

The Inverted Bid Model

ISA REPORT

June 2014

An aligned infrastructure investment model



ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

Matthew Linden

Director of Public Affairs

Phone: +61 2 6173 1825

mlinden@industriysuper.com

Jane McGill

Senior Policy Advisor

Infrastructure

Phone: +61 3 9923 7105

jmcgill@industriysuper.com

ISA Pty Ltd ABN 72 158 563 270 Corporate Authorised Representative No. 426006 of Industry Fund Services Ltd ABN 54 007 016 195 AFSL 232514

ABOUT COMPLEX PROGRAM GROUP

In July 2013, Industry Super Australia commissioned the Complex Program Group to review PFI financing and procurement processes both in Australia and internationally and further develop a new 'inverted bid' process and national policy framework to support significantly increased investment in Australian infrastructure by Australian superannuation funds and to document it in a report. This provided the basis for the 'inverted bid model' in this report.

For Complex Program Group's Report 'Superannuation Public-Private Partnerships' (SP3) (September, 2013) see ISA's website: www.industrysuperaustralia.com/reports

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Complex Program Group

Dr David Dombkins: +61 (0) 452 436 577

daviddombkins@complexpm.com

peterdombkins@complexpm.com

THE INVERTED BID MODEL

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Executive Summary

Industry Super Australia in conjunction with Complex Program Group, and IFM Investors has developed a new procurement process to support investment in Australian infrastructure by long-term equity investors such as Australian superannuation funds. The inverted bid model – also known as the ‘aligned infrastructure investment model’ – is presented in this report.

Five objectives

The purpose of this new model is fivefold: (i) escalate infrastructure investment by reducing bid costs and project timeframes and increase the flow of projects to meet the growing appetite of long-term equity investors such as superannuation funds for infrastructure investment; (ii) enhance member returns and reduce their return volatility by increasing the pool of attractive illiquid assets; (iii) address the infrastructure deficit; (iv) lift productivity growth through increased capital intensity and (v) fill part of the growth void as the economy rotates away from mining investment.

Productivity agenda

Australia is facing threats to its economic prosperity on multiple fronts: we are undergoing a demographic shift towards an older population, the boom in mining investment is winding down, environmental constraints are on the rise and we find ourselves in an increasingly competitive global environment.

The ageing of the population, in particular, will put significant pressure on economic growth, household incomes and government finances over coming decades. Higher productivity growth is the key to addressing these challenges and increasing investment in capital - including infrastructure - and skills are vital to lift productivity growth.

Rotation towards infrastructure

The other critical challenge facing the Australian economy is how to manage the rotation away from resource-led growth to more broadly balanced investment-led growth. The terms of trade, after having nearly doubled in the 2000s, have retreated and mining investment has been scaled back. The challenge now is to find new sources of economic growth. This will occur in an environment of limited household credit growth due to already high levels of indebtedness.

Part of the answer lies in the upward trend in mining production and exports. However, official forecasts show growth in the mining sector is not expected to exceed 1 per cent per annum. The issue is what will fill the void left by mining and part of the answer, at least, lies in a new upward trajectory for infrastructure investment to drive growth and address the infrastructure deficit of at least \$300 billion.¹

Investment appetite

Australia’s superannuation savings is one of the world’s top five pools of retirement savings in absolute terms and among the highest on a per capita basis.² Assets were \$1.7 trillion as at December 2013 and are expected to rise to over \$6 trillion by 2030 and likely exceed the assets of the banking system.³ On average, Australian superannuation funds invest around 5 per cent of their total assets in infrastructure.⁴

If this asset allocation to infrastructure is maintained, it will create a significant appetite for new infrastructure investments worth \$300 billion by 2030. Industry Super Funds have an even higher allocation to infrastructure and seek to invest up to \$15 billion over the next five years. This requires an infrastructure pipeline of new projects that the current infrastructure procurement model cannot support.

Greenfield equity

Under the current procurement model, Australia’s major infrastructure investors, including Industry SuperFunds via IFM Investors, rarely, if ever, participate in greenfield PPP projects either as a bid sponsor or

¹ Infrastructure Australia (2013) National Infrastructure Plan

² OECD (2013) Pensions at a glance

³ ISA (2014) Submission to Financial System Inquiry

⁴ Productivity Commission (2014) Public Infrastructure Inquiry, Draft Report

primary equity investor. Yet, combined, they control the majority of infrastructure investment in Australia. Very high bid costs and long procurement processes with ‘patchy’ deal flow limit the number of parties who can afford to dedicate large teams for such projects. Long-term equity investors like superannuation funds do not see the relative value to divert resources away from pursuing brownfield infrastructure to greenfield PPP projects that involve such a costly, lengthy and uncertain process. Their long-term investment horizon and their appetite for illiquid assets make them ideal partners for such projects, however, the current process is biased towards short-term financiers and contractors and requires reform to level the playing field.

Current model

The current PPP bid process produces a major misalignment of interests between the bid sponsors, who are short-term financiers and contractors and the equity investors they bring to the table. PPP bid syndicate leaders have been motivated by considerations other than the return to equity and the long-term success of a project. Investment banks acting as bid sponsors have been compensated significantly towards the front end of the project and, in the absence of competition, are able to collectively seek to extract outsized fees tied to winning and financing a bid – so called fee leakage – which is ultimately borne by government and tax-payers. In addition, construction companies generate their returns from project construction and have little or no exposure to the investment once operations commence.

Shared global challenge

Australia is not unique in facing a high-cost bid process, long procurement timeframes and a lack of long-term equity participation in partnership projects. In 2012, the UK Public Accounts Committee, commenting on UK Audit Office report: Equity investment in private financed projects, stated:

“The PFI procurement process takes too long, costs too much and restricts the market. The time and cost involved do not serve investors or taxpayers well. The scale of procurement costs constitutes a barrier to market entry for financial investors such as pension funds and smaller contractors. Successful bidders recover their procurement costs in the contract price, which means the taxpayer foots the bill.”

There is a global imperative to increase the level of private sector participation in infrastructure investment in both developing and advanced economies. Public sector balance sheets are constrained and regulatory changes arising from the GFC has impacted on the capacity of short term investors, such as banks, to undertake the task. The G20 has identified there is a need to develop concrete actions to facilitate involvement by long term investor/owners, such as superannuation and pension funds who have the capital to invest.

Inverted bid model

Industry SuperFunds believe that there is a better procurement process that meets both governments’ need for a competitive process, as well as investors’ risk/return appetite, ultimately providing certainty and value for money outcome for governments, patrons and investors. Under the proposed ‘inverted bid model’ the traditional bidding process is reversed by *fixing* the terms of project financing through a funding competition prior to the construction, operation and maintenance (O&M) tender and raising of any additional debt. In other words, the government tenders initially for the long-term owner-operator followed by separate bids for construction, operation and maintenance and residual debt.

