

Superannuation investment in infrastructure – Steps to further efficiency



EY

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19 December 2013

Updated Infrastructure Investment Consultation

Dear James,

We refer to our engagement letter dated 25 June 2013. We are pleased to submit this report (the "Report") of the consultation process we undertook for the Financial Services Council ("FSC") in respect of the market for superannuation investment in infrastructure as requested in the engagement letter.

Restrictions on Report Use

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Basis of Our Work

In producing the Report we consulted with a range of industry participants over their views on superannuation investment in infrastructure. The opinions presented in the report are a summary of those expressed during the consultation process and do not necessarily reflect the views of the FSC, Ernst & Young or any particular participant. We have not independently verified, or accept any responsibility or liability for independently verifying, any information provided to us by the FSC, or derived from the consultation process.

If you would like to discuss any aspects of this letter or the Report in further detail, please do not hesitate to contact me on (02) 9248 4525 or Richard Featherby on (02) 9248 5207.

Yours sincerely



Oliver Jones
Partner

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1. Executive Summary

EY has been engaged by the Financial Service Council to review the conclusions of our 2011 report *Financing Australia's Infrastructure Needs: Superannuation Investment in Infrastructure* against current industry views on the infrastructure investment market. The catalyst for this review is the recently announced Productivity Commission inquiry into the "provision, funding, financing and costs of public infrastructure projects". The inquiry is only considering projects classified as "economic infrastructure" at this point.

As a key investor in both greenfield and brownfield economic projects, the superannuation industry has a strong role to play in responding to elements of the Productivity Commission's inquiry and assisting them to understand the elements that form an efficient infrastructure investment market.

In preparing this report we consulted with a wide range of market players, including superannuation funds (domestic and international), investment advisors and government entities on four of the key questions under the terms of the Productivity Commission's inquiry:

What are the barriers to private sector involvement and financing?

What is the appropriate distinction between the funding and financing of public infrastructure?

What is the likely effect of recent changes to the taxation treatment of business losses made by eligible infrastructure project entities? What is the rationale for such concessional tax arrangements?

What is the scope for further privatisation or 'capital recycling' of existing government assets to fund new public infrastructure?

All of these questions have direct bearing on the level and efficiency of superannuation investment in public infrastructure.

1.1 The Market's View

There was a generally clear and consistent response from the market on all four key questions which we summarise below:

Q1 – Barriers to private sector involvement and financing

Our 2011 report highlighted the following as the key barriers to further superannuation investment in infrastructure:

- A lack of a clear pipeline and government commitment
- A lack of suitably structured projects
- Greenfield project risks
- Lack of specialist expertise readily available to superannuation funds
- Inconsistent, complex and expensive bidding processes
- Regulatory and industry pressures
- Sovereign and political risk
- Unfavourable Australian banking terms

The consultation for this report confirmed that while improvements have been made, to some extent, all the above barriers still exist - with increasing concern over the volatility in taxation legislation and superannuation regulation as an important theme. The key message was that further investment in complex, illiquid long term assets requires legislative and regulatory stability.

Q2 – Funding versus Financing

Participants confirmed that there is continuing confusion both in the media and in communication with government agencies over the difference between funding and financing and that this adds to the complexity in discussing the roles that superannuation funds play in the delivery of infrastructure. Superannuation funds finance infrastructure they do not fund it. Continued delivery of vital infrastructure largely depends on government identifying and allocating additional funding sources, not on improving the efficiency of current financing techniques. The consensus of the participants was the overall a lack of finance was not a strong barrier to further investment.

Q3 – Taxation Incentives

Participants were of the strong view that the recent changes in respect of the access to carry forward losses where project interests were sold would not have a material impact on their investment plans. The changes were largely viewed as removing inefficiency in the existing treatment of taxation losses. There was a strong message that, in general, taxation incentives distort investment preferences and are unlikely to create additional long term investment allocation to infrastructure from the superannuation industry.

Q4 – Capital Recycling

Participants were enthusiastic in their support for continued government privatisation. The stable long term cash flow profile of mature port, road, electricity and other infrastructure assets provide a clear match with the investment aims of superannuation funds. The privatisation process creates additional funding certainty for future greenfield developments, that can then be considered for future privatisation once they have established stable operating profiles.

