OPPORTUNITIES IN INFRASTRUCTURE

The state treasurer of Western Australia is joined by investors and financiers to discuss post mining-boom investment opportunities in infrastructure

Moderated and written by **Cherie Marriott**

Q Treasurer, can you start the discussion by telling us how the Western Australian economy is tracking?

Mike Nahan: Over the 10 years to 2012 2013, we witnessed a giant growth spurt that is possibly equivalent only to the 1860s gold rush in Victoria. Business investment, which was mainly driven by new iron ore, LNG (liquid natural gas) and oil projects, was growing at over A$6 billion ($4.39 billion) a year and peaked in 2012/2013 at a massive A$79 billion, representing just over 31% of our GSP (gross state product).

Now, of course, the commodities cycle has turned and investment is coming down at a rate of around 11% a year causing many to be pessimistic about business investment. As a state government we were never under the illusion that the cycle would continue forever, so in 2008 we decided we would underwrite a substantial public sector investment programme. We have invested A$46 billion so far and there is another A$24 billion allocated in the forward estimates. Much of our infrastructure programme has been dedicated to accommodating an expanding population by providing housing, water, electricity, roads and other utilities.

Q Is it realistic to think the government can offset the decline in private investment with public projects?

Nahan: No, in order to match the current rate of decline in business investment we would have to double our Asset Investment Programme and this isn't going to happen. We need to ride this out. Our focus now is to drive efficiencies in the delivery and productivity of public sector investments. We want to get more bang for our buck.

Q What opportunities exist for private investors in Western Australian infrastructure?

Nahan: We already have a track record in working with the private sector. We have expanded our PPP (public-private partnership) programme and have recently awarded projects such as the Perth stadium and some schools. We are in the process of privatising the Perth Market Authority, the Utah Point iron ore port facility in the Pilbara, and we are ready to lease the Port of Fremantle, which includes the outer harbour. We are also in the process of securitising up to 40% of the A$4.2 billion loan book held by the state-owned bank Keystart, which provides home loans to low-income borrowers.

Jonathan Reyes AMP Capital

Q Are there any opportunities in the transport sector?

Nahan: Yes, this is one of our biggest challenges in terms of infrastructure investment – funding the increased demand for public transport.

At present we are undertaking both rail and road expansions. We are working on a series of transport links around the airport that will benefit from private sector involvement to help drive down costs but also offer innovation. We are hoping that through funding negotiations with the Commonwealth Government other projects might also be able to proceed sooner rather than later, such as the proposed light rail service.

Q To the investment managers around the table, what exposures do you currently have to Western Australia and what appetite do you have for further investment?

Nik Kemp: We own a stake in Perth Airport which includes a portion we picked up through a merger with Westscheme. We have an ongoing appetite for infrastructure assets and we see WA as a market of interest. Just this week we invested in Airport Link in Queensland, which is reportedly worth A$1.9 billion. That gives an indication of the size of our appetite.

The key for us is finding assets that are well packaged, have an acceptable level of risk and are clearly defined. The recent sale of Transgrid in New South Wales is a good example of a well-run sale process. It had upwards of A$35 billion in capital chasing it.

Jonathan Reyes: AMP Capital is invested directly in the airport at Port Hedland and, through our listed portfolio, we have hold positions in a number of energy infrastructure assets in W.A. On the direct side of the business we are interested in buying assets in the middle market where we can add value by driving operational efficiencies. On the listed side, we would like to see more privatisation opportunities go to the public market.

Trent Carmichael: I represent QIC, and over time we have increased our focus on

PARTICIPANTS

Mike Nahan
Treasurer, Western Australia

Emmanuel Alfieris
Executive Director,
Commonwealth Bank of Australia

Ross Barry
Head of Research and Origination,
First State Super

Trent Carmichael
Principal, QIC

James Hoskins
Director,
Standard & Poor's Ratings Services

Nik Kemp
Senior Investment Manager,
Australian Super

Paul Kenny
Partner, Allens

Jonathan Reyes
Portfolio Manager, AMP Capital

Allan Wain
Head of Research and Strategy CP2,
Harvard Law School

Richard Wiles
Director,
Commonwealth Bank of Australia

Mike Nahan Western Australia Treasurer

Paul Kenny Allens

WA. Fundamentally we think the market is attractive, particularly given the state's favourable demographics and its skilled workforce. Pairing this with relative housing affordability, we see some sustainable long-term potential in WA. The Port of Fremantle would be a good fit for our client portfolios as we are an existing investor in landlord ports in Australia and see these as attractive long-term investments.

Ross Barry: First State Super has A$55 billion in total funds and manages the defined contribution assets for over 750,000 members. We have a target allocation of around 25% to alternative investments and infrastructure is part of this.

Our approach to acquisition, however, is opportunistic and we will only pursue assets that present a compelling reward for risk. So far we have deliberately avoided many of the large tender processes because of the stiff competition and the high multiples. However, we were successful in winning the tender to build Sydney's new light rail system, which is currently underway.

