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PERSPECTIVES

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BUILDING AUSTRALIA

DELIVERING INFRASTRUCTURE TO SUPPORT GROWTH

Australia has a pressing need for substantial infrastructure investment to support the nation's long-term growth. Key areas include metropolitan road and rail transport networks, long distance inter-city travel, social infrastructure such as hospitals and schools, and national fibre consumer telecommunications. In the post-GFC environment, financing constraints mean that traditional public private partnership models ("PPP") cannot be used for projects significantly larger than \$2bn to \$3bn. Indeed, for these projects the choice of a conventional PPP may constrain competition, increase pricing and place additional pressure on government balance sheets.

New delivery models and financing structures are needed to tackle these challenges. Marginal refinements of existing PPP structures simply cannot unlock the private sector financing required or attract the interest of sufficient competition from construction companies to deliver the infrastructure needed to ensure Australia's continued growth, competitiveness and prosperity.

The good news is that there is substantial global investor demand for assets that provide stable long-term returns, particularly where these offer in-built inflation protection. Many infrastructure assets offer these characteristics, so long as they do not include exposure to initial construction or the uncertainties associated with greenfield patronage risk. Traditional PPP structures embed construction risk, making them unattractive to most long-term investors, thereby limiting investor appetite to a relatively small pool of specialist investors happy to take such risk.

In a similar vein, initial public offerings have commonly been used to privatise major utility companies, as they offer a practical mechanism to sell businesses that are too large for individual companies or consortiums to purchase. Listed investments of this nature are not necessarily attractive to long-term infrastructure investors, however, who dislike the volatile valuations that result from mark-to-market valuation of minority investments in listed companies.

Meanwhile, many large construction companies are seeking to establish new platforms for growth, to make up for a low growth outlook in their traditional home markets. Australia offers attractive potential, so long as these companies can be confident that they will be able to win a reasonable share of new business in the face of competition from domestic Australian competitors with long-established government relationships.

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There are a number of new delivery models and financial structures that address these particular challenges. We have designed these so that they can readily be introduced by Federal and State Governments for little or no cost, whilst simultaneously improving the competiveness of Australia's infrastructure delivery sector as a whole.

- **Converting infrastructure bonds** combine a conventional government-financed "Design, Build and Operate" construction contract with a forward sale of the asset on guaranteed terms. This would allow construction to be funded using low cost government debt, whilst ensuring that the capital cost and associated interim borrowings are transferred off the government balance sheet at completion. Risks would be better matched with the optimal stakeholders, with construction companies accepting and managing construction risk, and long-term investors accepting long-term ownership risks. This would unlock access to a much larger pool of investment capital than would be available using conventional PPPs, thus allowing more projects to be financed at lower cost. Debt taken on by the government to finance construction would be clearly matched against the asset in question and there would absolute certainty that this debt would be extinguished once construction was complete, reducing or

eliminating any potential short-term impact on state credit ratings.

- **Initial superannuation offerings** combine the principles of a conventional IPO with a private ownership model for infrastructure. They preserve the advantages of a public offering financing structure while also addressing its shortcomings for infrastructure investors. In essence, the business in question would be prepared for sale following typical pre-IPO processes. Appropriate public company governance and management arrangements would be introduced as needed. Superannuation and other interested investors would bid for direct ownership of shares in the company, without the need to participate in bidding consortiums. Successful bidders would be chosen via a bookbuild process. This would allow long-term investors (like superannuation funds) to invest directly in relevant infrastructure assets, assured of long-term ownership, whilst avoiding the external consortium management costs typically associated with bid vehicles as well as mark-to-market valuation uncertainties. Governments could retain minority holdings in assets should they wish, and high governance standards could be maintained by imposing standards and requirements analogous to those required for listed public companies.

- **Credit reinsurance** has almost completely disappeared from the Australian market following the GFC, and is unlikely return over the medium term. As a result, there is an important role for the Australian Government to play in supporting the formation of a credit reinsurance provider to address this market failure. This would replicate the approach adopted to address an analogous market failure in relation to terrorism risk, which resulted in the creation of The Australian Reinsurance Pool Corporation. This entity would provide credit insurance on arm's length, commercial terms, helping larger projects unlock access to financing that would otherwise not be available. The entity would also have an important role to play in providing credit enhancement to mortgage securitisation vehicles, helping to improve the competitiveness of Australia's smaller residential mortgage lenders and creating a more even playing field between these entities and Australia's big four banks.

These innovative delivery models and financing structures are particularly relevant to the implementation of very large infrastructure projects, whether in the public or private sectors, both in Australia and other countries. Critically, they have been designed to increase market efficiency in a number of ways, and can readily be applied whatever the overall policy settings of the day. Our global market soundings have confirmed strong support from a wide range of stakeholders.

With the capital investment phase of Australia's resources boom likely to slow materially within two to three years, there is strong logic for the Australian Government to accelerate the development of major civil infrastructure projects in a commercial and fiscally responsible manner. Over the near term, this will help to bridge the gap in utilisation of infrastructure construction capacity in the economy, and more importantly, this infrastructure will then provide critical support to Australia's ongoing economic growth over the medium to long term.

