

How to Foster Investments in Long-Term Assets such as Infrastructure

by
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Mobilising private sector funding is essential in bridging the infrastructure funding gap. This can be done by appropriate regulation, targeted public financial support, and active involvement by institutional investors. Creating an appropriate policy framework and lifting regulatory constraints on long-term investments will foster financial stability of retirement savings systems and enable the development of strategic infrastructure projects that contribute to long-term growth. As capital markets and bank funding have dried up as sources of infrastructure financing after the global financial crisis, finding alternative long-term debt sources is critical. Private infrastructure financing can be promoted by targeted public measures and by building an infrastructure management culture amongst asset managers. Infrastructure investments also require long-term policy planning, with long-term strategic policy frameworks that exceed political cycles and are built on wide political consensus. Stable and accessible programmes of infrastructure projects and public-private partnerships (PPPs) are key in attracting private sector investors, complemented by adequate regulation.

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I. Introduction

Mobilising private sector funding is essential

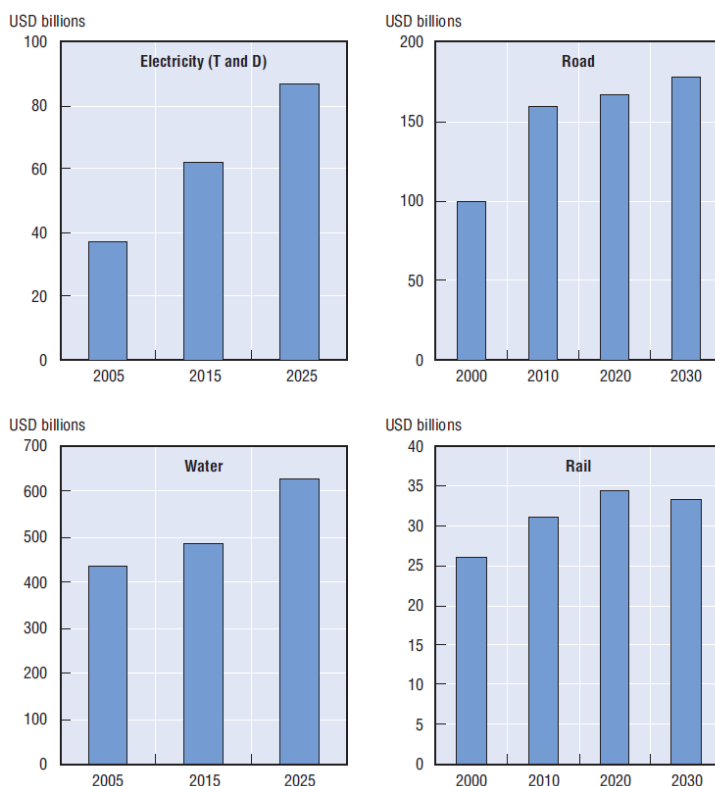
Mobilising private sector funding is an essential activity in bridging the infrastructure funding gap generated by the dramatic increase of infrastructure investment needs (Figure 1) at a time when most major OECD countries' governments have to manage heavy debt burdens (Figure 2).

OECD governments can foster investments in long-term assets

Building on its extensive experience as a long term equity investor in greenfield public private partnership (PPP) infrastructure projects in Europe and North America, it is Meridiam's¹ conviction that OECD governments can foster investments in long-term assets such as infrastructure through undertaking, in a timely manner, the following key actions:

- Align financial regulation and infrastructure policy objectives.
- Implement targeted public financial support for strategic projects.
- Promote active involvement in the management of infrastructure investments by institutional investors.
- Create a stable but demanding regulatory framework for project procurement that takes in account optimum risk transfer and availability of funding.

