INFRASTRUCTURE FINANCING SOURCES AND TRENDS:

AN INVESTOR'S PERSPECTIVE

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Structure of Presentation

1. Background
2. Private sector role
3. Risk allocation
4. Contract structure
5. Financing structures
6. Debt
7. Equity
8. Cost of Capital
9. Benefits of private financing
10. Valuing infrastructure
11. Conclusion

Infrastructure needs

- Structural decline in public sector investment in infrastructure over long time period
  - Greater priority to recurrent expenditure on social services – education, health, welfare
  - Debt reduction/consolidation from early 1990's
- Drivers for increased infrastructure/investment
  - Population and economic growth
  - Ageing assets need upgrading and/or replacement
  - Technological advances
- Widespread public recognition of the need for enhanced infrastructure investment

Governments have run out of money for infrastructure investment

Traditional government funding sources

- General pool of tax revenue (Commonwealth, State and local)
- Specific user charges
  - Fare box revenue – rail, bus, ferries
  - Tolls on roads, bridges, tunnels
  - Port charges, electricity and water charges
- Government borrowings
  - Need to be serviced from tax revenue

No “Magic Pudding”

Private sector role in infrastructure investment

- Government resources limited
  - Competing demands for additional expenditure
- Emphasis on service delivery rather than asset ownership and management
  - Does the public sector need to own assets to deliver services?
- History of public sector over-runs in delivering infrastructure
- Successful private sector projects interstate and overseas
- Leveraging private sector skills, expertise, experience to complement public sector

What makes infrastructure attractive to private sector investors

- Long term assets
- Predictable long term cashflows
- Most have sustainable competitive advantage
- Backbone to economy and industrial development
- Financial optimisation can add substantial value

Infrastructure assets

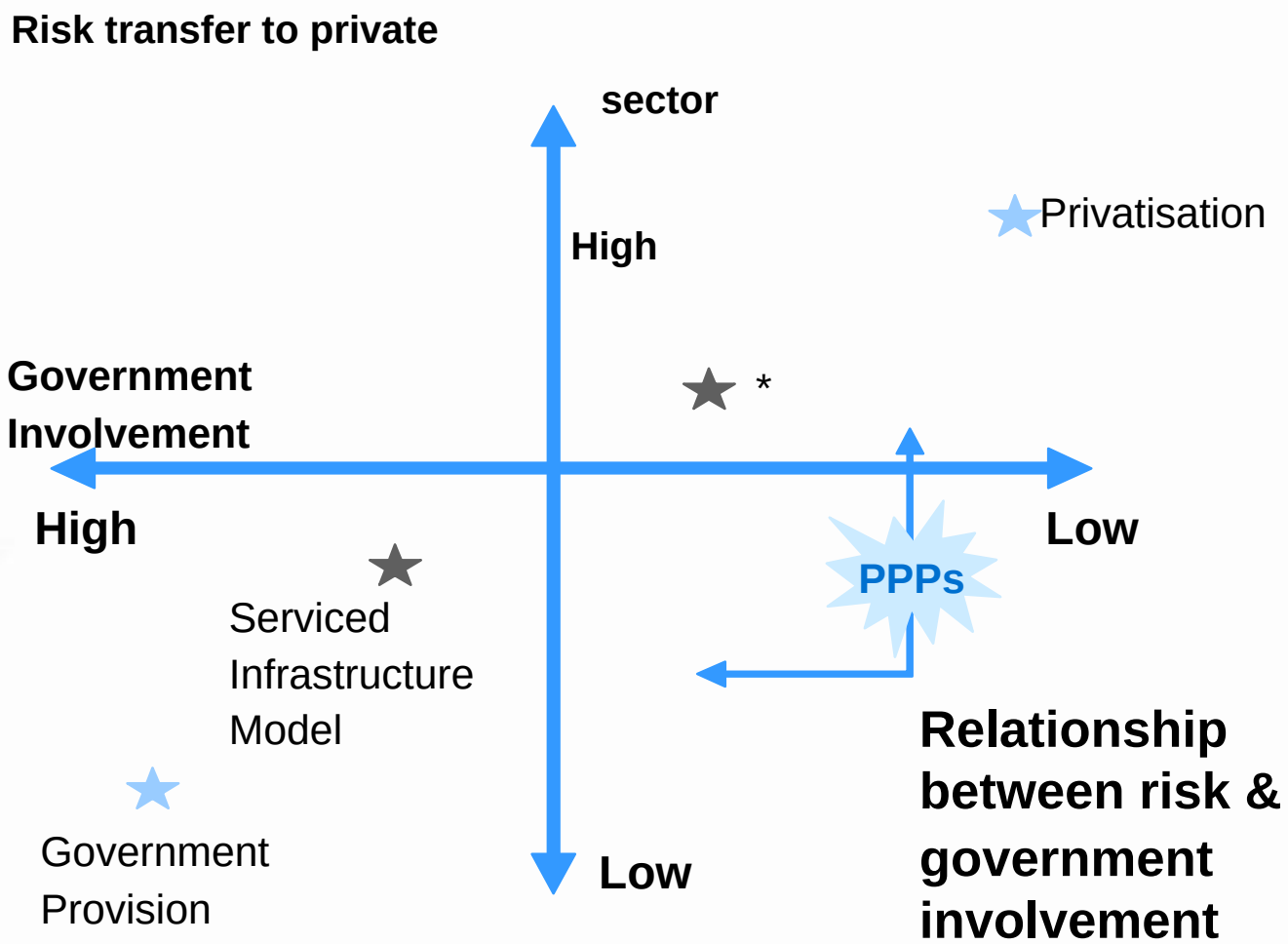
Commodity Risk	Regulated Assets	Patronage Assets	Social Infrastructure
Power Generation	Electricity Transmission & Distribution Gas Pipelines	Toll Roads Toll Bridges Rail Telecom	Hospitals Schools Prisons

