Australian Government
Infrastructure Australia

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Submission to the Financial System Inquiry

August 2014

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1. Introduction

Infrastructure Australia (IA) welcomes the opportunity to provide a submission in response to the interim report of the Financial System Inquiry (FSI).

A well-functioning infrastructure debt market is an important enabler for the successful delivery and ownership of economic infrastructure by the private sector and is therefore critical for addressing Australia's infrastructure needs. Australia's infrastructure debt market is not operating in a manner consistent with other advanced economies with a higher reliance on bank debt and shorter tenor than many other advanced economies. This suggests that there may be room for improvement.

In its Interim Report, the FSI has sought further information on what are the impediments to the development of liquid, tradeable claims on infrastructure projects? This submission addresses this question and in so doing addresses a number of other areas subject to consultation in the interim report of the FSI, particularly relating to development of the corporate bond market and Australia's retirement income system.

2. Impediments to the development of a liquid infrastructure bond market

Infrastructure Australia's February 2014 paper on the infrastructure debt market[1] examined demand and supply side factors impacting on the development of a liquid infrastructure bond market.

The paper was developed following an extensive consultation with industry and governments including the distribution of the infrastructure debt policy options consultation paper[2] ('Consultation Paper') to around 80 industry participants and three workshops, two in Sydney and one in Melbourne with a total of around thirty participants.

Supply side factors identified

Lack of a competitive liquid corporate bond market

During the consultation phase of the paper's development, the poor level of development of the corporate bond market generally, and in particular at lower credit grades, was acknowledged as a key hurdle for greater use of project bonds and infrastructure bonds more generally. The lack of a liquid corporate bond market inhibits the development of pricing benchmarks and certainty which would assist in the development of liquid infrastructure debt.

Infrastructure Australia agrees with the interim FSI observation that forces are at play that in themselves will advance the development of the corporate bond market in Australia.

On the demand side as a greater share of the population enters retirement, demand for fixed income products is likely to increase.

Infrastructure Australia further agrees that addressing the potential impediments and disincentives to the development of annuity-style retirement income investment products would further encourage the growth of the fixed income markets. Canada is seen as the world's best practice example in the development of an infrastructure project bond market. Canada has a well-developed annuity market which is an active player in the Canadian infrastructure project bond market.

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[1] See http://www.infrastructureaustralia.gov.au/publications/files/Review_of_Infrastructure_Debt_Capital_Market_Financing_2014_03_28.pdf

[2] Further detail on the issues raised in this paper and options discussed can be found in the Infrastructure Debt Policy Options Consultation Paper February 2013 and the Infrastructure Debt Technical Paper October 2012.

Infrastructure Australia also agrees with the interim FSI report's focus on reducing the compliance burden for corporate bond debt to make it commensurate with the regulatory burden for higher risk equity products.

On the supply side, corporate bonds issued by infrastructure sector issuers such as airports, ports and utilities are subject to the same issues as the general corporate bond market, and indeed infrastructure issuers represent 20 to 30% of this market.

Over the medium term a program of asset transfers of existing government assets as part of a capital recycling program will provide further opportunities for the development of the corporate bond market.

Infrastructure Australia has previously identified a significant portfolio of government held infrastructure assets that could be owned by the private sector, improving economic efficiency and government balance sheets as part of a capital recycling programme.[3]

The Australian Government's Asset Recycling Fund is an important initiative which should promote further reform in this area.

Bidding and procurement processes

It is difficult for investment managers to access greenfield deals due to complex and expensive bidding processes such as unique due diligence requirements for each project. Bond investors and managers are unwilling to bid due to the business risk involved.

For this reason and to provide price and volume certainty, bonds are usually required to be underwritten. However, firm underwriting is not likely in the current market. Uncertain investor appetite and unpredictable timelines represent significant challenges.

Industry noted that there are no active project bond underwriters and terms will need to reflect the lack of a market. Further industry was supportive of changing commitment requirements so bonds are not disadvantaged, for example by not specifying committed debt, permitting shorter validity term and the ability to change price subject to a transparent adjustment mechanism.

[3] See http://www.infrastructureaustralia.gov.au/publications/files/Australias_Public_Infrastructure-Part_of_the_Answer_to_Removing_the_Infrastructure_deficit.pdf and http://www.infrastructureaustralia.gov.au/publications/files/Balance_Sheets_Impacts_of_Sell_to_Buy_Update_Paper.pdf

In Canada, there is generally considered to be a functioning public private partnership bond market with a wide (50+) investor base. In this context, it is noteworthy that in most Provinces, underwriters have the benefit of a price flex mechanism where government takes on general market credit spread risk (both upside and downside) between the project bid date and financial close.

