CAPTURING VALUE

At a roundtable in Sydney, fund managers and financiers talk to NSW Treasurer Gladys Berejiklian about public-private collaboration on the government's ambitious infrastructure programme

Q Let's start with an update on the NSW Government's infrastructure pipeline and how it is progressing?

Gladys Berejiklian: When we came to government five years ago we started planning a 20-year vision for infrastructure. Now we are in a strong position to continue delivering our massive infrastructure pipeline because of our asset recycling strategy, careful management of the state's finances and the strength of the NSW economy. We have successfully completed the lease of TransGrid, the first of three transactions to lease 49% of the state's electricity transmission and distribution networks, and that delivered gross proceeds of over A$10 billion. All of these factors have placed the government's finances in an enviable cash positive position. Of course, that position will change as we start spending on new infrastructure projects. And all this has to be done while maintaining our triple-A credit rating and delivering healthy surpluses.

Q Can you outline some of these near-term projects currently underway?

Berejiklian: In terms of rail, there is the Sydney Metro NorthWest. The first phase is due for completion in 2019 and we are planning the next phase, including the second Sydney Harbour rail crossing. Then there is WestConnex, for which the government provided seed funding and private equity was used to fund the various stages. We have a number of education and hospital projects underway such as the new Northern Beaches Hospital which is a PPP project. Recently we announced we will use PPPs to meet prison capacity needs.

Q What are some of the challenges inherent in executing such a large pipeline of projects and how are you working to alleviate these challenges?

Berejiklian: We have been studying the experiences of similar jurisdictions with ambitious pipelines to make sure we don't face the same challenges they have faced. For example, we are keeping a close eye on the supply of skilled workers. At the moment we have healthy rates of migration into NSW as the mining sector declines in other states and people are bringing their skills to our road and rail projects. We are also keeping an eye on our project management capacity. With so many projects underway, we also need to make sure we have great project managers and a good assurance model to ensure each project is on budget and on time.

Q How do investors around the table rate NSW's track record so far and are there areas where you would like to see more opportunities for the private sector to participate?

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Michael Hanna: I don't think there is any doubt that NSW is leading the country in terms of infrastructure investment opportunities. The current political administration is stable and talented, with a mature perspective on private finance. IFM Investors invests on behalf of a range of superannuation funds and we own a number of assets in the state. Our largest investment is NSW Ports which were privatised back in 2013. We have been delighted with the performance of the business so far. We also invest in two PPPs, Axiom Schools and Wyuna Water (which supplies 25% of Sydney's drinking water) and two toll roads – the M5 South West and the Eastern Distributor.

Scott Speedie: NSW is a certainly a bright spot on the Australian investment landscape. More and more our investors are talking about investing in projects in the social infrastructure space – projects that improve social outcomes for people.

Q What is being done to encourage more investment in this area?

Berejiklian: We are seeing more potential for private sector involvement in social infrastructure and social impact investment. The community now recognises the private sector can be an efficient provider of social services as long as the government is there as a regulator. An example of this is UnitingCare Burnside's New Parent and Infant Network (Newpin) that aims to restore children in out-of-home care to their families. Private investors put up the funds, the not-for-profit organisation ran the project and government got a better outcome. The restoration success rate was about 60% while investors got a return of about 8%. This kind of collaboration allows us to open up more areas to private sector investment. I think we will see a lot more innovation in the future.

Q The government is also looking at private sector investment in low-income housing, right?

Berejiklian: Yes. We recently provided seed funding of just over A$1 billion for a social and affordable housing fund. We called for expressions of interest on how the private sector can utilise this fund to help us deliver additional social and affordable housing. The target is 7,000 homes in the first tranche.

Q How do you structure these social infrastructure projects in a way that is attractive to private investors?

Berejiklian: The private sector thrives on being given clearly defined incentives. In the case of the Newpin project, the target was to reunite children with their families and keep them there for 12 months. Once objectives like this are made clear, private investors can use their knowledge and their financing skills to put a package together that offers a return. Having the government there as a regulator and a guarantor makes these investments highly desirable.

Scott Speedie

Speedie: The risk profile on a 99-year port lease versus a social impact project is very different. The former is a hard asset that offers stable cash flows and is therefore likely to attract a vast array of interested investors. Hospitals and social housing projects on the other hand appeal to a narrower but growing pool.

Diana Callebaut: The NSW government is increasingly looking to combine the procurement of the delivery of infrastructure assets and related "social" services into one project. Current examples of this include the Northern Beaches Hospital and the Grafton Correctional Centre. These projects are led by operators rather than infrastructure investors. Private investors are still interested

Gladys Berejiklian

"THE PRIVATE SECTOR THRIVES ON CLEARLY DEFINED INCENTIVES"
–Gladys Berejiklian

Paul Kenny

"NON-CONFORMING BIDS CREATE DISRUPTION AND UNCERTAINTY FOR ALL"

–Paul Kenny

in these projects, but the money comes from a different pool of capital, or forms a different part of a fund's portfolio allocation. For example, CBUS is one of the largest shareholders in Healthscope which is building and will operate the Northern Beaches Hospital project.

