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Dear Peter

### **Private financing of major infrastructure projects**

This is a submission on one topic covered by your review, being barriers to financing of infrastructure projects.

Herbert Smith Freehills has extensive experience as legal advisors involved in infrastructure projects delivered by both the public and private sectors in Australia and other global markets.

We are very conscious of the extent to which the private sector is able to provide financial support and operational capability to help meet Australia's infrastructure needs – estimated at \$760 billion over the next ten years.

We wish to make a submission regarding private financing of major infrastructure projects. We believe that one particular avenue for government to support private infrastructure projects, especially during construction, is worthy of consideration.

We have canvassed this concept with Grant Samuel, who have contributed some thoughts and analysis which are set out in schedule 2 to this submission. Grant Samuel is a well respected independent advisory firm with a leading financing advisory team.

### **Some key impediments**

Significant pools of private capital are available to invest in infrastructure but there are a number of impediments which materially influence the cost and availability of that capital.

Impediments to the provision of finance for infrastructure projects which have already been identified by others include:

- greater financial support from the Commonwealth given that virtually all infrastructure needs are managed by state governments with limited financial resources;
- over – investment by state governments in infrastructure, especially electricity transmission and distribution and water infrastructure, which has the effect of:
  - limiting the pool of AUD debt capital markets instruments available for investment thus slowing the development of a deeper and more active market in longer tenor low priced issues; and
  - tying up government investment capacity which could be released to support new infrastructure investment;
- a reluctance on the part of government to embrace user charges either directly through tolls or charges or indirectly through property levies;

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- poor planning of an “infrastructure pipeline” of projects which allow both private sector investors and contractors to plan their resources;
- a reluctance on the part of government to tackle some of the risks for the private sector of participating in high cost tendering processes by covering a portion of losing bidders’ bid costs (recognising that this issue is partly addressed by the New South Wales government’s unsolicited bid process which may be suitable for some projects);
- the high cost of construction and high risk of cost blow outs (relative to other countries) associated with labour market constraints, inefficiencies, regulation and other factors;
- the relative unattractiveness of investment in projects which are loss making in accounting and tax terms for many years and the inability of many classes of investor to offset tax losses generated at the project level against other taxable income; and
- the challenges in accessing competitive, long term debt funding for infrastructure projects.

**This submission concerns only the last of these points.**

### **Funding models**

Models which have been developed in response to the need to find ways for private sector investors to access competitive long term debt funding for infrastructure projects include:

- government direct investment in projects whereby a government funds the entire cost of developing the project (by borrowing on its own account) and then seeks to sell the asset to the private sector when construction is complete, construction risk is removed and the project’s revenue model and debt servicing capability is well established;
- capital contributions by governments to meet part of the construction cost and reduce the need for debt funding;
- direct provision by government of debt funding for the project – either all of the debt or a portion which is subordinated to senior lenders;
- provision by government of guarantees to support project debt;
- assumption by government of revenue risk for a completed project by making availability payments or guaranteeing project revenue; and
- establishment of a specific fund controlled by government and dedicated to the giving of guarantees to support private sector borrowings.

These broad categories of avenues to support the funding of infrastructure projects are described in schedule 1 attached, together with some examples.

**This submission concerns only the last of these measures - one that has not yet been adopted in Australia. We consider is worthy of further consideration.**

### **Sources of debt funding for infrastructure projects**

A range of factors conspire to increase the cost of traditional bank debt financing for infrastructure projects including:

- total volume capacity constraints of the Australian bank debt market;
- the limited availability of bank debt for construction risk credit profiles;



- tightened global credit markets and increased capital requirements of banks generally;
- limited domestic deposit base of major Australian banks which encourage them to lend smaller amounts and for shorter terms than international comparators;
- limited number of Australian banks – which often acts as a natural limit to the number of competitive bids that can be made for a project especially where governments do not insist that tenderers for projects permit their lenders to also support competing bids; and
- poor performance of a number of recent projects due to cost or time blow outs or revenue miscalculations.

The deepest source of funds to support capital asset financing is the United States debt capital market. This funding source exceeds the size of the global listed equity markets by many multiples.

Investment grade borrowers can access low cost competitive funding from this market for attractive tenors such as 10 – 15 years. This is the market that Australian banks access for most of their funding needs.

There are also other debt capital markets in Europe and Asia and a small emerging AUD market in Australia.

These markets are capable of supporting large issues of relatively low margin debt on attractive terms.

Mature infrastructure projects can access these markets once construction risk is removed and revenue sustainability is secure and a strong investment grade profile evident. However, this source is not generally available until that time.

Hence equity providers to infrastructure projects have to allow for a high cost of debt during construction of a project and a short tenor which means earlier refinancing risk. Equity needs to factor these costs and risks into its expected returns.

