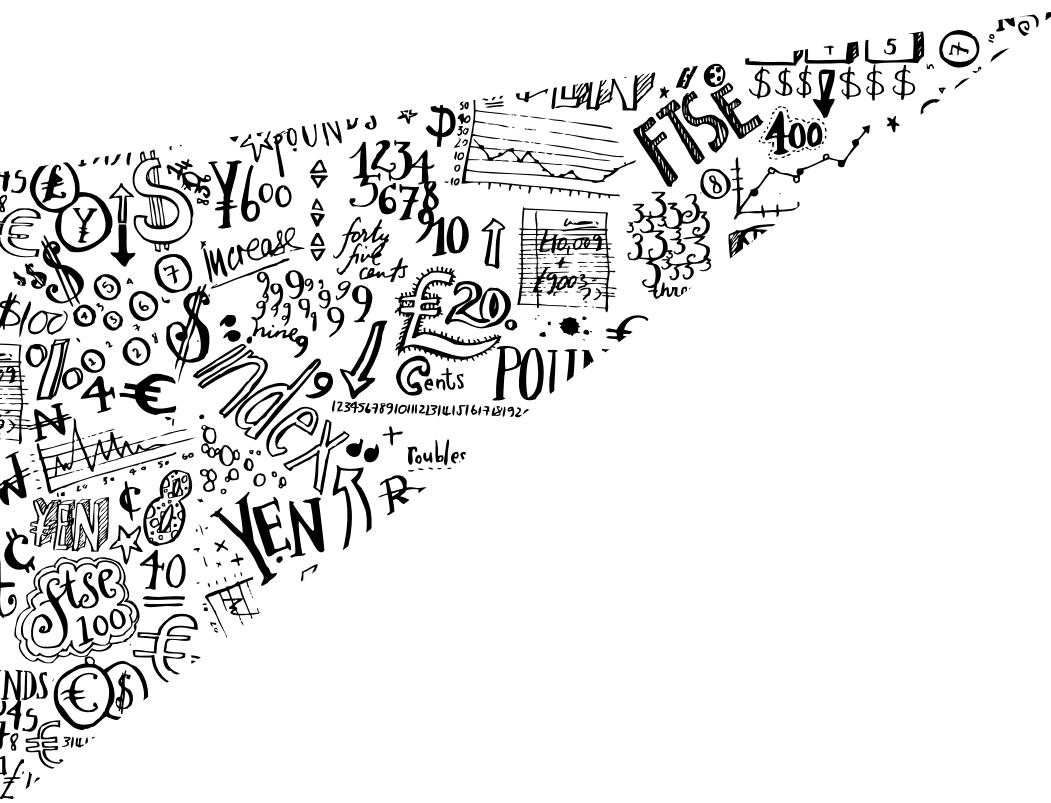


Financing Australia's infrastructure needs

Superannuation investment
in infrastructure



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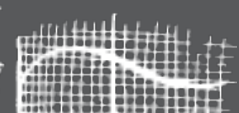
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Introduction from CEO



John Brogden
Chief Executive Officer
Financial Services Council

A handwritten signature in blue ink, appearing to read 'John Brogden', written over a light blue circular scribble.



Over the past 20 years, Australia's superannuation funds under management have grown from \$140 billion to \$1.3 trillion.

As superannuation funds have grown, Australia's infrastructure gap has widened.

So can Australian superannuation funds solve our infrastructure black hole?

Compulsory superannuation was always intended to serve two purposes. The first was to improve the incomes of retirees and reduce the burden on the Budget of paying the Age Pension. The second was to serve as a macro-economic tool by increasing Australia's savings.

In accordance with superannuation legislation, funds must invest on behalf of members to maximise returns.

This means investing in a range of assets that meet the risk/return profile required to achieve this goal and includes investment in Australian and international equities, infrastructure, commercial and residential property, bonds and deposits.

Superannuation is not a cash cow to fund particular economic ills in Australia.

1

However, superannuation funds do invest in infrastructure and will continue to do so where it delivers an appropriate risk weighted return for the investor.

Superannuation has a central part to play in Australia's macro economy and the goals of maximising returns and facilitating economic growth are consistent. By investing in assets that maximise returns to members, superannuation funds are also maximising economic growth.

The recent history of partnerships between government and the private sector to build infrastructure has seen the risks and returns faced by both partners change over time with substantial financial and political fallout. The goal for policy makers is to create projects that appropriately share the risks between investors and governments.

This report provides valuable insights for policy makers in the Commonwealth and State Governments on how to create the conditions that will facilitate continued and increasing investment in infrastructure.

The clear message from the superannuation industry in this report is "build the appropriate risk/return model and we will invest".

Executive summary

The question

A consistent theme in commentary on infrastructure development is that material additional superannuation investment in infrastructure is a key element in the medium term economic growth of Australia. The implication in this commentary appears to be that there is a significant pool of funds held by the superannuation industry that could be better invested in infrastructure and that this is potentially delaying governments delivering much needed services.

Ernst & Young Australia has been engaged by the Financial Services Council to review the overall profile of superannuation investment in infrastructure by consulting with a wide range of professionals involved in the superannuation investment allocation process to test:

- ▶ The appetite of superannuation funds to further increase investment in infrastructure
- ▶ Whether there are particular barriers that impact superannuation allocation to infrastructure assets
- ▶ If there are any solutions that superannuation funds have identified that could stimulate further appropriate investment in infrastructure assets

We acknowledge there are differing views in relation to the level of superannuation fund participation in infrastructure projects. This report focuses on the key group that would be impacted by an initiative in respect of institutional investment in infrastructure, not a wider canvassing of general views on infrastructure investment.



The response

The overwhelming message from entities involved in superannuation investment at all levels was superannuation funds have a single function: to invest member funds to meet members' future retirement needs by optimising the level of return. Considering the optimal allocation of these funds to a wide range of available investment assets is a complex process. It requires substantial analysis of the risk/return profiles of alternative asset classes. Funds regularly assess infrastructure project opportunities against their established risk/return hurdles and see infrastructure as an important class in developing optimal long term investment portfolios.

Participants have noted that while there are no material systemic issues in considering further investment in infrastructure, there are a number of barriers that need to be addressed to stimulate the current appetite to further invest in domestic infrastructure.

The key barriers identified were:

- ▶ Lack of a clear pipeline and government commitment
- ▶ Lack of suitably structured projects
- ▶ Inconsistent, complex and expensive bidding processes
- ▶ Regulatory and industry pressures

It was acknowledged that given the lack of suitably structured projects reaching the investment market and the perceived complexities associated with investment in infrastructure, a number of funds have not believed it viable to build the necessary expertise to be able to analyse the opportunities that do reach the market.