Procuring governments in Australia may be concerned that relaxing bid conditions and the acceptance of greater market risk between bid and financial close may lead to adverse outcomes (price movements). They are also likely to be reluctant to give up something that the private sector is prepared to offer.

However, the requirement for highly committed bids is costly and restricts access to the market potentially making it less competitive. There are a very limited number of non-banks willing to participate in the bidding process and differing appetite for bid phase involvement by banks. The problems associated with this are more evident in a soft market.

Infrastructure Australia welcomes the Productivity Commission's proposal that government's pilot bidding processes in which the requirement for bids to be fully financed at the time of tendering is relaxed.[4] This could encourage greater interest in greenfield PPPs by long-term bond investors by removing some of the impediments discussed above. However, a greater level of consistency in the commercial and financial provisions in concession deeds may be required to create greater confidence in financing outcomes.

Demand side factors identified

Lack of a well-funded greenfield infrastructure pipeline

The importance of a funded pipeline of projects was strongly emphasised by participants, particularly in order to build up critical mass in the investment community to understand and price the risks involved in greenfield infrastructure.

The Province of Ontario in Canada, through Infrastructure Ontario, is an example of best practice in this area, and this is often cited as one of the key success factors for the Canadian infrastructure bond market.

Infrastructure Australia is undertaking a national infrastructure audit and is developing a 15 year pipeline of infrastructure priorities. This should help provide governments with the tools to develop a well-funded pipeline of greenfield infrastructure projects.

In addition to improved project selection, Infrastructure Australia agrees with the recent Productivity Commission report on public infrastructure that

[4] See http://www.pc.gov.au/__data/assets/pdf_file/0003/137280/infrastructure-volume1.pdf

improved governance and user pays arrangements for transport infrastructure should improve conditions for private financers in supporting future public infrastructure priorities.

Retirement income products

As noted above, retirement income products can support a long-term, liability-driven investment approach as it is generally accepted that a more defensive investment strategy is appropriate for retirees. This will change asset allocation and increase the pool of funds available for defensive assets such as bonds.

The 2013 Melbourne Mercer Global Pension Index, which surveys and ranks the pension systems of 20 nations, rates the Australian system very highly - third overall (against adequacy, sustainability and integrity criteria) but identified the key weakness as an insufficient requirement or incentive to take retirement benefits as an income stream[5].

Infrastructure Australia supports the direction of the interim FSI report in this area. The provision of policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks or the introduction of a default option for how individuals take their retirement benefits should be explored further.

Industry has noted the lack of long term bonds in the market to match liabilities may be constraining development of retirement income products. Infrastructure Australia supports the suggestion in the interim FSI report for the issuance of longer dated Government bonds, including inflation-linked bonds to support the development of retirement income products.

The Australian Government recently issued a 20 year bond and further extension of the yield curve is under consideration. This should also help provide a pricing benchmark for longer term domestic corporate debt.

Long term inflation linked bonds have the characteristics of many infrastructure assets and could support the development of inflation linked infrastructure bonds issued against these revenue flows as a form of private sector infrastructure finance.

Superannuation prudential requirements impacting on illiquid investments such as infrastructure debt

In a superannuation fund, the requirement for liquidity can be caused by:

- fund flows and membership demographic profile;
- the potential for investment switching (more likely if the fund suffers poor performance, but also experienced due to market conditions);

[5] Australian Centre for Financial Studies, Melbourne Mercer Pension Index 2013

- portability rules under which members may change superannuation funds;
- negative investment returns may require portfolio rebalance – target allocation ranges may be breached;
- margin calls on futures positions;
- commitments on unlisted assets; and
- currency settlements.

During industry consultations the superannuation industry noted the impact that the portability rules have on the ability of superannuation funds to invest in illiquid assets such as infrastructure equity and debt. Why this may not be binding at the moment, it may impact on investment incentives, particularly as more infrastructure assets come to the market and as the infrastructure debt market develops.

Infrastructure Australia therefore supports moving from the current prescription-based approach for portability of superannuation benefits to a principles-based approach as raised in the interim FSI report.