Airports

Seaports

Water & Sewerage Treatment

Models for infrastructure delivery



* : build own operate transfer project

Risk Allocation

Optimal Risk Allocation

Risks allocated to party best placed to manage them

(at lowest cost)

Private Sector	Shared	Public Sector
• Construction • Patronage • Operations • Maintenance • Network/interface • Taxation and financing • General change in law • Force majeure	• Discriminatory legislative or regulatory changes • Planning • Interest rate risk	• Site availability • Changes in scope or requirements • Technological change • Residual value (?)

Risk allocation can change due to market dynamics

Transfer of risks to private sector on toll road projects in Australia

Project	Year Risk	Construction	Traffic Volume	Tax Risk	Financial Risk	Network Risk	Force Majeure
Gateway Bridge	1985	Shared					X
Harbour Tunnel	1986		X	Shared	Shared		X
M4 Motorway Upgrade	1990				Shared		X
M5 Motorway	1992				Shared		X
M2 Motorway	1994					Shared	Shared
Melbourne City Link	1995					Shared	Shared
Eastern Distributor	1997						
Cross City Tunnel	2002						
Western Sydney Orbital	2003						
Lane Cove	2003						
Mitcham – Frankston Freeway	2004						
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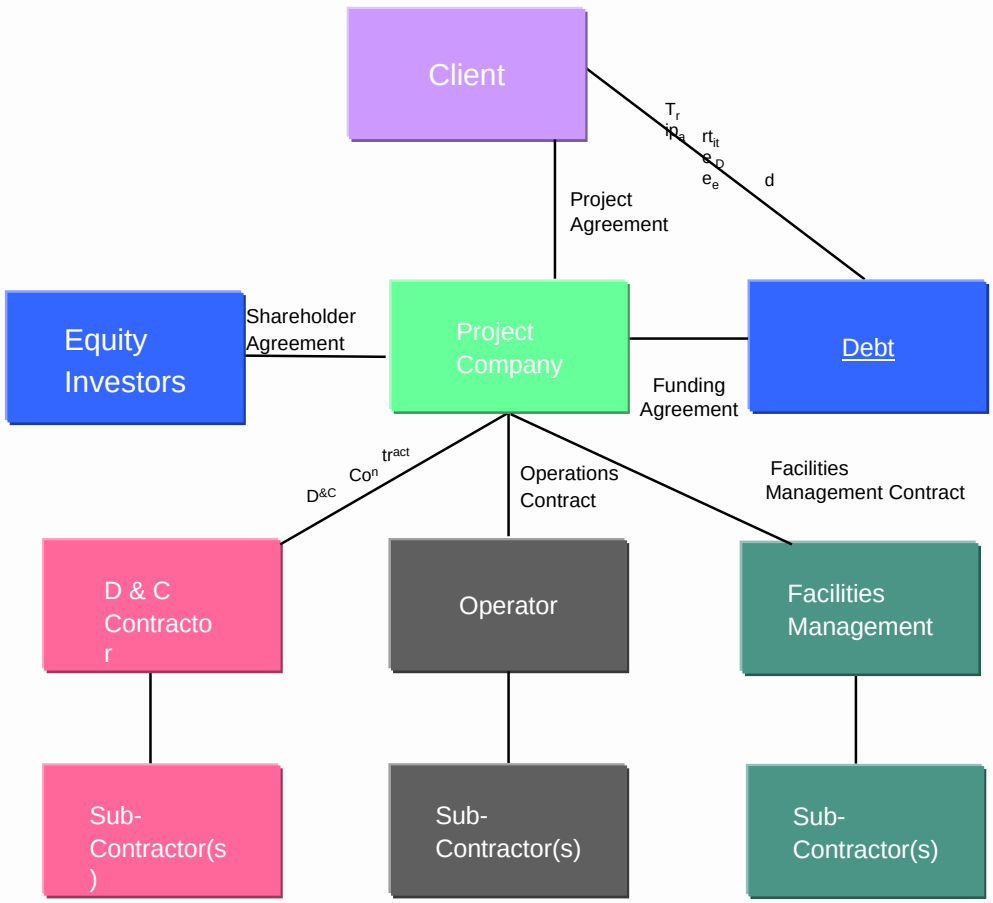
Illustrative Contract Structure



Roles Financiers Play

- Potential roles
  - Government financial adviser
  - Financial adviser to bidding consortia
  - Financier (debt and equity arranger and/or underwriter)
  - Sponsor

- Large number of financiers pursuing PPPs
  - Most acting purely as financiers
  - Some pursuing multiple roles
    - e.g. Macquarie, ABN Amro, Babcock & Brown, Plenary
  - Major Australian banks looking at sponsor roles
    - e.g. Westpac/Hastings, ANZ Infrastructure Services

Financing – The “Black Box”