Participants suggested a number of ways in which government can assist to encourage superannuation funds to increase the level of investment in infrastructure including:

- ▶ Developing a committed pipeline
- ▶ Delivering certainty over government funding commitment
- ▶ Appropriately structuring projects
- ▶ Increasing the recycling of capital
- ▶ Simplifying transaction processes
- ▶ Creating consistency and certainty of government regulation
- ▶ Improving taxation system efficiency (the 2011 Federal Budget assists with this through preserving real losses accumulated early in a project's life)

Opportunities

There is an opportunity to stimulate further investment in infrastructure by superannuation funds and institutional investors. We believe the following areas would have the greatest impact:

- ▶ Creation of a national pipeline
- ▶ Appropriate structuring of projects
- ▶ Recycling of capital
- ▶ Simplified transaction processes

Background

Investment in infrastructure

There are a range of views on the definition of infrastructure and what constitutes investment in infrastructure.

Infrastructure has been defined by some participants as assets that facilitate the movement of goods, people and services through the economy. For other participants, infrastructure has a broader definition that includes both social and economic infrastructure. Social infrastructure includes education facilities, health facilities and prisons. Economic infrastructure includes tollroads, airports, rail, ports, water supply, communication and energy.

There are a number of characteristics that are attributable to infrastructure such as physical nature, high barriers to entry, monopolistic and long term cash flows.

Investment in infrastructure in its broadest definition includes both direct and indirect investment. Investment can be made directly into an infrastructure project at either the start-up phase or at a later stage when the project is mature. This includes buying shares in a special purpose vehicle.

Investing indirectly through infrastructure funds or infrastructure based companies such as Transurban is also classified by many as infrastructure investment. This investment can fund major capital expenditure and assist in expanding the capacity of existing assets.

Funding versus financing

One important element in reviewing the development of key Australian infrastructure assets is the difference between funding and financing infrastructure. Media discussion frequently does not draw a distinction between these processes, calling for the superannuation industry to “fund” more infrastructure projects rather than finance further investment in such projects. This report draws a clear line between the two activities since the role of both is distinct but critical in developing an efficient infrastructure market.

The funding of infrastructure has been defined as the allocation of ultimate cash flows that support the construction and operation of infrastructure. The financing of infrastructure has been defined as selecting the immediate source of cash that will physically develop the assets with the repayment of this investment over the life of the asset. Funding is the revenue stream that repays the financing. For example, with respect to the M7 tollroad a mix of private sector debt and equity financed the infrastructure, with this private investment funded by toll charges from users of the asset. Superannuation funds are therefore financiers of infrastructure as they require their investments to earn a minimum return.

Funding

The implication of the above definition is that there are in reality only two sources of infrastructure funding for projects sponsored by governments: an allocation of general taxation revenue or direct user charges. Where projects cannot be funded by user charges governments must allocate taxation revenue. Naturally governments have the choice to fund through current taxation revenue, or future taxation revenue by borrowing to complete the infrastructure.

The implication of this is the pace of infrastructure development is entirely in the government's hands, as the limiting factor is not the willingness of institutional investors to finance projects, but the capacity of government to allocate certain funding to projects. In general state and federal governments rely substantially on direct year to year appropriation of taxation revenue to fund infrastructure and minimise additional borrowing or the imposition of additional user charging regimes.

This approach does lead to a conservative pace of development and by relying largely on year to year taxation to fund long term assets raises important intergenerational equity issues. A common theme during the consultation was faster infrastructure development requires a more innovative funding approach from government, and this would stimulate further financing from the superannuation industry.

Financing

Efficient financing of infrastructure is focused on the allocation of project and systematic risks to those parties best able to manage them. Governments have a wide range of financing solutions, both public and private, available to develop infrastructure and an important part of internal business cases is considering the efficiencies private sector financing can bring to an individual project.

Private investors have demonstrated a willingness to participate in a wide range of financing solutions in respect of government infrastructure including, Build Own Operate Transfer (BOOT) toll road transactions, availability based social infrastructure Public Private Partnerships (PPPs) and privatisation transactions such as the federal airport leases. The key point is that private interest in infrastructure depends on a complex set of factors including:

- ▶ The availability of capital in the market
- ▶ The risk/return profile of the project
- ▶ The attractiveness of alternative investment opportunities
- ▶ The performance of similar infrastructure projects

This necessitates the government procurement agencies to monitor investment conditions and investor appetite so that it structures future transactions which have an optimal chance of attracting private financing on efficient terms.



Superannuation investment in infrastructure

Structure of superannuation in Australia

The structure of superannuation in Australia is largely based upon the defined contribution model (or accumulation model). This is where the retirement benefit of the member is a reflection of the amount of employer and member contributions to the fund. It also reflects the investment return generated by the particular investment strategy of the super fund. Future benefits fluctuate on the basis of investment earnings.

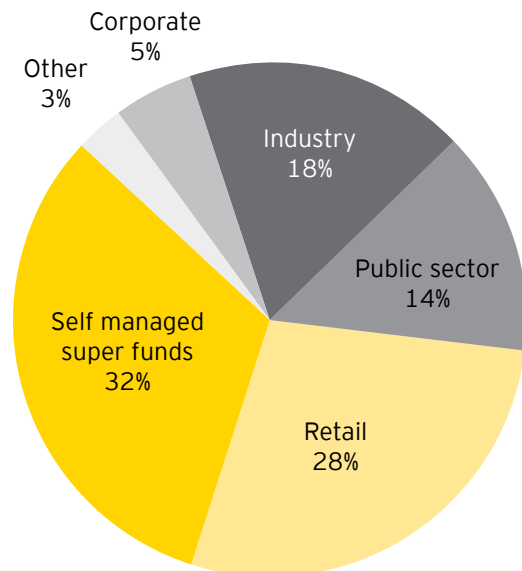
With a defined benefit model, the final benefit paid to the member is defined in advance of the member's retirement. A retirement benefit is based on a formula which usually takes into account the employee's salary history, age and length of employment rather than depending upon investment returns. The Dutch and Canadian superannuation industries are primarily based on the defined benefit model.

The structure of the superannuation model affects investment policy. Under a defined contribution model most assets are on call and there is a need for a balance between liquidity and long term investments. A defined benefit model is much more conducive to long term investments such as infrastructure.

Superannuation funds in Australia are classified into the following functional classifications:

- ▶ Retail
- ▶ Industry
- ▶ Corporate
- ▶ Public sector
- ▶ Self managed super funds

The chart below shows how the assets are shared by the different parts of the industry.



The value of total assets in the Australian super industry has grown by 92% from \$637 billion in 2004 to \$1,225 billion in 2010.

The value of total assets in the Australian super industry has grown by 92% from \$637 billion in 2004 to \$1,225 billion in 2010. The strongest growth has been in the small funds (predominately Self Managed Super Funds (SMSFs)) with total assets increasing from \$130 billion in 2004 to \$391 billion in 2010 (averaging 20% annual growth compounded). The total number of entities in the super industry has grown from 283,223 in 2004 to 432,596 in 2010. This growth has been single-handedly driven by the growth in the number of SMSFs from 273,369 to 428,198 in that period. The numbers of entities of every other type of super fund have fallen since 2004, consistent with the broader sector trend of industry consolidation and stronger licensing.

It is likely there will be a further consolidation of a number of the funds and an increase in the level of divestments (transfer of assets between different funds).

Comparison with other countries

The level of participation of individual superannuation funds varies. Participants indicated Australian superannuation funds have approximately 5%–10% allocation to infrastructure. This allocation is typically higher for industry funds.