1.2 Recommendations

The results of the consultation process can be developed into the following three key recommendations, which are considered to have the most impact in encouraging efficient and value-generating additional superannuation investment in public infrastructure projects:

1. Incentivise States to establish full capital recycling processes for key infrastructure: The largest barrier over further investment was limited certainty over project pipelines. While participants have noticed improvement in the level of State Government commitment for new projects, all noted that there was still substantial uncertainty over the available funding for significant projects. Formal capital recycling structures within each state would send a clear message on the importance of key infrastructure developments.

Result: Certainty over the available funding for state project pipelines. Additional funding for major projects where significant assets sales are possible.

2. Provide certainty over Commonwealth superannuation regulation and taxation policy: The superannuation sector manages the long term financial health of most Australian employees. Effective management requires a stable regulatory environment so that the focus can be on world class investment selection and management. To achieve stability the Commonwealth and State Governments should identify and articulate a range of common, preferred infrastructure procurement approaches and commit to maintaining the current regulatory and tax settings for infrastructure projects.

Result: Clarity over the shorter term regulatory framework for superannuation funds. This will remove a barrier to a wider range of funds investing in long term illiquid assets such as infrastructure.

3. Establish a formal 'early project' consultation process between the States and superannuation investors : As efficient potential long term owners of infrastructure, the superannuation industry believes that significant efficiency could be generated from earlier consultation with key state representatives. This process should be formalised as part of the procurement business case requirements whenever private finance options are to be considered.

Result: Early consideration of transaction structures and procurement approaches that will enhance superannuation participation in greenfield transactions. Greater competition and value for money from transaction tender processes.

2. Background

2.1 Investment in infrastructure

A key element of the previous report was in adopting a very wide definition of infrastructure investment, encompassing both direct and indirect approaches. This update considered a similarly wide view of investment, seeking participant views on whether there were any clear trends with respect to preferences and opportunities between direct and indirect investment.

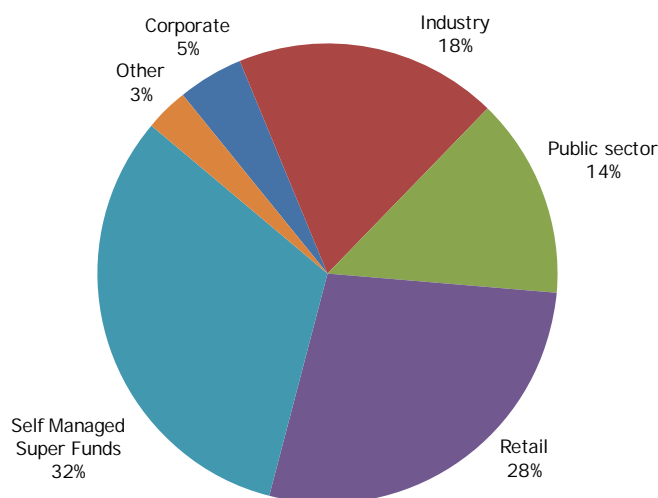
2.2 Australian Superannuation

Superannuation funds in Australia have traditionally been classified by the Australian Prudential Regulation Authority (APRA) into the following functional classifications:

- Retail
- Industry
- Corporate
- Public Sector
- Self managed super funds

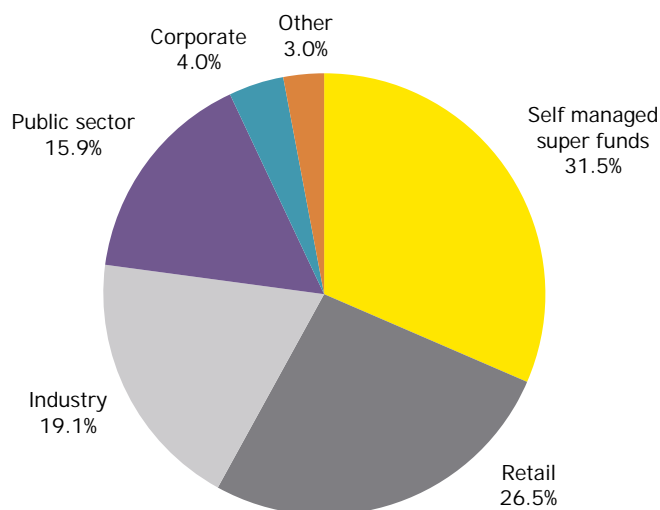
The share of assets across the different parts of the industry has remained largely the same in comparison to that reported two years ago. This is outlined in the charts below.

