

Investing in Infrastructure

INTRODUCTION

Private sector investment in the development of infrastructure has never been more important: governments in both developed and emerging markets are battling with widening budget deficits but the need to fund the construction and operation of vital infrastructure projects, many of which are core to the economic growth of these countries, continues to grow.

This paper outlines the rationale behind infrastructure investment and how and why private sector investment in infrastructure and private finance initiative (PFI) and certain public private partnerships (PPP) projects has become popular with both governments and investors.

WHAT IS INFRASTRUCTURE?

Infrastructure assets are the essential assets of communities.

We use “economic” infrastructure to define assets where performance varies according to macro-economic factors. For instance:

- Ports
- Airports
- Toll roads
- Power stations
- Wind farms and renewable energy.

We define “public” or “social” infrastructure (which is the type of infrastructure in which International Public Partnerships and Amber Infrastructure specialise) to include assets where performance is non-correlated to macro-economic factors. Examples include:

- PPP transactions (where the revenue stream is linked to the availability not demand for that asset)
- Rolling stock (where fixed lease rentals are underpinned by explicit or implicit government guarantees)
- Offshore transmission (where payments are linked solely to the availability of the cable supplying the energy).

We are cautious of seeing operating businesses as being infrastructure assets. For this reason we tend not to treat utility companies as true infrastructure assets.

We might call the definitions set out above “asset led” definitions. In our view though the most useful definition of infrastructure is focussed less on the asset itself and more on the qualities of the projected return.

Infrastructure exists as an asset class because, classically, it offers long term, sustainable returns with minimal risk to capital and moderate capital growth possibilities. Typical investors in the sector seek investments that provide long term sustainable income or, in the case of pension funds, “match” their own liabilities. Accordingly we can define infrastructure by its risk/return characteristics – in other words by its fit with investors’ goals.

The return expectations for investors in social or public infrastructure assets (such as projects developed under the UK PFI and PPP frameworks) are for steady annual distributions at a level a few percentage points above the yield on government debt with some capital growth contributing to an all-in annual return target of typically 8% to 9% per annum.

This expectation matches precisely with the investment dynamics of the assets that the fund invests in: PPP projects with no demand related risks where the revenue source is a 25 year – often indexed – cashflow from government. This type of infrastructure is clearly “core” infrastructure. Economic infrastructure offers higher levels of projected returns but it must be appreciated that it offers higher risks too.

So the key question is how much increased risk over core infrastructure can be sustained before an asset falls outside the infrastructure definition? In our view, an asset is not a true infrastructure asset if its ability to provide long term, low risk, sustainable returns with minimal risk to capital is materially more dependent on macro-factors outside the control of the asset owner (e.g. refinancing) than the inherent characteristics of the asset itself.

Historically, the public sector has usually funded and delivered infrastructure projects, with the taxpayer taking both the responsibility and risk of asset delivery, cost and operation. However a number of factors have driven the need for private sector funding and participation in infrastructure projects:

- Historic underinvestment in both new and existing infrastructure assets
- Rising public debt and budgetary constraints from the sustained economic downturn
- Exponential population and economic growth leading to an increased need for infrastructure
- Environmental considerations requiring a new approach to infrastructure delivery and operation
- Evidence of cost efficiencies and expertise of the private sector in the delivery and operation of projects.

WHAT IS PFI / PPP?

The Private Finance Initiative (PFI) is a form of public private partnership (PPP) which was first significantly implemented as a method of infrastructure procurement in the UK in the early 1990’s. In addition to addressing the bullet points above, it allows the public sector to spread payments for an infrastructure asset over the useful life of the asset while, particularly in times of fiscal constraint, avoiding the use of scarce public sector capital.

A significant number of social infrastructure assets such as roads, railways, rolling stock, courts, police facilities, government offices, schools, prisons and health facilities have been provided in the UK through the PFI / PPP model. In June 2009 there were 116

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PFI / PPP projects with a capital value of £12.4 billion¹ in the procurement pipeline and around 500 operational PFI schemes in the UK with a capital value in excess of £50bn².

