A POWERFUL PERSPECTIVE

INFRASTRUCTURE WORKING GROUP

SUMMARY OF DISCUSSIONS
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Summary of Discussions

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The gap between the amount invested in critical areas of infrastructure and the global need is well-known and often discussed, yet there has been slow progress toward bridging the difference. By some estimates, this gap could be as high as $1-3 trillion dollars annually just to support currently expected rates of growth. The impact of failing to address the most crucial areas – transportation, power supply generation and transmission, and water treatment – will have global consequences, stifling markets and eroding future growth potential and productivity.

With this as context, the Pacific Pension & Investment Institute (PPI), a U.S.-based, non-profit organization with a global network of pension and sovereign fund managers, endowments, consultants, asset managers and subject matter experts, convened on October 25, a group of 30 members and influential stakeholders for the first of what will be a series of discussions that aims to:

a) understand the roles, barriers and risks as viewed by project sponsors, asset owners, developers and investors in the current infrastructure investment environment;
b) support relevant investment platforms, whether currently in place or newly structured;
c) unify a number of the fragmented approaches to the issues; and
d) develop a set of recommendations that will be made available to PPI.

Joseph Cherian, practice professor of Finance and Director, Center for Asset Management Research Institute, National University of Singapore, served as moderator. *(In traditional PPI fashion, the working group discussions were subject to the Chatham House Rule, that states that all comments are not for attribution.)*

The working group, meeting on the margins of PPI's executive seminar and roundtable programming in Hong Kong, had only 90 minutes to discuss a broad number of critical issues. Some key questions were posed that need to be answered to move forward the conversation on solving the infrastructure funding gap:

- What do fund managers require?
- What do investors require from governments?
- What is the role of multilateral development banks and agencies?
- What additional information do investors need?

This point in history represents a tremendous opportunity for further investments into infrastructure in much-needed parts of the world. Every government now recognizes that efficient infrastructure is an extremely productive way to utilize resources, providing economic and as well as social goods for billions in need. There has been a growing understanding that short-termism is indeed a detriment to societies around the world and that a shift is needed.

The current zero interest rate environment is putting added pressure on investors to think long-term, and to look further afield for returns. Financial institutions currently represent huge pools of capital – money that in many cases could productively be put to work in a way that would contribute to meeting the return expectations of institutional investors. Many of these investors in developed countries are facing unfavorable demographics, adding an extra burden for pension funds to meet return targets. A sense of urgency must be instilled as these conditions may not last for long.

Progress has been made in building the capacity for investing in infrastructure in recent years, but far too little has been done up to this point. Many still see the limitation with the pipeline. New approaches are needed to expand the universe of investible propositions, and organizations from different sectors must work together collaboratively and engage the private sector upfront and early. This is especially true for PPPs in greenfield infrastructure projects; there are not enough projects in the pipeline.

Many, but by no means all, governments feel uncomfortable and tentative with PPPs in general. They are not convinced as to the best procurement method; more education is needed, including robust academic case studies of what has worked in the past, and what has not. Within these PPPs, there needs to be further alignment of incentives; the actors must be true partners. Right now, the mismatch arises from the typical timeframe of the public and private entities. Many infrastructure projects require 25 years to reach maturity; private capital will often look for an exit after only 6-7 years. Further alignment is needed – and if there are hurdles along the way the parties must commit to working around them together instead of seeking an exit strategy.

Financing is only a part of the problem. Funding, the fundamental question of who pays – the consumer or the procuring authority – is also vital. Perhaps more critical is the need to break the bottleneck upstream and to ensure that a pipeline of well prepared and financeable projects are available to investors. Existing projects are getting stuck because they have been poorly prepared, and many never even get to the financing stage. One only has to look at the lists of projects awaiting financing which have not changed in years as evidence of this fact. This is further exacerbated by new projects not being added to the pipeline in a timely manner. It has become clear that governments do not have the capacity and skill to be able to do this at scale. If one aggregates the list of projects from all Asian countries today; it will only fill at best 20% of the infrastructure gap.

Both the public and private sector (including financiers) need to fundamentally change how they prepare infra projects. The public sector needs to take on the risk that only they can manage, like in the Delhi-Mumbai Industrial Corridor, create special purpose vehicles that are responsible for all land acquisition, licensing, etc. The public sector should only put such projects into the market once these have been secured.

The private sector needs to be much more proactive and move upstream to help prepare projects. In return, the public sector needs to create incentives to encourage this, e.g. leverage Swiss auction rules where proactive bidders get first right of refusal on projects, or create funds whereby winning bidders of projects need to contribute 0.5-1% of project value towards funding future project preparation.

Additionally, financiers too need to change by supporting the funding of project preparation and enhance their willingness to finance greenfield projects that have been "de-risked".

What is the Role of Multilateral Development Banks, Bilateral Development Finance Institutions, and other Third Parties – Asian Development Bank, Asian Infrastructure Investment Bank, International Finance Corporation, United Nations' divisions, Non-Governmental Organizations?

One topic that was discussed extensively was the role of multilateral development banks (MDBs) and Development Finance Institutions (DFIs) in infrastructure investing. MDBs and DFIs are currently facing a big shift; investors insist that there is a need to follow more of a commercial model; as regulatory regimes restrict use of capital by commercial banks. MDBs and DFIs must take a more proactive role in assisting and working alongside investors and governments to bridge the infrastructure gap. Speaking generally, MDBs must engage more frequently and at an earlier point in the investment process. The pipeline and financing remain issues, but one party must act first to move the needle. One major impediment that was noted is the fact that many projects are cross-border in nature.

