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# Essential lessons from Australia’s asset-recycling programme

*Now the initiative has ended, with most of the available assets in private hands, Daniel Kemp looks at the risks of taking such large businesses private.*

By **Bruno Alves**, Infrastructure Investor - 17 September 2018

The tragic collapse of the Morandi Bridge, in Genoa, Italy, last month, prompted a swathe of negative headlines centering around the private owners of a crucial piece of infrastructure. The causes of the collapse will take some time to determine, but one thing is clear: the incident highlighted some of the sensitivities around private ownership of critical assets.

The economic realities in many countries, though, mean private capital is necessary to fund the construction and maintenance of infrastructure. This is something the Australian federal government took on board several years ago, launching its Asset Recycling Initiative (ARI).

The biggest assets in New South Wales and Victoria have all now been privatised through this programme, as Marsh & McLennan Companies points out in a recent report titled Infrastructure Asset Recycling: Insights for Governments and Investors. The consultancy has been involved in some capacity in most of the major privatisations in Australia under the ARI and has taken stock of the lessons learnt.

In particular, MMC highlights three main risks for investors when participating in privatisations: ensuring the risk/reward balance is right; securing a successful transition of the business’s people and culture when taking it private; and factoring in potential regulatory risks.

How can investors deal with these risks? And what lessons do they provide for future privatisations?

### Getting the balance right

One of the primary risks for investors that MMC identified was the need to get the risk/reward allocation right, particularly from an insurance point of view, as privatised assets generally do not have the same access to government indemnifications as publicly owned ones.

“The [governments] would try to pass on all liabilities – everything from pollution liabilities to directors’ and officers’ liabilities, and even workers’ compensation liabilities, which we weren’t really even sure was legal,” says Anthony Butcher, infrastructure practice leader at Marsh and a contributor to the MMC report. “We had to educate our clients, many of them international investors, as to the framework in Australia, and that you can’t just turn around to an insurance marketplace and say you’re taking on all these past liabilities.”

This meant there was sometimes negotiation required with state governments over what risks private investors should have to absorb, meaning that one of the main lessons from the process was knowing when to push back.

QIC was involved in the Port of Melbourne privatisation, leading a consortium alongside Future Fund, Global Infrastructure Partners and OMERS to operate the port on a 50-year lease. Ross Israel, QIC’s global head of infrastructure, says that Australian governments have tended not to want to retain too many liabilities and so ask buyers to price that.

"The Australian model has evolved to be very clear in terms of the risks that are being transferred and the risks that are inherent in the business," he says. "You assess them and price them – and some of those risks that are specifically undetachable from the government's ownership have typically been retained [by it], because the government takes the view that they want to maximise value."

Brett Himbury, chief executive of **IFM Investors**, echoes this. IFM participated in the privatisation of New South Wales electricity distribution business Ausgrid, securing 50.4 percent of the enterprise on a 99-year lease, as part of **a joint A$16.2 billion bid** with **AustralianSuper**.

"The risks were all clearly understood when we went into the due-diligence process," he says. "We were ultimately comfortable with the risk-return trade-off, clearly."

**Focusing on people**

The second major risk identified by MCC is managing people and culture through privatisation. There are two main priorities: getting the organisation structure and executive team right; and developing a reward structure for employees that is more appropriate to a private-sector business.

"In government ownership, businesses have different objectives from private [businesses] with shareholders," Israel says. He says there have "always" been objectives that receive lesser importance once an enterprise becomes privately owned.

Himbury says IFM looks to balance the need to move quickly when making changes alongside the necessity of doing it in a "sensible, empathetic and commercial manner".

"You need to ensure that there are the [required] strategic and cultural disciplines in the new enterprise, and that there will be sustained earnings growth. It's about balancing the long-term perspective with being empathetic to all of the stakeholders' needs – which includes us as investors, but also the staff and the users of the asset," he says.

On reward structure, Israel says the government has more constraints around how it can incentivise staff. "We focused a lot on reframing job descriptions and looking at an adjusted remuneration structure which might review short-term and long-term incentives," he says.

