Submission No 8

PROCUREMENT OF GOVERNMENT INFRASTRUCTURE PROJECTS

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Alister Henskens SC MP – Committee Chair
Legislative Assembly Committee on Transport and Infrastructure
Parliament House
Macquarie Street
SYDNEY NSW 2000

Dear Mr Henskens

Submission to the Committee on Transport and Infrastructure Inquiry – Procurement of Government Infrastructure

As a leading infrastructure manager on behalf of institutional investors globally, IFM Investors welcomes the opportunity to provide our input to the Committee's inquiry into the procurement of government infrastructure (the **Inquiry**).

Our submission focuses on the constraints on governments' ability to access private capital as a funding source for government infrastructure projects, and suggests alternatives to the public private partnership (**PPP**) model that would, in our view, increase the flow of private capital to government infrastructure projects.

Availability of private capital for government infrastructure
Although PPPs are increasingly common for major infrastructure projects, the vast majority of government infrastructure continues to be financed by the public sector via government accounts. Given the fiscal pressures faced by governments globally, this is unsustainable. Commercial bank debt currently provides a large proportion of private finance for greenfields infrastructure. Although banks can satisfy short term financing requirements, regulation continues to limit banks' ability to lend for longer tenors that would match the long lives of these assets.

In contrast, superannuation funds represent a significant and growing long-term funding source for infrastructure investment with superannuation fund appetite for new infrastructure investment forecast to be worth $300 billion by 2030.[1]

However, Australian superannuation funds rarely participate in PPPs, either as a financial sponsor or equity investor. The PPP model creates significant barriers to entry for many superannuation funds and other institutional investors because, amongst other things:

1. **Costs, timeframes and pipeline:** In comparison to brownfield infrastructure processes, PPP bid processes are lengthy, require substantial cost commitments, and are infrequently brought to

[1] Industry Super Australia (2014) – Inverted Bid Model Research Paper

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market. As a result, the relative attractiveness of PPP opportunities is not sufficient for institutional investors to divert resources away from brownfield infrastructure opportunities.

2. **Misalignment of interests:** The PPP model misaligns the interests of equity investors on the one hand, and bid sponsors and contractors on the other hand. Both bid sponsors and contractors extract financial compensation at the front end of the project, often with no or limited equity exposure following commencement of operations. This encourages a 'win at all costs' mentality with little consideration of longer term risks such as refinancing risk or patronage risk, which are ultimately borne by the long term equity investors.

3. **Lack of investment control:** The PPP model encourages passive equity investment, which increasingly does not suit institutional investors seeking to earn returns through ongoing capital investment and active asset management. Under the PPP model, equity partners accept delivery risks, but have limited ability to influence the structuring or risk allocation of the transaction, which is controlled by the financial sponsor. Further, once the project is underway, the equity partners' role is largely limited to acting as a proxy for the underlying contractors, rather than active management of construction and operations.

Alternative procurement models

In our view, the development of alternative procurement models would encourage greater private institutional investment into government infrastructure projects.

IFM Investors and Industry Super Australia presented the 'Inverted Bid' model to the G20/OECD forum in Singapore in 2015. We believe that the Inverted Bid model would facilitate institutional investment in government infrastructure projects, while maintaining the existing benefits to government of the PPP model.

Under the Inverted Bid model, the traditional bid process is split into two-stage bid process:

1. Selection of long term equity investor(s) based on an indicative internal rate of return against a set of government requirements.
2. Following selection of preferred equity partner(s), tendering out of construction, operation and maintenance packages and procurement of residual debt funding.

In our view, the Inverted Bid model generates the following benefits:

- Aligns government and equity investors focused on the long term success of the project by removing short term intermediaries such as bid sponsors.
- Ensures open, competitive, transparent and interactive tender process for all project aspects (including financing).
- Better value for money through reduced bid costs, shorter procurement timetables and lower financing costs.
- Increased availability of price capital due to attractiveness of model to equity investors.
- Better innovation and design outcomes through ability to 'mix-and-match' best operation/maintenance/construction tenders.

Where a fund manager, such as IFM Investors, is selected to be the preferred equity partner, additional social protection may be afforded by:

- Ensuring that a maximum fee is stipulated for managing the asset; and
- Requiring that all registered superannuation funds are offered the opportunity to participate on equitable terms.

Improvements to the procurement model

In some instances, a 'traditional' PPP may remain the most appropriate procurement model for a particular project. Irrespective of which procurement model is adopted, the NSW Government should focus on initiatives that:

- **Reduce bid timeframes and costs:** In comparison to privatisation processes, PPPs tend to have substantially longer and less structured bid processes, often involving one or more re-bids or best-and-final offer processes. This is, in part, a necessary consequence of tendering construction, operations, maintenance and finance as a single package, however any streamlining (or at least clearer upfront communication of) bid processes would provide more cost and time certainty to bidders.
- **Strengthen project pipeline:** A stronger project pipeline, as well as a track record of bringing announced projects to market quickly, would encourage more bidders to dedicate time and resources to pursuing opportunities. As described below, we believe the NSW government's asset recycling program will support a stronger project pipeline.

Other NSW government initiatives

In addition to the development of the Inverted Bid model, we encourage the NSW government to continue to pursue both its asset recycling program, and to expand its unsolicited proposal processes.

Asset recycling significantly strengthens the pipeline for both greenfield and brownfield investment opportunities, which encourages institutional investors to commit time and resources to pursuing investment opportunities in NSW. As an important additional benefit, where brownfield assets are sold to institutional investors representing Australian superannuation members (termed 'social privatisation'), the asset continues to be owned by and for the benefit of the community, while freeing up capital for government to invest in valuable new infrastructure.

Similarly, the NSW Government's support of unsolicited proposals encourages private sector investment in NSW, and importantly, incentivises the private sector to participate in the development of those investment opportunities. In practice, unsolicited proposals from incumbent parties (such as existing asset operators) have been relatively more successful than those submitted by third parties without an existing relevant 'foothold'. IFM Investors encourages the NSW Government to support unsolicited proposals where uniqueness and innovation can be established through means other than incumbency.

Conclusion
IFM Investors thanks the Committee for the opportunity to make this contribution to the Inquiry, and would be happy to participate in discussion or respond to any queries that you may have in the interim.

Yours sincerely

[redacted]

Garry Weaven
Chair
IFM Investors Pty Ltd