An estimate of the total level of superannuation investment in infrastructure has been made based on the total level of assets excluding SMSFs as at June 2010 of \$834.5 million¹. SMSFs have been excluded as this money is not available for direct investment into infrastructure. An infrastructure allocation of 5%–10% results in an approximate range of \$40 billion to \$80 billion.

The Australian Prudential Regulation Authority June 2010 Annual Superannuation Bulletin sets out the asset allocation of default investment strategy for entities with more than four members. Infrastructure is included in “other assets” along with

hedge funds and other assets not included in any of the other defined categories (Australian shares, international shares, listed property, unlisted property, Australian fixed interest, international fixed interest, cash, other assets). The allocation to “other assets” as at 30 June 2010 was 13%. This would equate to approximately \$110 billion.

Australia's superannuation fund allocation to infrastructure compares favourably to the rest of the world. Superannuation funds hold larger amounts in infrastructure and have been investing in infrastructure for a longer time than many other countries. Australia is considered a leader in investment in infrastructure along with Canadian and Dutch pension funds.

Australia also has a good reputation for superannuation funds investing in infrastructure on an international scale. For example Australian funds have made a significant investment in water assets in the UK.

In the 2010 client survey of the consultant firm Mercer², only 2.0% of UK pension plans are shown to invest in infrastructure (an increase from 0.7% in 2008). The average allocation to infrastructure by those plans is 3.8%. For Continental Europe, only 1.4% of pension plans are said to be invested in infrastructure, with an average allocation of 5.5% to the asset class by those funds invested.

This demonstrates that Australia has a very high rate of investment (at between 5%–10%) that is very widespread – covering approximately two thirds of superannuation assets (total assets less SMSFs) which is approximately \$800 billion as at 30 June 2010.

¹ APRA June 2010 Annual Superannuation Bulletin (Total assets (\$1,225.4 billion) less SMSF assets (\$390.9 billion))

² Asset allocation survey and market profiles, European institutional market place overview 2010, April 2010 (Mercer)

Examples of superannuation investment in Australia

Superannuation funds have invested directly and indirectly in numerous infrastructure projects in Australia. This investment has been made in both greenfield and brownfield projects and indirectly through funds that solely invest in infrastructure such as Macquarie Atlas Roads.

In the past superannuation funds invested in projects with greenfield patronage risk. However, given the failures of a number of recent toll road projects, there is no longer appetite to invest in greenfield projects with patronage risk.

This section sets out examples of superannuation investment in a range of projects and at different stages in the project lifecycle.

Public Private Partnerships

Superannuation funds currently hold investments in the majority of PPP projects in Australia. This investment has been made at various stages of projects' lifecycles:

- ▶ Development phase – superannuation funds are exposed to bid costs and risks associated with bidding
- ▶ Construction Phase – superannuation funds are exposed to greenfield design and construction risk
- ▶ Operations Phase – risk exposure is more clearly defined (e.g. patronage and operational history is known)

Table 1 below sets out examples of superannuation investments.

Table 1: Investment in PPP Projects

Time of Investment	Greenfield D&C Risk	Greenfield Patronage Risk	Brownfield Risk
Development phase	<ul style="list-style-type: none"> ▶ Peninsula Link (VIC) ▶ Victorian Desalination Plant (VIC) ▶ CLEM7 (Qld) – IPO ▶ Lane Cove Tunnel (NSW) ▶ Cross City Tunnel (NSW) ▶ EastLink (VIC) – IPO 	<ul style="list-style-type: none"> ▶ Lane Cove Tunnel (NSW) ▶ Cross City Tunnel (NSW) ▶ CLEM7 (Qld) – IPO ▶ EastLink (VIC) – IPO 	
Construction Phase	<ul style="list-style-type: none"> ▶ NSW Schools 1 (NSW) ▶ Defence Headquarters (Fed) ▶ Southern Cross Station (VIC) ▶ WA Courts (WA) 		
Operations			<ul style="list-style-type: none"> ▶ WestLink M7 (NSW) ▶ Prospect Water Filtration Plant (NSW) ▶ M5 (NSW) ▶ M4 (NSW)

Investors	Greenfield D&C Risk	Greenfield Patronage Risk	Brownfield Risk
	<ul style="list-style-type: none"> ▸ Prime Super ▸ Officer Super Funds ▸ STC Funds ▸ UniSuper ▸ Motor Traders Association of Australia ▸ Westscheme ▸ Retail Employees Superannuation Trust ▸ Commonwealth Superannuation Scheme ▸ Public Sector Superannuation Scheme ▸ AMP 	<ul style="list-style-type: none"> ▸ Motor Trades Association of Australia ▸ Westscheme ▸ Retail Employees Superannuation Trust ▸ NSW State Super ▸ Commonwealth Superannuation Scheme ▸ Public Sector Superannuation Scheme ▸ AMP 	<ul style="list-style-type: none"> ▸ QIC (asset manager) ▸ Industry Funds Management ▸ AMP ▸ Colonial First State

A significant level of superannuation investment is through large and successful investment vehicles specialising in infrastructure such as Industry Funds Management.

Privatisations

Privatisation is the full or partial transfer of ownership of a public asset to the private sector. Based on an observation of selected privatisation transactions in Australia, super funds have typically invested in privatised assets because the asset has already been constructed and in most cases, has been operating for a number of years. A selection of different assets has been included in Table 2.

Table 2: Superannuation investment in privatisations

Asset	Super fund investor	Other investors	Date of privatisation
Port of Brisbane	<ul style="list-style-type: none"> ▸ Q Port Holdings (Global Infrastructure Partners, Industry Funds Management) QIC (asset manager)) 	<ul style="list-style-type: none"> ▸ Tawreed Investments (part of Abu Dhabi Investment Authority) 	2010
Sydney Airport	<ul style="list-style-type: none"> ▸ Motor Traders Association of Australia 	<ul style="list-style-type: none"> ▸ Macquarie Airports ▸ Hochtief ▸ Ferrovia ▸ Ontario Teachers Plan ▸ Abbey National Treasury Services 	2002
Adelaide Airport	<ul style="list-style-type: none"> ▸ Investors as at June 2010 ▸ UniSuper (38.51%), Motor Traders Association of Australia Super Funds (28.35%) ▸ Local Government Superannuation Board (16.15%) 	<ul style="list-style-type: none"> ▸ Originally sold to Adelaide Airport Limited comprising super funds and others 	1998