These factors lead to significantly higher costs of a total finance package that the private sector can provide for infrastructure projects. Those costs then manifest themselves in higher charges to users (e.g. tolls or water charges) and / or greater government capital contributions or subsidies.

A comparison of the various types of debt which can be accessed by borrowers and the circumstances where that debt is available is included in the Grant Samuel analysis included in schedule 2. This also compares the cost of debt which has different credit rating profiles.

### **How do guarantee programs work?**

An entity with a strong credit rating guarantees financial risks associated with debt instruments such as bank debt or bonds, in a process known as “credit enhancement”. This allows equity investors in PPP projects access to the debt capital markets because the market will look to the blended enhanced credit profile of the offering rather than the credit profile of the underlying issuer.

The entity can provide guarantees or other forms of credit enhancement to all of the debt instruments issued by an infrastructure owner or only some. Support can be provided to enhance the repayment of principal or interest or first loss or junior debt or a combination. The support can be structured so that it falls away when the project achieves certain hurdles and meets credit metrics which are considered suitable for a stand-alone issuance at the desired pricing.

Prior to the global financial crisis entities known as “monoline insurers” would provide credit enhancement of this nature. They would charge a fee for providing the support but



the cost of the fee was small when compared to the savings in interest arising from the lower cost debt.

The global financial crisis resulted in material downgrades in ratings of the monoline insurers themselves (and in some cases insolvency) due to their exposure to the subprime mortgage asset market. The monoline insurers were no longer able to provide credit enhancement to debt instruments associated with major infrastructure projects.

The guarantees which are issued by such bodies are similar to those issued by the US TIFIA program and the UK Guarantees scheme (as described in schedule 1) except that the guarantees are issued by a standalone entity and not the State.

Recently, there has been a re-emergence of the monoline insurers supporting limited investment in infrastructure.

Assured Guaranty, for example, has provided a guarantee for bonds issued to finance the Sustainable Communities for Leeds hospital development in the UK, which in early 2013 became the first public primary PFI bond in Europe since the start of the global credit crisis in 2008. It is also reported to be involved in Edinburgh University's student residences PPP, as well as 2 other deals in the UK.

However, we have not yet seen the widespread re-emergence of monoline insurers. This may well happen over time but, for the moment, there is a gap in the market.

In general, utilities, airports and infrastructure business tend to have credit ratings that are at the lower end of the investment-grade scale, notwithstanding their tangible assets and generally solid cashflows. This is due to their relatively high capital expenditure requirements and demand for debt, in particular, long-term debt, and the extent of the leverage associated with optimal capital structures for these projects.

Nevertheless, the high quality of the assets and the reliable cashflows means that infrastructure assets are often more attractive than other businesses to providers of credit enhancement products because they are likely to offer a high recovery rate in the event of default. Indeed, very few calls were made on credit enhancement of infrastructure debt during the financial crisis.

### **How could a state owned Infrastructure Fund be established?**

A fund to support infrastructure project debt could be established by either state governments or the Commonwealth. Some States may prefer to have the fund under their own control so as to be confident that it can be established quickly and be available to support projects within the State and not be subject to "second guessing" by the Commonwealth which has occurred in a number of other areas.

A State could create a state owned entity to hold the Fund with its own independent governing body to oversee running of the Fund. It would be established as a separate body under its own legislation, similar to the Future Fund. The legislation would seek to "future proof" it so that future governments could not raid it for projects outside the express criteria for which it was created.

The Fund's governing body would need to maintain appropriate prudential requirements consistent with the requirements of the relevant ratings agencies to ensure appropriate levels of risk and contingency reserves and in order to achieve a high (ideally A) credit rating.

Thus both the initial establishment and sizing of the fund and its investment mandate would be designed to ensure that the fund maintained a credit rating in or above the "A" range. This should allow it to have the greatest impact on the cost of funds for those projects which it chooses to support.

