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Mike Fitzpatrick and Dominic Hudson on the funding equation

THE AUSTRALIAN CENTRE FOR PUBLIC INFRASTRUCTURE

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The Public Infrastructure Bulletin is published twice yearly by the Australian Centre for Public Infrastructure, a specialist teaching and research centre of the School of Enterprise at Melbourne University Private. It aims to promote debate and discussion about the conception, development and management of public infrastructure projects.

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THE FUNDING EQUATION

Private investment in Australian infrastructure is still in its early days and procurement via a PPP mechanism even more so. What makes an infrastructure project attractive to private investors? Players from the debt and equity side of the process outline their positions.

Epic Energy is one of those infrastructure projects spoken about in whispers in investment circles. The recent decision of the Gas Access Regulator in West Australia effectively reduces the tariff the company may charge with obvious implications for the business's viability. According to the regulator, the price that Epic Energy paid for the Dampier to Bunbury Natural Gas Pipeline was not based upon a sound commercial assessment. Neither was it affected by any representations made by the government regarding the level of tariffs. The case highlights one of the difficulties private investors face in getting involved in such projects: regulatory uncertainty. But, while there are still problems to resolve, the sector is showing signs of maturing and key players foresee a more promising future.

OPPORTUNITY KNOCKS

Private investment in Australian infrastructure projects ranges from full private ownership to BOOT (Build Own Operate Transfer) to Public Private Partnerships (PPPs). While Australia has a mature BOOT market it is still on a learning curve on PPP transactions according to Dominic Hudson, Director of NM Rothschild's Projects and Infrastructure Team and Fellow of the Australian Centre for Public Infrastructure.

From a financier's point of view, before you even start looking at numbers, the private sector needs to have an opportunity to add value to the transaction. 'In addition there needs to be some innovation that the private sector can bring to a project,' says Hudson. 'If it's just a box, the government has the ability to go and procure it itself on a design and construct basis. There's not a lot of value that the private sector can add. The design and construct price is almost the same. To make a deal attractive the Private sector needs a few things – certainty of process, release of PSC [Public Sector Comparator], ability to innovate and inclusion of non-core services.

'On top of that you have the issue that the private sector's cost of funds is more expensive than government money. So you need to have some innovation built into the project to justify the additional capital costs.'

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BIGGER IS BETTER

The size of a project is key. Hudson believes current privately financed projects need a capital cost of at least $50 or $60 million dollars to be attractive. 'That's taking into account that there is actually some market knowledge now, there is some sort of standardisation of project documentation in the market place. In the earlier rounds I would have said you wouldn't have bid any deal under $80 or $90 million.' These thresholds are determined by the huge cost of putting up a bid. 'You need scale on a project to justify those sort of costs, which will include your accounting, legal, financial advisory [and] design costs.' He thinks the size of projects offered by governments needs to be larger for that reason.

But once a project is assessed as worth bidding for financing it is relatively easy 'There's a highly sophisticated senior debt market and also a mezzanine debt market,' Hudson explains. 'So it's a deep market and [there is] an appetite for these sort of projects.' The current interest rate differential between Australia and other economies also makes it attractive for offshore banks to invest in Australia.

Australia is seen as a safe haven for investments with highly credible Federal and state governments that have demonstrated stability in the global market, he says. 'I've seen lots of people come through our doors from Asia and Europe looking to invest in Australia. There's lots of money around at the moment and they're looking for a safe place to invest.'

In the UK there's been very few examples of equity being lost in these transactions. In general they've been able to cajole the operators into reasonable performance.

SLOW AND STEADY RETURNS

While infrastructure projects tend to be 85 to 90 per cent geared, the sector is now also a growing part of the alternative investment market. Macquarie Bank and ABN Amro are even rumoured to be looking at the feasibility of specialist PPP funds. It is a sector dominated by wholesale funds and investors are assessing projects from a different angle than financiers.

Hastings Funds Management with approximately $1.8 billion in assets under management, manages a range of alternative funds including the Australian Infrastructure fund with interests in transport infrastructure, Utilities Trust of Australia and the Queensland Infrastructure Fund. The group takes a narrow view of PPPs defining them as projects with no demand risk. The long-term success of the Spencer Street Station redevelopment in Melbourne for example has nothing to do with patronage explains Hastings Managing Director, Mike Fitzpatrick.

'The main issue on the equities side is to make sure the operator has the skills to perform the operating agreement to the standards required,' he says. 'Probably you'll want to see some skin in the game, be that by putting some equity in or some sort of bonding in the event that they don't perform. In the UK there's been very few examples of equity being lost in these transactions. In general they've been able to cajole the operators into reasonable performance.'

It is an asset class dominated by superannuation funds because of its characteristic illiquidity and its stable long-term returns. 'If you're involved in the development side of the transaction then you're likely to outperform on average the ASX. But if you're focussing on mature infrastructure, like a Transurban, you might slightly underperform the ASX over a period of 20 to 30 years, but you will do it at a lot less risk,' says Fitzpatrick 'In terms of rate of return, [with] most PPPs, I guess you're looking for something like a geared return of 10 to 12 per cent. You may do as well as 15 if you're lucky. And you'd probably set it up so your downside risk is say 8.'