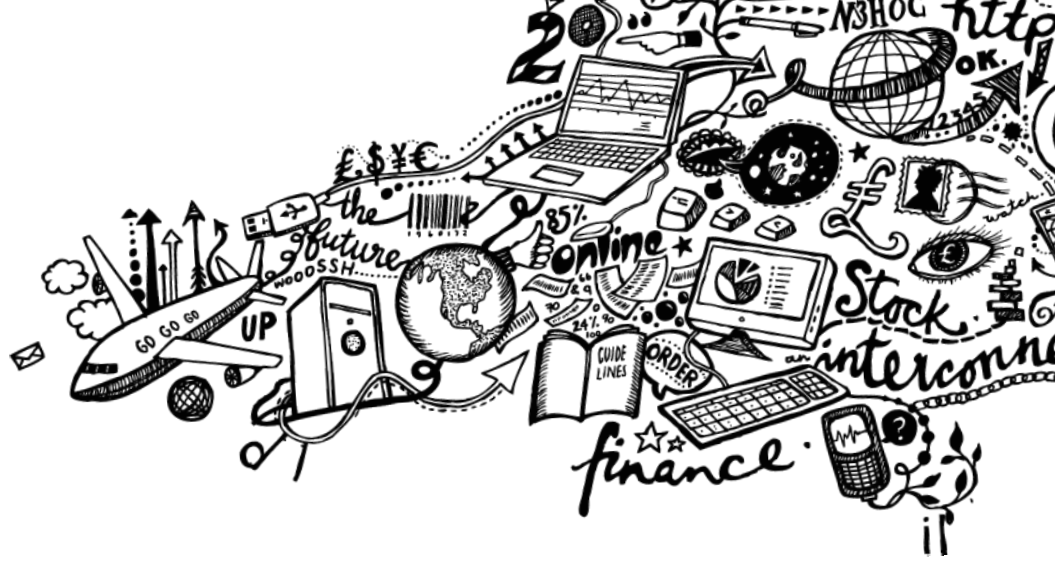


Table 2: Superannuation investment in privatisations (continued)

Asset	Super fund investor	Other investors	Date of privatisation
Dampier to Bunbury Natural Gas Pipeline ³	<ul style="list-style-type: none"> ▶ NSW State Super 	<ul style="list-style-type: none"> ▶ Epic Energy, El Paso, Consolidated Natural Gas, Hastings 	1998
Melbourne Airport	<ul style="list-style-type: none"> ▶ AMP Asset Management ▶ Deutsche Asset Management ▶ Hastings Funds Management 	<ul style="list-style-type: none"> ▶ BAA (formerly the British Airport Authority) 	1997
Yallourn Power Station	<ul style="list-style-type: none"> ▶ NSW State Super 	<ul style="list-style-type: none"> ▶ PowerGen of Britain, Itochu, Hastings 	1996
United Energy	<ul style="list-style-type: none"> ▶ NSW State Super 	<ul style="list-style-type: none"> ▶ Utilicorp 	1995

Super funds have significant investments in Australian unlisted infrastructure assets such as airports. One participant indicated that by its estimates in excess of A\$6bn is invested in unlisted Australian Airports which is more than 1% of industry and corporate superannuation fund assets.

³ IFM closed a substantial investment in \$550 million bond refinancing in 2010

Private sector investment in energy and resources

Projects in the energy and resources sectors are often initiated and sponsored by the private sector. The private sector is responsible for developing commercial structures and seeking efficient financing to facilitate the development of the infrastructure.

The funding of infrastructure sponsored by the private sector occurs through a variety of mechanisms including:

- ▶ Participant capital injections (from principal and joint-venture partners)
- ▶ Bank finance
- ▶ Debt issues on domestic or international capital markets
- ▶ Sale of equity rights in the project (e.g. stock exchange listing)
- ▶ Unlisted equity sale

Infrastructure assets may also receive Government funding (at the Federal and/or State level) if the project is of economic or social significance. A key example is the Oakajee Port and Rail Project, a joint venture between Murchison Metals and Mitsubishi Corporation, with the Federal Government and the Western Australian State Government committing \$339 million for pre-construction development works.

The majority of investment in energy and resource assets by superannuation funds has been during the brownfield phase of the projects. Table 3 provides a small sample of these assets. There has however, been one key instance of private financing of an infrastructure asset by a super fund during the development phase of the project. REST Superannuation and UBS International Infrastructure Fund acquired 100% of the Collgar Wind Farm from Investec Bank in April 2010 for an undisclosed amount. Capital costs for the wind farm project were estimated to be \$750 million.

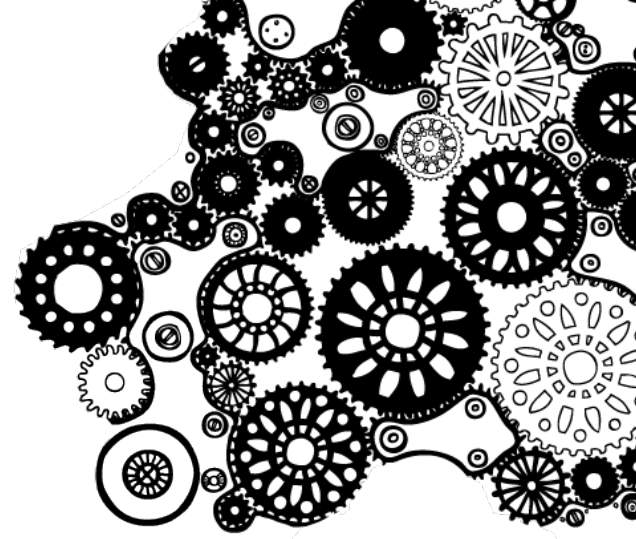


Table 3: Superannuation investment in privately financed investments

Asset	Super fund investor (current ownership)	Investment	Estimated Date of investment
Collgar Wind Farm (greenfield)	<ul style="list-style-type: none"> ▸ REST Superannuation (40%) 	Direct investment (in conjunction with UBS international Fund)	April 2010
Loy Yang Power	<ul style="list-style-type: none"> ▸ MTAA Super ▸ Statewide Superannuation Trust ▸ Westscheme 	Purchase of equity stake	July 2006
Pacific Hydro	<ul style="list-style-type: none"> ▸ Industry Funds Management (100%) 	Ownership purchase	2005
Leichhardt Coal (Blair Athol)	<ul style="list-style-type: none"> ▸ UniSuper 	Purchase of equity stake	December 1998

Participant views of barriers to superannuation investment in infrastructure

Introduction

It is important to note that a consistent theme expressed throughout the consultation process was, in general, the superannuation industry does not believe there are any serious issues surrounding the current level and spread of investment in infrastructure assets. Participants noted investment in any asset class was a complex matter, balancing the risk/return profile of the assets against the characteristics of the fund liabilities and current fund investment holdings. This implies it is impossible to set a simple optimal measure for the proportion of assets that funds should hold in infrastructure.

In discussing participants' appetite for additional allocation to the infrastructure asset class, most commented their view was largely dependent on assessing the characteristics of each individual investment opportunity against alternatives. The current appetite to increase the level of investment in infrastructure is impacted upon by a number of barriers which decrease the attractiveness of infrastructure assets when compared to alternatives.

Previous studies consistently identified the following barriers:

- ▶ The perception of infrastructure value
- ▶ Problems with liquidity
- ▶ Poor alignment with investment strategies
- ▶ Greenfield projects being less attractive
- ▶ Complex, expensive bidding processes
- ▶ A lack of a clear project pipeline
- ▶ A lack of specialist expertise

The participants indicated these barriers still exist. A summary of the participants' views on key barriers discussed during the consultation are as follows.

A lack of a clear pipeline and government commitment

A consistent theme of the consultation process was the level of fund investment is primarily limited by a lack of suitable projects reaching the investment market, particularly with respect to government sponsored projects. Table 4 highlights the level of uncertainty with respect to major projects to be tendered in 2012–2014 in Australia. The previously announced project timelines are now unclear and there is no strong pipeline in the immediate future.

