THE BIG SHIFT FROM BROWNFIELD INFRASTRUCTURE RECYCLING TO GREENFIELD DEVELOPMENT

- Michael Cummings, **AMP Capital**

Australia led the world in privatizing state-owned brownfield assets. With the pipeline running dry, the next phase will be the true test. State governments are looking to develop a next generation of greenfield assets, with the intention of selling to the private sector on completion. With potential investors scouring the globe for opportunities with plenty of 'dry powder' up their sleeves, this may well be another win for the lucky country.

Since our last review, we are at last seeing some "green shoots" in developed economies which hint at stronger future economic growth. The winding back of quantitative easing is an essential prerequisite for normalizing investment conditions. However, the road to recovery will be long and the generally low return environment is likely to persist for at least the medium term.

While all governments recognize the essential role that infrastructure plays in ensuring economic growth, the policies adopted by advanced economies to ensure adequate investment differ markedly both in concept and effectiveness.

Post GFC, Australia has almost been alone in championing the cause of the large-scale recycling of government assets and services. The past few years have seen a raft of large brownfield asset sales across roads, ports, electricity transmission & distribution and social infrastructure.

Strong demand for infrastructure assets from Australia's large superannuation funds is undoubtedly a factor in government thinking. The funds provide an acceptable face for the private sector, making "social privatization" generally more acceptable to voters.

As an example, Hostplus, an Australian not-for-profit superannuation fund which oversees A$23bn of assets on behalf of one million members, recently stated that it expects to raise the proportion of its balanced fund invested in infrastructure assets from 10% to 12%. The size of this allocation is not out of keeping with the broader trend among Australian industry funds.

The next stage of the "Australian experience" will be to see how well the proceeds of these transactions are re-invested into greenfield, growth-orientated infrastructure.

This raises the question: what opportunities and developments will lie ahead for private sector investors?

DE FACTO INFRASTRUCTURE BANK

Asset recycling involves state governments developing greenfield assets with the express intention of the future 'sale' (via long-term concessions) to the private sector. In this model, private investors are not exposed to greenfield patronage risk which has proved so problematic in many first-generation transport Public Private Partnership (PPP) concessions.

It is a pragmatic approach to unlocking private sector investment; if successful it will create a de facto infrastructure bank, continually re-investing sale proceeds in new infrastructure. The risk, however, is a feast-or-famine cycle developing in investment opportunities.

In Australia, New South Wales has by far the largest recycling pipeline. It has also proven to be flexible and is currently considering a pre-completion 'sale' of the large West Connex project after approaches from interested investors.

Other state governments are committed to asset recycling to greater or lesser extent. However, asset selection is strongly influenced by political acceptability.

GREATER EFFICIENCY AND GOVERNANCE

A second innovation in infrastructure funding may also have significant long-term impacts. In the latest Federal budget, infrastructure funding arrangements with the states have been radically reformed. Federal grants are now tied to funding specific projects, removing the discretion in spending federal grants previously allowed to states.

The rationale is to improve project governance as every project is subject to a comprehensive standardized benefit cost analysis. Overall, we believe that the policy reform could lead to an improvement in the efficiency of overall government infrastructure investment, although to maintain investor confidence and momentum, it is essential that politicians resist the temptations to bypass good policy development in exchange of short-term populist decisions.

PRIVATIZATION WINNERS AND LOSERS

While a number of state governments sought an electoral mandate to commence large asset 'sales' programs, New South Wales has been the most notable success story. It pushed through its program of full or partial long-term concession transactions of electricity transmission and distribution networks and other state-run services. The sale of the Port of Melbourne in Victoria was also a notable success.

State governments have enjoyed strong returns off the back of these 'sales' well above initial expectations due to strong international and local investor interest. And given its early mover advantage, New South Wales came out particularly well.