ON A LEARNING CURVE

The problem in Australia is that no one has much experience with PPPs. Compared to the UK, he says, Australian governments have tended to handle each transaction as a one off. 'The other issue with PPPs has been bid costs have been extremely high. That's because of the elaborate processes governments have run and we just need to get some standardised documentation, some sort of standardised operations.'

Hudson agrees. 'For a small country with a limited number of projects every single state and territory and federal government has got its own policy. And we've got a handful of projects. So as far as developing standardisation of documents I think we're a long way off.'

Yet standardisation of both documentation and processes will be an important factor in the success of PPPs as a procurement method. Hudson also points to the UK with now nearly 15 years experience with a large number of PPPs, but all delivered under one policy. By contrast, Australia has only delivered a handful of projects, but has a policy for each state. He sees lack of commitment to the process on the part of governments as another issue.

'In Victoria under *Partnerships Victoria* they talk about the process that all projects should be considered as PPP projects. I think that this process should be adopted. The question should be can the majority of potential deals be evaluated as Partnerships Victoria?. If the answer is yes, then it should be pursued,' he says.

'There are a lot of projects that can be considered PPP-type projects but haven't actually been done under the banner. Australia is a lot more advanced in the delivery of BOOT-type projects than probably most places in the world.'

TAXING MATTERS

It is not only wariness of the process on the part of state governments that has hindered private involvement in infrastructure. The tax regime has also posed some difficulties. Under the Income Tax Assessment Act, private interests risked losing depreciation allowances and hence equity if the Tax Office determined the asset was ultimately controlled by government. New rules replacing the provisions of section 250 of the tax act were due to take effect from 1 July 2003, but are still to be implemented.

Whether or not the new regime proves enough to encourage greater private involvement in public infrastructure, both Hudson and Fitzpatrick see a huge potential in the sector.

FUTURE POTENTIAL

'I think a lot of the new infrastructure will be done by private means,' Fitzpatrick predicts. 'We're seeing the PPP proposals grow, so I think you might see quite a bit of social infrastructure done this way, mainly because of the efficiencies. I think a lot of the big ticket road infrastructure will be done privately as well.' He is convinced that were it not for private investment in infrastructure in Melbourne and Sydney over the last ten years both would have 'fallen off the map as world-class cities.'

FOSTERING THE PPP PROCESS

Private investment in infrastructure projects is still in its early days in Australia. Both governments and the private sector are still learning how best to work with the PPP model. Dominic Hudson of NM Rothschild and Mike Fitzpatrick of Hastings Funds Management identify a number of issues that will improve the process and make projects more attractive to private partners.

- A commitment by governments to the process - many infrastructure projects that might be delivered under the PPP model are not being evaluated as potential PPP projects
- Publishing the Public Sector Comparator (PSC)
- Standardising processes and documentation to reduce costs – currently, each PPP bid must be treated as a one-off because each state and territory has its own policies and procedures
- Offering bigger projects
- Including in projects the opportunity for private sector to deliver non-core services
- Capturing the knowledge gained by governments in running the PPP process – a change of personnel in government will not then mean a loss of valuable experience

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He also dismisses accusations that privately-held assets are less transparent, pointing to cost and time overruns with Federation Square and the Geelong Road. Government inefficiencies can be hidden, he says, whereas private contracts are open to public scrutiny. The Transurban contracts are available in Hansard he points out.

Hudson sees a growing need for social and economic infrastructure that could be met well through private investment. As well as road infrastructure, his list includes schools, defence housing and transporters, flight simulation centres, university accommodation and hospitals. But governments need to understand business requirements and 'pressure points' in order to make these projects more attractive to private investors.

'It would change the sort of projects, it would change the dollar value of projects, the deal flow and how they're scoped - the output specifications - and inclusion of other services,' he says. 'The private sector is pushing toward providing more services to the PPP projects and there is some resistance in some of the social infrastructure areas.'

REGULATORY UNCERTAINTY

The regulatory regime is also a point of contention, especially in industries like electricity generation where there is a mix of publicly and privately held assets. The federal government is still working on a national energy policy which will apply to gas and electricity markets. But in some areas, investors have applauded the government's approach.

The Hastings Australian Infrastructure Fund includes a number of airport assets. Despite September 11, Bali and SARS, Fitzpatrick is pleased with the outcome of private involvement. 'The terrific thing about airports is that the Commonwealth Government is almost alone among Australian governments – it actually kept its word,' he says. 'It said when it sold the airports it would seek to deregulate after the first five years and they did, much to the ACCC's disgust and I think various other users of the airports.

'I think now there's possibly a different view from airport users where they've found it easier to get things done because there's not this sort of dead handed regulation sitting on top of them. Given the event risk it's very important that the airports have had the flexibility they've had.'

A CLASS ACT

As an asset class, infrastructure is still deemed an 'alternative' investment, but Fitzpatrick predicts that will change. 'I think it's becoming a mainstream asset class. In time it will become as big as the property class. Property as a class has grown and I think we'll see the same in utilities and infrastructure.'

In time governments will gain a better understanding of what the private sector needs and business of what government needs. With each new project both parties are learning what works and what to avoid. The challenge is to capture and build on that experience and avoid the whispering about future Epic Energies.

Helen Cronin spoke to Mike Fitzpatrick of Hastings Funds Management, and Dominic Hudson of NM Rothschild.