Participants questioned whether the level of government planning around projects was a driver in the limited success of governments turning pipelines into real projects. A number of participants commented on insufficient planning at the sponsor government level combined with poor integration between State and Federal processes has in the past led to unacceptable risk around government sponsored projects.

For institutional investors to invest the extensive time required to appropriately assess infrastructure projects there needs to be much more certainty around future project pipelines, particularly around the funding sources and commitment of the sponsor government.

Table 4: Pipeline

	2010	2011	2012	2013	2014	2015
NSW						
Convention Centre			Project under review / postponed			
North West Rail Link			Project under review / postponed			
WA						
Midland Heath Campus		Current PPP Project				
Mundaring WTP	Current PPP Project					
QEII Hospital Car Park	Current PPP Project					
SA						
Royal Adelaide Hospital	Current PPP Project					
South Road				Potential Future Project		
Northern Connector			Potential Future Project			
VIC						
Victorian Comprehensive Cancer Centre	Current PPP Project					
Westlink			Project under review / postponed			
Regional Rail		Project under review / postponed				
Melbourne Metro		Project under review / postponed				
QLD						
Sunshine Coast Hospital		Current PPP Project				
Gold Coast Light Rial	Current PPP Project					
Cross River Rail			Project under review / postponed			
East West Link					Project under review / postponed	

- Current PPP Project
- Project under review / postponed
- Potential Future Project

A lack of suitably structured projects

The need for a commercial risk based return

Participants are of the view that governments have difficulty in understanding all investment by funds is done solely for the benefit of their members. Funds do not make investment decisions based upon “social good” and therefore all investments made need to earn a return commensurate with the assessed risk.

Participants were of the opinion that a result of this government viewpoint was that project risk profiles were not necessarily designed to encourage efficient institutional investment and the consequent reluctance of investors to participate in government projects was further misinterpreted by government sponsors.

An example of this miscommunication quoted by participants was that some government bodies have commented to funds that they do not believe fund yield requirements should have changed in the light of the global financial crisis. This position ignores the parallel changes in alternative debt and equity product returns observed and the need for funds to recoup global financial crisis losses for their members. This type of comment reinforces the view of participants that government entities involved in the intersection of superannuation investment and infrastructure development do not fully understand the financial environment and fiduciary obligations that underpin the investment strategies of superannuation funds.

Size of equity investment

Participants noted there is an optimal investment size range for individual project investments and therefore infrastructure projects outside this range present an additional challenge to superannuation funds and other institutional investors. The optimal investment range varies for each fund and is influenced by the level of resources and any restrictions the fund may have (for example some funds can not invest more than a specified percentage of fund value into a single investment). It will be a function of the potential risk/return profile, cost to invest and the resources and time required to undertake the investment.

For smaller projects (projects that typically involve less than \$100 million equity) the cost of investing does not generally reduce in proportion to project size, especially where construction or patronage risks are key elements of the project profile. This can mean the net return after all costs is insufficient to justify further consideration.

For mega projects (projects greater than \$4 billion), the required funding is likely to need a large consortium of fund investors, and therefore there is the additional cost and complexity around consortium documentation and negotiation.

Government sponsors need to be cognisant of the impact of the size of the projects being developed on Australian fund investment profiles.

Greenfield project risks

Patronage risk

Greenfield patronage risk is of major concern to superannuation funds given the recent underperformance of a number of tollroad projects. Participants noted that it is unlikely they would consider greenfield investment where patronage or similar operational performance risks existed.

There is a willingness of superannuation funds to accept patronage risk on projects with a long operating history. Fund managers are able to gauge the brownfield patronage risk and acknowledge that investing during the operations phase implies buying into the project at a lower return.

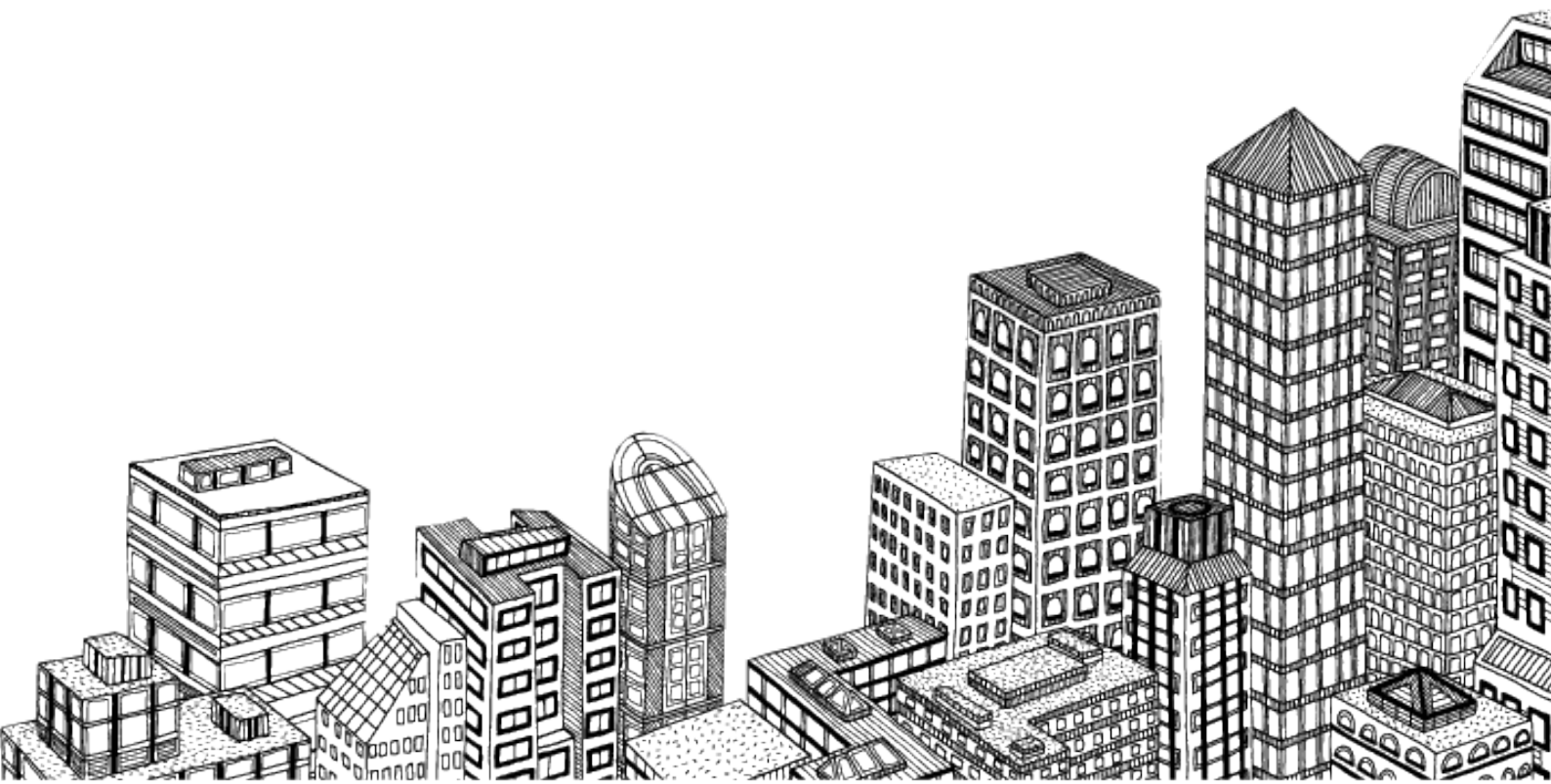
Participants indicated there are acceptable models which do not involve transferring all the greenfield patronage risk such as the availability payment model or potentially models which involve sharing patronage risk.