Inverted bid model benefits

The benefit of the proposed ‘open book’ inverted bid model is that it levels the playing field for genuine long-term equity investors who are seeking to make a reasonable return over the economic life of the asset by investing to upgrade the services and facilities to meet demand and not through the initial bidding, structuring and building of the asset. Preliminary analysis suggests bid costs can be expected to fall from 1.5 per cent to 0.8 per cent of the total value of the project and procurement timeframes are likely to be compressed from 17 to 12 months or by 30 per cent.⁵

⁵ Estimates are explained in section 6 of this report

1. The economic narrative

1.1 Productivity and infrastructure

“With the ageing of the population reducing participation, productivity growth will be the major contributor to real GDP (by 2050)” and “productivity enhancing reforms, particularly through nation building infrastructure and improving the skills base, will grow the economy, improve living standards, and partly offset the fiscal pressures of ageing.”

Australia to 2050: future challenges (2010) (Intergenerational Report) ('IG Report')

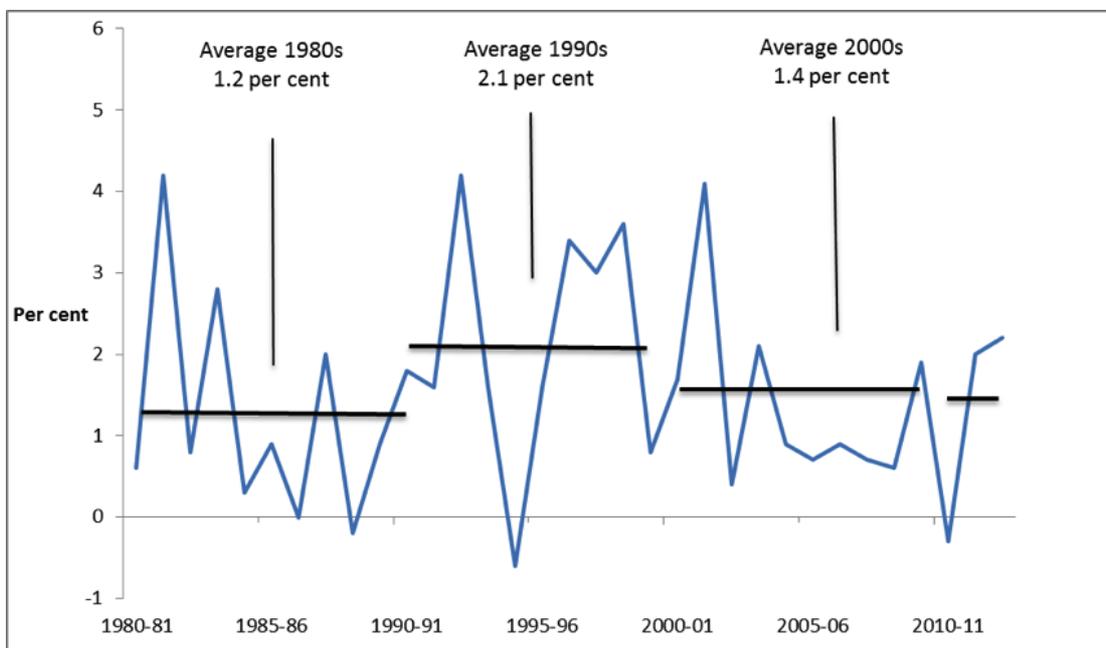
In the lead up to 2050, Australia is facing threats to its economic prosperity on several fronts. The country is undergoing a demographic shift towards an older population, the boom in mining investment is winding down, environmental constraints are on the rise and we find ourselves in an increasingly competitive global environment.

However, it is the ageing of the population, in particular, that will put significant pressure on economic growth, household incomes and government finances over the next four decades.

Higher economic growth is needed to meet this challenge and in the face of declining workforce participation, higher productivity growth is the key to increasing economic growth. Investment in new capital, especially in infrastructure and skills is, in turn, needed for higher productivity.

The challenge is substantial: so far this decade, Australia’s productivity growth has fallen back to 1.3 per cent per annum in the 2010s, slightly below the 1.4 per cent recorded in the 2000s but well below the 2.1 per cent growth rate recorded in the 1990s (Figure 1).

Figure 1 – Labour Productivity Growth: Real GDP per hour worked



Source: Intergenerational Report and ISA

The Intergenerational Report notes “if productivity growth were increased to 2 per cent per annum, the economy would be 15 per cent larger by 2049-50, GDP per person would be \$16,000 higher and fiscal pressures would be reduced as a result of an enhanced capacity to fund government services.”

There is little doubt that lifting the trajectory of infrastructure investment could make a significant contribution to delivering 2 per cent productivity growth over the medium-term.

1.2 Filling the mining void

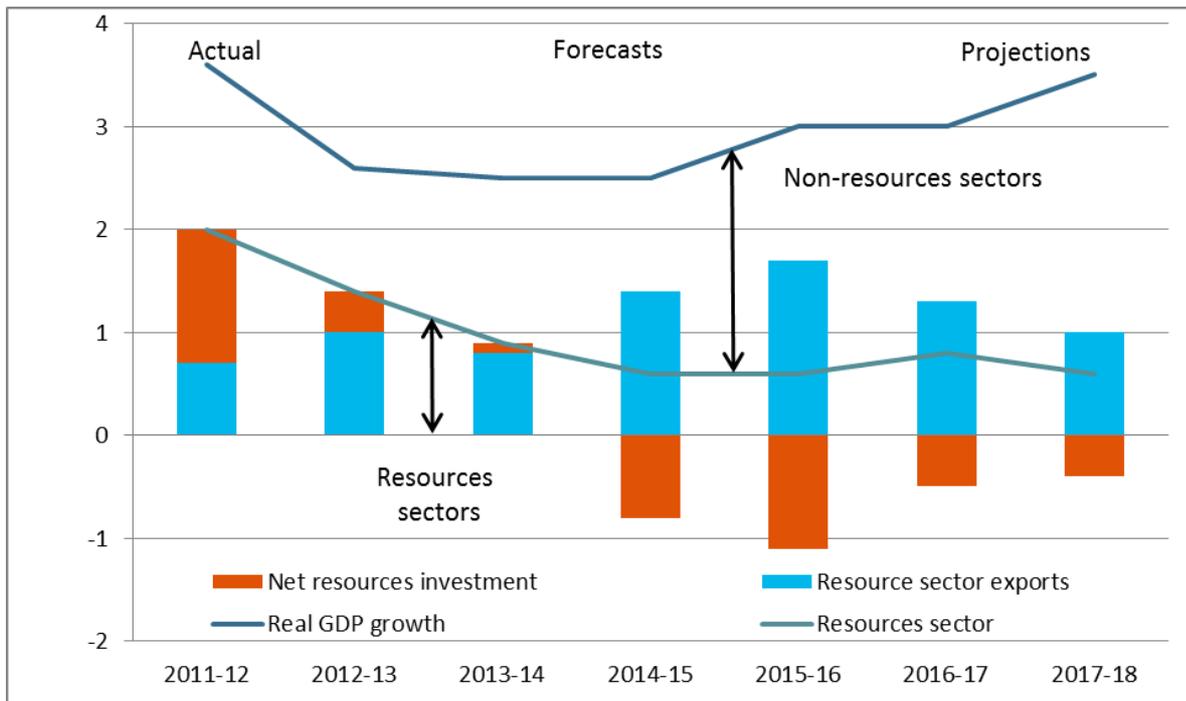
Another key challenge facing the Australian economy is how to manage the rotation away from resource-investment led growth towards alternative and more broadly based growth.