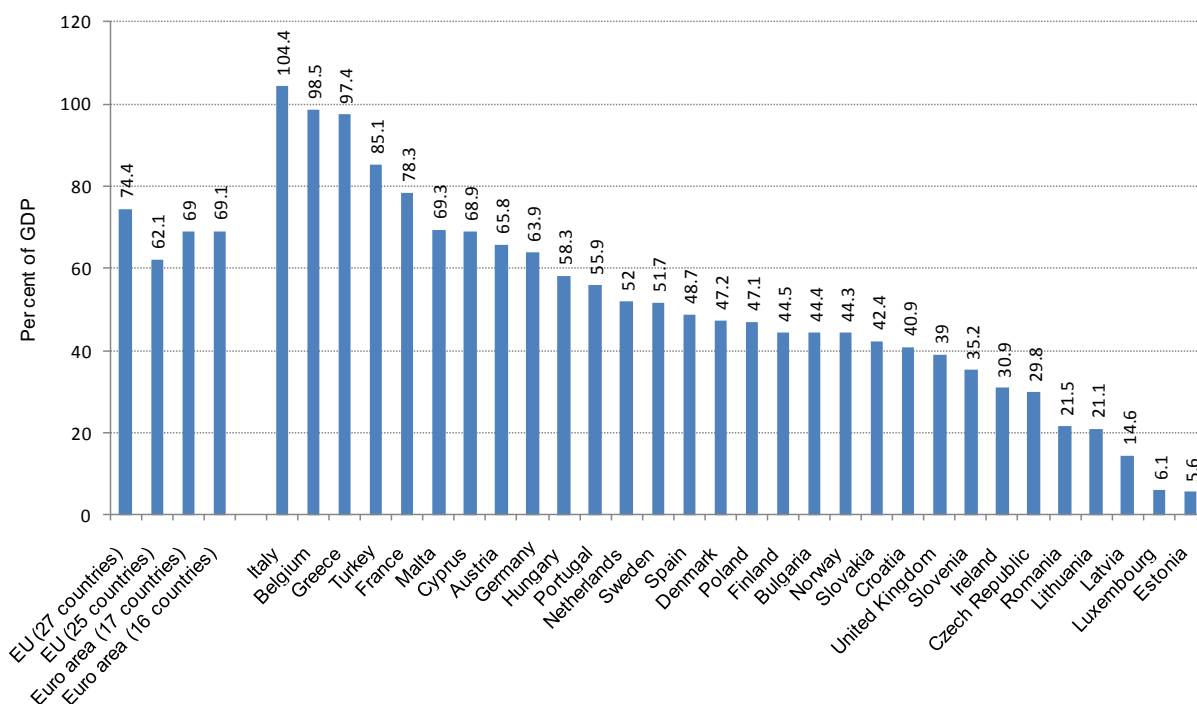
Figure 1. Infrastructure investment needs in OECD countries



Source: OECD (2007), *Infrastructure to 2030, Volume 2: Mapping Policy for Electricity, Water and Transport*.

Figure 2. EU Member State's Debt to GDP in 2009

General government consolidated gross debt in per cent of GDP



Source: Eurostat.

II. Align financial regulation and infrastructure policy objectives

Institutional investors' have ample funds

According to the OECD, the main institutional investors in the OECD (largely pension funds, insurance companies and mutual funds) held funds valued in excess of USD 65 trillion at the end of 2009, an amount commensurate to infrastructure needs.

Many of them are natural long-term investors

Among these investors, some are 'natural' long-term investors, having a requirement to match their liabilities to long term assets. For instance, pension funds start collecting contributions when individuals enter the workforce and pay benefits with the assets accumulated thirty to forty years later. Life insurers also clearly belong to this category of natural long-term investors.

But they need to be encouraged by a policy framework for long-term investment, leading to more sustainable retirement savings systems and long-term growth

These investors should be encouraged by a carefully designed policy framework to take advantage of long-term investments such as infrastructure that can notably provide inflation-linked and stable cash flows. The implementation of such a strategic framework could generate a 'double benefit' for governments, fostering financial stability for retirement savings systems, which would rely more on 'tangible' assets, and enabling the development of strategic infrastructure projects contributing to long term growth. Indeed a virtuous circle could be created whereby investments are made by local pension funds into infrastructure that would benefit the community, and at the same time generate returns that will fund the pension payments of future generations.