Figure 1: Share of assets by industry in 2010



Source: APRA June 2010 Annual Superannuation Bulletin

Figure 2: Share of assets by industry in 2012



Source: APRA June 2012 Annual Superannuation Bulletin

According to APRA June 2012 Annual Superannuation Bulletin, the value of total assets in the Australian super industry has grown by 14.3% from \$1,225 billion in 2010 to \$1,400 billion in 2012. Following the trend reported previously, the key driver of this growth has been Self Managed Super Funds (SMSFs,) which increased by 12.3% from \$391 million in total assets in 2010 to \$439 million in 2012.

The total of number of entities in the super industry has grown by 11.4% from 432,596 in 2010 to 481,957 in 2012. Again, this has been driven solely by the growth in the number of self managed super funds from 428,198 to 478,263 in that period. Consistent with the trend reported two years ago, the number of entities of every other type of super fund has continued to fall.

As the superannuation industry's Funds Under Management (FUM) grows, it is likely that consolidation in the number of funds will occur, resulting in a smaller number of larger funds over the next 15 years.¹

2.2.1 Superannuation investment in infrastructure

Infrastructure investment levels of Australian and global superannuation funds have remained relatively stable over the last two years. While not all superannuation funds invest in infrastructure, of the one-third of superannuation funds that do, infrastructure investment is estimated to make up between 2% and 10% of the total portfolio.

Various organisations have sought to articulate the extent to which superannuation funds have invested in infrastructure in Australia, however this is a notoriously difficult exercise considering the variability of markets and investment portfolios at any given point in time. A broad estimate is that around \$45 billion in total is invested by Australian superannuation funds in infrastructure in Australia. Projections are that this could rise by \$100 billion in the near term if State governments commit to privatisation of public assets², and to as much as \$200 billion by 2025 on the basis of likely asset allocations³.

¹ ASFA, Challenges of Financing Infrastructure, May 2011

² ISA, *Building Australia, Super investment initiative*, June 2013

³ ASFA, Enhancing financial stability and economic growth - the contribution of superannuation, August 2011

2.2.1.1 Recent Transactions

Since the 2011 report, superannuation funds continue to invest in the majority of PPP projects and asset sales in Australia at various stages of projects' lifecycles.

Table 1 below provides a list of PPP projects which have reached financial close since the last report.

Table 1 Superannuation investment in PPP projects

Asset	Year of Financial Close		
	2011	2012	2013
Victorian Comprehensive Cancer Centre Project			
Gold Coast Rapid Transit			
New Darwin Prison			
New Royal Adelaide Hospital			
Single Living and Environment Accommodation Precinct (Phase 2)			
Mundaring Water Treatment Plant			
Queen Elizabeth Hospital Carpark			
Eastern Goldfields Regional Prison			
Midland Public Hospital			
Sunshine Cost University Hospital			
Bendigo Hospital			
Sydney International Convention, Exhibition and Entertainment Precinct (SICEEP)			

- PPP Projects with superannuation investment
- PPP Projects without superannuation investment

Table 2 below provides a list of asset sales that have been undertaken by governments since the last report.

Table 2 Superannuation investment in government asset sales

Asset	Year of Financial Close		
	2011	2012	2013
Queensland Motorways Limited			
Sydney Desalination Plant			
QR National (Freight)			
Port Botany and Port Kembla			
Brisbane's Legacy Way Tunnel and Go Between Bridge			

- Privatisations involving superannuation investment
- Privatisations without superannuation investment

3. Participant views on superannuation investment in infrastructure

3.1 Introduction

The key focus of the consultation process was to assess market views on elements of the Productivity Commission review scope that were believed to have most impact on the market for superannuation investment in infrastructure.

