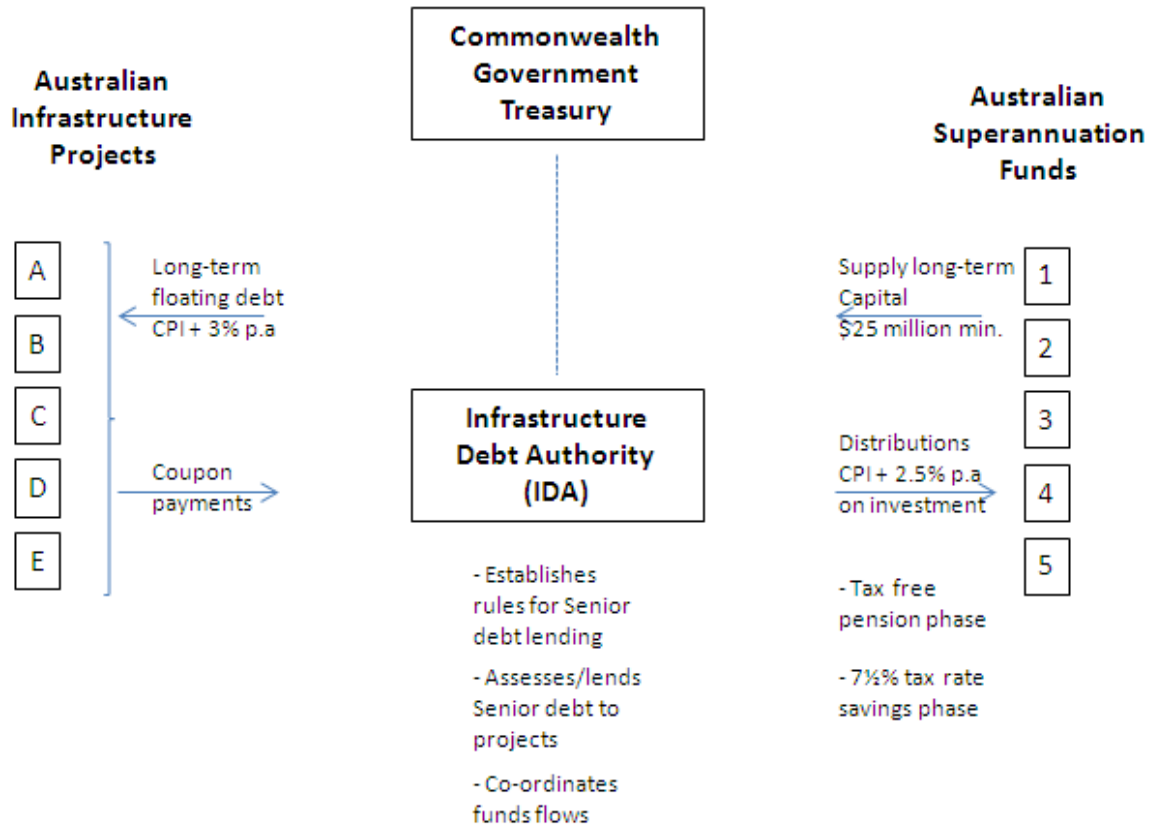
The risks of significant failure with any large single infrastructure asset will weigh heavily on much more than any individual superannuation fund.

There are flow-on risks for the Regulators (APRA, ASIC) and for the Australian Governments flowing from failures in infrastructure projects and relative financing arrangements. The failures may also contribute to a loss of confidence in the retirement savings industry.

The valuation “risks” associated with ongoing market re-pricing of assets are removed with the fixed term/consistent valuation at par characteristic.

## 10. Diagrammatic Representation of Infrastructure Senior Debt Structure

The following chart shows the recommended structure in simple terms.



## 11. Debt Funding Infrastructure Investment Opportunity for Superannuation Funds

The opportunities for Australian Superannuation Funds to participate in long-term infrastructure debt as funders are substantial. The following key advantages will flow from the opportunity.

- i) Participation in Australian infrastructure development where the ultimate beneficiaries of the projects will be the fund members in terms of external national and community facilities.
- ii) A reduction in the need to source similar Senior Debt-type investments offshore as the only currently viable route for placement of infrastructure debt (Australian superannuation funds are also currently significant investors in UK/European water, gas and rail infrastructure).
- iii) A matching of the investment return characteristics of infrastructure debt with the investment objectives of the more conservative investment options within funds and with the preferred risk profile of many pension phase or near retirement members.
- iv) The scope to build specific investment options based on largely or partly on conservative cash plus type return profiles.
- v) The capacity to put real substance on post-retirement investment strategies and on concepts of asset allocation “glide paths” whereby members progressively reduce investment risks through accumulation phases into retirement without compromising outcomes by locking into an infrastructure annuity type investment.
- vi) We have not taken into account any of the social responsibility opportunities listed above into the model as the scope has mainly focused on the financial aspects within the model. However we stress that there is a considerable potential social benefit related to enhancing the security/stability of fund member retirement incomes implied in the model in particular.

## 12. Debt funding for Infrastructure – the opportunities for Australian Governments

The facilitation of a sustainable, domestically sourced flow of debt investment for Australian infrastructure projects provides the following advantages for Australian Governments.

- i) The creation of a substantial long-term (25 year) private infrastructure debt market which currently does not exist in Australia. This program is also consistent and complementary to the recent creation of an extended corporate bond market.
- ii) The acceleration of prioritised Australian infrastructure projects at all levels of Government.
- iii) The reduction in overall funding costs for infrastructure projects and the reduction in re-financing risks within projects.
- iv) The opportunity to provide a substantial cost effective plank in the Australian retirement savings system particularly in the retirement phase.
- v) A reduction in overseas sourced debt for Australian infrastructure projects.
- vi) A redirection of financing from Australian Superannuation funds of some funding currently to overseas infrastructure projects to Australian based projects.

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Ken Marshman

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