Israel says there were "a lot of moving pieces" in the first 12 to 18 months following privatisation of the Port of Brisbane, which QIC carried out in 2010 as part of a consortium alongside Global Infrastructure Partners and IFM Investors.

"In the main, we probably kept a higher level of resource and augmented it with some further competencies, more at the senior-executive level than in the bowels of the business," he says. "If some matters are going quickly you can't compromise on the people side, so you've got to match your resource to the workflow and if that workflow's accelerating then you live with it."

**Prepare for regulatory change**

The third privatisation risk for investors comes in the form of understanding and negotiating the potential regulatory pitfalls associated with each asset. This is particularly topical now, with Australian energy policy in an uncertain position.

IFM Investors is aware of this risk, particularly when it comes to a business like Ausgrid.

"In some of our assets, like the regulated electricity assets, the federal energy policy continues to concern us," Himbury says, highlighting the need for investors to monitor what is happening and react accordingly.

Israel says that QIC and its partners sought to engage heavily with the users of its port assets, building a better relationship that can help alleviate any potential concerns around sensitive issues such as pricing. He also points out that regulators are increasingly looking at industry structures – worth bearing in mind for investors who are looking to acquire complementary assets in sectors they already operate in (just look at the competition concerns that CKI's bid for APA Group is facing, as well as the ACCC's review of Transurban's bid for WestConnex).

The lesson here is relatively simple – investors must devote more effort to understanding the potential regulatory pitfalls and be prepared to deal with them if they arise after privatisation is complete.

### ASSET RECYCLING HIGHLIGHTS

As is well known, NSW took the lead with Australia's ARI initiative

| State | Year | Asset sold | Terms | Buyers | Proceeds (A$m) | Federal contribution to states (A$m) |
|---|---|---|---|---|---|---|
| NEW SOUTH WALES | 2015 | Transgrid | 100% lease for 99 years | CDPQ, Hastings, Tawreed Investments, Spark Infra, Wren House Infra | 10,273 | 2,190 |
| | 2016 | Ausgrid | 50.4% lease for 99 years | IFM Investors, AustralianSuper | 16,200 | |
| | 2017 | Endeavour Energy | 50.4% lease for 99 years | MIRA, AMP Capital, bcIMC, QIA | 7,624 | |
| | 2017 | Land and Property Information | 35-year lease | Hastings, First State, RBS Pension Trustee | 2,600 | |
| VICTORIA | 2016 | Port of Melbourne | 50-year lease | Future Fund, QIC, GIP, OMERS | 9,700 | 877.52 |
| | 2018 | Land Titles Registry (final bids due) | 40-year concession | Cbus/First State Super & MIRA (bidders) | 2,000 (est) | |
| NORTHERN TERRITORY | 2015 | Port of Darwin | 99-year lease | Landbridge | 506 | |
| SOUTH AUSTRALIA | 2018 | Land Titles Office | 40-year lease | MIRA & Public Sector Pension Investment Board | 1,605 | 36.6 |

Source: Marsh & McLennan Companies

### Lessons for the future

In Australia, most of the major assets in New South Wales and Victoria have gone through the privatisation process, with the Victoria land titles business currently subject to a bidding process.

But the other states, notably Western Australia and Queensland, are still holding out. Himbury argues it is "virtually an imperative" for Queensland and WA to find alternative sources of funding for infrastructure and that asset recycling may eventually form a part of that, despite the current political realities.

"Both of those governments had an anti-privatisation agenda as part of their election narrative – I respect that politically as there are clearly cases where privatisation hasn't been good for users," he says. "But I continue to want to engage with those governments to reinforce that there are very different forms of privatisation. When pension funds own these assets, we look after them in a very different way from many other forms of private-sector capital," he argues.

Adrian Dwyer, chief executive of Infrastructure Partnerships Australia, is forthright: "This stuff is easy to say, but hard to do. Resource states like WA and Queensland and other countries would be wise to read the NSW and Victorian playbook on asset recycling. The results are so compelling, and the opportunities are too big to ignore."