Design and construction risk

Superannuation funds are amenable to taking greenfield design and construction risk and have done so on a number of social and economic infrastructure projects. The appetite for such risk depends on availability of construction entities with the particular skills and financial capacity suited to individual project issues.

Bid cost risk

A common view was investment in greenfield projects was particularly difficult for superannuation funds, especially if participation involved a competitive tender process. Participants noted the expense, time and effort involved in tender processes was often hard to justify in the light of their fundamental fiscal obligations to fund members and the difficulty in forming an accurate view on the likelihood of success.



Inconsistent, complex and expensive bidding process

The lack of consistent, simple and clear bidding processes has been identified as a significant hurdle with respect to PPP tenders and was one key driver in participants' muted interest in greenfield projects.

Participants commented that contract and risk allocation structures differ between States particularly with respect to greenfields PPP project processes, and this lack of commonality exacerbates the cost of participating in a wider range of transaction processes. It was noted by all that these bidding processes are individually lengthy, complex and involve significant costs. Specialised skills are often hired by superannuation funds in order to participate in the bidding process.

One particular issue raised was the focus on "competitive tension". To participants this emphasis drives project sponsors to demand too much detail at early project stages and to select too many consortia for the request for tender (RFT) stage. The impact on superannuation investors discourage them from participating in this primary project market since the cost/benefit balance is poor.

Regulatory and industry pressures

Regulatory pressures

Participants commented that a number of funds that heavily invested in illiquid assets were hit hard by the global financial crisis and as a result Australian government entities involved in the regulation of superannuation investment have responded conservatively.

It was noted that APRA particularly has been pressing funds for more information and justification around investment in illiquid assets such as unlisted infrastructure and this additional compliance overhead acted as a deterrent against additional investment.

The lack of clarity over what is considered a reasonable allocation to long term illiquid assets was a factor that concerned some participants.

Development of MySuper product

A number of participants expressed the view the introduction of MySuper, the Federal Government's proposed new mandatory default superannuation product, could reduce Trustees' desire to invest in infrastructure.

More specifically, infrastructure was not seen as compatible with the strong focus on low cost investments contained in the MySuper proposal – particularly as a consequence of new statutory duties for MySuper trustees.

Trustees would potentially find it more difficult to allocate funds to infrastructure investment in a regulatory and competitive environment heavily focussed on cost.

Sovereign and political risk

Participants commented that recent events have raised sovereign risk as a real issue in assessing investment in infrastructure. Elements discussed included:

- ▶ The current uncertainty around carbon pricing and renewable energy initiatives
- ▶ The impact of political motivations

Specific comments were made that the lack of clarity over the long term policy structures on the form and level of any carbon price, and how carbon initiatives will interact with renewable energy initiatives is considered a significant risk element overshadowing all infrastructure investment. The obvious impact is on the attractiveness of investment in the power sector, but it was also noted, depending on the design of the carbon measure, the impact on infrastructure sectors may differ significantly. Given infrastructure investment is by nature illiquid, uncertainty over how different sector values may change in response to a carbon tax is considered a significant sovereign risk issue. This risk impacts both consideration of additional investment and the valuation of existing assets.

Electoral cycles have impacted upon the level of risk perceived by investors. This has arisen due to lack of clarity around the timing of projects and the cancellation of two large projects during the tender evaluation phase. Some participants pointed to the recent Victorian experience where there was momentum building with the Metro project and Westlink, however, this stopped as a result of the State election. This has increased the level of uncertainty with respect to government commitment and future pipeline.

Proliferation of SMSFs

Most participants were of the view that SMSFs would find it difficult to allocate funds to unlisted infrastructure and the continuing proliferation of such funds represented a challenge to government entities seeking substantial increases in fund investment in infrastructure.

Unfavourable Australian banking terms

Participants that have assessed Australian opportunities against global projects commented that Australian bank debt terms continued to be materially less favourable to those available in the global market for infrastructure projects. It was specifically noted Australian banks are still reluctant to lend longer than ten years whereas European and US loans are available for 20+ years. Poor debt terms produce unbalanced risk/return ratios for infrastructure projects and limit the interest of funds in considering either green or brownfields investment.

Lack of specialist expertise

Given that infrastructure is a complex asset class, specialised skills are required to conduct the necessary analysis before investing in projects. Lack of specialist expertise has previously been identified as a key barrier to further investing in infrastructure.

There is a perception that superannuation funds often rely solely on the skills of others to assess opportunities and do not necessarily build up the resources in-house to be informed enough to either undertake or outsource major investment decisions. Whilst this is the case for some superannuation funds, a number of participants indicated that superannuation funds have been increasing the level of skills in-house. The increase in skill base has varied between enabling in-house staff to be informed gatekeepers and monitor what they outsource to enabling in-house staff to make the actual investments.

Whilst it is important to outsource some of the major investment decisions there is still a requirement for infrastructure expertise in-house.

Participant views of potential solutions

Committed pipeline

There is a requirement for a greater supply of projects and an integrated pipeline across the State and Federal Governments. Political championing of the pipeline was noted as an essential component in creating a believable process to highlight future infrastructure investment opportunities.

Participants pointed to the overarching procuring bodies created in some Canadian States, (eg Partnerships BC) that are responsible for developing and delivering privately funded projects. They were keen for the body to be a Federal entity so that it could control the integrity and consistency of national planning and enforce a robust and time efficient process for the selection, prioritisation and development of potential projects. Some participants commented that a federal agency's (for example Infrastructure Australia) role and powers could be expanded to fulfil this role provided it was further isolated from the political process.

There are challenges in creating a national pipeline given the Federal system of government.

Appropriate structuring of projects

Institutional investors have particular requirements around the risk/return mix of long term illiquid investments and projects that do not conform to these will not attract sustained investor interest. Governments need to understand these requirements and the impact they have on the structure of infrastructure projects when developing value for money transactions.

Participants noted the post global financial crisis investment market is particularly concerned with:

- ▶ Regulatory and legislative risk, including uncertainty around carbon pricing and renewable energy initiatives
- ▶ Demand and network risk for all infrastructure sectors
- ▶ Funding market dislocation risk, with significant concerns around medium term refinance risk. This is exacerbated by the inability of Australian banks to offer debt with term longer than ten years

Governments need to consider how to address these issues when structuring projects.

Government recycling of capital

Government recycling of capital was raised by many participants as an effective way to fund further core projects and attract further superannuation fund investment in infrastructure. Participants commented that brownfield projects, even demand based, with a strong operating history are highly desirable investments.

