

This submission follows Assured Guaranty's original submission to the Inquiry (reference submission 29). Our focus is the Information Requests in chapters 5 and 6 of the Commission's Draft Report, which discuss raising finance for infrastructure development and alternative finance mechanisms. Furthermore, we propose an innovative structure to support the development of an Australian infrastructure bond market for Greenfield projects. Finally, we also specifically address the concept of repo eligibility for infrastructure bonds that we raised in our submission and which the Draft Report indicates that the Commission wishes to discuss further (p204-205).

Financial Guarantees

Several submissions to the Inquiry referred to the 'withdrawal' of 'credit insurers' from the Australian market, usually recommending that this role be taken up by governments. The Commission notes these views in Table 6.1 of the Draft Report, which summarises participants' views of impediments to infrastructure financing. The Commission also referred to our submission in the context of an observation that "there may be indications that the commercial monoline market is beginning to re-emerge in some instances" (p187).

We would like to clarify the situation with regards to the private sector providing financial guarantees. Although the most recent public bond issued in Australia with an Assured Guaranty financial guarantee was in 2008, the company has at no stage exited the Australian market. Indeed, since then we have worked with institutional investors and have provided financial guarantees on a private basis. Furthermore, in July 2009, Assured Guaranty successfully acquired competitor Financial Security Assurance, which resulted in an increased exposure and a current portfolio across Australian project and infrastructure-related bonds of more than A\$6 billion of net par insured.

However, the bid process for greenfield transactions, including the requirement to obtain a fully funded bid, hinders the ability of any project to seek longer term, capital markets funding. In turn, this impedes creating opportunities for any monoline to provide financial guarantees in this market. These obstacles are in no way linked to any unwillingness or inability on our part to provide financial guarantees.

Whether governments also provide guarantees on some transactions is another matter entirely, but Assured Guaranty remains well and truly open for business and has the financial capacity and resources to support worthwhile projects.

We also note that our international business has been writing new deals (see section 3 of our original submission). Our European office has successfully closed several new UK greenfield transactions with long-dated term to maturity funding. These transactions illustrate the potential for Assured Guaranty to play a constructive role in Australia in addressing some of the key impediments to infrastructure financing, in particular the reluctance of many institutional debt investors to accept greenfield project risk.

Greenfield Risk

Several submissions to the Inquiry noted that there is a reluctance on the part of a number of institutional debt investors to accept Greenfield risk. This specifically includes construction risks as well as patronage and early start-up phase risks. In recent years, institutional debt investors have been developing their corporate credit risk analysis teams and skills to enable greater coverage of the bond universe, however the more technical aspects of construction risk are more difficult and expensive to manage and mitigate.

In part, this is one of the impediments to developing bond market capability as contemplated by the Commission’s Information Request 5.1.

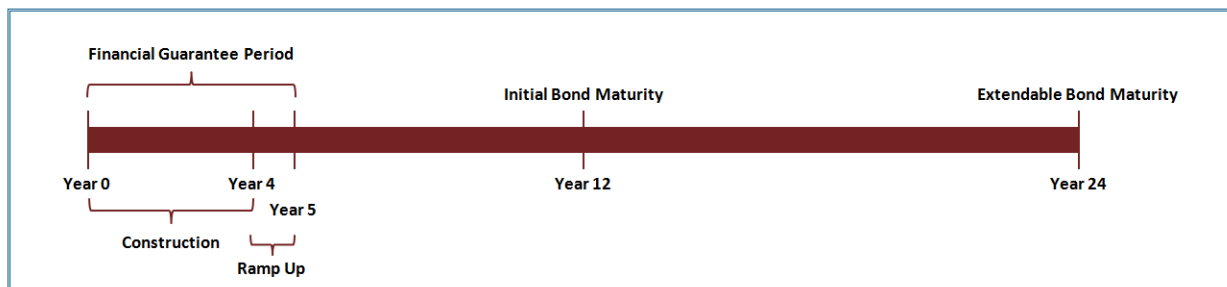
This reluctance has not always been a feature of the Australian landscape. In fact, many greenfield projects were successfully financed when private sector infrastructure financing first emerged in Australia, in the late 1990’s/early 2000’s.

The model that was adopted then was that the risks during the construction phase were supported by a letter of credit (“LC”) from a “AA” rated financial institution. Debt securities were issued with a longer term to maturity than the period covered by the LC. With this credit enhancement, the ratings agencies tended to ‘look through’ the more high risk construction phase and typically assigned to the security a rating in the “A” band at issuance. The stronger credit quality of the LC provider supported the bond during a risk period that would otherwise have seen a significantly lower rating assigned.