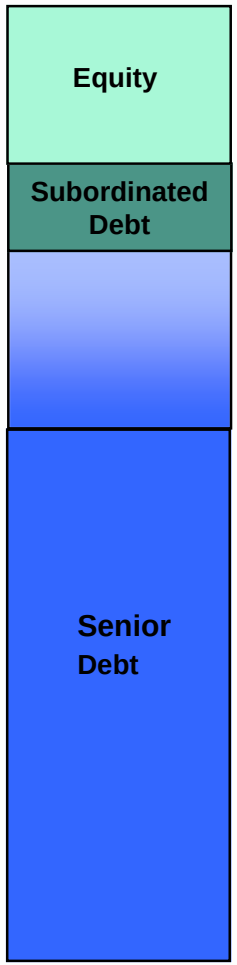
- Financial adviser’s key roles:
  - Financing modeling
  - Advising on the funding requirement

- What does the SPV need to raise today, or in the future, to meet its obligations
  - How will the payment stream (e.g. from Government) be applied to repay the funding raised
  - Sources for funding
  - Competitiveness of funding cost
  - How it can be raised
  - Develop financing structure
  - Assist financiers in analysing risk
  - Supervising due diligence processes

Key issues for debt and equity markets

- Capital value and nature of underlying asset
- Size and length of contract
- Asset provision and service delivery
- Contract structure
- Risk transfer and accounting treatment
- Management of affected parties
- Third party revenues
- Asset ownership at contract completion and residual value

Typical private financing structure

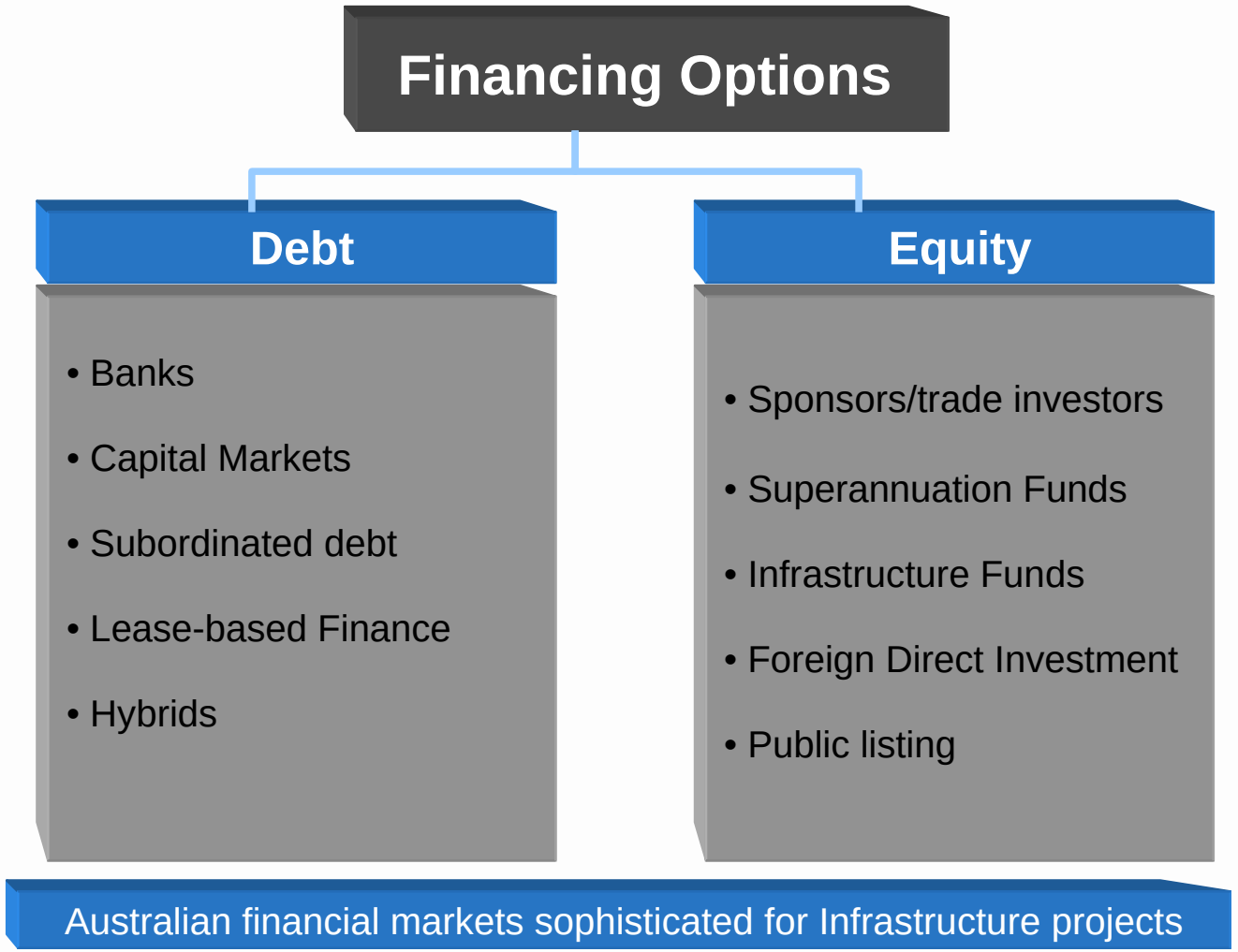


90%

60%

- Projects financed individually
  - ➢Project companies funded by non-recourse debt and equity
- 60-90% gearing typically through bank debt or capital market bonds, with term closely matching the life of the long-term contract (or with refinancing assumption) Restrictive covenants common, for example:
  - ➢6 month debt service reserve and capex reserve
  - ➢DSCR: 1.2 - 1.5 times
  - ➢No further senior debt borrowings allowed
- Strong credit ratings possible due to long term contracts and secure cash flows
- Gearing becoming more conservative in current environment