Beyond Australia, there has been talk of other countries following the antipodean example and launching their own recycling initiatives – most notably the US.

"The need over there is just so huge," Himbury says. "The policy prioritisation [by the Trump Adminsitration] of infrastructure is encouraging. We're pragmatic about the focus on the midterms, but we're confident that after that, there's a strong likelihood there'll be some action."

He does add one caveat, though: it's imperative that the first few privatisations are executed well. "We hope the first case studies are really good ones, where the voters and users of the assets see it as a very good thing rather than being in any way concerned about it. If we do the first few well, it's very likely those case studies will be looked at and emulated. But if that is not the case, and egregious private-sector capital gets in and upsets the users, it will put us back decades."

Investors have obviously viewed Australia's Asset Recycling Initiative as a positive policy. And, largely, so has the public, particularly as new infrastructure is announced and built Down Under.

Applying the lessons from the ARI will help ensure private capital is seen as a positive influence on infrastructure and society as a whole – as well as securing strong returns for investors.

# China seeks FDI for offshore wind, but is there too much water under the bridge?

*A breakdown of trust across sectors between China and the West stands in the way of the country's ambitious offshore wind plans.*

By **Zak Bentley**, Infrastructure Investor – 6 December 2018

The onshore wind behemoth is beginning to wake up. China, the world's largest wind power market since 2009 and now the location of about 35 percent of the world's wind power capacity, wants to ramp up its fledgling offshore wind market. The catch? It needs foreign investors' help in doing so.

China is already the third-largest offshore wind market in the world, according to the Global Wind Energy Council. The 1.2GW it installed in 2017 took its total installed capacity to 2.8GW, only behind the 5.3GW and 6.8GW installed by Germany and the UK, respectively.

However, the country has long wanted these figures to be larger, as it bids to surpass the UK and Germany by 2022. That hasn't been easy, considering its plans have often fallen by the wayside. For example, a 2011 five-year plan to install 5GW of offshore wind was missed after responsibility for achieving that target was delegated to individual provinces. China's installations to date have also largely been dominated by near-shore developments, rather than the deep-shore projects seen in Europe.

Building such projects, China realises, may require the help of foreign investors who have experience in their domestic markets; the kinds of investors China has watched **flock to Taiwan**. Steps were taken along these lines in June, when Denmark's energy, supply and climate minister Lars Christian Lilleholt and the then Chinese energy minister Nur Bekri reached what was described as a "historic agreement", positioning Danish companies in a market traditionally difficult to enter for foreign investors.

"China has huge ambitions for their offshore sector," said Lilleholt at the time. "We now commit Danish know-how and technology to make a difference for China's offshore wind sector. It is good for Danish companies, but it is also good for China's green conversion, where offshore wind can play an important role."

Alas, that agreement may be drowning in the water it was meant to build out from. Aside from Bekri's resignation in September amid a corruption probe and his replacement by the former president of PetroChina, the country's second-biggest oil producer, relations between the two countries have since deteriorated further.

The Danish government in September stepped in to prevent autonomous Greenland awarding a build-and-operate contract of its airports to China Communications Construction Company. Two weeks ago, ministers revealed plans to enact a new critical infrastructure bill, with defence minister Claus Hjort Frederiksen explicitly outlining Chinese companies as the cause.

"We want Denmark to be able to stop the sale of critical infrastructure if we do not trust the buyers," added Kristian Jensen, Denmark's minister of finance. "We also have the opportunity to say no to an investment if we do not trust that the investment is purely commercial."

Western governments have long distrusted Chinese capital, but this has reached new levels in 2018. **Germany's explicit exclusion** of China State Grid from 50Hertz was a high-water mark, while the chief of Britain's MI6 this week warned its government about allowing telecoms group Huawei to participate in the country's mobile network.

So too in the US, where its ambassador to Portugal, George Glass, said in September that it would not allow US energy assets owned by Portuguese group EDP to be sold as part of its takeover by China Three Gorges.