It was suggested the Federal Government could commission a review of operating assets still held by Australian governments to highlight where there was potential to sell down and recycle the capital to enable the development of more greenfield assets.

Simplified transaction processes

All participants commented there was substantial opportunity to streamline current government PPP processes. The key elements participants believed would have the most impact were:

- ▶ A set of common PPP tender processes and pro-forma contracts with individual State compliance controlled by an independent Federal body
- ▶ Simplified EOI processes that minimised the largely unnecessary financial structure content requested
- ▶ Agreement with the Federal Government on acceptable taxation structures
- ▶ Limiting the number of consortia taken to the detailed bid process to two

Participants commented again that Infrastructure Australia could play a more concrete role in developing and enforcing consistency around these issues.



Consistency and certainty of government regulation

All participants noted infrastructure assets are long term assets requiring substantial analysis. Volatility in government regulation that impacts on this asset class was a significant issue in setting investment allocations. A number of participants noted that State and Federal Governments tend to give the impression they see Superannuation Fund money as simply another pool of funds available for deployment and this view produced a lack of focus on the combined effects government policy initiatives have on fund investment.

Participants commented that superannuation funds represent the largest domestic pool of private investment capital in Australia and are concerned when governments reactively respond with short term regulatory changes without analysis of the longer term impact. The key improvements looked for in this area included:

- ▶ Greater coordination between and within State and Federal Governments around policy that impacts on institutional investment. Tension between ministers and regulators around infrastructure investment was noted as an example where funds are caught between conflicting government aims
- ▶ Less road testing and more detailed development of policy with consequent greater certainty over announced initiatives. Carbon pricing was the example given here. Funds are able to include the impact of any concrete carbon initiative into their investment appraisal processes but cannot proceed with certainty over the scheme's form and implementation timetable
- ▶ Further consultation between governments and investment professionals on future policy initiatives

Further improvement in the taxation system efficiency

Participants did not favour government intervention via new taxation incentives as these tend to distort investment patterns. Participants also noted the failure of past initiatives such as the tax free Infrastructure Bonds to produce long term improvements in the infrastructure investment market. It was stated that superannuation funds currently pay one of the lowest taxation rates on investment income and therefore they naturally are the least influenced by taxation incentives.

There was agreement that changes to increase the efficiency of the current system would have a positive impact. One issue that was frequently commented on was improving access to taxation losses locked up in special purpose vehicle entities holding infrastructure assets. In this regard there were welcome measures in the 2011 Federal Budget to assist in improving efficiency with respect to preserving the real value of tax losses accumulated early in a project's life.



Certainty over government funding commitment

Participants noted a key element in the level of market cynicism over government infrastructure pipelines is the lack of certainty over funding allocations for large projects. A key element of this is the aversion Australian governments have to incurring significant additional debt to fund budgetary announcements. This forces government to fund the direct subsidy elements of a project's cost out of yearly budget allocations rather than long term debt repayments.

Participants noted this produces a volatile environment within which projects are developed and tendered. There was universal support for the use of additional long term government borrowing to fund appropriately development infrastructure projects, (as opposed to borrowing to fund immediate government consumption) on both equity and certainty grounds.

Participants also commented that another positive impact of further substantial long term government borrowing initiatives would be an improvement in the efficiency of the Australian debt markets. There is currently a shortage of AAA rated debt products with terms longer than ten years and this naturally acts as a deterrent to banks lenders in structuring longer term lending products. The issue of government debt products in volume with terms 20 years or greater would assist banks to efficiently price and hedge long term lending exposure.

It was accepted there are political issues to overcome in expanding government debt levels, with a common suggestion being that developing debt products specifically identified as being for the development of infrastructure (the NSW Waratah Bond concept) could be an effective approach to minimise political opposition.

Conclusion

We acknowledge there are differing views in relation to the level of superannuation fund participation in infrastructure projects. This report focuses on the key group that would be impacted by an initiative in respect of institutional investment in infrastructure, not a wider canvassing of general views on infrastructure investment.

The overall view is that Australian superannuation funds have demonstrated a keen interest in infrastructure as a viable investment sector; the evidence is in the higher allocation to infrastructure compared to other countries. That does not mean there is no opportunity to stimulate further efficient investment in infrastructure by superannuation funds and institutional investors. While we agree that all the barriers listed by participants are affecting investor appetite we have set out below our view on the areas where improvements would have the greatest impact. We have also provided our view on how initiatives in the 2011 Federal Budget could assist with these improvements.

Creation of a national pipeline

In order to generate market confidence and simulate further interest (domestic investors, global investors, domestic and international contractors, domestic and international operators and project sponsors), a national pipeline of funded projects needs to be created using the existing Infrastructure Australia priority project list as a basis.

The expanded role defined for Infrastructure Australia in the 2011 Federal Budget is an important initial step in providing a more definitive picture of the projects that will require further allocation of private financing. The proposed National Infrastructure Construction Schedule is an excellent starting point as it focuses on projects that are expected to require physical construction activity in the medium term. We support the general commentary made by participants that the establishment of independent, statutory bodies with authority to control procurement of infrastructure assets, as in some Canadian provinces would assist in the development of more robust and achievable pipelines.

Appropriate structuring of projects

Superannuation funds have indicated they are willing to invest in projects that have suitable risk/return profiles to optimise the long term benefits of members.

This requires Governments to work more closely with the private sector to develop structures that are more conducive to attracting institutional investment rather than relying on past precedent forms. Areas that should be investigated are:

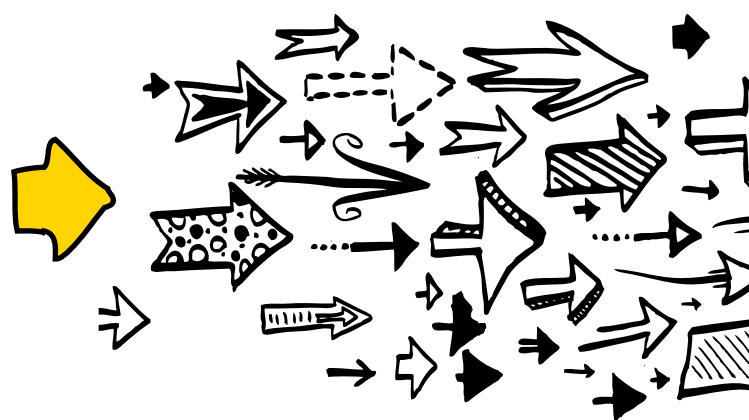
- ▶ Patronage risk sharing models
- ▶ Packaging projects so that institutional investors have multiple buy-in points
- ▶ Optimal structuring of government funding contributions from tax and funding cost perspective

A point that impacts on all the above design issues that needs consideration is the optimal role of the Government in the development process.

Recycling of capital

There is still a significant number of Government owned entities operating in competitive and regulated business environments. Given there is a general consensus that material additional investment in infrastructure is required and institutional investors favour brownfield over greenfield assets; then potential to efficiently recycle government capital in operating businesses should be further investigated.