However, since these sales, there has been a tightening of foreign investment guidelines, which has seen some heat come out of the market. In addition, the electricity distribution operating model is entering a period of heightened operating and regulatory risk. The states that failed to push through asset sales may find it more challenging to achieve commensurate results in future sales.

PRIVATIZATION PIPELINE RUNNING OUT OF STEAM

The asset recycling pipeline of large cap assets that fuelled the privatization boom is running out of steam[1].

Political opposition has seen most of the prospective sales involving electricity transmission and distribution assets in Queensland, Western Australia and Tasmania previously withdrawn from 'sale'. These 'sales' will not happen under the incumbent state governments.

The most reliable indicator of the future pipeline of assets are the already announced and credible proposed transactions, currently totalling less than A$10bn.

GREENFIELD BOOM THANKS TO PUBLIC FUNDING

In contrast to the hiatus in large cap privatizations, the development of greenfield economic infrastructure, particularly road and rail, is entering a boom driven by increased public sector investment[2]. Total active prospective projects (announced, under procurement and preferred bidder stage) total almost A$70bn, in addition to the A$35bn currently under development.

Not included in this prospective list is the A$5bn project to develop Sydney's second airport at Badgery's Creek. Construction of the project will begin in 2019 using a traditional design and construction approach and federal funding. Initially intended to be operated by a government-owned corporation, it is an obvious candidate for future sale, given the great success of airport privatizations in Australia.

This project will also act as a catalyst for the development of supporting infrastructure projects, including road and rail connections.

Bulging state coffers in New South Wales are now funding the development of a flurry of transport and social infrastructure projects, with more than A$20bn in projects announced and under procurement. Alongside mega transport projects, there are several hospitals and an innovative low-cost housing project. These are potentially suitable for development as PPPs with the private sector.

Victoria has also had a strong infrastructure investment pipeline investing mainly in road and rail upgrades. Announced and under procurement projects total approximately A$12bn. They feature an unusual A$1bn social housing PPP which is currently under procurement. This may mark a new model of social housing provision in Australia.

Queensland announced and under procurement projects total approximately A$5bn. These are focussed mainly on transport infrastructure and are reliant to a significant degree on federal government grants. There appears to be little opportunity for private sector investors.

New Zealand announced and under procurement projects total approximately NZ$8bn, including a mix of social, transport and water treatment and distribution projects, with some potential private sector involvement through PPPs.

AUSTRALIAN ENERGY SECTOR DEVELOPMENTS

In contrast to the largely bi-partisan support for private sector investment in infrastructure, Australian energy policy has seen bitter political infighting. Generating plant closures and extreme weather events have revealed supply vulnerabilities in the eastern states. A recent review by Australia's Chief Scientist concluded[3] that the greatest threat to energy security is policy uncertainty which is stifling investment in the generating sector. More specifically:

- A lack of long-term national policy on carbon pricing has slowed new utility scale generation projects;
- A lack of base load investments has resulted in increased reliance on gas-fuelled intermediate generation;
- Renewable targets subsidies have resulted in increased penetration of intermittent renewable generation giving rise to concerns about network stability;
- While Australia is now the world's largest exporter of LNG, East Coast gas prices have soared as a result of inadequate reservations for domestic customers; restrictions on on-shore CSG development; and lack of capacity trading liquidity in the gas transportation market.

This comes at a time when technological change permits marked improvements in network utilization which should be producing lower costs for consumers. Australia's regulatory framework is an impediment to the effective utilization of the new technology. Assuming legacy technology, it mandates a strict separation of roles for distribution system operators and electricity retailers. The effective integration of small-scale distributed generators and batteries into networks will require a more flexible regulatory framework.

The result of these uncertainties has been a ~20% increase in retail electricity prices in recent months. Consequently, energy cost and reliability of supply has become a top political issue in Australia. Government intervention in the National Energy market has been swift as summarized below:

- The South Australian state government has called for the immediate construction of new gas-powered generation station and a high-profile 129 MWh battery storage facility, designed for network support;
- A federal requirement to reserve gas for domestic use. Gas pipelines will be needed to divert export volumes into the domestic transmission system;
- A requirement that new utility scale renewable generators are coupled with either new energy storage or fast response generators.