China's ambitions to build a world-leading offshore wind market with the help of foreign know-how and equipment cannot be fulfilled if the counterparts do not trust that the technology sharing involved will not be leveraged against them or their domestic governments.

A wind-market expert we spoke to recently says Beijing is beginning to realise the predicament it faces in attracting investment from countries and companies that so explicitly distrust it. The question is: can anything realistically be done to change that?

# Careful who you exit to

*Much is made of restrictions to foreign investment. Little, however, is heard about what happens when exits to certain types of investors create odd bedfellows.*

By **Bruno Alves**, Infrastructure Investor – 28 June 2018

If you're following CK Infrastructure's **$9.8 billion bid for APA Group** – Australia's largest natural gas pipeline company – you will have noticed a familiar refrain: heavyweight Asian investor plonks down a large cheque for a critical infrastructure asset; a Greek chorus of pundits speculates about the likelihood of said bid making it through the various Australian watchdogs; local capital sources marshal together to try to provide a counter-bid – or at least be ready for the potential fallout.

That, or at least a similar pattern, is what you can reasonably expect will unfold in many OECD countries going forward each time a critical infrastructure asset finds itself in the crosshairs of a certain type of foreign investor. And by certain type, we mean sources of capital that are perceived to be – or are – directly controlled by foreign states, especially foreign states with which OECD countries are not aligned.

While CKI, one of the biggest overseas infrastructure investors in Australia, would argue it does not fall under that category, it has not escaped unscathed Down Under. We are of course referring to its 2016 bid for New South Wales electricity distributor Ausgrid, alongside China's State Grid Corporation, which was **knocked back by FIRB** due to what treasurer Scott Morrison cited as "national security concerns" (IFM Investors and AustralianSuper snapped up the asset on the rebound).

What's much less talked about is what happens when exits pair those cash-rich, statebacked sources of capital with partners that were, perhaps, not expecting to find themselves in that situation. In that respect, you could feel the anticipation in the market earlier this year when IFM Investors mooted the sale of a 20 percent stake in Germany's 50Hertz to China State Grid, before fellow shareholder Elia ended up using its pre-emption rights to **snap up the stake**.

But late last year, for example, Brookfield sold its stake in Transelec, Chile's biggest pure-play power transmission company, to China's Southern Power Grid, another stateowned enterprise. That deal has received all the necessary regulatory approvals, which means the asset's other shareholders – British Columbia Investment Management Corporation, Canada Pension Plan Investment Board and PSP Investments – now find themselves teamed with a very different type of investor.

In our **just-published keynote**, Scott Lawrence, CPPIB's new head of infrastructure, had this to say: "We're seeing that more traditional funds need to recycle capital and exit, which creates question marks and concerns, not only by investor bases but management teams and regulators". Lawrence, however, subsequently stressed he was confident that CPPIB's long-term investment horizon and willingness to deploy follow-up capital made
the pension a good partner for all stakeholders.

When confronted with the same scenario, though, another long-term investor implied it now spends more time thinking about who its best partners are. The implication being that future partnerships will at least be partly dependent on how – and to whom – past partners exited in previous deals.

Alignment of interests is, of course, at the heart of these concerns, with both investors and managers wanting to make sure they couple with kindred spirits. When it comes to state-backed capital, that's not always the case.

"Alignment is everything in a partnership," Michael Harrington, a Mexico-based partner for Actis, **told us previously**, commenting on the suitability of partnering with Chinese SOEs in Latin America. "We will build up a business, get it to a certain scale and exit in five to seven years. I don't think SOEs are buying to exit in five to seven years. They're buying for the next hundred."

In addition, state-backed capital often has lower return targets, sometimes being able to eschew immediate returns altogether for the sake of other, 'strategic' interests. All of which has the potential to leave a bad taste in the mouth of a newly minted private partner.

If you're in the position of putting someone in that situation, our advice would be to think carefully about whom you exit to.