4 April 2014

Public Infrastructure Inquiry
Productivity Commission
LB2 Collins Street East
Melbourne, VIC 8003

By email: peter.harris@pc.gov.au

Dear Commissioner

Public Redacted Version

Productivity Commission Draft Report – Public Infrastructure

IFM Investors welcomes this opportunity to respond in-confidence to the Productivity Commission Draft Report on Public Infrastructure, released on 13 March 2014.

As you will be aware, IFM Investors provided an in-confidence response to the Issues Paper in which we noted, among other things, that there are no fundamental financing issues, just a lack of deal 'pipeline' and recommended a transparent partnership model with equity to replace the traditional Public Private Partnership ("PPP") model in order to level the playing field for long term equity investors.

In this submission, we will respond to the Commission's information request 6.3:

The Commission seeks feedback on the advantages and disadvantages of alternative procurement processes focused on long term equity, such as an 'inverted bid' model. In particular, the Commission is interested in how an alternative procurement process should be designed to maximise efficiency gains and the likely benefits and costs of such an approach.

We will outline the need for the traditional PPP model to evolve and recommend the principles and process required to implement a transparent partnership model, also referred to as the 'inverted bid' model. IFM Investors is supportive of Industry Super Australia's ("ISA") position on this model and has been working closely with ISA to develop the concept.

Why does the traditional PPP model need to evolve?

For long term equity investors like superannuation funds, the traditional PPP model has several impediments. Opportunity cost is the first: bid costs are high, procurement periods are long and deal flow is 'patchy'. Long term equity investors do not see the relative value to deploy additional resources or divert resources away from pursuing brownfield infrastructure to greenfield PPP projects that involve such a costly, lengthy and uncertain process.

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The second impediment as we see it is a principal-agent problem: PPP bids do not specifically require bid sponsors of consortia to be long term equity investors. To be clear, whilst equity investors do establish and provide equity and debt finance to the Special Purpose Vehicle ("SPV") that enters into the PPP contract with the relevant government agency, the SPV is not represented by genuine equity owners. It is represented by their agent or adviser or by another party in the consortium. The alignment of interest between the agent and the SPV is of vital importance. If the agent is bringing its own balance sheet equity, or if the agent is a manager of long term orientated investment funds, then the interest of the agent and the SPV is aligned. The agent will price project risk accordingly – but if the agent is a developer, contractor or investment bank that does not have a long term interest in holding the asset, or if the agent is a manager representing unsophisticated retail investors in the SPV, then there is poor alignment, and the risks will not be adequately factored in the project.

[REDACTED]

Without proper alignment between the agent of the SPV and long term equity interests, short term incentives to take fees and profits as soon as possible are likely to prevail over long term incentives to own and operate the project over its economic life. [REDACTED]

What are the principles of the transparent partnership model?

The principle criterion is that bid sponsors must have 'skin in the game' by providing long term equity. Agents who lead bids and represent SPVs must bring genuine and meaningful amounts of long term equity to be able to bid. The model should provide a level playing field to long term equity investors, without favouring superannuation funds, or any other particular type of investor.

How should the procurement process be designed?

The procurement process for an equity partner could consist of three stages:

Stage 1: Indicative bids for appointment of preferred bidder

The government will invite long term equity investors to prepare indicative bids against requirements in the proposed PPP contract. Bidders will submit their indicative internal rates of return ("IRR") to build and operate the project for the duration of the concession. The government will assess the indicative bids and rates of return based on transparent criteria. In order to meet the best value-for-money outcome, the government will reserve the right to negotiate with one or more of the bidders at its absolute discretion. At the completion of Stage 1, the government will select the bid sponsor with the most competitive IRR as its preferred equity partner. If the government assesses the indicative bids as not meeting its benchmark, it will reserve the right to reject them, go to market or seek an alternative procurement method.

Stage 2: Detailed proposal by preferred bidder

Once the government has selected a bid sponsor as its preferred equity partner, the preferred bidder will put out competitive tenders for construction, operations and other services. Debt financing would be sourced under a book-build scenario. The preferred bidder and government will work in partnership to finalise all outstanding issues and convert indicative bid terms into final and binding terms.

Stage 3: Negotiation of final binding offer

This stage will involve the preferred bidder entering into a binding PPP contract with the government, should the government agree with the final IRR. If the government assesses the final IRR (or other terms of the final offer) as not meeting its benchmark, it will reserve the right to reject it, go to market or seek an alternative procurement method.

What should be the assessment criteria for bid sponsors?

Bid sponsors should either be principals acting on behalf of their own long term equity or fund managers of long term orientated investment funds. If developers, contractors and investment banks lead the bid and represent the SPV, they must bring their own long term equity to invest, for example 25% or more of the total equity required for the project.

Under the current procurement model, bid sponsors are compensated at financial close through high transaction and advisory fees which are ultimately paid by the government. Long term investors make their returns through project cash flows and not through upfront fees. The transparent partnership model would more effectively align the interests of all parties, reduce fee leakage and deliver a better value-for-money outcome.

There should also be holding period requirements. Sell down and change in ownership would be permitted 5 years after construction completion and the commencement of operations, and only with the consent of the government. All purchasers would need to meet the same criteria as the original bid sponsors. The above process will ensure that the PPP is built, owned and operated by genuine long term investors over its economic life.

Will the transparent partnership model deliver value-for-money?

