

DOMESTIC ISSUES IN INFRASTRUCTURE FINANCING

Commentary

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INTRODUCTION

A man had nearly paid off the mortgage on his house when he mortgaged it again to buy a new car. Having the car, he sought out a banker to try to get a mortgage on the car to build a garage.

"If I do make the loan" the banker said, "how will you get the money to buy petrol for the car?"

"It seems to me" the man replied with dignity, "a fellow who owns his own home, car and garage should be able to get credit for petrol."

This perception of unlimited sources of capital is as we all know incorrect. This theme is relevant to some of the following comments.

The accompanying paper by Tony Browne provides a comprehensive overview of what is "infrastructure". His analysis quite correctly excludes privatisation of assets which do not rely on the government for its key revenue streams. Examples of such assets are the power assets in Victoria where the government has or is exiting from any economic interest as an owner. My comments will be constrained to financing of infrastructure where the government desires to retain an economic ownership interest.

I will provide a brief overview of the current status of infrastructure finance. Then, I intend to comment on some risk allocation issues alluded to in Tony Browne's paper as well as address the issues of standardisation of risk principles and documentation and conflicts of interest.

CURRENT STATUS OF INFRASTRUCTURE FINANCE

The demand for the private sector provision of public infrastructure has grown markedly over the past decade and this has of course led to an increasing demand for private sector capital, both debt and equity, to fund both new projects and to purchase assets from government.

From a very low base the market for infrastructure investments has also developed considerably to the stage where infrastructure finance is now the flavour of the month in international financial circles and infrastructure investment is becoming the fund management fad of the 90s.

The result of this is that project sponsors, governments and their advisers are now faced with a plethora of financing alternatives in terms of:

- Debt;
- Quasi Equity; and
- Equity.

Pre-M2 (the neo-lithic age of Australian infrastructure finance) a sponsor was faced with little choice in funding a private sector infrastructure project. You used sponsor equity and syndicated bank debt to fund private infrastructure as was typical of the funding of projects such as Loy Yang B and many others.

Those projects which did use institutional debt were primarily projects such as the Sydney Harbour Tunnel and the Tax Office projects, where the income stream was government or semi-government risk. Westpac acted as adviser to the Sydney Harbour Tunnel project and arranged and underwrote \$500 million of 30 years CPI linked securities.

The M2 transaction, however, was a watershed in that it was the first major project in which institutions, as opposed to banks and sponsors, accepted significant amounts of project risk (ie the risk that revenues would not be as forecast). It was particularly significant in that this was a patronage risk project, which are traditionally the most challenging projects to fund privately. Westpac acted as the Debt Arranger in the M2 project. Our role covered arranging all the debt aspects of the project. Westpac was instrumental in pushing for the combined debt structure of bank debt and CPI linked securities. Westpac structured both components and led the underwriting group for each component.

Now we are faced with a choice of financing alternatives including:

- Index (eg CPI linked) Securities
- Listed Equity
- Infrastructure Bonds
- Converting Infrastructure Bonds
- Direct Institutional Equity
- Floating Rate Notes
- Offshore placements

But does this really mean that private infrastructure is being funded more efficiently? Or are we just creating additional layers of complexity and increasing both front end costs and the time taken to close a deal?

DEVELOPMENT OF INFRASTRUCTURE FINANCE

Private infrastructure investment has now been utilised in the Health, Water, Prison, Transport and Power sectors. Each of these sectors have their own particular attributes, but two key factors which are common to most infrastructure projects are:

1. Projects have a long economic life, usually in the range of 20 to 40 years; and

2. Project returns are normally constrained through government involvement in the process. Governments need to be seen to protect the public interest and this usually takes the form of ensuring that equity returns are not excessive.

To date the majority of projects have been funded by sponsor equity and syndicated bank debt. But particularly in the case of bank debt, the nature of the product is not ideally suited to funding infrastructure projects as the maximum tenor of bank debt is around 17 years compared to the 20-40 year economic life of the project.