To date, there has been little clarity on a longer-term clean energy policy, which is likely to lead to continuing disruption in the sector. In contrast, New Zealand energy

[1]Infrastructure Pipeline: Brownfield by Transaction Status, Infrastructure Partnerships Australia.
[2]Infrastructure Pipeline: Greenfield by Project Status, Infrastructure Partnerships Australia.
[3]Independent Review into the Future Security of the National Electricity Market - Blueprint for the Future June 2017

policy is much more settled and its energy regulatory system seems more capable of adapting to technological change.

OPPORTUNITIES - COMPETITION WILL BE FIERCE

According to a 2015 Mckinsey Global Institute paper, we are on the cusp of seeing a much-needed global build-out in greenfield infrastructure, to the tune of US$57tn worth of assets required over the next 15 years.

Overall, while medium- and longer-term prospects look good, the opportunities for investors in large projects are few in the shorter term. We expect short-term investment activity to be dominated by small and medium opportunities.

In the absence of immediate mega deals and tightening foreign investment guidelines, we expect that large foreign investors will show less interest in Australia. However, local superannuation funds have ample "dry powder" and competition for quality core infrastructure assets will be fierce.

Falling foreign interest and the prospect of rising long-term bond rates off the back of winding back of quantitative easing in the US has led to asset prices finally appearing to stabilize.

Australia's social PPP market is continuing to attract investors, due to high yields and bond proxy characteristics. The greenfield and brownfield pipelines are strong, and include opportunities in social housing in NSW, Queensland and Victoria, school portfolios across Western Australia Queensland and Victoria, hospitals in NSW and South Australia and light rail projects in Queensland, NSW, the ACT and Victoria.

Fig. 1: Risk Profiles of the Opportunities Expected to Emerge in the Next 12 Months

Sector	Opportunity	Risk Profile
Transport	Rail rolling stock	Availability contract
	Newly built toll roads	Availability contract
	Light Rail	Availability contract
Energy	Gas transmission	Capacity contracts
	Fast response gas generation	Availability and performance contracts
	Electricity storage	Availability and performance contracts
	Rooftop PV/battery	P/E play
Social	Health	PPP concessions
	Public housing	PPP concessions
	Aged care	Occupancy, operational and regulatory
	Schools	PPP concessions

Source: AMP Capital

WHERE TO NEXT? ENERGY SECTOR REFORM OPPORTUNITIES

For investors seeking higher returns, opportunities emerging from the reform of the energy sector look promising. Emerging opportunities include:

1. reducing costs are seeing increasing penetration of residential photovoltaic generation, more recently combined with batteries;
2. in gas processing, transmission and storage;
3. new gas-fired peaking generation and large-scale energy storage for network support.

Risk profiles of the opportunities expected to emerge in the next 12 months are summarized in Fig. 1.

CONSISTENCY AND CONFIDENCE CONTINUES

Both policy makers and investors are queuing up to explore new methods of efficiently deploying private capital to develop and operate Australia's next generation of infrastructure. With a long track record of successful delivery of high-quality assets behind us, both Australia and New Zealand are in the box seat in terms of operating to high standards, supported by contracts forms and regulation.

For investors, this consistency has been the key in creating the confidence necessary for investors to continue to commit to the sector.

In this context, the forecast slowdown in the value of short-term investment versus the recent levels of large transactions is a timing issue and in no way signals a lessening in confidence in the partnership between government and private capital that has emerged in recent years. Medium-term prospects continue to look strong and attractive, although to maintain investor confidence and momentum, it is essential that politicians resist the temptation to bypass good policy development in exchange of short-term populist decisions.

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