The exogenous rise in commodity prices in the 2000's resulted in a near doubling in Australia's terms of trade. This triggered a sequence of events culminating in a surge in investment in the mining sector while investment in other sectors languished. More recently, as the terms of trade has retreated from its highs, investment in mining has been scaled back. The key challenge now is to find new sources of growth.

Part of the answer lies in the transition underway from resources investment towards resource production and exports. However, official forecasts⁶ for resource exports have been downgraded to reflect the fact that this transition is proceeding more slowly than expected. Over the four years to 2017-18, growth in the mining sector is expected to be not much more than 0.5 per cent per annum.

Official real GDP forecasts are for 2.5 per cent growth for 2014-15, accelerating to 3 per cent per annum in 2015-16 and 3.5 per cent in 2016-17. This implies a significant increase in the contribution to growth from non-resource sectors from 1.9 per cent in 2014-15 to 2.9 per by 2017-18. The critical issue is where this growth is going to come from in the non-resources sectors of the economy. The issue is encapsulated in Figure 2.

Figure 2 – Composition of growth



Source: Treasury

Reform of the infrastructure procurement process – in particular the bid model – has the potential to deliver a significant increase in infrastructure through partnerships between government and long-term equity investors, including superannuation funds. This would go a significant way to shoring up and rebuilding the foundations for GDP growth in the wake of the mining investment boom.

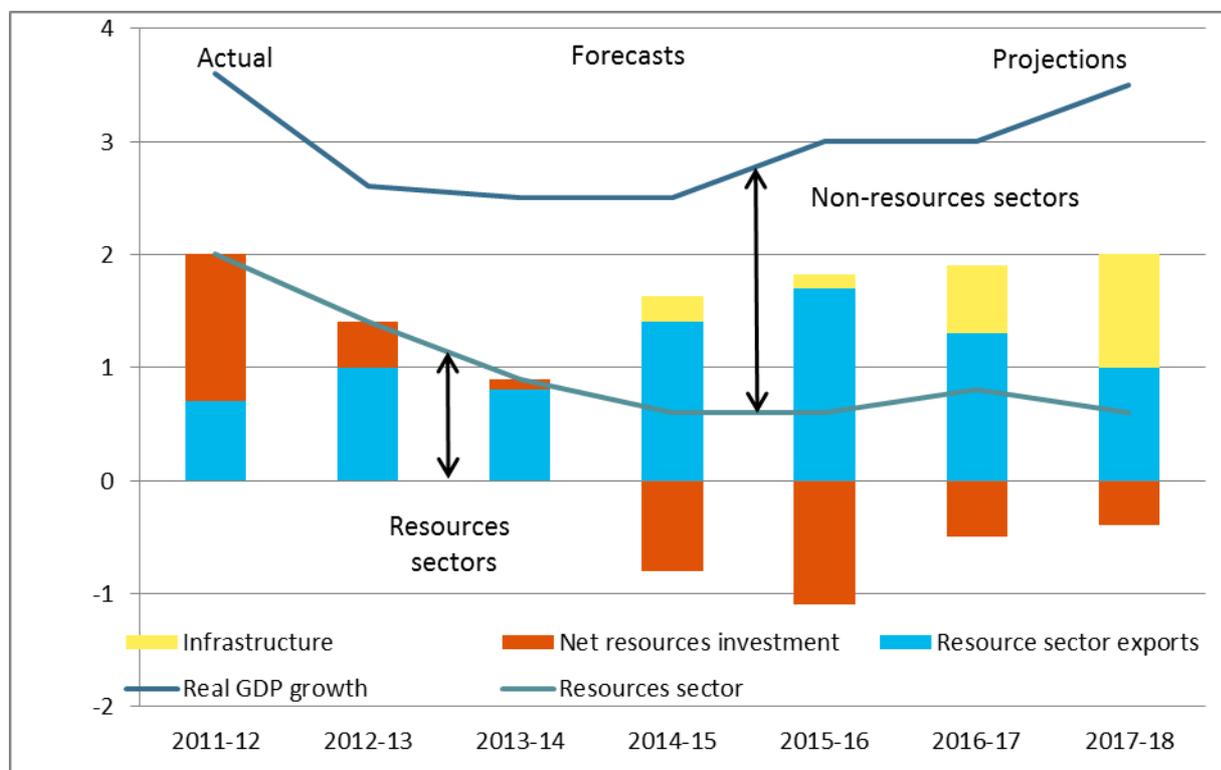
Figure 3 shows the degree to which an additional \$125 billion in necessary infrastructure expenditure, made over the forward estimates, would boost GDP growth towards medium-term official forecasts of 3.5 per cent GDP growth per annum. \$50 billion of this will come from the Australian Government including \$5 billion

⁶ Commonwealth Government of Australia (2014) Budget 2014-15

attached to the *Asset Recycling Initiative* (already included in GDP forecasts) with the balance of \$75 billion coming from states and territories and private investors such as superannuation funds from now to 2017-18.

Industry SuperFunds have already indicated that under the right circumstances they expect to invest up to \$15 billion in new infrastructure assets over the next five years.⁷ If reforms removed the barriers they face to investment in greenfield projects – high bid costs, long procurement timeframes and “patchy” deal flow – this target could be achieved even earlier.

Figure 3 – Infrastructure contribution to growth



Source: Treasury and ISA estimates

2. Industry SuperFunds and infrastructure investment

2.1 Industry SuperFund credentials and expertise in public infrastructure

Industry SuperFunds have a long and successful track record in the long-term investment in infrastructure with direct and unlisted investments in assets as diverse as energy, water, ports, roads, airports and property as well as social infrastructure such as aged care, hospitals and schools. By virtue of their scale, expertise and long-term focus they are able to access illiquid assets such as infrastructure not open to retail investors.