Banks' ability to lend long term is limited by the fact that their primary source of funds (deposits) is predominantly short term. Lending long in liquid assets such as infrastructure projects is not a prudent activity. Continental Bank, Rothwells and Farrow Corporation are examples of what can happen. Therefore, banks are not natural providers of funds to long term infrastructure projects.

Institutions, such as superannuation funds, however, are the natural investors in longer term investments, both for debt and equity securities, due to their offsetting long term liabilities to superannuation beneficiaries and like constituents. In overseas markets, particularly the USA and Europe, institutions are major players in certain segments of the infrastructure market. Therefore, it is only natural that they play an increasing role in Australian infrastructure financing.

Institutions are therefore an increasingly important source of funds for infrastructure investments and increase the market capacity to undertake private infrastructure projects both in terms of exposure to individual projects and to the infrastructure sector as a whole. This is very important on large projects such as the Melbourne City Link, which would be extremely difficult to finance without institutional involvement as it is beyond the capacity of sponsor equity and syndicated bank debt to fund alone.

What does all this mean for the future?

1. Projects will be increasingly structured to appeal to institutional investors both in terms of debt and equity.
2. Banks will increasingly become providers of risk management facilities and underwriting capacity rather than holders of long term debt.
3. Financing structures will become more complex to accommodate the needs of the different types of participants.
4. Market participants will become more sophisticated as their knowledge increases with their experience.
5. Standardisation will increase particularly on the small to medium size transactions.

The result is more opportunities for financiers, sponsors and investors in the infrastructure area. However, for those of us responsible for forging these new developments, we owe a duty of care to new market participants, in order that we create a sound basis for future developments.

RISK ALLOCATION

Like any normal commercial deal, risk allocation is essentially a trade-off between risk and reward. Risk should be absorbed by the party most able to manage the risk. Of course, there are a number of risks which fall outside the control of both parties. These need to be negotiated and a suitable compromise achieved as pointed out by Tony Browne.

There is a view being pursued by some sections of the market that the government should not be entertaining any compromise in the grey area.

An example lies with the issue surrounding force majeure and insurance proceeds.

Force majeure risk is a classic example of a risk category which is beyond the control of any party. Debt and equity parties have been prepared to accept this risk, in other commercial projects, primarily because adequate insurance has been available for most force majeure circumstances. An additional point is that debt and equity parties have retained the right to deal with the economic asset as they see fit.¹ Naturally, this precedent has been the starting point for infrastructure projects.

The addition of a third vested interest in the form of government overlays this risk allocation with the proposition that the government requires that in all circumstances, force majeure or otherwise, the asset is to be reinstated. This is consistent with their current practice of self insurance and is consistent with the political reality that the assets are for the public good.

The difficulty arises in several areas.

Firstly, there is a difference between the parties with respect to what each considers its economic asset. Government is primarily concerned with the physical asset. The private sector, on the other hand, is primarily concerned with the concession agreement which gives it limited rights to a potential revenue stream to service debt and equity. The private sector will only want to reinvest in the physical asset so long as it is economically viable to do so. Given a fixed concession term, this means that if the project revenue has not met expectations then there may not be sufficient revenue to justify any additional investment to cover any insurance proceeds shortfall. For the private sector, it may be preferable to relinquish the concession and take the insurance proceeds to mitigate any loss on investment.

Secondly, the private sector entity is generally a highly geared special purpose vehicle whether listed or not. This means that the vehicle has no other committed sources of funding available unless the revenue stream at the time can justify additional investment by either debt, equity or both. The government generally does not have this limitation although a budget process is acknowledged as a hurdle, but this would equally apply to a multi-purpose corporate entity.

Thirdly, the consequence of the government position with respect to automatic reinstatement is that breach of such an obligation leads to termination without compensation. From a government perspective this is a satisfactory outcome. From the private sector viewpoint, this position potentially forces the private sector to fully reinstate the asset to maintain the concession irrespective of commerciality. Furthermore, termination without compensation is a potential outcome despite the fact that a force majeure event was the cause.