It's important to remember that super funds are focused on delivering value to their members over timeframes of 30 to 40 years or more. In this timeframe, we are likely to pass through four-to-five political administrations, refinance the asset five-to-six times and deal with about a dozen big strategic planning issues. It's important therefore to buy well and get the structure and governance right – in this sense, we would prefer to work with local, like-minded consortium partners including other super funds.

Ross Barry First State Super

Kemp: In 2013 we invested in Port Botany and Port Kembla in New South Wales in a consortium including large Australian institutional investors. At the time, it was termed a "social privatisation" because the asset went to local investors representing local stakeholders.

Q Treasurer, how do you see the interplay between foreign and local ownership of infrastructure assets? Is it necessary to have foreign participation in the market?

Nahan: It can depend on the particular opportunity. When selling an asset you want to generate as much competitive tension as possible to push the price up. Foreign investors can play an important role in creating competition. Politically it can sometimes be beneficial to transfer ownership to Australian stakeholders and workers. Having said that, the Canadian pension funds – which are very active in Australia – are a good fit for us because of the similarities we share. They have been here a long time and are staffed by Australians. Global sovereign wealth funds also have a role to play.

If you take the sale of Fremantle Port, for example, this is a port with links to the rest of the world. Therefore, it may make sense to involve investors from, say, Dubai or Singapore. On some of the smaller deals, like Keystart and the Perth Market Authority, we expect the buyers will be local.

Q Western Australia recently lost its AAA credit rating, how does that change investor attitudes towards the state?

Reyes: We are not anticipating a return to AAA soon, so we are defending the AA credit as a workable rating. As a look-through credit, AA seems like a more sustainable rating to us.

Nahan: State-based ratings in Australia are high compared to states in the US and Canada. The reason for this is the perception that the Commonwealth government will bail out the states if they get into trouble by transferring funds directly to the states or via the grants commission, which equalises the income the states receive on a three-yearly cycle.

Nik Kemp Australian Super

We continue to face challenges on this front with recent credit rating commentary focusing on the impact of lower iron ore prices on our revenue outlook. We were collecting record revenue from mining royalties during the boom and now this has eased back. The credit rating agencies are worried about our capacity to cope with boom and bust volatility which has always been an issue for Western Australian public sector finances and for the broader State economy. We have dealt with some of these concerns. We have brought expenditure down to a 20-year low while still maintaining our capital works programme and we have raised some more from taxes.

Our aim is to be AAA again once we get our share of GST revenue back. In three years' time we are projecting a A$2 billion-A$3 billion surplus according to the forward estimates in the May Budget. But it will take time to move back to a AAA credit rating. We should also note that AA+ is still an extraordinarily good credit rating – Western Australia is a very safe place to invest.

James Hoskins: I am not a sovereign analyst so I can't comment on the overall rating for Western Australia. From the point of view of rating individual infrastructure assets, the state rating doesn't make a huge amount of difference. Sure, it's unlikely we would rate individual assets above the state rating, but beyond that we consider factors that are particular to the asset, such as the regulatory environment.

For regulated assets, clearly we are more comfortable where leverage is reduced to offset a higher proportion of unregulated revenues, as we would expect unregulated revenues to be more volatile. In WA we rate Perth airport and the biggest factor there is patronage – the amount of traffic moving through the airport.

Q For the financiers here, has the ratings downgrade made a difference to bank appetite for WA credit?

Emmanuel Alfieris: I don't think so, particularly on smaller assets where the bank balance sheets are on the table, like hospitals, social housing or schools. There's plenty of liquidity in the banking system to support good deals and pricing is coming back now. It is possible for governments to add extra value by assigning some of the cash flow to the SPV (special purpose vehicle) and getting a lift in the rating. Clever structuring can really help in these situations.

Q Would the super funds around the table agree that funding conditions are favourable?

Carmichael: It can depend on the nature of the cash flows, including whether they are regulated. But, in general, equity investors are always navigating that space between investing in a long-term asset using upfront bank funding, where the tenors typically cut out at five to seven years, and then assessing the refinancing risk on an investment that might have a 99-year lifespan. We seek to diversify funding sources and this can lead us to go to offshore debt capital markets where the tenors are longer.

Kemp: How we manage refinancing risk is always a key consideration among consortium partners. PPPs in particular are usually highly geared and during times of volatility – such as the GFC – the return on these assets fluctuates wildly.

One of the ways to counter this volatility is for the super funds to finance some of the construction debt themselves. We put some debt into the East West Link road in Melbourne and we are looking at more opportunities like this. That means superannuation funds investing in 100% of the capital structure, both equity and debt.

Q Is there a cap on your level of appetite for this type of all-in deal?