2.2 Asset performance and member returns

The innovative approach of Industry SuperFunds and their appetite for illiquid investment, has paid dividends to members by delivering stronger investment returns and lower volatility. Over the last 18 years, IFM Investors has delivered after tax returns of over 12 per cent per annum, outperforming most other asset classes. Even over the past five years in the wake of the GFC, unlisted infrastructure returns have averaged

⁷ ISA (2013) Building Australia: Super Investment Initiative

8.3 per cent per annum. Moreover, over the past 15 years, the volatility (standard deviation) of unlisted infrastructure was 6.5 per cent – one third of the volatility exhibited by domestic and international equities.

2.3 A partner in private ownership

Independent research by Newspoll, commissioned by ISA, shows that superannuation funds have the potential to cut through community concerns about private sector ownership and potentially change the infrastructure game, unlocking billions of dollars for investment in new economic and social infrastructure. The poll found that community support for privatisation rose from 13 per cent to 75 per cent if the new owner was a superannuation fund. Industry SuperFunds have proven themselves to be responsible investors: they seek stable, income generating assets capable of delivering sound returns with an investment time horizon measured in the decades. In short, it makes sense for Industry SuperFunds to manage these assets as the public desires – as a sensible long-term employer, service provider and corporate citizen.

3. Issues with the current model

3.1 High bid costs, long procurement timeframe “barrier to competition”

Under the current procurement model, Australia’s major infrastructure investors, including Industry SuperFunds via IFM Investors, rarely, if ever, participate in greenfield PPP projects either as a bid sponsor or primary equity investor. Yet, combined they account for the majority of infrastructure investment in Australia. This report examines how the current PPP bid model acts as a barrier to entry/competition from long-term equity investors such as superannuation funds and the impact this has on value for money.

Very high bid costs and long procurement processes combined with ‘patchy’ deal flow, has limited the number of parties who can afford to establish and dedicate the necessary resources for such projects. Bid costs are estimated to average 1.5 per cent of the total project cost and the average length of procurement for PPP projects is 17 months.⁸ With potentially only three or so PPP projects coming to market each year and a similar number of established bidding consortia, the barriers are high for new entrants.

Long-term equity investors have not seen the relative value in diverting resources away from pursuing brownfield infrastructure to pursue greenfield PPP projects that involve such a costly and lengthy process and which are infrequently brought to market. This is despite the fact that they are natural investors in such projects. Their extensive experience in brownfield infrastructure and their long-term investment time horizon means they are well suited to own and manage greenfield infrastructure assets over their long life-cycle. Unlike bid sponsors and short-term investors, they are motivated to price project risk on the basis that they will own and operate the asset over its lifetime, and will make their returns through efficient service delivery, operation and management and investment.

The current PPP bid process represents a major misalignment of interests between short-term financiers and contractors, and the equity investors. This has been perfectly illustrated by a series of failed toll road PPPs in Australia over the last eight years. PPP bid syndicate leaders have been motivated by considerations other than the actual return to equity and the long-term success of a project. The investment banks acting as bid sponsors have been compensated significantly at the front end of the project and have extracted tens of millions of dollars in transaction and advisory fees – so called fee leakage – which is ultimately funded by government and tax payers. In addition, the construction company generates its returns from project construction and has little to no equity exposure to the investment once operations commence.

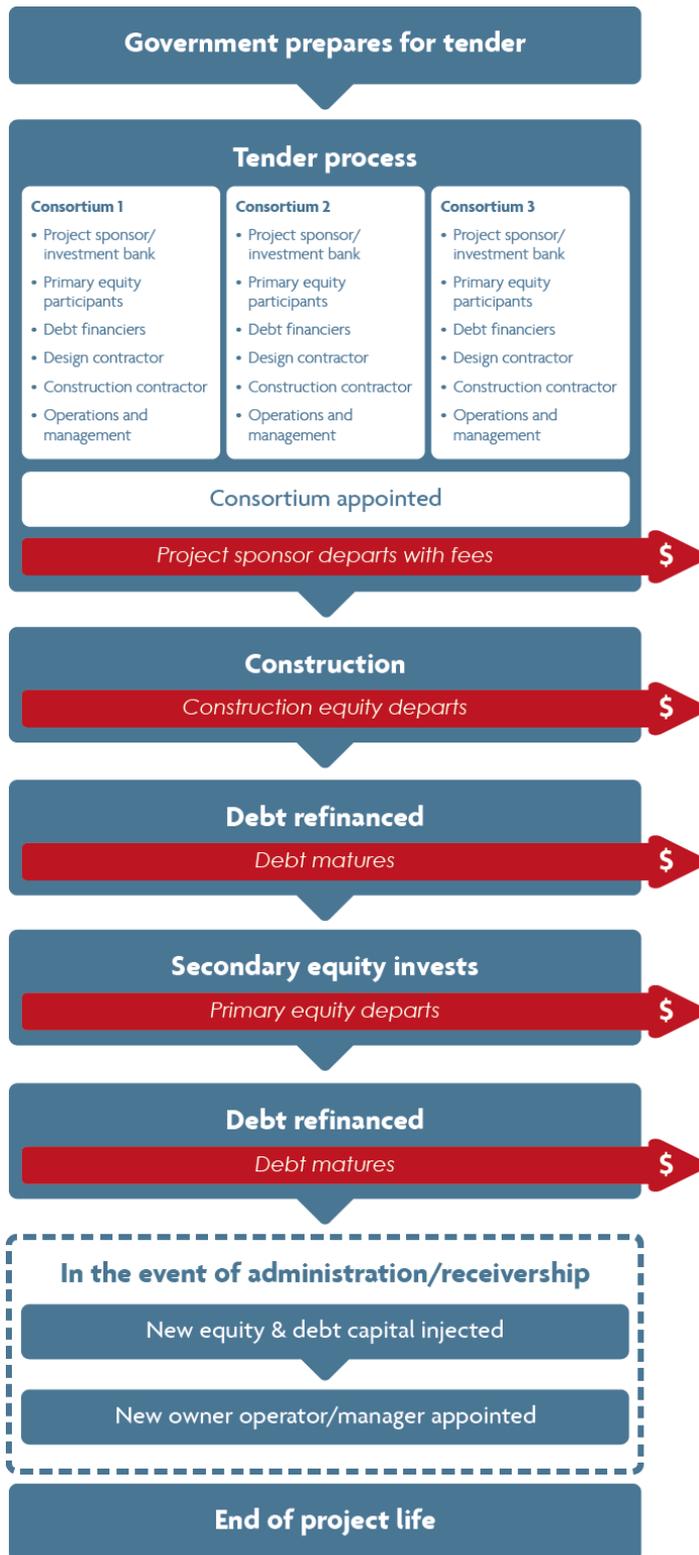
Driven by these significant short-term incentives, bidders put forward aggressive patronage forecasts as this positions them to win. Exacerbated by high levels of gearing, these overly optimistic traffic forecasts have

⁸ KPMG (2010) PPP procurement review of the barriers and competition and efficiency in the procurement of PPP projects

led to the financial failure or significant stress of projects. Ultimately, this risk is borne by relatively passive equity investors (brought into the deal by the investment bank and contractor as bid sponsors), as they themselves have extracted their returns upfront and have limited to no on-going equity exposure to the transaction.

