

INFRASTRUCTURE INVESTMENTS IN AN AGE OF AUSTERITY: THE PENSION AND SOVEREIGN FUNDS PERSPECTIVE

World Pensions Council cofounders M. Nicolas J. Firzli and Vincent Bazi examine the rise of infrastructure investments as a “new” asset class for pensions funds and sovereign wealth funds at a time when most governments have to cut back on direct public spending. Some of the arguments advanced in this article are based on a presentation made by the authors at the 4th Annual Public Private Partnership in Central Europe Summit hosted by Jacobs Fleming (Prague, June 9 2011).

AN ERA OF BUDGETARY HARDSHIPS AND GOVERNMENT DISENGAGEMENT

In many ways, the 2008-2009 financial crisis and the ensuing “debt crises” currently afflicting the US and most European economies mark the end of an era *soft statism* started with the New Deal in 1933 (National Industrial Recovery Act, Public Works Administration...) that saw a massive deployment of government resources and the advancement of state ownership across (formerly private) industries and infrastructures throughout the Western world (“Folkhemmet” in Scandinavia, “Welfare State” in the UK...). That model worked *relatively* well for 75 years as Russia, China and Eastern Europe stagnated under the yoke of *total statism* and as the primary commodities of Latin America and the Middle

East were sold off at suboptimal prices.

The budgetary profligacy of G7 countries on the domestic front (Social Security, Medicare, cheap water and electricity, subsidized housings, ‘bridges to nowhere’...) was only made possible through the continuous flow of cheap commodities from the Arabian Gulf and South America (a continent largely ruled until recently by subservient comprador bureaucracies) and cheap labor from the low-cost manufacturing platforms of Asia (“*made in Taiwan*” in the 1970s, then “*made in China*” in the 2000s), and, most importantly, cheap capital from their own central banks or from thrifty countries with current-account surpluses (China, Singapore, South Korea, Germany, Switzerland, Luxembourg, Abu Dhabi...). After decades of criticizing the macroeconomic

choices of Asian and Latin American nations (and downgrading their bonds at the first sign of weakness), Western rating agencies are now increasingly chastising European governments themselves as well as the European Central Bank. Tellingly, the hastily drafted, unevenly transposed in national law, and poorly enforced EU rule on rating agencies (Règlement CE n° 1060/2009) has had little effect on the way financial analysts and economists interpret data (in itself not a bad thing) or on the potential for conflicts of interests created by the fuzzy contractual arrangements between credit rating agencies and their clients (a far more troubling issue)...

As predicted by a handful of contrarian economists, the financial balance of power has clearly shifted further away from Western governments and central banks in favor of large private agents such as investment banks and pension funds as well as Asian and Middle-Eastern sovereign wealth funds, a shift marked by the decline of formal inter-national rules, which are being progressively “*superseded by more informal norms (broad standards of behavior defined in terms of rights and obligations), in a manner not unlike that of English common law – unwritten law (lex non scripta) in lieu of written or statute law (lex scripta)*”.⁽¹⁾ The year 2011 clearly marks the beginning of a new era charac-



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terized by the *de facto* default of formerly “investment grade” countries such as Greece and Portugal (and the forced fire sale of vital infrastructure by those countries) despite the combined efforts of the ECB, the IMF and the EU Commission, the adoption of unprecedented austerity measures in the US (at federal and state levels) and across key European countries including Spain, Italy, Ireland and the UK⁽²⁾, and the abrupt winding down of direct public spending on infrastructure across many Western economies- with the notable exceptions of a few cash-rich Canadian and Australian provinces such as Manitoba and Western Australia.

CASH-RICH INVESTORS WITH LONG LIABILITIES

In that particularly dire economic context, governments cannot resort anymore to the worn-out Keynesian or Rooseveltian recipes based on massive borrowing to fund job-intensive infrastructure projects that allegedly “multiply” aggregate demand and reduce unemployment, with little regard for the long-term monetary and fiscal repercussions of such policies.⁽³⁾ But, while carefully factoring in and monitoring the monetary and solvency consequences of public spending, Western governments still need to maintain and repair existing infrastructure assets and to build new ones to ensure the economic attractiveness of their territories, while the rap-

idly growing emerging countries of Asia, Eastern Europe and Latin America need to construct new facilities across the board- which will represent twice as much in GDP terms as OECD countries: “*The investment requirement is enormous and the traditional provider of capital for those facilities – government – does not have the capital to do that anymore, so they are [increasingly] looking to the private sector to provide [a larger share of] that expenditure*”.⁽⁴⁾

It’s important to understand the growing role of these private sector investors: chief among them are pension funds, even though, according to OECD researchers, the average allocation to infrastructure only represents 1% of total assets under management by pensions- excluding indirect investment through ownership of stocks of listed utility and infrastructure companies⁽⁵⁾. But there are wide typology differences across regions with many large, sophisticated, pension funds in jurisdictions such as Ontario, Quebec, California, Holland, and Australia already investing more than 5% of their total assets (and typically more than a third of their “alternative” assets) in infrastructure. And, in key areas such as Scandinavia and the US (US pensions had \$15.3 trillion in assets at the end of 2010, more than half of the world’s total pension investments), we seem to be witnessing a rapid rise of the allocation to infrastructure, even

among more traditional pension funds: “*The Oregon Investment Council [...] approved its first-ever specific infrastructure allocation, which will reside within a new 5 percent allocation to alternative investments not already represented in its portfolio*”.