Kemp: At the moment we are looking at opportunities above A$400 million, and ideally around A$1 billion per asset, and I expect our appetite will change as the fund grows. Today we have over A$90

Emmanuel Alfieris Commonwealth Bank

"COMPETITIVE TENSION PUSHES UP PRICES"
–Mike Nahan, West Australia treasurer

billion in assets under management and in five years we foresee having around A$160 billion, so we may look at bigger opportunities in the future.

Hoskins: For relatively simple projects, such as accommodation PPP's construction risk is not normally the issue which drives the rating. The ratings of availability-based projects in particular is normally driven by leverage. There is no reason why an appropriately structured green field accommodation project including construction risk cannot achieve a strong investment grade rating.

Within the infrastructure space, there are several key issues at present. The first is mitigating procurement and financing costs, particularly for smaller scale projects trying to access the capital markets. In the UK, a large programme to batch procure around 100 new secondary schools is underway funded by a single financing vehicle using common documentation. Aggregator Finance PLC issued bonds and loans rated A-/Stable to finance each of 5 batches of school projects.

The second issue, which is specific to Australia, is dealing with the refinance of a number of bank-funded operational projects and the extent to which either the capital markets or direct pension funding lending is able to pick up the slack.


James Hoskins Standard & Poor's Ratings Services

Q What other interesting funding models or deal structures are being trialled in the market?

Paul Kenny: There is a difference between concession projects where investors take the refinancing risk and the sale of utility assets where the states assume some of the risk through regulatory price resets that are structured to reflect the financing conditions in the market at the time. In instances like this, I wonder if governments are actually paying too much for the refinancing risk, and maybe it would be more economical for them to assume more of the risk or actually take out a portion of the debt themselves.


Trent Carmichael QIC

Nahan: There have been a number of PPPs where the government has taken some of the financing. On the stadium we made a capital contribution of 60% of the project cost and the private partnership financed 40%.

Alfieris: I've seen some interesting structures in social housing projects where bidding parties put forward a model, rather than a price. The government makes a call on which model suits their needs, including the financing package, and then effectively sets a price band. If the operating outcomes fall under the band, it is financed by the government. Conversely, if revenue outcomes shoot higher than the top band, a significant portion is channelled back to the government, to avoid bidders making a super profit. This can be an interesting way of overcoming some of the refinancing risks.

Kenny: As time goes on, I expect governments will become more focused on value capture. In any infrastructure project there are a number of different beneficiaries, not just the project sponsors but the surrounding local businesses and land owners, for example. Allens has worked with other governments on developing policy frameworks that look at the value created by infrastructure projects and identify the beneficiaries. The idea is to establish mechanisms that capture some of this value to assist with the funding task on projects.

"NEW POLICY FRAMEWORKS WILL LOOK AT VALUE CAPTURE"

–Paul Kenny, Allens

Allan Wain: I want to ask the Treasurer whether the Western Australian government had considered taking unsolicited bids from investors for projects. In the United States at least 20 states are now running formal unsolicited bid programmes. In fact, they favour unsolicited bids over auctions which frankly they view as inefficient. The reason we don't see many US public pension funds bidding for local assets in Australia is because they are unconvinced by the auction process; they view them as aggressive competitions for assets with doubtful financial rewards. Bidding for such assets can be time-consuming for an uncertain outcome.

Nahan: I agree that consortiums can spend enormous amounts of money in the bidding process and we certainly do accept unsolicited bids in relation to land sales. Generally though I am sceptical about unsolicited bids for PPPs and social projects because these are intrinsically complex and transparency is also an issue. Politicians are faced with having to defend their decisions to the broader electorate.

Q How should bid processes be run to make them more fair and transparent?

Barry: The Baird Administration and the New South Wales government more generally have done an outstanding job for NSW taxpayers. A critical success factor, particularly for PPPs, has been the extent of forward planning and pre-tender work to de-risk many of the projects. In our experience there has been very constructive engagement with bidders and timelines and commitments are always adhered to. It is a professional approach helped by an internal team of experienced former investment bankers, asset managers and project engineers within Treasury and other departments.

Richard Wiles: Sale processes need to be streamlined to ensure the return dynamics on a project don't shift markedly during the bidding phase. The number of government departments that are involved on a project should be minimised where possible and those departments that are in charge should be encouraged to work together to accelerate the process to achieve an outcome relevant to the market conditions of the time.


Allan Wain CP2 and Harvard Law School

Q Treasurer, can you wrap up by telling us what opportunities lie ahead in Western Australia's infrastructure sector?

Nahan: Down the track we will sell some electricity assets but first we need to overcome some impediments including a pre-existing commitment to the electorate not to sell.

We need to get popular support for a change in this stance and then we need to change the way Western Power – the poles and wires company – is regulated. We are currently in the process of moving Western Power from a boutique regulator over to the national Australian Energy Regulator.

Beyond the polls and wires, there will be opportunities in road projects and other social projects. **FA**


Richard Wiles Commonwealth Bank