MDBs, DFIs and non-government institutions can also be helpful in the identification of bankable projects.

Some progress is being made as MDBs and DFIs are working on these issues. The International Finance Corporation, (IFC), (a member of the World Bank Group) believes that credit enhancement is critical to encourage further infrastructure investments. The IFC manages a co-lending portfolio program that provides capital alongside international banks and private investors. The IFC can also provide first-loss protection, and boasts a long list of countries that would assist with the credit enhancement system. This allows the private sector to have exposure in new markets without the actual market risk.

As with many other multilaterals, there are misperceptions about the Asian Infrastructure Investment Bank (AIIB). The AIIB is an organization owned by its global group of 57 shareholders and not the Chinese government. The bank will not do each and every project brought to them by individual members; it will turn down projects that purely have a geopolitical agenda. The AIIB also boasts 21st Century oversight mechanisms, gleaned by learning from and cooperating with other development banks.

There are a number of infrastructure development institutions at work – these institutions provide objective information and facilitation for infrastructure investment on issues such as benchmarking, risk allocation analysis, global needs analysis, and information on the project pipeline. However, comments were made that ***these institutions should be more open to sharing information and working together towards their common goals.***

Toward that goal, a new organization, the Global Infrastructure Hub ('the Hub'), was created by the G-20 to act as a knowledge clearinghouse that fosters greater private investment in infrastructure on a global basis. The Hub is working with governments (both members and non-members of the G-20); with the private sector; and with the MDBs and other international organizations. To create a series of tools to help governments, particularly those in the emerging markets, to develop a pipeline of bankable PPP infrastructure projects:

- a very detailed set of sample risk allocation matrices – developed when it became clear that many of the countries that want to offer PPP programs had very little understanding of even the basic principles of risk allocation;
- data on specific infrastructure needs, sector by sector, and on a country-by-country basis;
- a new form of project pipeline, which will show prospective investors what opportunities are available globally, and how these projects are being progressed; and
- an examination of the incentives that exist at the MDBs to use existing instruments and to develop new instruments to achieve this goal.

What do regulators need to support projects?

The working group also touched on the role of regulators in promoting infrastructure investment. Two issues were made clear. The first, a lack of reliable data on infrastructure projects remains one of the chief roadblocks for further investment. Data is a clear, powerful tool for regulators. Many in the room went as far as to say that without it, there is little they can do to support an initiative. Whether requested by governments or asset owners, objective information is key. The Long Term Infrastructure Investors Association (LTIIA) has funded the work of the EDHEC Risk Institute in Singapore in developing infrastructure equity benchmark methodologies and these have already been successfully used to persuade European Insurance and Occupational Pensions Authority (EIOPA), the European regulator, to reduce the level of regulatory capital required for certain infrastructure investment.

Secondly, the lack of standardization of practices remains a key impediment to further projects in the pipeline – organizations must work together to make information available that is clear and applicable for projects regardless of origin or scope. Regulators are seeking investors to bring forward new ideas for investment, instead of waiting for bureaucracies to make the first move.

What is the Role of Asset Owners in Moving the Needle?

A group of PPI's asset owner members (pension funds, sovereign wealth funds, and endowments) were represented at the meeting. ***These institutions, as holders of billions in available capital and with a long-term view, can act as a focal point to improve standardization and information sharing, as well as generally bolster the pipeline through their willingness to invest.***

One suggestion that drew support from many in the room was the need for rigorous academic case studies prepared for asset owners. Doing this in an objective manner would allow institutional investors the opportunity to see successes and failures in infrastructure investing. However, the case studies would need to be fair and balanced in order to prove to be a trusted resource for investors.

Institutional investors would also consider investing further in infrastructure with a sovereign guarantee. Specifically, investors stated that governments should take on more tail risk in infrastructure projects. This is a step which governments have, thus far, been hesitant to provide. Nonetheless, discovering a way for governments and investors to further share risk is critical to bring their capital into this area.

Asset owners are also interested in ascertaining ways to minimize political risk in infrastructure. Most importantly, all parties must understand and mitigate the negative effects of the imbalance between a political election cycle (short-term) and the lifecycle of infrastructure projects (long-term). Asset owners also mentioned the need for a contract enforcement mechanism in a neutral jurisdiction. Implementing this set of checks and balances will allow asset owners to minimize the political risk. It was acknowledged that getting policymakers to think long-term will be difficult. Balancing the interests between governments and investors, avoiding cronyism and political one-upmanship are essential to bring forward more asset owners.

The Next Steps

The genesis of this infrastructure working group was an informal discussion between PPI and one of its long-time supporters, Dr. Teh Kok Peng, director, Sembcorp Industries; formerly president, GIC Special Investments. Dr. Teh suggested that PPI's unique position as a noncommercial organization with a global network of asset owners and managers makes it ideal for structuring and hosting these discussions.

PPI will remain committed to serving as a platform for convening the key stakeholders to discuss practical, actionable ideas that will address the issues laid out in this paper and others.

We propose an ongoing series of webinars and meetings over the next year that will yield a set of recommendations that can be distributed through PPI's and the working group participants' networks. Our goal, stated simply, is to move the needle toward solutions to this global issue.

We propose that our next gathering be held by webinar on the third week of April, 2017. The date and agenda will be announced in December. After the broad initial discussion in Hong Kong, we will narrow the focus of our next meeting in order to devote substantial time and focus to one or possibly two issues.

In keeping with PPI's practices, we invite your feedback on this report and on the working group format and content.