There are a number of precedents in New South Wales and Victoria where private sponsors approached governments with unsolicited proposals that the parties subsequently developed in partnership to fund and deliver major projects. Whilst these were unsolicited proposals, they do share the same key features as the transparent partnership model. Specifically:

- The two parties jointly developed the scope and indicative price but the rate of return was negotiated after being initially bid by equity;
- Once the government agreed to the indicative terms, the sponsor put out competitive tenders for construction, operations and other services; and
- The government only accepted the final outcome if it met value-for-money criteria.

The success of these precedents demonstrates that early involvement of an equity partner *can* deliver innovative, value-for-money outcomes to governments:

Tullamarine Calder Interchange and M1 Upgrade

The Victorian Government funded the delivery of two freeway upgrade projects, the Tullamarine Calder Interchange ("TCI") project and the M1 upgrade, through partnership with an incumbent, Transurban, rather than through a transaction with a third party via a tender process.

The Victorian Auditor General examined the partnership arrangements in December 2007 and reported that the "benchmarking analysis provided relevant and reliable evidence that better value was likely to be obtained through a transaction with Transurban, rather than a third party."[1]

A more recent report by the Victorian Auditor General noted that the TCI project "had been effectively managed and is delivering the expected benefits to date. Overall, the audit found that the interchange had been delivered on time and under budget, with initial indications that the TCI has achieved expected functionality."[2]

M5 West Widening

In an example of early contractor involvement, the NSW Government worked with the incumbent, Interlink Roads, on the M5 West Widening project commenced in August 2012. [REDACTED]. When completed, the project will increase capacity along the corridor [REDACTED], accommodate more traffic and reduce travel time for motorists using the motorway and surrounding roads.

M1 to M2

The NSW Government negotiated the delivery of the M1 to M2 project, now known as NorthConnex, through the development of an unsolicited proposal by Transurban. Transurban approached the NSW Government in 2012 under the Government's unsolicited proposal regime to design, build, operate and finance the link. In May 2013, the proposal moved to its final stage, which involved negotiation between the parties and Transurban submitting a final binding offer.

The early involvement of a sponsor led to a fast-tracked timeframe and turn around, reduced cost for tenderers, and a design solution that meets or exceeds government's requirements.[3]

How can tendering be improved?

The government can reform tender processes to reduce bid costs. As proposed by the Commission, supporting documentation can remain a condition of the tender but only required to be submitted by the preferred bidder. Further, the government can provide due diligence investigations for the benefit of all bidders, as this would reduce the cost of undertaking confirmatory due diligence by individual bidders and bring down the overall cost of the tender process. Governments can also consider reimbursing a portion of bid costs to unsuccessful bidders in return for ownership of intellectual property, as noted by the Commission.

Next steps

For next steps, we recommend that the transparent partnership model be refined through the development of guidelines by State governments that outline how they will engage with equity investors for the delivery of PPPs under this procurement process. Once a set of guidelines is finalised in consultation with industry, the model should be trialled for a series of pilot projects.

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[1] Funding and Delivery of Two Freeway Upgrade Projects, December 2007, Victorian Auditor General
[2] Managing Traffic Congestion, April 2013, Victorian Auditor General
[3] Media release, 16 March 2014, Transurban

I trust that you will find this submission useful as you advance the Public Infrastructure report. IFM Investors would be pleased to work in partnership with governments to implement sustainable funding and financing solutions that benefit superannuation investors, the community and the economy.

If I can provide any further assistance or clarify any part of this submission, please do not hesitate to contact me on 03 8672 5357.

Yours sincerely

Michael Hanna
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IFM Investors Pty Ltd

APPENDIX

About IFM Investors

IFM Investors is one of Australia's largest investment management firms and manages in excess of $50 billion on behalf of institutional investors globally. IFM Investors was also recently ranked as the number one manager of alternative investment products[4] in Australia. IFM Investors has extensive infrastructure investments in Australia and around the world and has approximately 19 years of experience investing in infrastructure. We believe that given this experience, we are in a strong position to contribute to the Productivity Commission's review of public infrastructure through this submission.

IFM Investors is owned by, and invests on behalf of, 30 Australian industry superannuation funds, including AustralianSuper, the largest Australian industry superannuation fund, whose members represent a cross-section of Australian workers, Construction & Building Industry Super (Cbus), the health and community services industry super fund (HESTA), and the hospitality, tourism, recreation and sport industries super fund (HOSTPLUS). It is estimated that the success of IFM Investor's investments ultimately impacts the savings of approximately five million working Australians and their families.

IFM Investors, through its Australian and international unlisted funds, invests equity and debt globally in infrastructure sub-sectors such as airports; seaports; toll roads; telecommunications; electricity generation, transmission and distribution; gas distribution and social infrastructure. Our investments include assets of national significance such as the capital city airports (Melbourne, Brisbane, Adelaide, Perth and Darwin) and ports (Ports Botany and Kembla and Port of Brisbane), as well as PPPs such as Southern Cross Station in Melbourne, New Royal Adelaide Hospital and Victorian Comprehensive Cancer Centre.

These investments offer Australian superannuants the potential for relatively consistent investment returns while providing essential services to local communities. IFM Investors' philosophy is that investing into assets that provide essential services also carry critical responsibilities including maintaining safe, modern and reliable facilities, and catering for growth over time to support Australia's economy and attractiveness.

[4] Rainmaker Roundup September quarter 2013