However, financial regulatory frameworks prevent this

However, financial regulatory frameworks, often designed without taking into account the specificities of the infrastructure sector, prevent this theoretical match from being realised in practice:

- In several OECD countries, quantitative constraints on asset allocation of institutional investors (for instance maximum or minimum limits per basket of heterogeneous asset classes which include infrastructure assets or even exclusion of certain asset classes as eligible assets) are still in place. For example, a strict limit of 5% on illiquid assets (regardless of the class) applies to national pension plans in Sweden.
- Liquidity requirements for institutional investors' assets, such as exclusion or limitation of assets that are not listed and traded on an organized security exchange, also strongly penalize infrastructure assets.
- Last but not least, the financial regulation of several OECD countries, notably in continental Europe, does not provide for capital investment vehicles with a sufficient lifetime to implement long-term equity investment in infrastructure projects with a tenor superior to 20 years. French regulations for example make it difficult to set a vehicle with a maturity longer than 15 years.

Infrastructure is disadvantaged as alternative asset

Due to these inadequate frameworks, the unlisted infrastructure asset class notably has to compete with 'exotic' or alternative asset classes such as hedge funds and at the end of the day only a small part of long term savings can be invested in infrastructure.

The mark-to-market approach and solvency regulations impede long-term investments

Other features of 'modern' regulation tend to prompt institutional investors to make short-term investments and thus penalise long-term investments. Use of mark-to-market valuation of assets and liabilities introduce notably artificial cyclical moves in long term assets even if the economic fundamentals of these assets have remained unchanged. Whilst it is important to agree on adequate measure of valuations, the mark-to-market approach could be detrimental to the perception long term assets. Solvency regulations (e.g. Solvency II in Europe) may also lead insurers to lower exposure to less liquid long term assets such as infrastructure assets.

III. Implement targeted public financial support for strategic projects

Before the crisis, project debt...

Before the so-called 'Global Financial Crisis', the route to raise project debt was relatively straightforward:

...was easily available from capital markets...

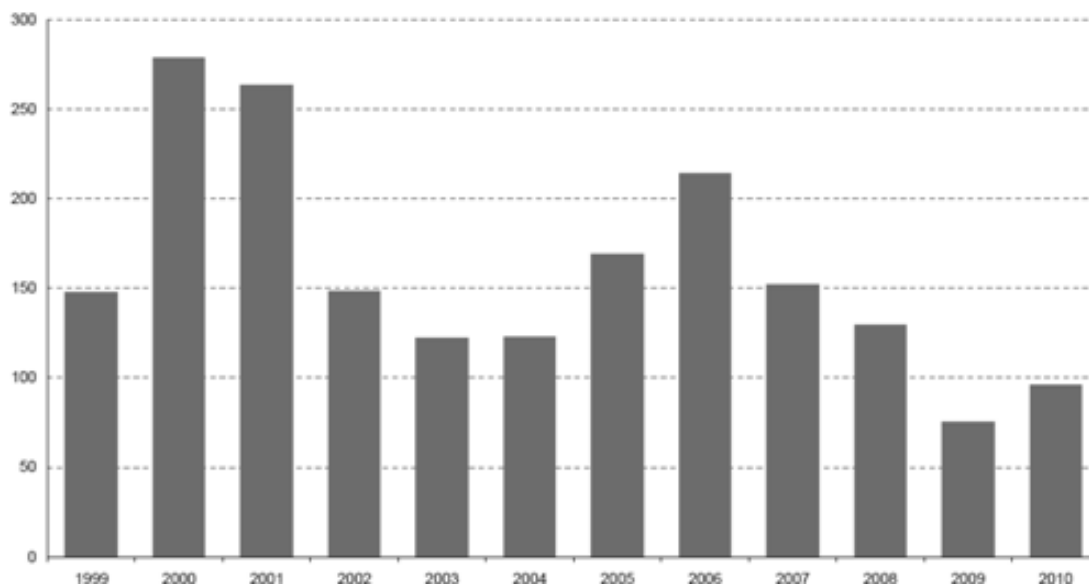
- Capital markets were a significant source of debt funding. European capital markets were notably active, in particular the UK, thanks to the credit enhancement packages provided by the monoline insurance companies. The dramatic rating weakening of these entities as a result of the GFC led nevertheless to a disappearance of such capital market funds as 'wraps' or insurance could no longer be provided.