The superannuation industry has an overwhelming view that there are no overarching material failures in the infrastructure investment market. Super funds have a wide range of investment conduits and understand the value of infrastructure as an asset class in matching long term superannuation liabilities. A common comment was that properly developed government sponsored infrastructure projects had never failed to attract the required private financing. The key question that this raises is: *why isn't there a much greater pipeline of transactions in the market for private finance?* The clear answer from our participants was that State Governments lack the funding capacity to accelerate project procurement through their traditional tools.

We set out below detailed views from the survey participants on the four elements of Productivity Commissions review that impact most on superannuation participation in the development of key public infrastructure.

3.2 Detailed views on barriers

The 2011 report specifically addressed the key barriers observed by superannuation. For this report, we tested whether participants had observed significant reduction in any of the barriers and if any new issues had arisen. There was a clear distinction between those areas where substantial improvements had been made and those where little progress was noted - but an overriding message was that all the barriers identified were still operative and impacting the willingness of the superannuation market to consider further infrastructure investment.

Barriers where substantial improvement has been noted:

- A lack of government commitment
- A lack of suitably structured projects
- Greenfield project risks
- Lack of specialist expertise

Barriers where minimal progress has been made:

- Inconsistent, complex and expensive bidding processes
- Regulatory and industry pressures
- Sovereign and political risk
- Unfavourable Australian banking terms

3.2.1 Key messages - Improvements

We summarise below the comments in respect of barrier improvements:

3.2.1.1 Improvements in the commitment of Government

A consistent theme of the consultation process was that there has been improvement in the performance of State Governments as they plan, develop, and implement infrastructure projects as potential private sector investment opportunities.

Increasing focus over the available funding for the mooted project pipelines and continued progress in line with announced timetables for major projects such as the North West Rail link and the East West Link road project has increased institutional investor confidence and encouraged investors to devote the extensive time required to appropriately assess infrastructure projects. However participants still noted that the most significant barrier for further investment was a lack of suitable projects in the market.

Additionally, the recent early introduction of Federal legislation to fundamentally reform and upskill Infrastructure Australia was viewed as a positive step change to addressing the issue of national project pipeline uncertainty. This reform is expected to provide a clearer structure and will place greater focus on advancing projects and reforms in partnership with the State Governments.

3.2.1.2 Innovative Project Structuring

Participants commented that structures such as the proposed rolling “build and sell” approach for the Westconnex toll road development were a positive sign that governments were focusing on developing project structures consistent with private sector risk preferences rather than simply relying on past precedents. A number of participants noted that where governments spend the additional development time to analyse and package project revenue streams they will attract a wider pool of investors and obtain better value from the transactions.

3.2.1.3 Abating Greenfield Risks

State Governments have accepted that there is limited investor appetite for greenfield patronage type exposure in transport related projects. Participants noted that government use of availability PPP structures and transactions based on the sale of brownfield revenue would attract more efficient private investment funding.

3.2.2 Consolidation of superannuation industry and implications for expertise

Regulatory and market pressure on superannuation fee levels have continued to influence further consolidation of superannuation funds in the Australian market. The average size of non-self-managed superannuation institutions has increased in recent years and this has meant an increase in the number of funds with the critical mass to consider developing in-house infrastructure investment skills.

Some participants additionally noted that investment managers were developing additional indirect infrastructure investment vehicles aimed at medium sized funds that could not justify the expense to create an in-house infrastructure team.

The international superannuation funds that are currently engaged in the Australian market, particularly those from Canada and the UK, are viewed as having relatively greater in-house staff experience and expertise when it comes to investing in infrastructure assets. In summary participants believed that access to infrastructure investment assessment and management skills continues to improve.

3.2.3 Key Messages – Unresolved areas

The following issues were those most referred to as having the greatest negative impact on the further expansion for superannuation investment in infrastructure.

3.2.3.1 Sovereign Risk - tax and regulatory framework uncertainty

Participants noted that volatility in both taxation legislation and the superannuation regulatory framework continues to act as a disincentive for funds to step up current investment levels.