Financing options



Debt Funding

- Major source of infrastructure funding with many PPP projects geared 60 – 70% for, 80 – 90% for Serviced Infrastructure

- Advantages:
  - Tax deductibility of interest payments
  - Fixed returns
  - Stronger security position
  - Cost of debt is cheaper than equity

- Disadvantages:
  - Not able to capture up-side potential
  - Over-gearing may cause distress (ie bankruptcy)

- Factors such as availability of funds, external constraints, level of government support etc will largely determine the debt to equity mix

Debt wants to ensure it gets its money back ➡ focus on downside risks

Bank Debt

- Traditional primary source of project debt funding
- Flexible repayment schedules (compared to Capital Markets)
- Historically reluctant to exceed 80% gearing or 15 - 20 year terms
- Competition from Capital Markets and international banks have seen banks offer more competitive terms
  - Up to 90% gearing
  - 25+ year term
  - Margins – 75-250 basis points above swap
- Terms of debt depend on quality of project cash flows

Capital Market Debt

- Increasingly used to fund large infrastructure projects
- Bond structure chosen to best match project cash flows
- Wide variety of capital market debt instruments including:
  - Corporate Bonds
  - Infrastructure Debt
  - Inflation Indexed Bonds (CPI Bonds)
  - Zero Coupon Bonds
- Commercial Paper and Medium Term Notes
- Subordinated Debt

Bank debt vs bonds

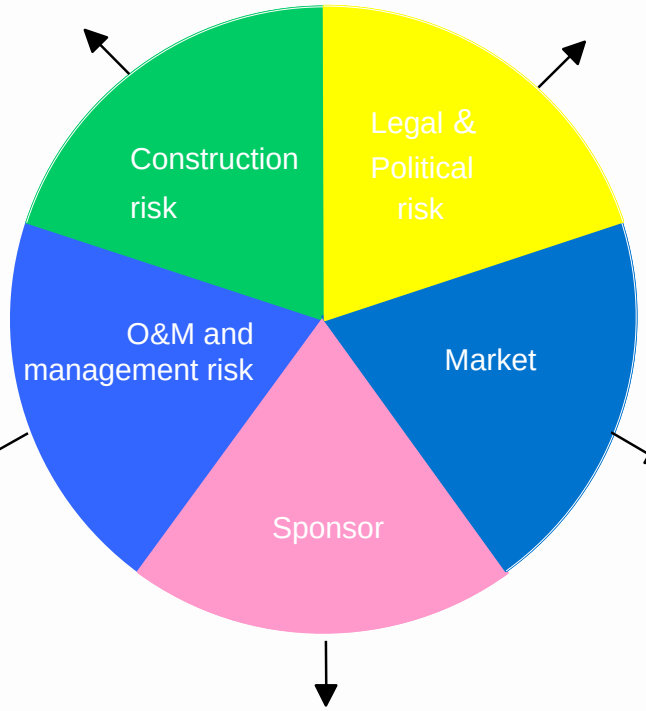
Factor	Bank Debt	Bonds
Size of Project	Suitable for big projects More flexible on smaller projects i.e. below $50-100m	Suitable for big projects Not as flexible for small projects I.e. $50-100m
Maturity	Typically between 15 and 20 years but increasing in tenor due to competitive pressure of other funding mechanisms i.e. bonds	Tenor up to 35 years Suitable for longer concession periods
Pricing	Driven by swap market demand and supply Competitive tension between banks has reduced margins	Driven by gild yields and corporate bond spreads reflecting investor's appetite for different credit risks Rating and pricing can be enhanced with monoline insurance
Deliverability	Generally considered more deliverable than bond finance Cost of bank finance likely to vary (in line with bonds) due to market conditions as reflected in the swap market	Amount raised dependent upon market conditions except if monoline wrapped. If not wrapped, certainty of pricing is an issue
Flexibility	Generally more flexible than bond finance. Usually accept construction risk Willing to deal with minor variations, debt re-scheduling to full scale refinancings	Less accommodating than bank finance on variations Usually bondholders do not accept construction risk though this risk is slowly starting to be accepted

Debt Financier's Project Risk Assessment

On time and on budget

Certainty of PPP mandate

Impact of adverse regulatory outcomes



Longevity of the key contracts, subcontracts of key responsibilities and obligations

Industry/business analysis

Competition from alternate assets or service providers

Ramp up period

Downside volume and usage risk

Risk profiles of the sponsors, credit rating

Equity funding

- Securing equity is one of the most difficult tasks for infrastructure projects

- Equity receives returns over full concession term, so incentivised to:
  - Take whole-of-life view (cost optimisation)
  - Ensure project operates successfully (including effective management of sub-contractors)

- Issues for equity investors
  - Upfront or deferred contributions
  - Returns
  - Tax treatment
  - Liquidity/exit strategies