⁽⁶⁾ In 2Q 2011, 25% of the Global Pensions 100 panel respondents said they planned to implement a new allocation to infrastructure or increase an existing one this year, one of the highest figures on record.

This growing interest for infrastructure investments should come as no surprise to actuarial experts: most pension funds as well as sovereign wealth and reserve funds have long-dated liabilities, be it explicitly (pensions) or implicitly (sovereign and reserve funds, often acting as “future generations” long-term revenue diversifiers in the Arabian Gulf, Norway, Venezuela, Malaysia etc.). These large institutional investors need to protect the long-term value of their investments from inflationary debasement of currency and market fluctuations, and, if required, provide some kind of recurrent cash flow to pay for retiree benefits in the short-medium term (pensions) or to fund the acquisition of other assets (SWFs). From that perspective, infrastructure is an ideal asset class that provides tangible advantages such as long duration (thus facilitating cash flow matching with long-term liabilities), protection

against inflation and statistical diversification (low correlation with ‘traditional’ listed assets such as equity and fixed income investments), thus reducing overall portfolio volatility.

As of March 31st 2011, the various types of pension plans (public and private pensions and superannuation schemes) accounted for approximately 40% of all investors in the infrastructure asset class⁽⁷⁾, excluding projects directly funded and developed by governments and public authorities which still account for the bulk of infrastructure investments. Three Canadian public pension funds (OMERS, CPP, OTPP), one Australian superannuation scheme (AustralianSuper), one US private pension fund (TIAA-CREF), and only one sovereign wealth fund (Malaysia’s Khazanah Nasional) are among the ten largest infrastructure investors globally (excluding governments and public authorities). But the values of sovereign wealth fund investments in infrastructure are probably under-accounted as many of them (notably in Asia and the MENA area) don’t disclose their holdings.

The preeminence of Canadian and Australian players is due to historical and geographic factors: the development of these very large, resource-rich, and under-populated countries has required massive infrastructure spending since the mid-19th century, thus familiarizing public decision makers and private sector invest-

tors early on with the complex financial, technological and legal processes underpinning infrastructure investments... In June 2010, the British government, through state-owned London & Continental Railways, announced the start of a competition to sell a 30-year concession to own and operate the 67 mile HS1, the high speed line that connects the UK's Channel Tunnel to London, viewed by many as "the crown jewel of British infrastructure". After a five-month long highly competitive tender process, it was announced UK High Speed 1 had been sold to two Canadian institutional investors- Ontario Teachers' Pension Plan (OTPP) and Borealis, the infrastructure investment arm of the Ontario Municipal Employees Retirement System (OMERS)⁽⁸⁾. Disgruntled UK and European bidders had to recognize the ascendancy of foreign pension investors in their home turf: with dedicated infrastructure teams comprising tens of highly specialized professionals (financial analysts, fund managers, but also lawyers, actuaries and civil engineering experts) based in Toronto, Montreal and Sidney, Canadian and Australian pension funds and the local investment banks and law firms who advise them have acquired a leading position in the field. Infrastructure investments are usually categorized along risk/return/lifecycle lines: the less risky "Core and Core Plus" (bridges, tunnels, toll roads,

energy transmission and distribution, water and waste-water systems), the intermediary "Value Added" (airports, seaports, rail links, contracted power generation) and the more risky "Opportunistic" (development projects, satellite networks, merchant power generation or any investments in non-investment grade countries and/or countries with insufficient legal security)⁽⁹⁾, with total returns deriving from a combination of long-term capital appreciation and recurrent cash income. But one has to keep in mind that the above-described risk/return categorization and other project-specific considerations actually come *after* the choice of country, which constitutes the key factor in any infrastructure investment decision, as the economic assessment (GDP growth outlook, monetary stability, government finances) will determine the expected rate of utilization of all infrastructure assets in a given country and the expected inflation-adjusted revenues derived from them, and, more importantly, the political/legal assessment (independence and efficiency of court system, fair treatment of private foreign investors, stability of regulatory environment, government payment/repatriation...) will give investors the required levels of confidence and legal security necessary to invest.