The following table shows some of the projects that were successfully financed with the LC:

Project	L/C bank	Closed	Bonds	Initial Rating
Spencer St Station	ABN Amro	2003	US\$74 mn Bullet (due 2014)	Aa2/A
			A\$1,587 mn Bullet (due 2014)	Aa2/A
			A\$135 mn Annuity (due 2032)	Aa2/A
Queensland Schools II	ABN Amro	2006	A\$80 mn CPI bonds (due 2035)	Aa2/A
			A\$34 mn CPI bonds (due 2031)	Aa2/A
Darwin Conference Centre	ABN Amro	2006	A\$45 mn CPI bonds (due 2033)	Aa2/A
			A\$45 mn Annuity (due 2033)	Aa2/A
Southbank TAFE	ABN Amro	2006	A\$95 mn CPI bonds (due 2035)	Aa2/A
			A\$127 mn Bullet (due 2020)	Aa2/A
			A\$20 mn Annuity (due 2018)	Aa2/A
Single LEAP	Deutsche	2007	A\$237.2 mn	Aa2/A

To meet the needs of the Australian market, Assured Guaranty has developed a product that, in essence, revives the LC model. This structure addresses many of the issues identified in the Draft Report. The following diagram illustrates this structure. The example is of a 12 year bond on a project that has 4 year construction and 1 year ramp up. Of course, if investor demand existed, bonds of longer tenor could be issued.



This structure significantly de-risks projects for institutional investors as they only face the project without a financial guarantee once:

- Full operations phase service has commenced;
- The government procuring authority has begun making service payments;
- Operations phase security / reserves have been funded; and
- Independent certification of project completion has been provided and there are no material disputes in relation to the building works.

The benefits to issuers of bonds with this form of financial guarantee include:

- Opening up of financing options for greenfield projects beyond reliance on bank debt;
- Access to longer dated debt than currently available from banks, which reduces refinancing risk;
- Ability to issue bonds rated higher than the underlying construction / ramp-up phase ratings; and
- Dealing with a single, highly experienced, counterpart in negotiating project agreements; and Assured Guaranty will work with project sponsors during bid phase.

The benefits to institutional investors of such bonds include:

- Irrevocable and unconditional guarantee against construction / completion risk – which are the risks that investors are not equipped to assess or manage;
- Greenfield risk covered by a highly rated counterpart (AA / A2), and a highly experience project risk underwriter;
- Increases the flow of investment opportunities as there is no need to wait for deals to mature and be refinanced away from banks or sold by government owners at brownfield stage; and
- Provides a higher yield – i.e. better return - than bonds which are fully guaranteed and carry the rating of the guarantor (In Assured Guaranty Municipal Corp's case, its Standard and Poor's rating is "AA" (stable)).

Traditional Financial Guarantees

We have worked up our product proposal based on a bond term of, say, 10-12 years because the domestic market still seems unwilling to invest heavily in longer term debt, such as the terms to maturity that would match a project concession.

However, if demand was found to exist for long term debt, then a more traditional credit wrap would come once again into play. In this respect we note the proposal included in the submission made by Maritime Super (sub 15) that an Infrastructure Debt Authority be established to intermediate superannuation fund investors and infrastructure project sponsors. Assured Guaranty believes that the activities we undertake in assessing and supporting projects over their life as in a full credit wrap situation are very similar to what Maritime Super (and their consultant, JANA) have in mind.

Government and Guarantees

It was presumed in many submissions received by the Commission that some form of government involvement – whether direct funding of some sort, or a guarantee to investors – is the only option available for greenfield projects. However, while many projects are likely to be best served by government balance sheet support, Assured Guaranty is able to offer private sector alternatives that support longer term bonds through the greenfield stage by providing our financial guarantee through construction and ramp-up.

In respect of the Commission's Information Request 6.1 we note also that governments could make use of our expertise and risk management capability in relation to project-specific infrastructure bonds. In many instances, Assured Guaranty may be able to provide financial guarantee to the state against construction risk and could apply our strong credit management processes to assist the government negotiate appropriate credit terms on the bonds it issues. Furthermore, as part of this proposal, Assured Guaranty would also manage the transaction (on behalf of the state) including waiver and consent requests during the construction period and subsequent ramp-up of operations. This could serve to eliminate any conflict of interest where government is both lender and off-taker.