Equity is driven by scope for higher returns → focus on upside potential

Sources of Equity

Sponsors/Trade Investors

- Companies involved in development or operation of project

e.g. construction, engineering, operation and maintenance companies

- Generally more interested in securing roles in their core competencies
- May accept a lower IRR then institutional investors to secure other roles in project added familiarity and comfort with project

Superannuation and specialised Infrastructure funds

- Matches liability profile: long term, predictable/stable returns
- Can usually invest around 10 – 20% of project value
- Generally require a post-tax IRR of 10 – 25% depending on characteristics of project

Sources of Equity (cont…)

Foreign direct investment

- Emergence of sovereign wealth funds and other international/regional development funds
- Can have strategic objectives for investing
- May have trade/aid objectives

Listed Equity

- See next page

Equity markets broader and deeper than debt, but many projects competing for equity funds

Unlisted vs listed Equity

Unlisted	Listed
Lower volatility	Higher short term volatility – linked to underlying market conditions
Predictable yields	Less predicable – subject to market conditions
Greater management control	Less direct control
Greater flexibility in reporting	Subject to listing requirements
Less liquidity	Greater liquidity
Low correlation to bond yields/equities	Greater correlation to bond yields/equities

Recent trends in financial markets

Re-pricing of risks

Debt

- Margins increasing
- Tenor reducing
- Availability limited (credit crunch)
- More restrictive covenants
- Focus on downside ("bank") case/risks

Equity

- Appetite for infrastructure investments
- Higher equity risk premium
- Base case assumptions more conservative

GOOD PROJECTS WILL STILL ATTRACT FUNDING

Evolution of funding mechanisms for toll roads in Australia

Project	Year	Funding Mechanism
Sydney Harbour Tunnel	1986	Government Guarantee
M4 Motorway Upgrade	1990	Bank Debt / Existing Motorway
M5 Motorway	1992	Bank Debt, Government, Contractor
M2 Motorway	1994	Listed Equity, CPI Bonds, Bank Debt
Melbourne City Link	1995	Listed Equity, CPI Bonds, Bank Debt, Infrastructure Bonds
Eastern Distributor	1997	CPI Bonds, Bank Debt, Infrastructure Bonds, Subordinated Debt
Cross City Tunnel	2002	Private Equity, Bank Debt – bullet facilities
Western Sydney Orbital	2003	Private Equity, Bank Debt, Equity Bridge Facility, Construction Loan Notes
Lane Cove	2003	Private Equity, Credit wrapped bonds
Mitcham Frankston Freeway	2004	IPO, Private Equity, Bank Debt
NSBT	2006	IPO, Private Equity, Bank Debt
Airport Link	2008	IPO, Private equity, Bank debt