The ultimate outcome is poor value for money for government and tax payers, as well as a loss of shareholder value leading to risk aversion and scarcity of capital. Whilst the limitations of the PPP procurement model have been best illustrated by the toll roads, similar issues exist for social (or availability based) PPPs where significant value capture and fee leakage occurs during the initial bid process and the achievement of financial close. In order to avoid future failures, such as the Airport Link (Brisconnections) toll road failure, the procurement model must be changed.

Figure 4 – The current bid model



3.2 Refinancing risk

Finance packages based on overly optimistic assumptions and skewed 80-90 per cent towards debt, provide a lower cost upfront but may not be capable of refinancing. Ultimately, the risk is borne by equity or, in the case of reversion to the government, the taxpayer.

Debt will always be a significant source of finance for infrastructure projects, however, reform of the bid model would be expected to help foster more sustainable capital structures with reduced refinancing risk and, hence, a reduced likelihood of equity having to inject further capital or assets to enter receivership.

3.3 Lack of innovation

Under the current one-step bid model, financial terms, the business case, project design, construction, operation, management and maintenance contracts are all fixed up front. A winning consortium may not include the 'best in class' of all of the project components and this may stifle innovation, the quality of outcomes and value for money achieved.

3.4 Under investment in assets

Governments may experience significant challenges over the medium-term if they wish to enhance aspects of the asset and the services provided if the concession was awarded to investors with short-term interests. Long-term owners are motivated to invest heavily in those assets over their lifetime to enhance facilities, services and investment returns.

3.5 Poor value for money

A lack of competition from long-term investors, significant 'fee leakage' to sponsors and windfall gains to primary equity investors when they depart after construction, all combine to undermine value for money in the early stages of a project. Moreover, ultimately 'value for money' cannot be assessed at a single point in time, but is an ongoing process that extends over the project's life.

3.6 High whole-of-life transaction costs

Transaction costs related to establishing and maintaining a partnership over the life of the project encompass legal, financial, technical, advisory and other costs incurred by both the public and private sectors in the procurement and operational phases of a project. Average transaction costs are estimated at well over 10 per cent of a project's value and have the potential to erode savings achieved through the partnership model.⁹

4. International perspectives

Australia is not unique in facing issues with the complexity and high cost of the bid process, long procurement timeframes and the desire for greater participation of long-term equity investors in PPPs.

⁹ European Investment Bank (2005) Transaction costs in public private partnerships: A first look at the evidence

4.1 Complex bid process

In its 2012 report, 'A new approach to public private partnerships', HM Treasury described the complex process of infrastructure procurement in partnership with the private sector:

"Procurements of PF2 projects have a number of features that make them more complex than many other types of procurement. PF2 projects will be a long-term agreement for the design, construction, financing, maintenance, and sometimes operation, of a new asset; and their procurement needs, therefore, to address all these issues during the tendering process. Addressing these issues appropriately takes time. For instance, it will take many months to complete the detailed design development and obtain planning approval for the new asset. Additionally, agreeing how the PF2 project is going to be financed by a private sector partner will add further cost, complexity and time in procurement as financiers require time to conduct their own due diligence and to complete their separate financial negotiations."

HM Treasury (2012) *A new approach to public private partnerships*

4.2 High bid costs and long procurement timeframes

The UK shares Australia's experience that high bid costs and long procurement timeframes present a barrier to entry to infrastructure procurement under the PPP Model, and the absence of competition has added to bid costs and undermined value for money outcomes.

UK National Audit Office

In 2012, the UK Public Accounts Committee, commenting on a 2012 UK Audit Office report 'Equity investors in privately financed projects' said: "Under the standard PFI Model the deals have involved long procurements and high bidding costs. This has acted as a barrier to competition as only a small number of companies can afford to be regular bidders. High bidding costs have also added to the cost of projects."

"The PFI procurement process takes too long, costs too much and restricts the market. The time and cost involved do not serve investors or taxpayers well. The scale of procurement costs constitutes a barrier to market entry for financial investors such as pension funds and smaller contractors. Successful bidders recover their procurement costs in the contract price, which means the taxpayer foots the bill.

Those negotiating contracts for the public sector too often lack the appropriate commercial and financial skills. The growing emphasis on localism makes this skills problem worse as all too often inexperienced local bodies undertake complex negotiations with experienced private sector counterparts. The Treasury, in consultation with investors, should identify and address the sources of cost and delay in the procurement process. The Treasury should consider whether best value would be secured by greater centralisation of the procurement of PFI projects."

UK Public Accounts Committee (2012) Audit Office report: *Equity investors in privately financed projects*

United Kingdom HM Treasury

The UK HM Treasury made similar observations in its 2012 report: A new approach to public private partnerships stating "the PFI procurement process has often been slow and expensive for both the public and the private sector. This has led to increasing costs and has reduced value for money for the taxpayer." It believes that procurement timescales for PFI have been excessive and is committed to reducing the time and cost of procurement of PF2 projects going forward.

“Average PFI procurement timeframes, from initial tender to financial close, have stubbornly remained at around 35 months. This average, however, varied by sector; the average procurement time for schools was 22 months in 2008 whilst in sectors such as housing and waste procurement times have consistently been significantly longer.

The period from the initial project tender to the appointment of the preferred bidder is the most expensive phase of procurement, as this is when multiple bid teams are in competition. In the past, significant bid costs have been incurred by the private sector over this period which ultimately are borne by the public sector in the form of higher contract costs. On average this period took just under 2 years for past PFIs and in the worst PFI cases took over 60 months.”

HM Treasury (2012) *A new approach to public private partnerships*

European Investment Bank

The European Investment Bank examined the cost of projects in its report ‘Transaction costs in public-private partnerships: A first look at the evidence.’ “As regards the level of transaction costs in the procurement phase, it is estimated that total costs amount on average to well over 10 per cent of the capital value of the project. Transaction costs to the public sector and the winning bidder vary between countries (legal systems) and sectors, and they are significantly higher in small projects (below £25 million) and in projects that take (a) long (time) (over 50 months) to procure.”

