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Financial System Inquiry: Infrastructure Equity August 2014

Inefficiencies in capital markets has resulted in poor delivery of equity capital into infrastructure investment. It indicates failure in a key purpose of capital markets which is the facilitation of the provision of finance. There are a limited number and range of participants in this market. Broadening of the participants is required. Breaking down the opaque market would encourage participation and enhance provision of capital as transparency is required.

It is proposed that exchanges be established for mature infrastructure equity increasing transparency.

Estimated requirements for additional infrastructure in Australia has been forecast at $300bn. Currently the stock of public sector infrastructure is estimated at $327bn including over $100bn on government balance sheets prospectively available for privatisation. Listed infrastructure market capitalisation is $86bn. Provision of capital is essential as infrastructure it is the foundation of a growing economy.

Two broad categories in the sector are economic and social infrastructure. Economic infrastructure provides prospective revenue from user payments. Social infrastructure provides a public need and is not the subject of private sector equity capital.

There are two principal stages of infrastructure. Greenfield infrastructure is assets which are being developed. Mature infrastructure projects are assets which are completed and fully operational thereby generating revenue.

Finance for infrastructure is either in the form of equity or debt. Equity investment provides investors with entitlement to the financial benefits from the operation of the business and from ownership of the asset.

Pricing of equity capital for infrastructure reflects a range of factors.

Transparency: Pricing of capital in infrastructure is opaque. Information is available only for a small group of investors and intermediaries as participants in the market which effectively forms an oligopoly. Commercial in confidence stipulations prevail reinforcing lack of transparency. Only exchange listed entities provide transparency about pricing.

Disclosure: Information about the operations in infrastructure is limited. Government owned infrastructure assets are not the subject of disclosure. Privately held assets do not disclose business information about operations or financial statements. Only listed assets disclose comprehensive business information.

Liquidity: Limited liquidity exists in infrastructure reflecting the large size, high transaction costs, long time horizon and lack of disclosure.

Regulations: Regulators are silent unless a public offer is involved through an exchange or in a capital raising from the public.

Research: Research providers do not have access to information in an opaque environment.
Clearing house: There is no clearing house established for holdings in infrastructure assets.

If all these factors were effective rather than being opaque or limited it is considered that additional capital sources would participate specifically in investment in mature infrastructure assets.

Mature infrastructure assets have clarity about the business in which they operate.

- Established assets
- Established revenue stream
- Established operating costs, including capital maintenance
- Established debt servicing costs
- Established governance structure

With business information and financial transparency, liquidity facilities, regulations setting continuing information disclosure standards, research providers and clearing house facilities the potential is high for establishing an exchange marketplace which will provide price information and disclosure. This would increase prospective participation by a wider group of capital providers.

Financial data vendors have the structures for provision of information requirements in the marketplace. There are more than 25 vendors operating globally. Clearing house providers are available. Research capabilities are readily available. While participants may be limited in numbers they may be large individually by size or collectively. A business case for the market provider will require payment for the information flow rather than an exchange business driven by turnover for revenue and profitability. Participants will include the businesses which are currently part of the oligopoly in infrastructure finance. New participants might include the general public through superannuation savings and institutions building investment products. Both groups currently lack access into this opaque market.

Contrast in attributes between mature assets and greenfield assets is very substantial. Objectives of capital providers in the two stages of infrastructure equity are distinct.

Investment in greenfield development will require very high returns on equity as the commercial risks involved are high and require significant reward. They will also be seeking the transition reward from the very high discount rate applied for the greenfield stage into the relatively low discount rate applied when the infrastructure assets are stabilised as mature operations.

Mature infrastructure asset investors will pay the premium as they will not be willing to incur the development risks of greenfield assets. A relatively secure long term revenue stream is attractive for a wide range of investors including institutions and individuals.

Cost of capital for greenfield assets will be high. Greater disclosure may reduce the cost of capital in the development stage. Greater clarity regarding the pricing on exit from the development stage should reduce cost of capital. Businesses and investors with the capacity for acceptance and management of commercial risks in greenfield development are necessary.

It is in the interests of those funding the development stages of infrastructure either directly or through a carried interest by government that exit at the mature stage is most efficient. As government is inevitably involved it has a vested interest in enhancing the structure for mature infrastructure asset sale.

Government involvement in the greenfield developments will be either directly as funder or as a mitigator of risks. Government will benefit if the assets are offered into an exchange with full disclosure through a financial data provider of business information, offer document structure, transaction facility, research reports, clearing house and price disclosure. Feasibility analysis of greenfield infrastructure development by government and private sector partners would prospectively reduce the prospect of inefficient capital spending if the prospective exit terms at the mature stage are transparent.

In contrast with mature infrastructure assets, greenfield assets have additional factors influencing the cost of capital. The elements involved in development include land acquisition, zoning, planning, construction costs being materials, contractors and staff and environmental issues. Prospective operational outcomes will vary with usage levels, operational costs, management capabilities and contract terms. Capital structure and management will also influence outcomes. The exit terms from development is critical in the return on equity from projects by reducing some uncertainty.

Risk mitigation in this structure is in part dependent on government decisions. Action taken by government in mitigating risks, will lower the cost of capital of the project. A fundamental issue for government is whether private investors or the community should be the beneficiaries from this reduction in cost of capital.

As a reflection of the extent of the commercial risks in greenfield infrastructure development the returns on equity sought by investors will be high. Any government participation would also expect high returns on equity either directly or through a carried interest where risk mitigation is provided. Return on equity will be an integral part of the feasibility analysis undertaken at the start of the project.

Government will be involved in the majority of greenfield infrastructure development as it is the only party which can provide some forms of risk mitigants.

Utilisation of the government balance sheet is best served by providing capital for development with high return on equity. Recycling of capital at the mature stage provides sound financial outcomes. Maintaining a portfolio of mature infrastructure assets when greenfield opportunities are available is not an efficient application of government capital. Recycling captures the value enhancement from transition from high discount rate greenfield development to low discount rate mature assets.

Establishment of an efficient exchange of information which will maximise the exit terms from the development stage into the mature stage is desirable for the community through government.

By providing a more efficient exchange for the mature assets the cost of capital for the development stage may be reduced for all parties participating in projects as uncertainty would be reduced regarding exit terms.

Infrastructure assets are the responsibility of State governments in Australia. The States recognise the need for infrastructure investment.

It is proposed that the States commission the establishment of exchanges for mature infrastructure assets reflecting business information including financial transparency, liquidity facility, reporting standards, research and clearing house facilities, thereby promoting price discovery and disclosure. It would be an integral component of any infrastructure project initiated by State governments that the infrastructure asset on completion be included on the exchanges.