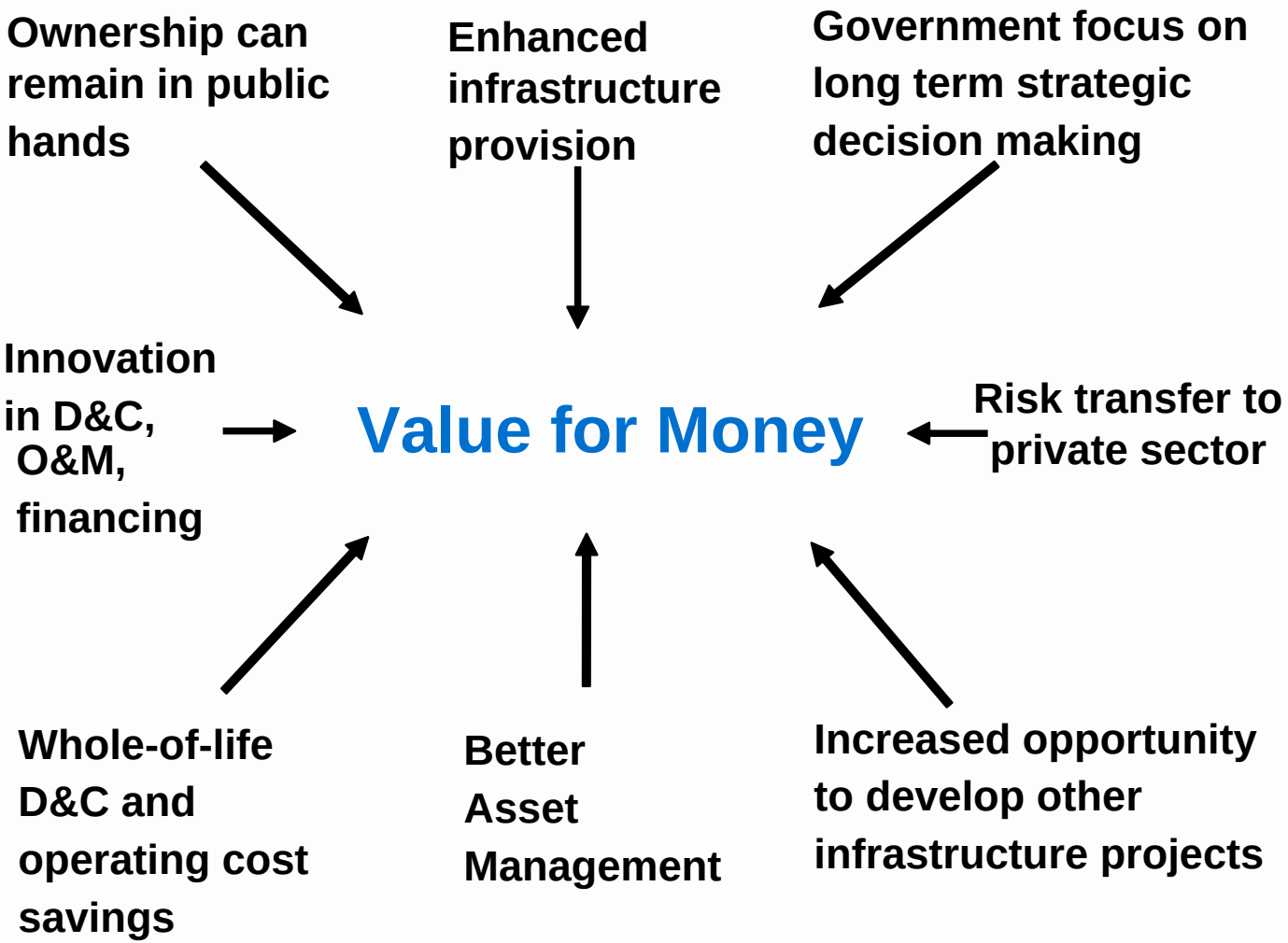
Cost of capital

Why use private funding, when government's borrowing cost is lower?

- All projects have risks – whether delivered by public or private sector
- Government's risk-free borrowing is a misleading benchmark
- Need to make "like-with-like" comparison of risks and costs
- Public sector risk on projects often "lost"in government balance sheet
- Government's risk-adjusted cost of capital not necessarily lower

Cost of not properly accounting for risk is borne by taxpayers rather than investors