...and banks, but these sources of long-term lending are now constrained

- Bank funding was abundant with notably the provision of sculpted loans tailored for each project, with notably very long term tenors and low margins. Nevertheless, in the aftermath of the GFC abundant and flexible long term bank loans may belong to the past due both to the severe reduction of the interbank liquidity, an increase in the cost of interbank lending and the expectation of the change to banking regulation in respect of the use of capital as part of the introduction of Basel III rules. Against this background, the banking sector is likely to become increasingly constrained in relation to the continuing provision of long-term debt. Additionally, as the bank market has declined overall, the potential for syndication of loans has reduced significantly, thus resulting in a reduction in the overall amount each bank may fund and causing further problems in fundraising for projects as Figure 3 illustrates.

Figure 3. Average mandated lead arranger (MLA) ticket per deal

EMEA Top 10 MLA: Average Ticket per Deal in USD million



Source: PFI.

Finding alternative sources is critical

Therefore, finding alternative long-term debt sources is critical, both in terms of amounts, maturity and pricing conditions.

Targeted public measures can support private infrastructure financing, like the ...

Some OECD countries have implemented targeted actions that played a key positive role for infrastructure financing in this framework. In the United States, the access to capital markets for infrastructure projects has for instance been favored by a comprehensive federal program:

- Implementation of the Transportation Infrastructure Finance and Innovation Act (TIFIA), which is a credit programme offering three distinct types of financial assistance (direct loans, loan guarantees and standby lines of credit);

- Tax exemption up to USD 15 billion across the USA for private activity bonds (PAB).

...TIFIA credit programme...

The TIFIA credit programme managed by the Department of Transport offers:

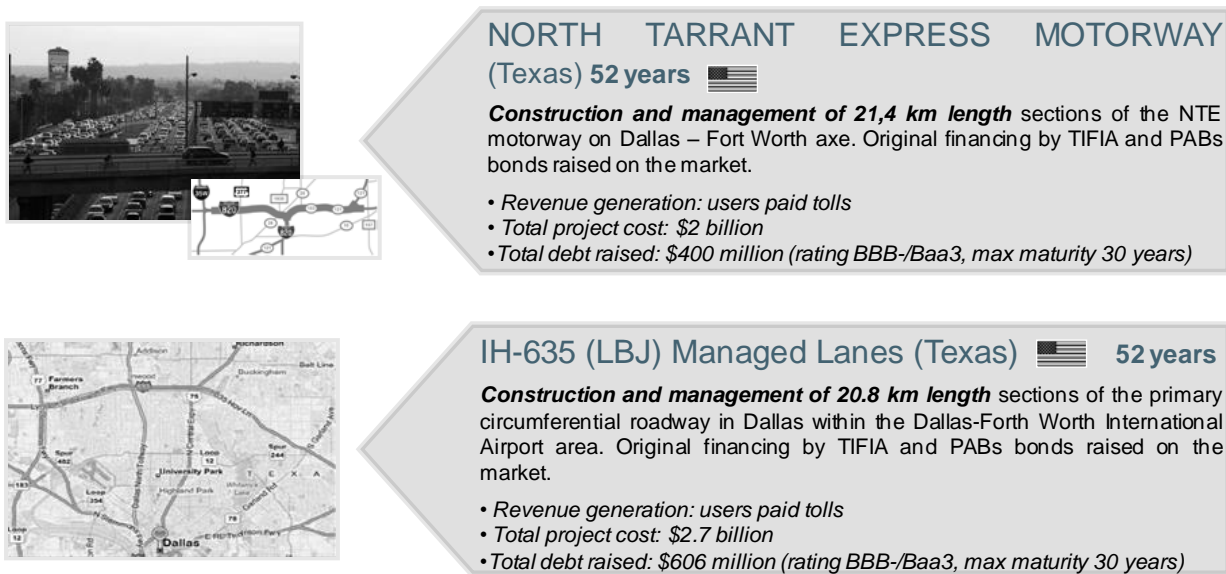
- Secured direct loan – Maximum term of 35 years from substantial completion, with repayments starting no later than 5 years after substantial completion. This allows for ramp-up, particularly in toll-road projects;
- Loan guarantee – guarantees a project sponsor’s repayments to a non-Federal lender. Loan repayments to lenders must commence no later than 5 years after substantial completion of project;
- Standby line of credit – contingent loan available for draws as needed for up to 10 years after substantial completion of project.