Q So how does a superannuation fund like CBUS gain exposure to social infrastructure projects?

Callebaut: Depending on your risk adjusted return expectations, there are a number of options. For example, CBUS recently partnered with a community housing provider and developer to respond to the NSW government's social and affordable housing EOI. Looking ahead we also intend to lead social infrastructure project investments, such as schools, museums and convention centres.

Ross Barry: There is great scope to tap into the innovative spirit of private investors for social impact projects such as home-based aged care and youth homelessness, however I wonder if this is unduly restricted by the current bidding process for such projects. Is it possible, for instance, to open this up to a broader range of solutions and unsolicited bids? Does it need to be centralised within Treasury or can projects be worked up directly in collaboration with government departments and authorities closer to the problem.

Berejiklian: The social and affordable housing fund is being run by the Department of Family and Community Services but Treasury is also intricately involved. Last year we set up a dedicated Office of Social Impact Investment and we are aiming to deliver at least two new social impact initiatives a year. On the issue of unsolicited bids, there is plenty of scope for us to consider ideas put forward from private investors. In fact, the NorthConnex road project is an example of an unsolicited proposal turning into an actual project.

Leisel Moorhead: We are an equity sponsor in the NorthConnex project which is a fantastic example of what can happen when governments and private investors collaborate together. We invest in projects all over the world and we can see the benefit that private sponsors can bring working with public governments to deliver innovative infrastructure solutions.

Berejiklian: Unsolicited bids can be harder to achieve because the proponent has to demonstrate uniqueness and convince us not to take it to tender. But, that said, it certainly isn't impossible.

Q Unsolicited bids aside, is the government open to receiving non-conformist bids on projects that have a clear scope?

Berejiklian: There's no doubt we need to be flexible around tender processes. When we were looking at the contract for the Sydney light rail project we had an idea about the best way to deliver the project and after the private sector came back with feedback on various elements of the contract we agreed to alter the scope. We are open to scope changes, but we want to make sure we can communicate these changes to the community. There is a fine line between a scope change and a non-conforming bid. If everyone in the market is telling us they believe a project should be approached differently then we are prepared to listen, but for some things we can't accept non-conforming bids – either because they don't meet our needs, they aren't beneficial for the public or they don't comply with Australian building codes or other standards.

Is there a potential for non-conforming bids to create too much uncertainty in the market?

Paul Kenny: Bidders are motivated to submit non-conforming bids for a variety of reasons whether it is to alleviate certain risks or manipulate the return dynamics, but I agree, non-conforming bids create disruption and uncertainty for all parties involved, not to mention increased costs. We would always advocate for a more extensive market-sounding period prior to the bid process being launched rather than waiting until after the formal tender process has started.

Tim Stewart: Investors would rather operate on a level playing field where there is certainty. The evolution of the PPP process in Australia has seen a big push to reduce costs by trying to commoditise the process. I think this might be going one step too far. There is always an inherent tension that needs to be met by a government process. We need a level of innovation to ensure that everyone benefits from a particular project, but bidders need certainty of process. Ultimately it comes down to each bidder deciding if this is the right asset for them, if they want to get involved in the bidding process and if they can stomach the cost of doing so.

Thomas Jacquot: The Australian market definitely prefers a higher level of certainty in the scope of bids, but you have to question whether this limits possible innovation. One transaction that stands out as a great example of non-conformity is the bid to renovate the Home Office in the UK. The government initially said the plan was to refurbish certain offices around central London. But then one bidder came in with the idea of building an entirely new building on a piece of land in central London. Eventually the government came around to the new idea. Interestingly, the UK National Audit Office, in its review of the transaction, recommended that government departments should always allow bidders to come up with new ideas as this project was clearly an example of a better outcome for the public sector. I believe this type of flexibility is much easier in markets where PPPs don't require the same level of engineering and financial commitment at the time of the bid as required in Australia.

Berejiklian: One solution is to run a number of industry briefings before we start the process and get private sector input early.

Jacquot: Yes, I agree, but the problem with the market-sounding process is that bidders are only prepared to share a certain amount of information. They don't want to give away any secrets when their competitors are in the room.

Ross Barry

Thomas Jacquot

Tim Stewart

Q With non-conforming or unsolicited bids there is also the risk of being taken to the cleaners, right, unless the government has the resources and the skills to evaluate proposals which are often highly complex?

Moorhead: It is important that governments have the resources and skills to evaluate unsolicited proposals and this was demonstrated on the NorthConnex project. Private sponsors can alleviate some of the risks if the government is clear about its performance criteria. This comes back to the Treasurer's point about functional criteria and setting clearly defined targets, such as, we want to accommodate X-number of people in social housing in X-number of years.

Berejiklian: The Treasury is slowly building its evaluation expertise. We have an infrastructure finance unit that looks at the bid process as well as the financing solutions.

Q What feedback do you get from investors about the cost of bidding for NSW infrastructure projects?

Berejiklian: Overseas funds and firms sometimes complain about the cost of bidding, saying we require too much paperwork and there are too many standards to comply with. On the one hand this ensures the integrity of the process, but we also want to keep competition alive. It is in the government's interests to reduce bid costs and foster increased competition.