Participants commented that the recent income tax changes to thin capitalisation and withholding tax for Managed Investment Trusts highlighted that sovereign risk was a continuing issue. While participants noted that they are used to managing income tax risks in structuring transactions, these changes were introduced with minimum warning and without effective grandfathering. Participants noted that if the new government shows a similar approach to the introduction of unfavourable changes to tax and other regulations, then investors will start to demand risk

premiums for their investment in infrastructure compared to alternatives, reflecting the substantial long term exposure to income tax risks and the basic illiquid nature of infrastructure as an investment class.

Some international participants commented that over time continuing uncertainty over the taxation system can potentially reduce foreign competition in the Australian infrastructure market, particularly as other emerging markets 'catch up' in terms of their infrastructure market as a viable alternative.

3.2.3.2 Continuing Industry Structural Changes

Participants commented that the further changes to the superannuation industry structure, particularly the "MySuper" initiative, continued to influence contributors to take a shorter term view of their superannuation investment strategies. A common comment was that the focus of MySuper on the level and transparency of administration expenses would drive funds to offer very simple and liquid investment options.

3.2.3.3 The Bidding Process

Participants still view government bid processes, particularly greenfield transaction processes, as overly proscriptive. The general view was that evaluation structures were largely focussed on assessment of the construction contractors and the financing certainty, rather than on the long term alignment of the potential asset owner.

Some participants pointed to the process run by the NSW Government in responding to the unsolicited Transurban proposal for the F3/M2 link as an example of a more effective collaborative approach to securing private sector investment in greenfield infrastructure.

3.2.3.4 Debt Market Inefficiencies

A number of participants commented that there had been little improvement in the debt terms available in the Australian market. Refinancing risk was referenced as an important issue to consider when assessing greenfield opportunities. Participants noted the substantial exposure that exists between construction completion and commissioning, with a poor refinance outcome having the potential to substantially reduce the long term equity return.

3.3 Taxation Incentives

The recent Commonwealth announcement to exempt certain infrastructure projects from the "same business" and "same ownership" tests in retaining access to accumulated losses and allow application of uplift, based on the Commonwealth bond rate, to these losses was discussed with participants. The general view was that the "incentive" component of this change was of minor consequence. Participants considered that the removal of the tests to retain the losses was a correction of a long term inappropriate application of taxation principles, not an incentive. There were consistent comments that this change should be expanded to all infrastructure special purpose entity structures as a matter of taxation efficiency.

As typical purchasers of operating infrastructure assets, it was noted that the uplift factor simply changes the market price of assets with access to the uplift - it does not change overall attractiveness of infrastructure as an asset class.

Subsequent discussion with participants confirmed a general view that specific taxation incentives were not an efficient mechanism to secure long term additional investment in infrastructure. It was noted that such incentives are typically applied for limited time periods and distort market preferences without lasting impact on the transaction forms and processes used by government sponsors of public infrastructure. Taxation incentives do not transform non-viable projects into viable projects.

Participants commented that the Commonwealth focus should be on synthesising taxation legislation and retirement income regulation into a stable policy envelope that permits superannuation investors to efficiently manage the long term challenge of the transition of the

Australian superannuation profile from funds inflow to outflow. This requires the Commonwealth to accept that a short term approach to regulatory and taxation changes is a strong disincentive to the superannuation industry to consider further allocation to infrastructure assets.

3.4 The funding/financing difference

The 2011 report highlighted the lack of clarity, particularly in media reports, over the difference between funding infrastructure and financing infrastructure. Participants noted that while some Government agencies now had a much clearer understanding on the difference, there was still widespread confusion between the two terms. The difference has been noted again as follows:

Funding refers to the cash flow sources that will be allocated to paying for an infrastructure development. These are general taxation revenue, user charges, or specific value capture levies.

Financing describes how the funding amounts raised are used to develop the infrastructure assets. Financing techniques include the full range of procurement approaches from D&C contracts with payments made by Government borrowings to complex PPP structures with a mix of private and public financing.

Superannuation funds do not fund infrastructure, they finance it. For superannuation investors to be interested in financing a project there must be certainty over the level of funding available to support the project expenditure and pay the funds a return commensurate with the project risks.