...and the PABs programme

The PABs programme aims at providing low-cost financing to projects with private involvement to increase private sector investment in U.S. transportation infrastructure. In present value terms, the Federal tax-exemption subsidy for PABs could represent approximately a 15–20 percent reduction in the underlying cost of the borrowed funds.

Thanks to the utilisation of both elements of this funding support package, Meridiam recently raised long-term Project Bonds for two key projects for the Dallas Metropolis in achieving their congestion management objectives (Figure 4).

Figure 4. Two key projects for the Dallas Metropolis



Source: Meridiam Infrastructure.

...matching investors' need for stable cash flows

These US experiences show that targeted financial support by the public sector can facilitate access to long-term debt for projects through the matching of long-term investors looking for stable cash flows and long-term assets such as infrastructure projects.

The EIB supports infrastructure in Europe

The European Investment Bank has also been supporting infrastructure for a much longer term and brought banks to adapt their lending capacity to more optimal maturities. It has recently launched jointly with the European Commission a consultation regarding an instrument aiming at facilitating the access to project bonds by institutional investors.

Other examples show that adapted procurement processes are critical to the realisation of bond financing

These examples, as well as the project Meridian closed in Canada in the early part of 2010 through the capital markets by completing a bond financing of a major healthcare PPP project, the “*Centre de Recherche du Centre Hospitalier de l'Université de Montreal*” (CRCHUM) project, also stresses the fact that adapted procurement processes are critical to the realisation of bond financing. In Texas, the procurement process notably left a significant period of time (12 to 18 months) between commercial and financial close to ensure best market conditions available for capital market usage. Moreover, a protection of the private partner against any variation of the risk-free interest rate for 360 days after concession contract signing was granted by the public authority. These features enabled flexibility to be created in the timetable for financial close that allowed the project company to take advantage of the optimum market conditions over this period.

IV. Promote active involvement in the management of infrastructure investments by institutional investors*Developing the right culture is essential*

Developing an infrastructure management culture amongst asset managers, investors and also the public sector will be essential in order to ensure that these entities obtain the best value from infrastructure investment.

Infrastructure assets require a whole life costing approach

Infrastructure assets require a whole life costing approach to provide best value to the public. Both public and private sectors would benefit from adopting such approach. The public sector often under the pressure of short democratic mandates tends to favor construction of new facility as a goal and does not always plan the budget for the up keeping and the maintenance of the asset. This results in a severe degradation of the level of service to the public over the years and a significant loss of capital at the end of a 20 to 30-year period. Infrastructure investment is about asset preservation.