“There are several reasons why transaction costs in PPPs would be high, especially compared to traditional procurement of public investment projects. The main sources of higher transaction costs in PPPs are their long-term character, ownership and financing structures, and risk-sharing features. Due to all these reasons, the degree of contractual incompleteness is high in the case of PPPs, and attempts to reduce that contractual incompleteness give rise to correspondingly high transaction costs. Consequently, the search (tendering and bidding), contracting, and monitoring processes become more resource-consuming than in traditional short-term contracting aimed to supply assets, rather than services, to the public sector. Negotiating the contract is especially costly, not least due to the high cost of advisory services, and such costs are not limited to the pre-delivery phase, as renegotiation is almost inevitable in contracts that stretch over decades.”

European Investment Bank: *Transaction costs in public-private partnerships: A first look at the evidence*

4.3 Short-term equity investors

While some initial equity investors are looking for a long-term investment, under the current model, most primary investors will sell their equity shares on the secondary market shortly after the asset has been delivered in order to realise a profit and recoup their investment.

A UK Audit Office report into the role of equity in PFI projects found that since the cash flow of a public private partnership project generally only provides investors with returns towards the end of the contract operations period, primary equity investors seek to accelerate returns by selling equity.¹⁰

Their analysis shows that “investors selling shares early have typically earned annualised returns between 15 and 30 per cent. In exceptional cases, returns have been higher (up to 60 per cent) or lower (5 per cent). These returns were mainly driven by the prices secondary investors were prepared to pay to invest in an

¹⁰ UK Audit Office (2012) Equity investment in privately financed projects

established project (and) inefficiencies in the initial pricing of equity will also have been a contributing factor.”

4.4 Long-term equity investors

The UK Government is keen to see more long-term investment by pension funds in infrastructure. It acknowledges that pension funds typically invest on a long-term basis to earn stable long-term returns to match their maturing liabilities i.e. payments to pension holders. Typically, these investors have invested in projects during the operational phase of a project (following a sell down by the original bid sponsors) so as not to be exposed to bidding and construction risks.

“The Government is keen to see more investors with longer-term investment horizons, such as pension funds, investing in projects at an earlier stage. These longer-term investors have tended, historically, not to invest directly in projects. In part, this is because they have not developed the in-house skills and resources to manage these investments, but also because they have been averse to the time, risk and cost of bidding for projects.”

HM Treasury (2012) *A new approach to public private partnerships*

“The Government will, therefore, implement a mechanism to provide an investment opportunity for these investors. Where appropriate, it will require an equity funding competition after the preferred bidder stage for a proportion of the equity requirement. The timing of such a competition, when project documentation and commercial and financial arrangements are substantially complete, will keep the costs of participation in the competition down and so meet concerns expressed by long-term equity providers. It is also expected that widening access to different types of investors could be expected to increase competitive tension, with downward pressure on equity pricing in the longer-term.”

HM Treasury (2012) *A new approach to public private partnerships*

5. The proposed ‘inverted bid model’

5.1 Unique features

Industry SuperFunds believe there is a better procurement process that meets both governments’ need for a competitive process, as well as investors’ risk/return appetite: the inverted bid model. This model would provide appropriate certainty and value for money outcome for governments, patrons and investors.

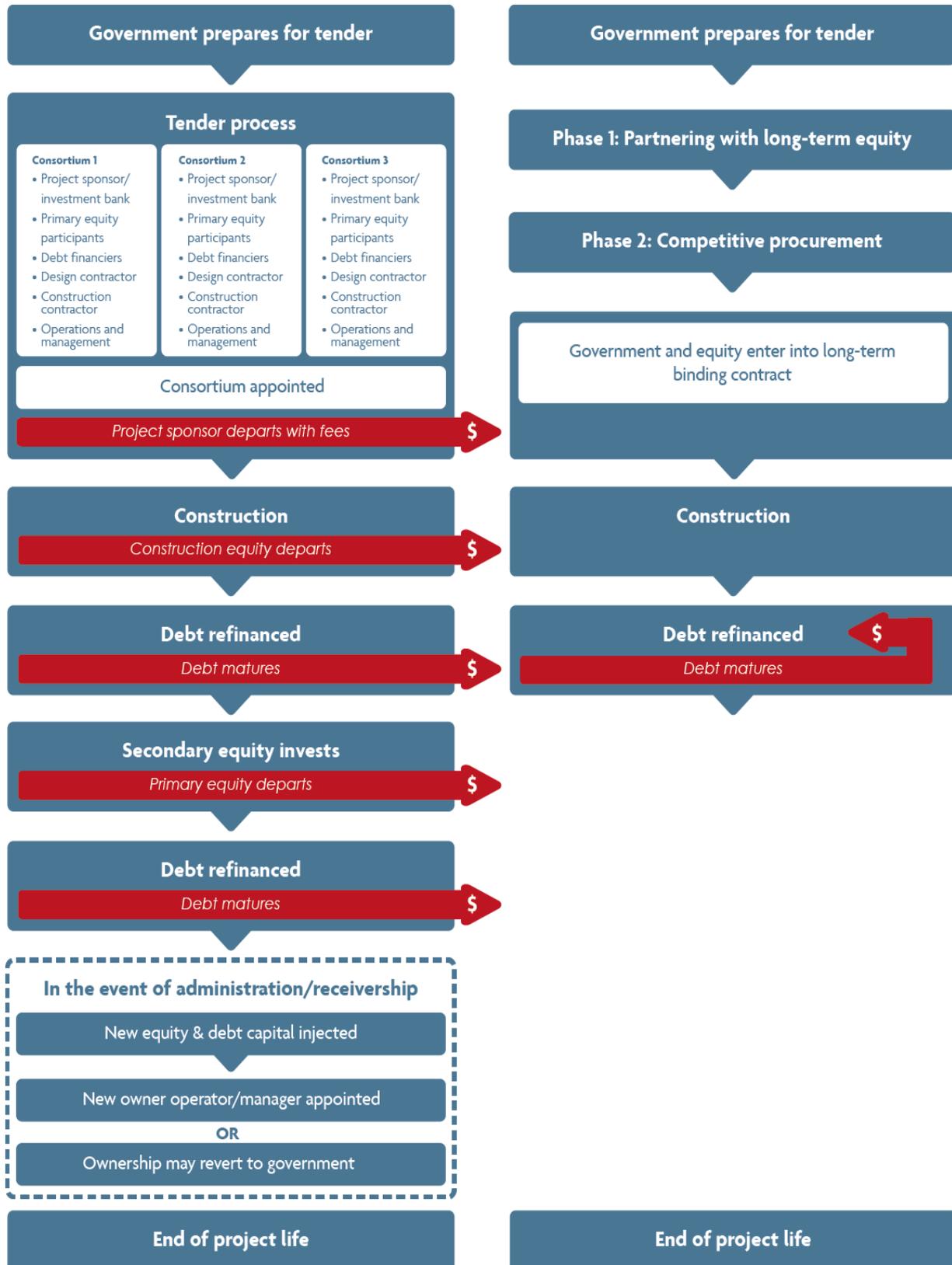
The two critical points of difference between the current bid process and the inverted bid model are:

- The bid process is reversed: financial terms are *fixed* upfront via a funding competition before separate tenders for construction, operation and maintenance and residual debt
- The process delivers government a long-term ‘open book’ equity partner who owns/operates an asset over its economic life and earns its returns through efficient asset management

Unlike the current procurement model, the inverted bid model creates a genuine life-time transparent partnership. Government and long-term equity investors are able to work through issues such as project design and risk allocation to the satisfaction of both parties, and maintain that open and co-operative relationship throughout the life of the project. Under the current procurement model – where all aspects of the project are fixed up-front – probity requirements make such an open partnership impossible and impractical.

Figure 5 shows the current and inverted bid model side by side: in particular the one phase versus two phase bid process and the ongoing project refinancing versus a single long-term equity partner. The operation of the inverted bid model is detailed in section 5.3.

Figure 5 – The current model versus the inverted bid model



5.2 The bid process

The procurement process for an equity partner under the inverted bid model would consist of two phases (Figure 6):

Phase 1: Indicative bids for appointment of preferred bidder

The government will invite long-term equity investors to prepare indicative bids against requirements in the proposed PPP contract. Bidders will submit their indicative internal rates of return (“IRR”) to build and operate the project for the duration of the concession. The government will assess the indicative bids and rates of return based on transparent criteria. In order to meet the best value-for-money outcome, the government will reserve the right to negotiate with one or more of the bidders at its absolute discretion. At the completion of Phase 1, the government will select the bid sponsor with the most competitive IRR as its preferred equity partner. If the government assesses the indicative bids as not meeting its benchmark, it will reserve the right to reject them, go to market or seek an alternative procurement method.

Phase 2: Detailed proposal by preferred bidder

Once the government has selected a bid sponsor as its preferred equity partner, the preferred bidder will put out competitive tenders for construction, operations and other services. Debt financing would be sourced under a book-build scenario. The preferred bidder and government will work in partnership to finalise all outstanding issues, and convert indicative bid terms into final and binding terms.

On completion of phase 2, government and long-term equity would negotiate a final binding offer. This stage will involve the preferred bidder entering into a binding PPP contract with the government, should the government agree with the final IRR. If the government assesses the final IRR (or other terms of the final offer) as not meeting its benchmark, it will reserve the right to reject it, go to market or seek an alternative procurement method.

In order to mitigate the risk of the bid return varying after the equity investor is appointed as the preferred bidder, the government can effectively ‘lock in’ the bid return by finalising engineering and detailed design sufficient to allow a detailed risk allocation *prior* to inviting equity investors to bid on the project. The preferred investor then puts out ‘open-book’ tenders for construction, operations and debt in partnership with the government, however, the project IRR is not subject to change. All subsequent project risks identified are borne in accordance with the agreed risk allocation. Any new risks would need to be dealt with using a pre-agreed mechanism.

5.3 Governance

Equity investors will establish and provide equity and debt finance to the Special Purpose Vehicle (“SPV”) that enters into the PPP contract with the relevant government agency.

During the bid stage, and prior to Financial Close:

The consortium will be led by a bid sponsor nominated by the equity investors. The bid sponsor will act on behalf of the equity investors to negotiate terms and conditions with the government, contractors and lenders. The bid sponsor will need to be an equity investor as noted in section 6.1.

Essentially, this is the same model as used by Industry SuperFunds and other equity investors to bid for the privatisation of Port Botany and Port Kembla in 2013. The consortium was led by IFM Investors and included AustralianSuper, Cbus, HESTA, HOSTPLUS and Tawreed Investments Limited, a wholly owned subsidiary of the Abu Dhabi Investment Authority. IFM Investors negotiated and finalised the terms of sale with the government, arranged debt and equity finance and oversaw the transition of the state-owned asset to private ownership, which included a transfer of employees and separation of services.

Whilst the consortium engaged a suite of commercial, legal and financial advisors to assist in the bid, it paid no advisory or underwriting fees to itself. This is an important distinction from investment bank and developer led bids, as noted in section 3.1.

Post Financial Close, and pre construction completion:

The SPV will be capitalised with debt and equity. Experienced directors will be appointed to the board, and a project management team will be employed to interface with contractors and oversee project delivery during the construction phase. The majority of board directors will be nominees of the equity investors, complemented by an independent chair or other independent directors who bring specific industry experience.

Post construction completion:

The board of directors may make changes to the board composition to complement its skill-set as the project enters its operational phase. Similarly, the management team will be resourced with staff knowledgeable in operating essential public infrastructure facilities and able to interface with service providers and other key stakeholders.

This model is already being used by Industry SuperFunds through IFM Investors for managing a suite of PPP projects in Victoria, New South Wales and Western Australia. The PPPs include the Southern Cross Station in Melbourne, the Defence Headquarters near Bungendore, NSW, the Perth CBD Courts Complex in WA and Axiom Education, a portfolio of nine primary and secondary schools, in NSW. AssetCo Management Pty, a company wholly owned by the Industry SuperFunds through IFM Investors, oversees the day-to-day operations and management of the PPPs over their concession period.

Figure 6 – The inverted bid model



5.4 Examples of value for money

There are a number of precedents in Victoria and NSW¹¹ that were unsolicited proposals but share the same characteristics of the inverted bid model, specifically where:

- The government and private sector worked together in partnership to jointly develop the scope, rate of return and indicative price
- Once agreed, equity issued competitive tenders for construction and operations and raised debt
- The government only accepted the final outcome if it met value-for-money criteria¹²

¹¹ IFM Investors (2014) Response to Draft Report, Productivity Commission, Public Infrastructure Inquiry

¹² IFM Investors (2014) Response to Draft Report, Productivity Commission, Public Infrastructure Inquiry

The success of these precedents demonstrates that early involvement of an equity partner *can* deliver innovative, value-for-money outcomes to governments.

Tullamarine Calder Interchange and M1 Upgrade

The Victorian Government funded the delivery of two freeway upgrade projects, the Tullamarine Calder Interchange (“TCI”) project and the M1 upgrade, through partnership with an incumbent, Transurban, rather than through a transaction with a third party via a tender process.