By Nigel Lake and Andrew Agnew

A full version of the white paper can be found at www.pottinger.com

About Pottinger

Our clients say that we offer a completely different proposition to traditional consulting and investment banking advisors, seamlessly integrating true strategic thinking, commercial insight, financial expertise and execution excellence. Our assignments typically relate to one or more of:

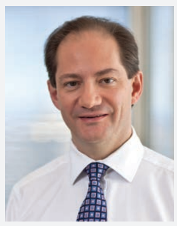
- Strategy and public policy
- Mergers and acquisitions
- Partnerships and joint ventures
- Restructuring and capital advice
- Risk, sustainability and related decision-making

Our approach to every assignment reflects a fundamental belief that strategy, business and execution perspectives must underpin any business initiative if it is to be commercially successful and stand the test of time.

Together our team has advised on over 200 M&A and financing transactions, as well as many significant strategic advisory assignments. Our first hand experience covers most of the world's larger economies, and we are accustomed to working on complex assignments across borders and cultures.

We are highly regarded for our investment in people, most recently being profiled by the Australian Workforce and Productivity Agency as a role model for effective skills development in financial services. In addition, Pottinger is the only organisation ever to have won the ABA's "Recommended Employer" award for six years in a row.

Cassandra Kelly
Joint CEO



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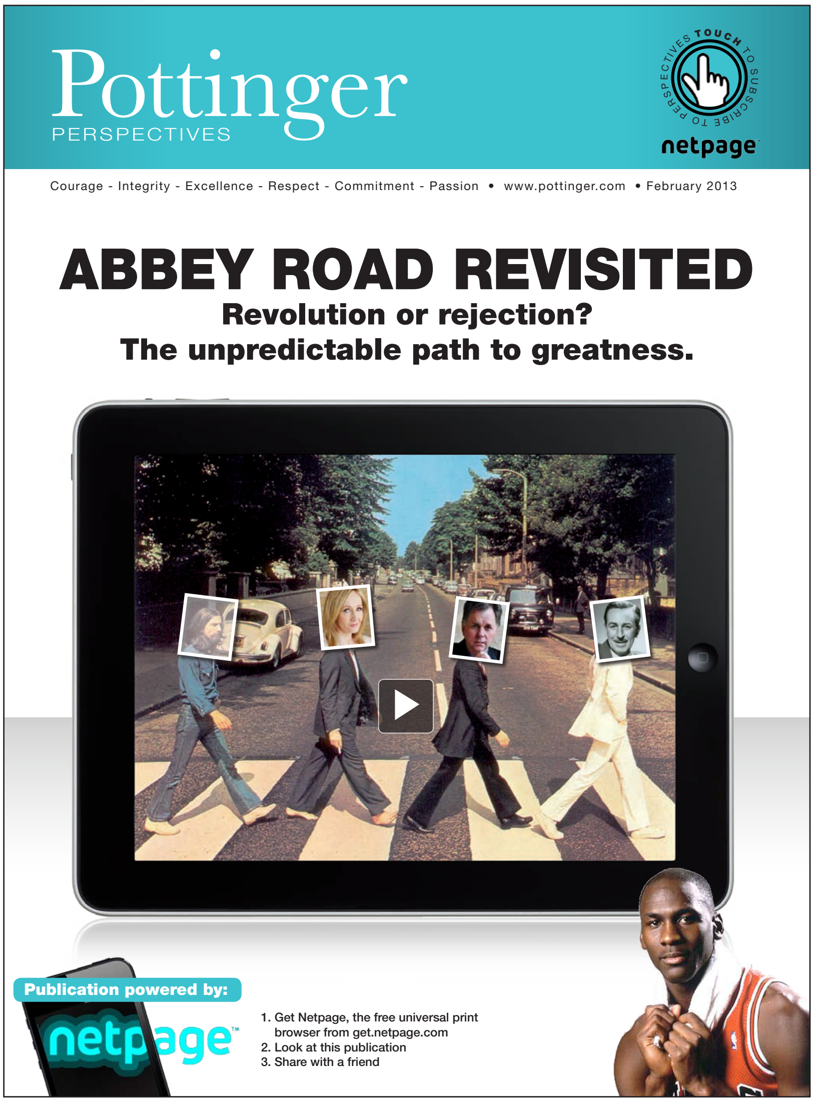

How many record labels rejected The Beatles? How many publishers said 'no' to Harry Potter? If the next Facebook walked into the Facebook boardroom, would Mark Zuckerburg and colleagues invest in the new pretender? Or would they think that the company was simply too speculative, too different, too risky? Remember, eight years later the original Facebook listed at a $100 billion valuation, having added an average of over 300,000 monthly active users *a day* since its launch in 2004. Revolutionary successes are by definition easy to see in hindsight, but how do you spot a business that will define a generation before it becomes great?

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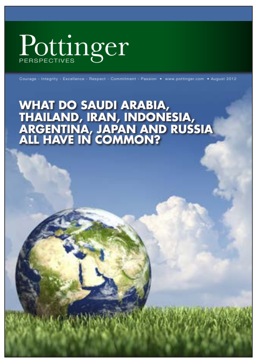

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