An infrastructure asset should not be seen as a “financial line” but an industrial challenge to be managed

Specific skills are indeed needed to invest in these less liquid, longer term assets. One of the most important is the appreciation that an infrastructure asset is not a “financial line” but an industrial challenge to be managed. The original concept behind infrastructure investment was that ‘infracos’ would be created – that is dedicated and focused companies holding investment over the lifetime of the asset. In the early days of infrastructure investment financial investors, in particular, looked to shorten the period of investment, and to flip the asset for a quick return. There were few attempts to foster a business culture – this is now changing as a greater understanding of the nature of infrastructure

investing has evolved and as longer term investors have come to the fore. Creating and supporting this business culture is critical.

OECD could contribute to building this culture

To contribute to the building of this culture, leading multilateral institutions, such as the OECD, can play a key role in educating the financial community in infrastructure sector challenges and specificities (e.g. EIB or EBRD already “sponsor” infrastructure funds, EIB sponsors with the EU Commission the European Center for PPP Expertise to serve the 27 member states).

Incentives should focus on asset preservation and development

In addition, the regulatory frameworks and the guidelines promoted by OECD and other multilateral bodies could provide the right incentives for fund managers and investors to favour transparency in business models and alignment of interest between general partners managing infrastructure funds, investors and public sector. These incentives should notably focus on asset preservation and development including profit sharing schemes to promote alignment.

V. Create a stable but demanding regulatory framework for project procurement that takes in account optimum risk transfer and availability of funding

Infrastructure investments require long-term policy planning and stability

Due to the duration of the underlying assets, infrastructure investments require long-term policy planning. Stable and accessible programmes of infrastructure projects and public-private partnerships (PPPs) are notably key in attracting private sector investors who must invest development funds up front in order to secure such projects and can make informed choices about the geography of the projects they choose to follow.

Development of national long-term strategic policy frameworks for key infrastructure sectors, whose duration shall exceed political cycles, building, when possible, on wide political consensus, is highly desirable. This environment should be stable to maintain a high level of credibility of government commitments and build investors’ confidence.

This framework can be optimised through adequate regulation, perhaps including lock-up periods

Such a long-term and stable framework does not mean that the participation of the private sector cannot be optimised through adequate regulation. Certain changes to current arrangements in relation to the involvement of the private sector may be considered so that there is a balance between them and the stability of the public programme. For example, in certain countries allowances were made for investors to join and depart from projects at times of their choosing – this has caused a short-termist approach and has been counter to the concept of the creation of ‘infracos’ whose development requires commitment for a significant period of time. Additionally, longer term investors identified at the outset of this paper have a vested interest in long-term involvement in a project. Such investors’ interests are more aligned with public partners. Consequently consideration should be given to the introduction of lock-up periods for equity providers in PPP contracts to enable stable companies to be created by committed investors.

Benchmarking or market testing

There has been concern that long term fixed contracts between public and private sectors do not allow for value for money, as they are not able to take

procedures could be introduced account of any changes in the cost of services over time – consideration should also be given to regulation introducing benchmarking or market testing procedures throughout the life of a project, and more generally a demanding regulatory framework at project level, should ensure that projects remain cost-effective.

VI. Conclusion

Recent developments in the infrastructure sector are positive Despite the hurdles created by inadequate regulations or the lack of incentives, a certain degree of optimism can be derived from the recent developments in the infrastructure sector. Long-term investors whether from Canada or Australia have led the way to greater involvement in the sector and they are now followed by investors from around the globe including sovereign funds. The GFC, if disastrous for the economy, has had the merit of making credible the players of the market who have promoted a long-term approach to infrastructure as well as a better alignment of interests between the real source of long-term capital represented by pension funds, those would deliver infrastructure and the community that will benefit from it.

Note

1. Meridiam Infrastructure is a leading fund manager developing exclusively 25 year maturity infrastructure funds with € 1.5 billion of assets under management (as of 31 march 2011) dedicated to the development, construction and management of public services infrastructure in OECD countries (Europe and North America) and the European Union.