The Victorian Auditor General examined the partnership arrangements in December 2007 and reported that the “benchmarking analysis provided relevant and reliable evidence that better value was likely to be obtained through a transaction with Transurban, rather than a third party.”¹³

A more recent report by the Victorian Auditor General noted that the TCI project “had been effectively managed and is delivering the expected benefits to date. Overall, the audit found that the interchange had been delivered on time and under budget, with initial indications that the TCI has achieved expected functionality.”¹⁴

M5 West Widening

The NSW Government worked in partnership with the incumbent, Interlink Roads, part-owned by IFM Investors, to design, finance, construct and operate the M5 West Widening project, which commenced in August 2012. When completed, the project will increase capacity by 50 per cent along the corridor, accommodate more traffic and reduce travel time for motorists using the motorway and surrounding roads.

M1 to M2

The NSW Government negotiated the delivery of the M1 to M2 project, now known as NorthConnex, through the development of an unsolicited proposal by Transurban.

Transurban approached the NSW Government in 2012 under the Government’s unsolicited proposal regime to design, finance, construct and operate the link. In May 2013, the proposal moved to its final stage, which involved negotiation between the parties and Transurban submitting a final binding offer.

The early involvement of a sponsor led to a fast-tracked timeframe and turn around, reduced cost for tenderers, and a design solution that meets or exceeds government’s requirements.¹⁵

6. Benefits

6.1 Well aligned partnership

The fundamental issue under the current PPP model is that short-term bidders are building long-term infrastructure. We believe that the overarching benefit of introducing the inverted bid model is that it will reduce the risk of failed investments by correcting the misalignment between short-term bidders and equity. More infrastructure equity investors will be encouraged to enter the greenfield PPP market, and governments will benefit from greater competition, much reduced fee leakage and a better value for money outcome.

If developers, contractors and investment banks wish to bid, they must bring meaningful balance sheet equity to invest, for example 25 per cent or more of the total equity required for the project, and be restricted in selling down that equity for a meaningful period of time after construction and only with government consent. All purchasers would need to meet the same criteria as the original bid sponsors.

¹³ Funding and Delivery of Two Freeway Upgrade Projects, December 2007, Victorian Auditor General

¹⁴ Managing Traffic Congestion, April 2013, Victorian Auditor General

¹⁵ Media release, 16 March 2014, Transurban

The reform will ensure that infrastructure is built, owned and operated by genuine long-term investors seeking to make a reasonable return over the economic life of the asset, not through the initial bidding, structuring and building of the asset.

6.2 Faster procurement and lower bid costs

The inverted bid model is expected to reduce project procurement timeframes and lower bid costs due to the following reasons:

- The inverted bid model expects to avoid unnecessary bureaucracy and reduce the time between decision making, action and completion
- In traditional, fully financed bids, bid costs and legal and advisory costs are duplicated across multiple government departments and multiple bidding groups – this does not represent good value for taxpayers
- The model increases the pool of contractors available to the preferred bid sponsor
- The model also enables construction contractors to tender based upon more precise project specifications, leading to reduced tender costs

Preliminary analysis suggests bid costs for phase 1 are estimated to fall from 1.5 per cent¹⁶ to 0.8 per cent (0.3 per cent for phase 1¹⁷ and the industry standard best practice 0.5 per cent for phase 2¹⁸). Procurement timeframes are expected to be compressed by 30 per cent from an average of 17¹⁹ to 12 months.²⁰

6.3 Lower financing costs

In an inverted bid model, the preferred bidder will have access to a greater number of banks than would a bidder in a competitive bid. In a competitive bid, large banks typically run multiple teams to cater to multiple bidders, however, smaller banks unable to run multiple teams are only available to a single bidder. In an inverted bid model, the entire pool of banks, large and small, will be available to the preferred bidder. Based on market soundings, we believe that the greater availability of bank capacity is likely to improve liquidity and lead to more competitively priced fees and margins than may otherwise be the case. Banks are also likely to be more responsive when there is bidder certainty.

6.4 Greater innovation

The inverted bid model allows the long-term investor the opportunity to explore the most innovative ways to design, deliver, operate and finance infrastructure projects. We believe long-term investors have the most to lose and their participation stimulates greater innovation than current bid processes where innovation is promised by advisor-led consortiums.

¹⁶ KPMG (2010) PPP Procurement review of the barriers to entry and efficiency in the procurement of PPP projects

¹⁷ Estimates provided by Complex Program Group excluding cost planner estimates which were provided by Aquentia Consulting (formerly Curry and Brown) and design estimate which is based on the Association for the Advancement of Cost Engineering (2012) Recommended Practice

¹⁸ Engineer project organisers conference (2011) The cost of tendering

¹⁹ KPMG (2010) PPP Procurement review of the barriers to entry and efficiency in the procurement of PPP projects

²⁰ Estimate provided by Complex Program Group based on Infrastructure Australia (2012) Efficiencies in major project procurement

6.5 No fees

Under the inverted bid model, long-term equity investors, including superannuation funds, are not paid *any* transaction, advisory or other fees of any kind – they earn their returns through the management of a project over its lifetime.

6.6 Transparency

The inverted bid model is an ‘open book’ partnership between government and their long-term equity partners based on open competition and complete transparency throughout the course of the project. All stages of the inverted bid process are subject to transparent, interactive and competitive tendering including the funding competition and competitive tenders for design and construction, operation and maintenance and residual debt.

6.7 Better value for money

The inverted bid model is designed to deliver value for money for government, taxpayers and long-term equity in the following ways:

- In the absence of short-term interests and intermediaries, it will address the leakage of tens of millions of dollars in fees during the early stages of a project
- Open, competitive, transparent and interactive tendering for all aspects of the project including finance, design, construction, operation and maintenance
- Separation of tenders means the most capable and best value contractors can be selected because they are not tied to any individual consortium
- The development of risk allocation in partnership between government and equity underpins the design, construction, operation and management of the asset over its lifetime

7. Conclusion

The inverted bid model is based on market-tested, best of breed precedents to provide better value for money outcomes for governments. In this model, those asked to take the greatest risk are also responsible for pricing that risk. The current system is imperfect in this regard: in this current model, short-term bidders build long-term infrastructure. Bid decisions are made for pools of investor equity, often superannuation money, by advisors who rely on investor capital deployment to realise their own fee revenues. This misalignment of investor and advisor motives leads to the inappropriate pricing of risk, and if this persists, many of Australia’s largest infrastructure investors will continue to ‘sit-out’ of the PPP greenfield market and the value for money outcome will be less than optimal.

At a time when governments across Australia want superannuation funds to deploy greater amounts of capital into infrastructure, the inverted bid model provides an opportunity to rectify the current system, eliminate fee leakage and introduce a framework that can safeguard the retirement savings of working Australians in building their country’s infrastructure.