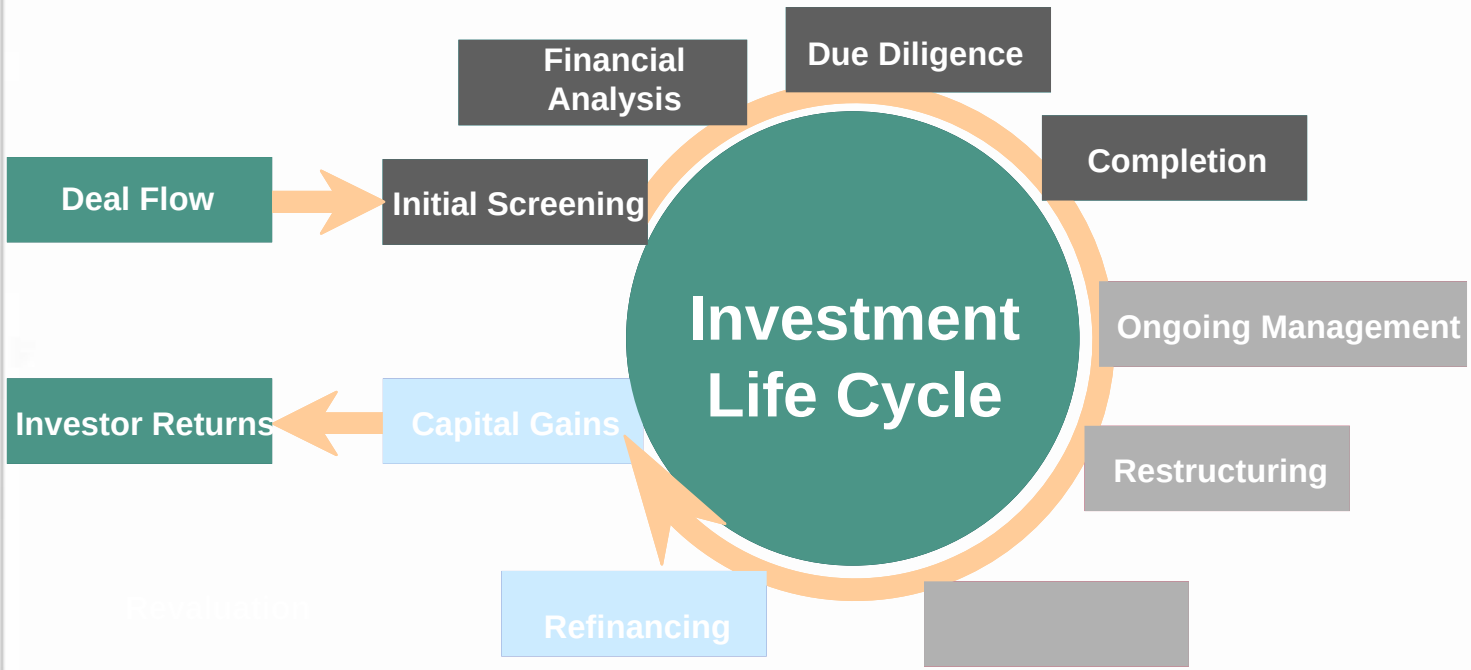
Benefits for Government/taxpayers



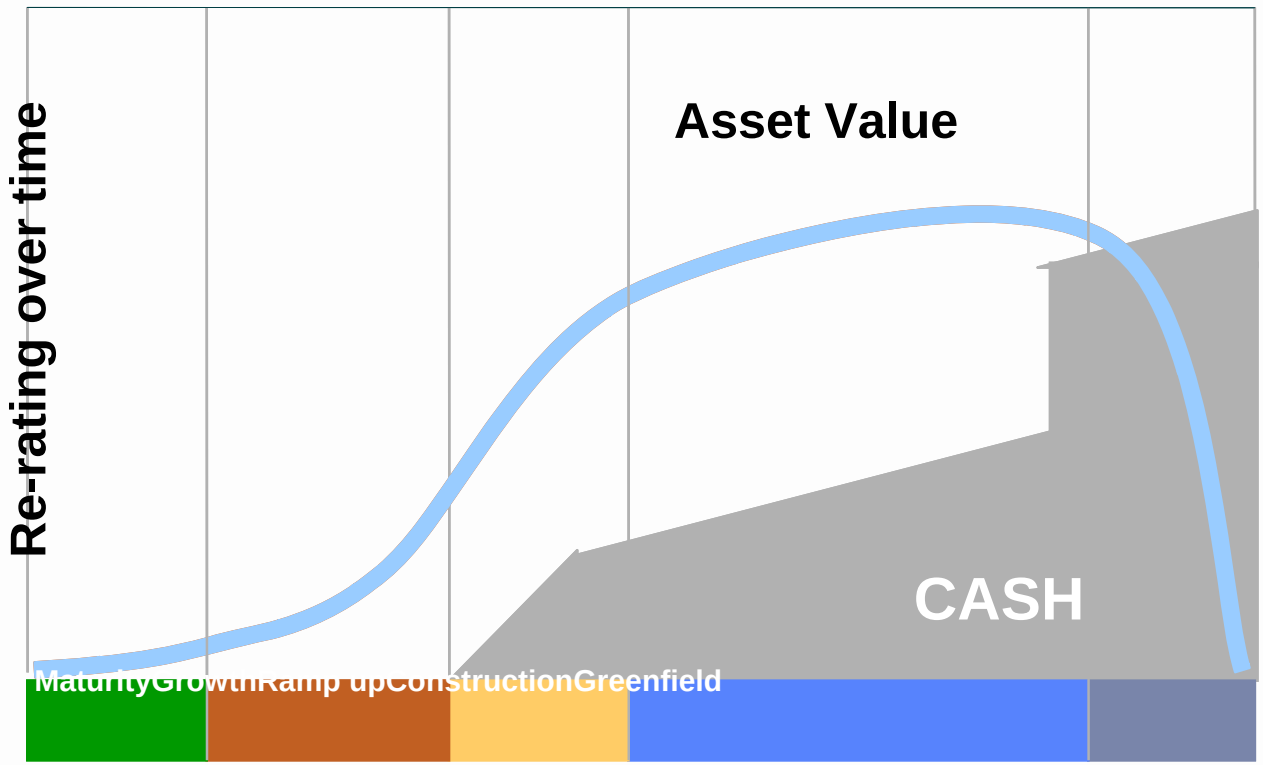
Valuing infrastructure

- Very different from usual company valuation.
- Industrial companies valued on yield and accounting earnings growth.
- Infrastructure assets best valued on:
  - Internal rate of return (IRR) or. net present value (NPV) basis.
- WHY?
  - infrastructure assets have very high growth in dividends.
  - over time, a reduction in the level of risk in the project.
  - accounting results do not allow for time value of money.
- Difficult to capture the value of these two points in yield valuation.
- IRR/NPV valuation takes into account the value of future cashflows

Value changes as assets become more established…



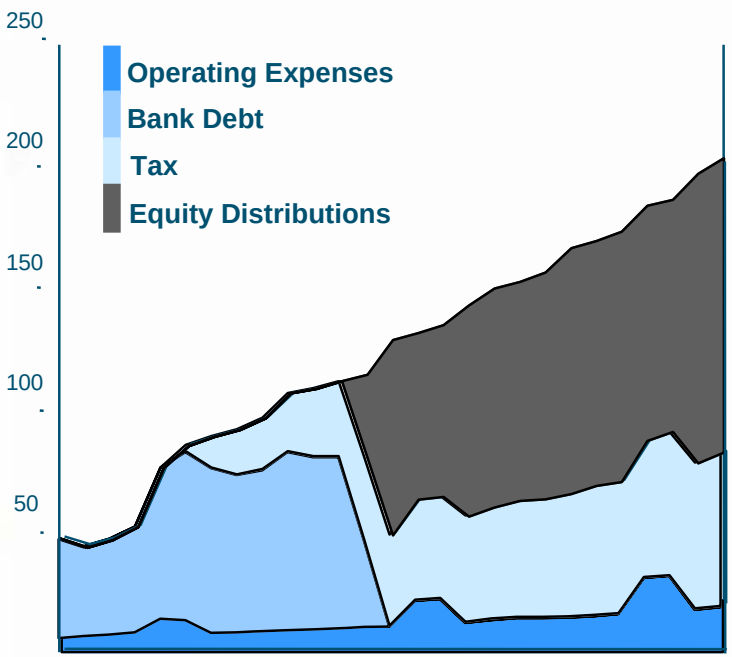
…and more cash is available for distribution