Infrastructures are expensive, complex investments: they include large chunks of national assets "stripped away" from the

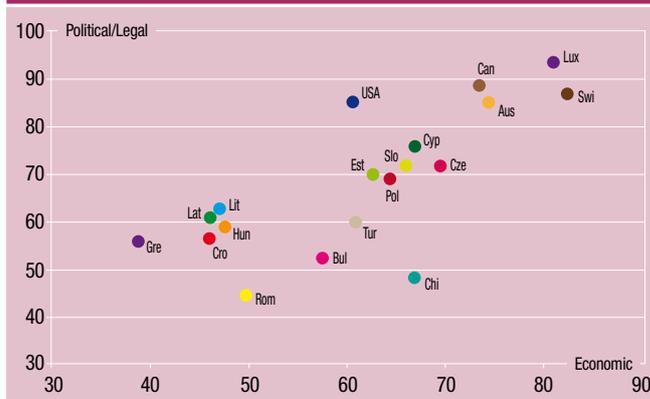
state's direct control for a long period of time (concession contracts duration can be superior to 25 years). In that perspective, the government can act simultaneously as asset owner/landlord, co-investor and co-manager (in the case of public-private partnerships), sector regulator, client, policy maker, and, in case of litigation, (often) judge of last resort! This is why legal security and evenhandedness are critical for pension investors: governments (at federal, state/provincial and municipal levels) really have to walk the extra mile for economic fairness, legal stability and regulatory efficiency if they wish to attract and retain pension investment money. The following chart shows how pension funds and SWFs view prospective countries where they might invest in infrastructure assets, with a focus on Central and Eastern Europe. The chart is based on the results of the bi-annual Euromoney Coun-

try Risk survey (as of March 31 2011) from which we've extracted statistical series for two key factors: 'Economic Assessment' (x-axis) and 'Political/Legal Assessment' (y-axis). What the chart tells us (among other things) is that a former Soviet republic such as Estonia is now viewed as having attractive traits in terms of political/legal development and economic dynamism, whereas its Baltic neighbors Lithuania and Latvia are lagging behind on both fronts, or that large institutional investors will prefer Cyprus and Turkey over other Balkan states, with Greece and Romania at the bottom of the group...

INFRASTRUCTURE AS ECONOMIC DRIVER vs. THE 'WASHINGTON CONSENSUS'

In the past, Latin American countries fell behind the rest of the world with roughly 2% of GDP invested in infrastruc-

INFRASTRUCTURE INVESTMENT LOCATION: HOW PENSIONS & SWFS VIEW HOST COUNTRIES



Sources: Euromoney Country Risk (ECR) survey (as of March 31 2011), The World Pensions Council

ture in the 1990s and 2000s, whereas most of the emerging economies of Asia invested 5% of their GDP on average in infrastructure throughout the period- the figure reaching 9% in China in recent years⁽¹⁰⁾, thus allowing the Chinese economy to grow at near optimal conditions while many South American economies suffered from various development bottlenecks (poor transportation networks, ageing power grids, mediocre schools...). This development gap was due largely to ideological motives, with US and IMF experts advising Latin American governments not to invest “excessively” in infrastructure projects while Asian “state capitalists” embarked on ambitious infrastructure modernization projects aimed at helping private sector companies operate more efficiently (high-speed rails across industrial regions, huge logistical hubs connecting highways to key ports and airports...) and innovate (new schools, universities, and hospitals fostering the development of high-tech and biotech industries): “*The well-rehearsed argument that what is needed is yet more of the same sounds increasingly hollow. Maybe the Washington Consensus [the dominant neo-liberal doctrine] is just one of the many heaps of ideological recipes still waiting for a proper theory (or a fire...); how can it explain that so many in Asia do things ‘wrong’ (sometimes very ‘wrong’) but develop fast, while Latin Amer-*

ica does almost everything ‘right’ but can only achieve a low intensity growth dynamic that the ‘invisible hand’ does not know how to break?”⁽¹¹⁾ Last year, California Governor Arnold Schwarzenegger said he was hoping for some financial and technical assistance from China to help lower construction costs and develop his state’s proposed high-speed rail project.⁽¹²⁾ The US has practically no high-speed rail expertise whereas infrastructure-savvy China is the world’s leader in the field, with a high-speed rail network of 4,300 miles (6,920 kilometers). The US and other G7 countries are not alone in trying to lure China’s superior infrastructure investment and civil engineering capabilities. Tellingly, the Aquino administration sent its chief economic decision maker, Finance Minister Cesar V. Purisima accompanied by half of the Filipino Cabinet and the Governor of the Central Bank on a weeklong investment bank-style roadshow in Beijing and Shanghai earlier this year⁽¹³⁾, to drum up interests among Chinese pensions, sovereign wealth funds (notably SAFE and the China Investment Corp.) and Chinese banks for the Philippines’s ambition infrastructure plan: “*We want to encourage Chinese investors to put their money in the Philippines and invest in our infrastructure projects. We want to deliver the message that the Aquino administration is committed to transparent negotiations*

with them unlike before [...] [Infrastructure investments constitute] the Aquino administration economic centerpiece”... ■

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