INFRASTRUCTURE TRENDS - #1: WHERE ARE THE BROWNFIELD OPPORTUNITIES?

11 September 2017 | Australia
Legal Briefings – By **Simon Haddy, Kate Cahill and Nick Baker**

In this series of short articles we look at the current trends affecting infrastructure investment in Australia. This article considers trend # 1 - reduced brownfield investment opportunities.

CORE VS NON-CORE AND GREENFIELD VS BROWNFIELD

FIRST SOME EXPLANATIONS OF THE TERMINOLOGY USED

"Infrastructure" can take many forms and has many classifications, but the basic distinction is between "core" and "non-core" infrastructure:

- Core infrastructure: developed infrastructure assets with long-term concession or offtake arrangements with governments or creditworthy counterparties that operate in a stable regulatory environment. They may also be assets that provide essential services or occupy a monopoly position in their industry and provide stable cash flows. They will usually provide protection against inflation and volume/throughput risk (or have very low elasticity of demand for their services). These range from regulated electricity networks, pipelines and toll roads; to essential infrastructure with monopoly characteristics such as ports and airports; to services with a government offtake or capacity commitment. Core infrastructure is viewed as the safest way for infrastructure investors to secure long-term yields that generally match their liabilities to investors; and
- Core-plus/Non-core infrastructure: infrastructure assets that do not have one or some of the characteristics above but are still capital intensive sectors with barriers to entry. These assets are usually more exposed to factors such as development risk, inflation and

volume/throughput risk, as well as increased competition.

A further classification is between “greenfield” and “brownfield” assets. A greenfield asset refers to an asset that has some level of development or construction requirement and risk. A brownfield asset is a developed asset, albeit one that may still require ongoing capital expenditure and expansion. The distinction between brownfield and greenfield infrastructure is often not a bright line. Many brownfield transactions already involve considerable development and construction projects or offer expansion, enhancement or retro-fitting programmes (ie. “khakifield” transactions).

THE SLOWING PRIVATISATION PIPELINE

A key source of brownfield infrastructure transactions in the Australian market has historically been provided by various State and Federal privatisation programmes. The past three years have seen some significant privatisation transactions for core infrastructure assets, including long term leases of the NSW electricity transmission and distribution networks and of the ports of Newcastle, Darwin and Melbourne.

However, this pipeline of privatisation transactions has now slowed. The pro “asset recycling” governments of NSW and Victoria have largely exhausted their core infrastructure assets of scale that are available, or publicly acceptable, for privatisation. Meanwhile the election of anti-privatisation governments in Western Australia and Queensland has abruptly ceased any privatisation activity in those States.

While there are some remaining privatisation opportunities, including NSW’s proposed sale of the WestConnex toll road business/development, the immediate outlook for traditional brownfield transactions of any scale in Australia is currently limited.

INVESTOR RESPONSES

Many infrastructure investors, particularly superannuation funds, are facing significant pressure to deploy their accumulating investor funds.

This pressure, in combination with the diminishing brownfield transaction pipeline, is causing:

- intense competition and prices for any remaining brownfield core infrastructure transactions of scale, resulting in lower equity return expectations for such assets;
- a developing preference by investors for the higher returns of core-plus/non-core infrastructure (eg. Government services, social infrastructure, rail rolling stock, energy metering, telecommunications towers, student accommodation and data centres); and

- Governments to create “infrastructure” type investments for private sector investment. For example, the concessions to operate the NSW and SA land titles registries (with a Victorian transaction imminent).

We are seeing investors:

- consider unlevered transactions to deploy larger amounts of capital, notwithstanding that this may not be the most efficient capital structure;
- consider core plus and non-core assets. If we look to overseas examples, Australia may see the development of infrastructure-like investments in fields as diverse as municipal services (waste, parking buildings and parking meters), tourism precincts, street lighting and smart poles and even crematoriums;
- develop a greater focus on greenfields infrastructure development and PPP transactions in the near term, particularly in road, rail and other transport sectors. Investors must develop in-house expertise in greenfield infrastructure or obtain that experience by joint venturing or investment (CDPQ’s 20% investment in Plenary is an example of this). We expect to see greater involvement by traditional brownfield investors in greenfield developments;
- seek to create their own investment opportunities through development of their existing assets, approaching other ‘incidental’ infrastructure owners such as mining companies for “off-market” purchases and taking unsolicited proposals to Government; and
- look offshore for investment opportunities.

Investors appear willing (or are perhaps resigned) to move up the risk curve and look at greenfield and development infrastructure. Many investors are also increasing their risk appetites (and return expectations) and actively looking for core plus/non-core assets.

Few infrastructure investors now are troubled by greenfield construction risks as it has been demonstrated that these can be managed by appropriate contracting structures. The WestConnex transaction in NSW will perhaps push the boundaries on this the furthest. Here the State is proposing the sale of a 51% interest in the WestConnex toll road development: an interconnected series of stages, new roads and tunnels - all prior to traffic volumes being established and prior to letting design and construct contracts for the latter stages.

WHERE MIGHT FUTURE BROWNFIELD OPPORTUNITIES BE?

In addition to the areas noted above, we see opportunities in the medium term for:

- the privatisation of assets whose development has been seed-funded by Government. WestConnex is an example, as could be the Western Sydney airport development;
- the Australian Rail Track Corporation and Inland Rail;
- rail franchising in NSW and QLD;
- the separation of infrastructure assets out of "operating" companies (eg miners, power companies and industrials);
- water infrastructure, although this is still dependent on the development of appropriate pricing and regulatory models;
- smaller scale infrastructure-related sectors such as renewables;
- government and municipal services; and
- depending on the politics and State budget positions, Queensland electricity generators, electricity networks, Snowy Hydro, ports, water infrastructure and Queensland Rail and in Western Australia, the electricity generators, electricity networks and ports.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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