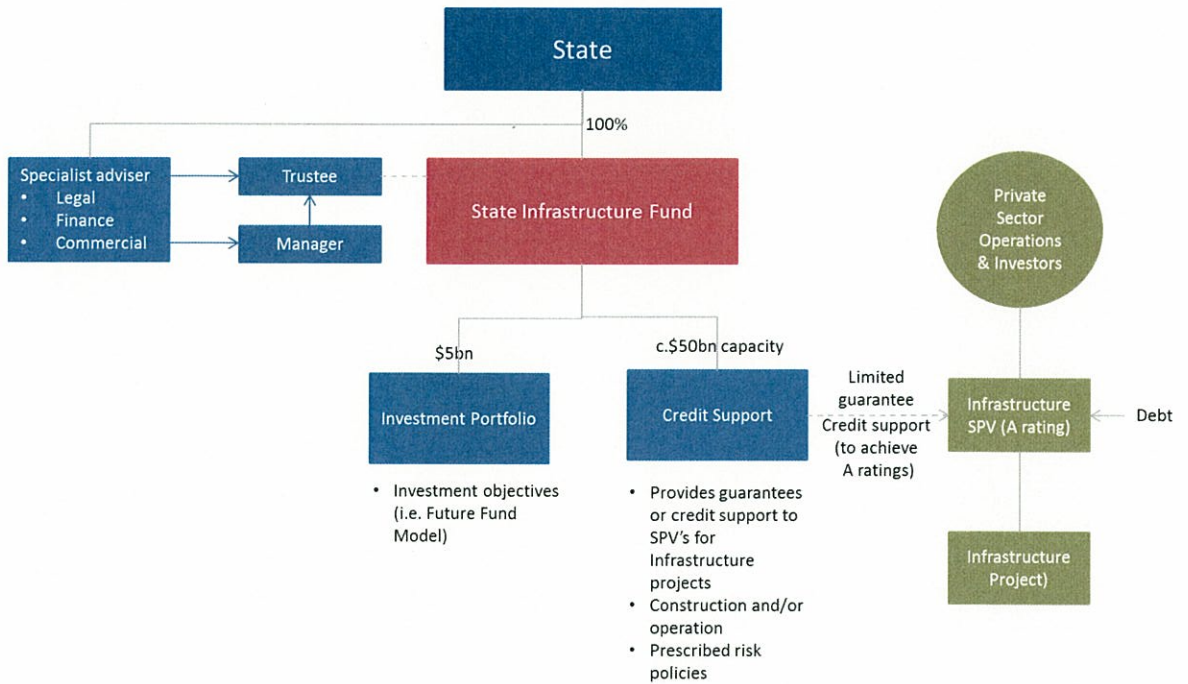
There would be a requirement for the Fund to develop competence in risk assessment, financial structuring and relevant project delivery skills, as well as experience in both domestic and international credit markets.



Seed capital could be provided for the fund through the sale of an asset by the state. The seed fund would grow over time through prudent investment and by earning guarantee fees.

If a State were to establish a fund of this nature, it may make sense for it to support appropriate projects in other states, since the guarantees issued by the Fund could be many times the Fund's size and the more projects are added the greater the diversification and the stronger the fee revenue streams.

The Funds structure and operation is illustrated as follows:



### How would such a Fund operate?

The Fund would focus solely on providing credit enhancement for debt instruments issued by major infrastructure projects, modelled on the US TIFIA program and UK Guarantees Scheme (see schedule 1 attached).

The Fund would need to have clear criteria for the deployment of its resources. Criteria could include:

- projects which are accorded a particular status by Infrastructure Australia
- projects of a particular size and financial structure (for example minimum equity requirement, minimum interest coverage ratio based on an audited financial model)
- projects within a particular definition of "infrastructure"
- maximum exposures to particular projects or credits
- target number, size and diversity of exposures within a medium term timeframe (e.g. 5 years)
- probity arrangements (e.g. how the Fund would engage with bidders for a project)



Through robust risk assessment and the charging of fees for providing guarantees, it would be expected that seed funding would never be called upon to support the Fund's obligations.

The Fund could attract new sources of funding for proponents of infrastructure projects – especially debt capital markets - by improving credit ratings. These sources can deliver lower cost and longer term funding than traditional bank debt.

It may also be possible to use the Fund to support offerings of debt securities into the Australian wholesale investor market, which has the capacity to absorb reasonably sizable issues of well rated debt instruments. There may even be the potential to tap the retail investor market thus providing avenues for self-managed superannuation funds and private investors to invest in infrastructure projects which is currently limited.

Seed funding could be applied to support infrastructure lending and investment of many times the size of the fund, particularly if the focus of the Fund is to provide debt guarantees. The US Department of Transport estimates that its TIFIA budgetary commitment supports a ten-fold amount of lending capacity. Hence, as per the US model, a \$5 billion fund may be able to provide credit support for \$50 billion in project debt.

The granting of infrastructure guarantees may not be suitable for application to all infrastructure projects, particularly those that are traditionally procured directly by government.

However, it could potentially be applied to any infrastructure project best procured through the traditional PPP model (e.g. projects above a certain capital threshold which are considered likely to benefit from private sector innovation and compare favourably on PSC measures).

### **What impact could a Fund of this kind have on the cost of financing an infrastructure project?**

A comparison of some of the different types of debt which the Fund may potentially enable a project to access is set out in Grant Samuel's analysis in schedule 2.