3.5 Capital Recycling

3.5.1 Current Challenge facing Governments

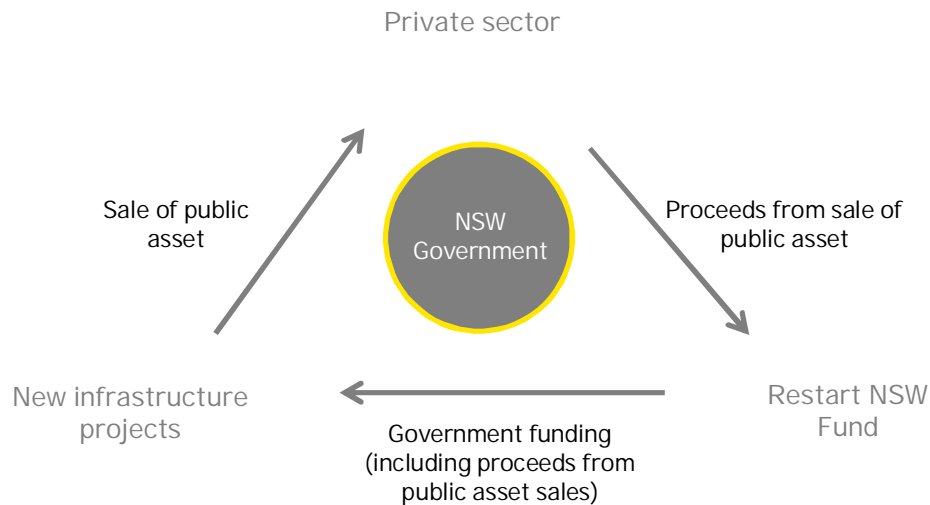
Participants appreciated that Australian governments are facing increasing pressure on their budgets with a need to deliver new infrastructure and improve services. State Governments in particular have had limited capacity on their balance sheets to fund a growing infrastructure task. Infrastructure ownership has been seen by credit rating agencies as adding to balance sheet risk and often requires longer-term capital spending requirements putting pressure on the maintenance of government credit ratings. These constraints on the public sector mean that there is a need for new sources of funding to bridge the infrastructure deficit.

3.5.2 Capital Recycling – a Viable Solution

The recycling of capital from mature assets to finance new infrastructure was considered by participants to be an effective approach to freeing up government funds to address the infrastructure backlog. There was a strong view that this allows governments to create a “virtuous circle” whereby:

- superannuation investors would purchase brownfield assets at yields consistent with their established operating profile
- governments could invest the proceeds in new ‘greenfield’ projects, avoiding the need to involve early expensive private funding, and
- eventually sell the greenfield infrastructure as a brownfield asset when the cash flow profile is stable.

In the context of the NSW Government, the flow of funds in the capital recycling process can be demonstrated below:



Asset sales such as these help to encourage investment in infrastructure by superannuation funds as outlined in the case study below.

Case Study: Port Botany and Port Kembla sale

A key example of capital recycling transactions driven by the NSW Government is the recent sale of Port Botany and Port Kembla. In May 2013, the NSW government agreed to a 99-year lease of Port Botany and Port Kembla (Wollongong) in exchange for \$5.07 billion from a consortium led by Industry Funds Management (IFM), Australian Super and Tawreed Investments Ltd, a wholly-owned subsidiary of the Abu Dhabi Investment Authority. The ports were sold for a combined price of 25 times earnings before interest, tax, depreciation and amortisation, well in excess of NSW's Treasury expectations of \$3-4 billion. This reflects the significant demand for attractive infrastructure investments from superannuation funds. Under the deal, the government agreed to retain the cost of providing a range of expensive services required for the proper functioning of the two ports, including pilotage, vessel tracking and monitoring, emergency response and overseeing dangerous goods.

The net proceeds of around \$4.3 billion from the sale will be channelled to new infrastructure, in particular the NSW Government's \$1.8 billion commitment to the WestConnex toll road project. The benefit of capital recycling is also expected to extend to the long-term interest savings for the NSW government through the maintenance of the state's AAA credit rating.