The way the PFI / PPP model typically works is, after an open competitive process, a consortium of private sector entities (comprising a construction company, a facilities management operator and financial investors) are selected by the government as its preferred developer of a project. This consortium then enters into a contract with the public sector client to design, build, finance and maintain a public or social infrastructure asset in accordance with agreed service standards and is remunerated for this under a mechanism agreed by both parties. Typically this provides for fixed payment (usually at least partially indexed) for a 25 or more year period subject to the private sector consortium keeping the facility available for use and meeting pre-defined performance standards.

Upon successful build of the project and once the agreed service levels have been met, the consortium will receive long term contracted payments from the public sector body. As noted above, these payments are often partially or fully inflation-linked or fixed in real terms with reference to specific inflation indexes (e.g. RPI or CPI).

The private sector consortium seeks to eradicate as far as possible the risks associated with construction and operation of projects by entering into contracts with subcontractors, who are then usually liable for any cost overruns, delays or poor performance of the assets, subject to any relevant caps and limits on liability.

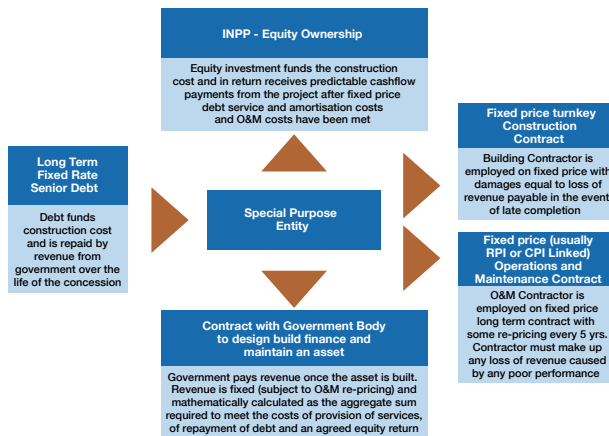
The standardised PFI model now has a strong intellectual pedigree which has delivered value for money and ensured the successful implementation of projects on time and on budget.

This allows these payments (and hence the payments to investors) to be projected with some accuracy. Indeed there is some level of analogy with government bonds given the long term nature of PFI / PPP contracts and the credit quality of the revenue stream (although it should be emphasised that PFI / PPP projects do also carry some level of operational risk notwithstanding that this is substantially passed down to subcontractors responsible for day to day management of the project).

The main characteristics of investing in infrastructure are as follows:

- Long-term stable cash flows producing low volatility and attractive yields relative to the risk profile of the asset
- Availability based payment streams are indifferent to competition due to the fixed payment obligation from the public sector entities, which are normally high quality, creditworthy counterparties
- Projects are structured to reduce risk exposure with the effective pass down of project related risks to subcontractors (subject to contractual terms) and insurance arrangements
- Opportunity to enhance income through active management of assets (client variations, third party income, refinancing and portfolio synergies)
- Public and social infrastructure is significantly uncorrelated to other investment classes or wider market forces and is necessary in times of economic growth or recessions
- Assets are often valued higher once projects finish construction and become operational, offering investors capital appreciation in addition to fixed, long-term returns
- Solid growth potential of the asset class as governments are expected to procure more assets through the PFI / PPP model and/or sell interests in public infrastructure.

Structure of a Typical PFI / PPP Project



WHY INVEST IN PUBLIC INFRASTRUCTURE?

The predictable and stable long-term revenue streams offered from public infrastructure makes it an attractive investment opportunity for investors. Public sector payments to the private sector consortium in PFI / PPP schemes are agreed up front and are mostly based on the physical availability of the asset, rather than the level of demand or usage of the asset.

THE FUTURE

While the UK and Australia have been the front runners for the adoption and development of the procurement method, an increasing number of countries are establishing the legal and institutional frameworks required to accommodate PFI / PPPs.

Most EU countries have PFI / PPP procurements as does the EU itself. International Public Partnerships and Amber have completed investments in:

- the UK
- Ireland
- France
- Belgium
- Germany
- Italy
- Canada
- Australia.

PFI / PPP schemes are increasingly being rolled out on a global scale (for instance in the US) as governments around the world look for a viable option to re-develop or replace ageing public infrastructure assets and services, in an efficient and cost effective manner.

¹ HM Treasury – Projects in Procurement (June 2009)

² NAO Report – Private Finance Projects (October 2009)