This paper also seeks to quantify the savings that could potentially be made for a notional project with a 5 year construction period and a total capital cost of \$5 billion where the project is able to fully utilise a credit enhancement product made available on commercial terms for \$1 billion of debt, compared to relying wholly on the bank debt market.

In this hypothetical example, the savings could be of the order of \$213-525 million over the 5 year construction period, excluding fees earned by the Fund.

In a project which relies on state revenues (because there are no third party user charges), this saving should be fully transferred to the state and reduce the demand on the budget by the same amount.

There are many variables in this type of analysis. It could, for instance, be that the savings would be even greater if the project required less equity as a result of the enhancement or if the equity came at a lower cost due to the more secure debt package. It also has no regard to any savings after the initial 5 year construction period which might also benefit from credit enhancement.

Finally, the fees generated by the Fund from providing the credit enhancement (in the example used, a total of \$75 million over the 5 year period), add to the value of the Fund and could be re-invested. Thus, the gain in value by this amount and any income earned on these fees would add to the value of the Fund assuming no claims are made on the Fund.



### **How would the Fund's operations impact on the State's credit rating?**

As this model has not been instituted before in precisely this form, the manner in which it would be assessed by credit rating agencies has not been tested.

However, the Fund would be expressly established as an statutory corporation which does not enjoy any State support. Any guarantees or other support granted would be granted on the express basis (and with appropriate acknowledgements of the recipients) that the State does not support the Fund's obligations and the recipients of the guarantees would have recourse only to the Fund.

Further, the State would make it clear in the legislation under which the Fund is established and in parliamentary processes which support it that the Fund does not enjoy any support from the State – explicit or implicit.

In these circumstances, we would expect that the obligations of the Fund would not be factored into the State's credit rating.

We would hope that the existence of the Fund and the potential for it to be realised by the State in the future, combined with the strengthening of the State's infrastructure made possible through the Fund may even enhance the State's credit rating.

### **Does this model still make sense for projects which do not deliver significant user pays revenue?**

Much of the literature on infrastructure financing assumes that a notional project will deliver revenue from the public which will support the project.

In fact, most of the infrastructure projects which governments are seeking to deliver do not deliver external revenue sources sufficient to service equity and debt.

For example, Victoria's 2012 submission to Infrastructure Australia includes projects such as Melbourne Metro (a \$9 billion project which will only support relatively minor incremental growth in public transport ticket sales or, property rental), a progressive programme of level crossing removals, the Avalon – Melbourne rail connection, the Western Highway and Princess Highway East duplications, the Shepparton bypass, rail signalling upgrades and a rail link between Mildura and Broken Hill.

These projects would deliver no or very little incremental revenue. This means that, if the state wishes them to be delivered by the private sector, the state will need to write concession agreements which will provide ongoing financing from the state budget for the life of the investment (say 20 years).

The model canvassed above of a State infrastructure fund supporting project debt through guarantees will, however, still be very valuable for the State because it will materially reduce the cost of debt to the project and therefore reduce the State revenues which are required to service the project capital.

This could save the state significant amounts over the life of the project and thereby allow the State to fund more projects than it would otherwise be able to support.

### **Would the Fund still be needed if other market mechanisms emerge to fulfil a similar role?**

It is possible within a 10 year timeframe that monoline insurers could re-emerge to the point where a Fund of this nature may no longer be required in order to deliver lower cost debt funding and longer debt funding tenors.

At that point the Government which established the Fund could look to sell the Fund (either to one of the monolines or perhaps a superannuation funds).



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

**Comparison of the establishment of an Infrastructure Fund with other forms of State support for infrastructure development**

A quick comparison of the funding models mentioned in schedule 1 to this paper with the state infrastructure fund model is as follows:

Funding Model	Risk Transfer to private sector		Impact on State debt (to the extent using borrowed funds)	Impact on State credit rating	Projects to which model could be applied
	D&C	O&M			
Full government funding followed by sale of asset/business	x	√	Increase in State debt initially	Negative until sold	Economic infrastructure
Capital Contributions	√ (depending on when contribution is made)	√	Increase in State debt	Negative	Economic and social infrastructure
Government Supported Debt Model	√	√ (partial)	Increase in State debt	Negative (but lower impact depending on nature of support)	Economic and social infrastructure
Availability Payments	√	x (although partial risk transfer in setting performance standards)	Debt neutral	Negative	Social infrastructure
State infrastructure guarantees	√ (partial)	√ (partial)	Debt neutral	Negative	Economic and social infrastructure
State Infrastructure Fund	√	√	Debt neutral (to the extent seeded by money from sale of large asset)	Neutral	Economic and social infrastructure meeting relevant guarantee criteria similar to that applied by monoline insurers





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### Conclusions

We consider that a Fund of this nature has the potential to become an important pillar in the delivery of infrastructure investment in Australia.

Yours faithfully

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