Of course, a bond financing alternative like this is only practically feasible if projects are not discouraged from seeking longer term, capital markets financing solutions. Therefore, we turn to the second element of the market that we believe impedes the development of bond market financing mechanisms for infrastructure – the PPP bid process.

PPP Bid Structure

In Australia, parties that bid to participate in PPPs are required to include fully underwritten, price-certain debt terms at bid date. This approach does not support capital markets execution, which typically cannot lock in pre-commitments from investors, and thus strongly gravitates financing towards banks who are in a position to provide such commitments.

In the context of Information Request 5.1 we note that this is a further impediment to developing a bond market response in financing new build projects.

Furthermore, governments tend to reward those bidders who base their pricing on the lowest cost of debt. Typically this means that bids look for the lowest current interest rate on debt, and assume that this can be maintained over the full life of the project / concession. Again, this encourages reliance on short term, bank finance instead of longer term, capital markets solutions.

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In our view, this represents a focus on short term cost as opposed to long term value for money. It leaves project companies significantly exposed to refinancing risk, in particular when the refinancing margins assumed in the bidder's financial model prove unrealistic. The Commission's Draft Report refers to refinance risk on p170, but we would note that this risk is greater than the examples noted. The issue is not just that refinancing can be difficult if the credit quality of the project has deteriorated. Rather, it is the risk that the cost of credit available at refinancing points can be much higher than factored into the equity valuation at bid even for a project that has maintained its credit quality.

For one thing, credit spreads are not constant. This was dramatically demonstrated in 2008 and it should never be assumed that narrow risk margins provided by the banks today for 5 year funding will again be available at every refinance point in the future.

For another, the absolute cost of credit is not constant. The positive slope of the yield curve at the moment should be warning bidders that the market expectation is that they will have to refinance at a higher interest rate down the track.

It is, therefore, in the interests of effective financing of infrastructure that the best value for money options are able to be explored.

This issue has been addressed in the UK where the PPP bid process does not require fully committed funding up front. Rather, in the UK the successful bid is first determined and then the project is subject to a competition for funding. HM Treasury requires a range of funding models to be included, each of which makes the case for its value proposition. The goal has not been to reduce bank funding per se, but to encourage complementary financing sources.

As noted, Assured Guaranty has successfully closed four project finance transactions on this basis since mid-2013. These Greenfield deals were successfully financed in the long term bond markets with the benefit of our financial guarantee on terms considered by project sponsors to be more attractive than the bank debt alternative.

In Table 6.3 of the Draft Report and in Information Request 6.3 the Commission refers to a proposed "inverted bid process". The UK model discussed here could be consistent with that proposal, which envisages financing being considered much later in the bid process than is currently the case. However, the UK model would be a sufficient development in our view to make a significant difference to the debt funding aspect of infrastructure in Australia and should be considered alongside other recommendations in relation to the bid process.

Repo Eligibility

The Draft Report discusses this on p 204-205, commenting on a suggestion that we made in our original submission. The Commission indicated that it isn't convinced of the case, "but will consult with relevant parties and investigate the proposal further for its final report".

As we noted in our submission, "there are other policy factors that have priority for the RBA in determining what type of securities it will repo". We do not presume to be in a position to put a weight on those factors versus the liquidity benefit to bonds issued for infrastructure financing. In particular we note the issue that the Commission mentions that the RBA would be required to undertake due diligence that is not currently required to repo APRA regulated ADI's.

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Our response to that is to stress that our proposal is that only highly credit risk rated securities should be eligible to become part of the repo scheme. That would need bonds that were guaranteed unconditionally and irrevocably by a highly rated guarantor. The current regime means that it is possible for “BBB” rated securities to be included – the risk mitigating factor being that the issuer is APRA regulated. Any move to include counterparties that aren’t covered by APRA would need to be rated at least as highly as the four major Australian banks – ie “AA-” as the lowest rating permitted.

In this respect, Assured Guaranty is currently rated “AA” stable by Standard & Poor’s, having been upgraded from “AA-” in mid-March 2014.

Assured Guaranty would be more than happy to present its credentials in detail to the RBA to assist in the consideration of this proposal.

On a minor issue, we note that in Table 6.3 of the Draft Report the extension of repo eligibility was listed under the sub-head of proposals relating to Guarantees. This is not the right place as this proposal is really about improving market liquidity to make infrastructure bonds more attractive to a broader range of investors.

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