Our view is strategic reviews of current government operating assets should be initiated and focused on identifying and testing the rationale for continued government ownership. Where the case for continuing government ownership is not sustained plans to consider full or partial divestment should be produced. Infrastructure Australia could consider producing a separate pipeline of privatisation transactions.



Simplified transaction processes

The complexity and disparate nature of bid processes has impacted the willingness of superannuation funds to participate at the bid stage. Naturally limiting the set of potential bidders limits the competition and innovation that will be brought to the bid phase. The Federal Government recognised this issue and, through Infrastructure Australia, produced national guidelines on PPP procurement to improve these processes. Investor experience still indicates there are diverse interpretations of the guidelines and overly risk averse views to the procurement process. The investor view is that Government requests too much information at EOI stage and often short list more than two bidders.

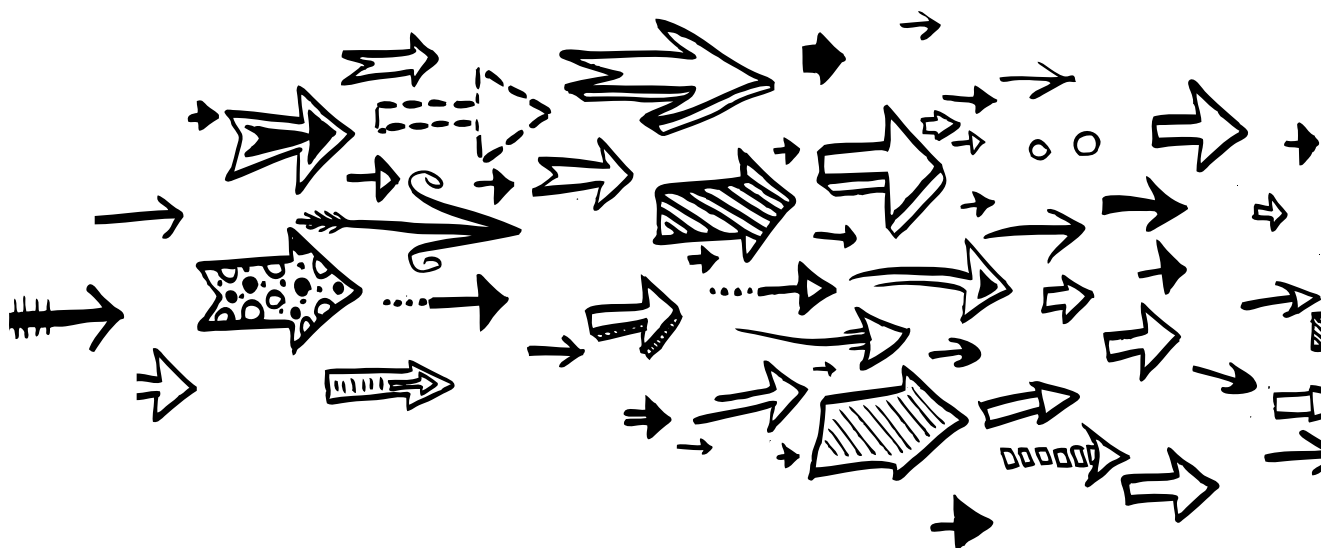
Our recommendations include:

- ▶ Adoption of standardised documentation
- ▶ Information requirements at the EOI stage be considered with the view to simplifying the requirements
- ▶ The number of short-listed bidders be reduced to assist in reducing bid costs

Inefficient measures

Our view is that mandating investment levels in infrastructure creates distortions and forces superannuation funds to invest in assets that do not necessarily meet the risk/return profile being sought. Superannuation funds have a duty to invest in the best interest of their members and should not be forced to allocate funds to assets which they do not believe optimise returns for their members.

Government intervention via specialist tax incentives such as investment allowances can also distort investment patterns and will not necessarily encourage additional investment from a large number of investors. However, improvements in the efficiency of the current tax system could assist in encouraging further investment.



Federal Budget Initiatives

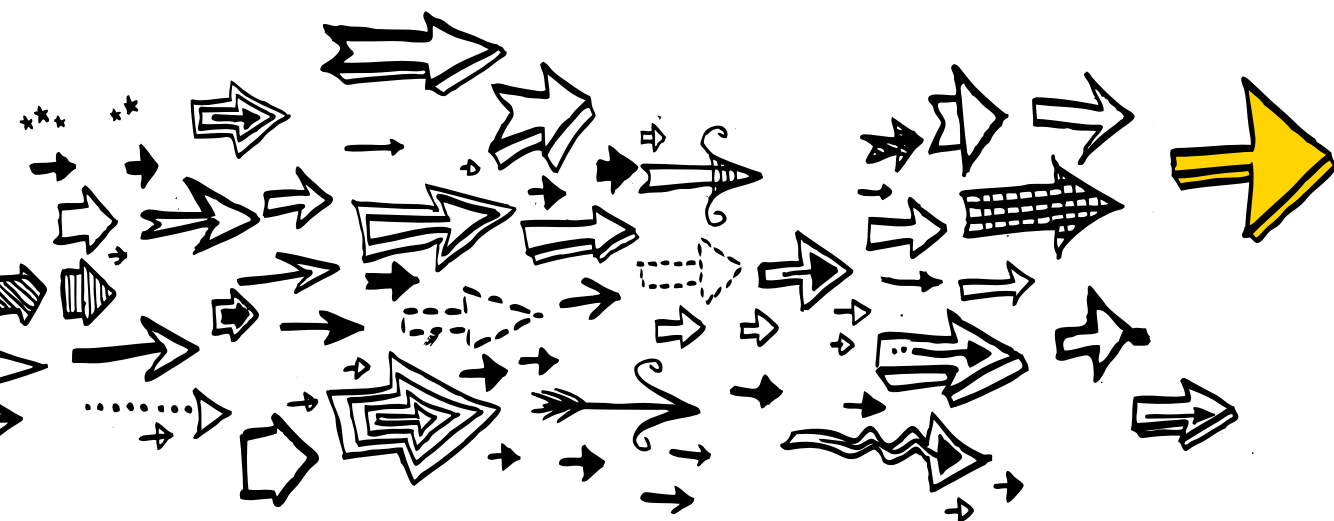
The 2011 Federal Budget includes initiatives which provide a useful starting point for addressing some of the issues identified.

Infrastructure Australia has been given an increased budget, an expanded role and a greater autonomy. Infrastructure Australia has been asked to take a more proactive role in project prioritisation through the top down development of a National Construction Schedule. This should feed into the development of the national pipeline of funded projects.

It has been proposed to establish an Infrastructure Financing Group comprising public and private sector participants to examine opportunities to improve private investment in public infrastructure. It will be extremely beneficial for both parties to discuss and understand each others requirements and use this

to identify potential activities to assist in stimulating further investment. The Infrastructure Financing Group should provide a useful forum for discussing views on structuring projects and Government's role in relation to the development process and recycling capital.

The budget also includes a new incentive in relation to preserving the 'real' value of tax losses accumulated early in the life of projects. This should mitigate the wastage of accumulated losses in projects, when new investors enter after the early development stages. This has previously impeded superannuation funds investing in infrastructure projects in Australia.



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