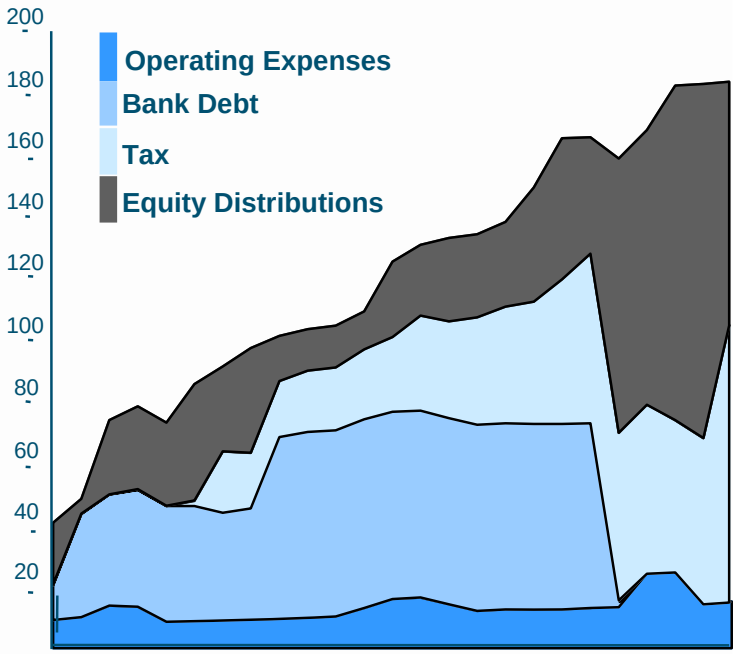
Changes in the value proposition

- Refinancing can add substantial value to equity investors.
- Interlink Roads (M5, Sydney) refinancing

Before



After



Changing risk profile – roads

Construction

Risks

Construction Time

Construction Costs

Initial Traffic

Ramp Up Rate

Natural Traffic Level

Risk Premium

6 – 8%

Ramp Up

Risks

Ramp Up Rate

Natural Traffic Level

Risk Premium

3 – 5%

Full Operations

Risks

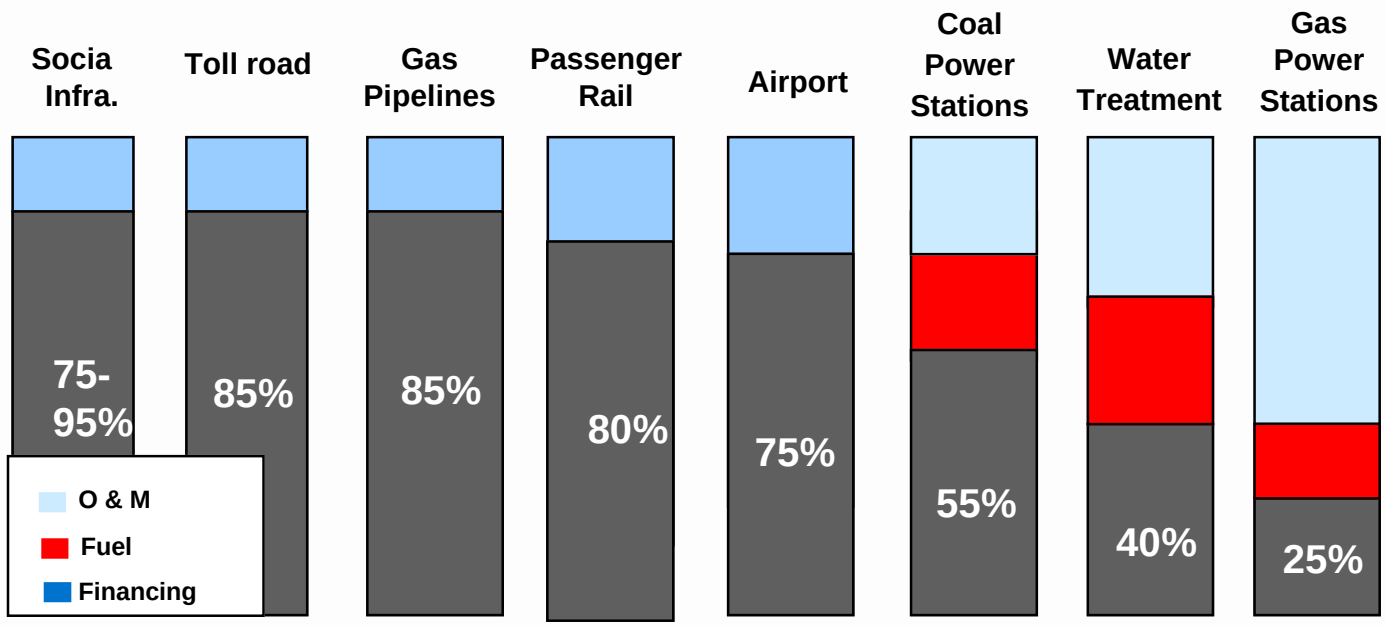
Impacts on Traffic

Risk Premium

1 - 2%

Assets increase in value as they mature

Importance of Financing



- On PPP transactions:
  - Capital component tends to be the largest cost component
  - Financiers have most funds at risk
- Significant impact on value proposition to government
- Financial optimisation can add substantial value to equity investors

Conclusions

- Private financing offers an alternative/additional source of capital
  - Government funding always under pressure
  - Expansion of infrastructure delivery
- Private financing drives different behaviours

•Financier discipline **•Investor scrutiny**	⟺	**•Cost /Time savings** **• Risk Management** **• Innovation** **•Efficiency in ownership/management**

- Current market conditions have changed dynamics
  - Higher funding costs
  - Re-pricing of risk
  - Availability of funds more limited
  - Closer scrutiny of project viability