I contend that termination without compensation as a remedy in what is essentially force majeure circumstances is inappropriate and unbalanced risk allocation.

The solution is simple but requires compromise. An economic viability test should be included as a trigger to remove the termination remedy from government. This can be overlaid with triggers under which automatic reinstatement is required. Please note that this is a significant shift for the private sector but effectively represents commercial reality.²

In addition, as Tony alludes to with his comment, some governments are even reluctant to accept that the private sector is entitled to the same reciprocal rights for contractual breach as government seeks for itself. I leave this to the reader's judgment as to the equity of such a proposition.

¹ It is noted that debt financiers and equity do share this control under certain circumstances. It is common for debt parties to seek absolute discretion over the use of proceeds subject to a cap under which all proceeds are applied automatically to reinstatement.

² An alternative for government is for it to pay compensation for the right of termination as postulated in Tony Browne's paper.

STANDARDISATION OF RISK ALLOCATION AND DOCUMENTATION

A common complaint from both the private sector and the public sector is the cost of the private sector involvement in infrastructure. The private sector is concerned with the cost of tendering and the government is concerned at the total cost of the development. A key cost in some of the earlier projects was the legal cost involved. The only way this will be overcome is that some standardisation in risk allocation be attained. Yet I still see many participants trying to re-invent the wheel or at the very least try to negotiate unsustainable risk allocation.

Many of the perplexing issues such as the insurance/force majeure issue discussed above do not need to be debated each time. Of course, there will always be exceptions to the rule. A good example of this is the Olympic Stadium Project.

The concept of some standard risk allocation and hence documentation would in my view help improve the efficiency of delivery in time and cost.

CONFLICT OF INTEREST

The new listed vehicles have introduced new entrants and required change to the roles of sponsors, underwriters, advisers and direct investors. The question is raised, *who should really be negotiating the project?* The sponsors, the advisers, the equity underwriters or the direct equity participants? All these parties have different interests and objectives which can lead to major conflicts within the ownership group. This makes it difficult to present a united front when negotiating with debt providers or the government.

For the debt parties similar issues arise although the conflicts are less apparent than those between equity parties. Where banks are both the syndicated debt arrangers and bond underwriters these issues can be dealt with internally. However, where additional bond underwriters are brought in, it further complicates the negotiation process if those new parties have different interests. This is further complicated where you now have the same institutions taking both debt and equity in a project.

These issues can be complex enough in the project development/negotiation phase, but an issue that is becoming increasingly relevant in the US is the question of *what happens in a default situation?* With traditional syndicated projects loans you are faced with the daunting prospect of negotiating with up to 30 banks (200+ in the case of Eurotunnel) in a default situation. Where capital markets instruments are also involved you have to add to the equation dozens (if not hundreds) of bondholders whose agreement you need. Combine this with the difficulty of trying to restructure a publicly listed vehicle and you are faced with a very daunting prospect indeed.

A key area of concern in any project is the divergence of views which emanate between those whose reward is solely tied to the successfully closing of a transaction and those whose reward is tied to the successfully long term operation of the project being undertaken. Short term vested interests rarely show proper concern for the long term equity and debt holders. Decisions are made particularly with respect to equity which in the interests of doing a deal are detrimental to equity.

An example is the use of indexed debt securities in infrastructure projects. These securities share first ranking position with bank debt yet carry with them development reward. Once these securities are issued they can only be bought back at the prevailing market price whereas bank debt only ever receives its nominal balance outstanding. The prevailing market price of these instruments will vary according to relative interest rate movements but also with respect to the success or otherwise of the project. In issuing such instruments equity is forgoing a pro-rata portion of its upside. Whilst this is a proper commercial decision to be taken, there are other options which are potentially more advantageous to a long term owner.

CONCLUSION

It is up to both the public and private sectors, as participants in the industry, to review the development of each project, and consolidate the experience gained into the next project, so that we continue to move forward and hone the process, thereby maximising the likelihood of an acceptable outcome to all sides.