Leisel Moorhead

Q Turning now to value capture, how is the NSW Government attempting to recover some or all of the value generated from its infrastructure projects?

Berejiklian: We have been talking about value capture since we came to government and it is now becoming a large area of focus, especially on projects where there is potential for additional development. The truth is, value capture can be hard to implement. We must ask: who are we capturing the value for and who gets the benefit of the value. The key is to educate the community about value capture and bring the public along with us. At this stage the Parramatta light rail project is probably the most suited to value capture.

Speedie: Finding the right model is a vexed issue. When you look internationally there are a number of models to draw from. In the UK, the government took a view on the cross-London railway project and concluded the whole city would benefit from such a large-scale development. It was able to charge a widespread levy as a result. The question is whether this type of model is directly replicable in NSW especially on smaller projects with a narrower corridor. The trick is not to disincentivise developers from adding value to the corridor which, over time, undermines the value of installing the infrastructure.

Kenny: There are eight to 10 different value capture mechanisms that can generate value from surrounding property and commercial developments, or capture value from the broader beneficiaries of new infrastructure. In many ways, user-pays can be viewed as a value-capture mechanism. Whatever models the government uses, they should be formally defined in a clear policy framework. And this framework should be applied right at the beginning of the planning process, not when it comes to Treasury for funding.

Diana Callebaut

Q Levies or user-pays fees might be seen as unoriginal. Wouldn't it be better to approach value capture through the lens of redevelopment potential?

Callebaut: The extension of London's Jubilee underground tube line to Canary Wharf received £400 million from the commercial property developer of Canary Wharf. This can be a very workable option. However, the pre-requisite for success is strategic alignment of project specific planning, transport and social policy outcomes, and this can be challenging.

Hanna: The comprehensive redevelopment of the old Spencer Street train station in Melbourne has been a key driver in the significant redevelopment of the western end of the CBD and the Docklands precinct. IFM Investors is the 100% owner of the interchange and it's amazing to see how this urban precinct has flourished since it opened in 2006. We are a decade ahead of our patronage forecasts and are currently working on a master plan that could see a range of new capital works to accommodate this passenger growth. In hindsight, it would have been wonderful to have some sort of value capture structure in place to pay for this master plan and the redevelopment work. It is, however, complex and time consuming to create a good value capture model and there is little precedent in Australia.

Kenny: Part of the problem is being able to bring the public along with you on the value capture journey. There is a perception in the community that value capture is just another way of saying "tax", so there needs to be some way of explaining to people that the revenue generated from value capture is what is needed to keep the infrastructure pipeline flowing.

Berejiklian: I agree, it is a cultural adjustment. The UK's experience with the cross-London railway was one of organic acceptance. In the end, all businesses along the route in London – whether small or large – were happy to contribute. I agree that we need to have the conversation early in the process by letting people know that certain projects just won't go ahead unless contributions are made.

Barry: At the moment the value capture argument is caught up on the issue of how to carve up the value rather than how to create it. There is a great opportunity to build partnerships between government, capital providers, developers and end-owners and take a 30-40 year view on urban planning goals to recreate suburbs that are carbon neutral, have sufficient parking, utilities and are linked to affordable public transport, parklands and other amenities.

Q What infrastructure projects would you like to see developed in NSW?

Barry: I would like to see the government spend more time fostering economic hubs outside of the Sydney CBD. Housing is becoming unaffordable in inner-city areas and we hear rhetoric about a multi-centric city but what is really happening to make this a reality? There are plans for infrastructure investments in the Western suburbs, such as the second Sydney airport at Badgerys Creek, but we don't seem to have done a lot to build a critical mass of economic activity or create jobs in those areas to stem the surge of commuters in and out of the CBD every day and the associated strain on transport infrastructure.

> "IT IS COMPLEX AND TIME CONSUMING TO CREATE A GOOD VALUE CAPTURE MODEL"
> –Michael Hanna

Jacquot: The saying goes: build and they will come. However, there are too many examples of projects being built and the patronage not following. The stigma around failed infrastructure projects can hang around for decades – as happened with some of the early toll road projects in Australia.

Hanna: This is a great challenge for states on the eastern seaboard of Australia over the next 15 years. The three largest cities of Brisbane, Melbourne and Sydney dominate but as population growth continues it just isn't viable to keep packing people into these cities. Progressive policies are required to encourage jobs and hence population growth in second-tier cities like Newcastle, Wollongong, the Gold Coast, Geelong and Bendigo. This could encompass the setting up of special economic zones in these areas where major commercial players are attracted by the offer of say, tax incentives for development, rents, staff and profits.

Berejiklian: The NSW government understands this and we are trying to support jobs growth in outer areas by relocating certain government offices and encouraging staff to move to western Sydney and the south and central coasts. In terms of the regions, NSW accounted for two-thirds of regional jobs growth nationally so there is a lot of activity there. And with the lease of our poles and wires businesses, we have committed $6 billion towards building new regional infrastructure. FA

Michael Hanna