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Committee Secretariat
Transport and Infrastructure Committee
Parliament Buildings
Wellington

To the Secretary of the Transport and Infrastructure Committee

Infrastructure Funding and Financing Bill Parliamentary Submission

1. INTRODUCTION

The New Zealand Infrastructure Commission, Te Waihanga ('Infracom') welcomes the opportunity to submit on the Infrastructure Funding and Financing Bill ('the Bill') and does not wish to be heard in support of its submission.

Infracom's purpose is to co-ordinate, develop, and promote an approach to infrastructure that improves the well-being of New Zealanders. Infracom must consider the long-term trends that impact on, or are impacted by, infrastructure.

It is widely understood that the current system is not enabling infrastructure to contribute its maximum value to the well-being of New Zealanders.

Infracom considers that to deliver better infrastructure outcomes, it is important that we strive for a planning and delivery system that:

- ensures that land supply, infrastructure and housing development meet demand at an affordable price
- enables and incentivises greater integration
- delivers more pipeline certainty, and
- ensures central and local government have access to best practice planning, funding, financing and procurement capabilities.

We are submitting on the Bill because timely investment in infrastructure is critical in meeting the demands of urban growth. The Bill sets out a framework that seeks to accelerate investment in infrastructure by providing for an alternative funding and financing model ('the IFF model') where the cost of infrastructure is borne directly by the beneficiaries of that investment.

The IFF Bill is one element of a package of reforms designed to improve urban planning, governance, funding and delivery. The introduction of the Urban Development Bill, coupled with resource management and local government reform, will also support the delivery of infrastructure to New Zealanders living in urban areas.

Infracom is the government's lead advisor on major infrastructure procurement and delivery. One of Infracom's core functions is to provide advice on innovative and non-traditional approaches to procurement, including alternative financing arrangements. This role includes guardianship of the New Zealand Public Private Partnership (PPP) model. There are strong parallels between the PPP model and the IFF model given both are forms of project finance.

Because of the permissive nature of the Bill, our comments largely relate to the implementation of the IFF model rather than the drafting of the Bill. Our submission draws largely from our experience and knowledge gained from working with the PPP model and with the procurement and delivery of major infrastructure projects.

2. SUMMARY

Infracom supports the intent behind the Bill, which is to ensure that infrastructure to support urban growth is delivered in a timely manner. Infracom makes the following additional general comments in relation to the Bill:

- **Infracom welcomes the IFF model as an additional tool to expand the options available for funding and financing infrastructure.** The IFF model should help alleviate local government financing constraints, enabling high value infrastructure investment to proceed. The IFF model has the potential to improve economic efficiency through better aligning the costs of infrastructure investment with the beneficiaries of that investment. However, the IFF model is only a part of the solution – Infracom also supports further reform and better use of existing funding and financing tools.
- **The IFF model has the potential to act as a catalyst for deepening New Zealand's project finance market.** A long-term pipeline of IFF projects will contribute to building depth in the project and structured finance market, improving liquidity and lowering costs. To maximise the positive impacts of the IFF model, SPV ownership should eventually be expanded beyond the Crown. The design of the model needs to ensure that there is a competitive market to lend to these projects.
- **Infracom's experience with the PPP model suggests that the IFF model will, initially, be best suited to projects where risks are well understood and can be priced and managed efficiently**. As confidence grows in the IFF model, Infracom hopes the model will be expanded to more complex brownfield projects. Projects with unpredictable risks, and/or where beneficiaries are difficult to identify, are unlikely to be well suited to the IFF model.
- **The roles of the Recommender and Monitor will be crucial to the successful implementation of the IFF model.** The Recommender should be resourced to conduct the rigorous feasibility analysis required to ensure that the IFF model is only used in the circumstances to which it is best suited. In addition to regulating the use of the IFF Model, the Monitor will also provide an important feedback loop to the Recommender. Infracom plays a leadership role in building skills in this area and is keen to work with these agencies in the future to develop this community of interest.
- **The scope of any Government Support Package (GSP) should be limited.** Information prepared in support of the Bill acknowledges that for some projects a GSP may be needed. Infracom recommends that the use of the GSP covers limited categories of risks similar to those the government covers in the PPP model - typically low likelihood and high consequence risks that are outside of the control of the private sector Special Purpose Vehicle (SPV), for example, the time and cost impacts on the project of a natural hazard event.

Infracom also makes specific comment on one clause in the Bill that may benefit from supporting guidelines.

3. GENERAL COMMENTS

a. Infracom supports the introduction of the IFF Model

The IFF Bill introduces a funding and financing model to support the provision of infrastructure for housing and urban development. The IFF model aims to contribute to functioning urban land markets and reduce the impact of local authority financing and funding constraints.[1]

Local infrastructure investment plays a critical role in supporting well-functioning communities. Local authorities are responsible for meeting current and future infrastructure requirements for their communities, including roading, water, wastewater and other community services. A mix of incentives and funding constraints are limiting the ability of some local authorities to invest in infrastructure to the degree needed to support and service urban growth. These incentives and constraints are well covered in the Bill's Regulatory Impact Statement (RIS).

The IFF model has the potential to unlock high value infrastructure investment to support urban growth

The IFF model seeks to overcome local government investment constraints by expanding the toolkit of available funding options through the use of a SPV that will finance and construct the infrastructure for a defined location. The finance is repaid from a levy on the beneficiaries of the infrastructure. This approach has the potential to bring forward investment that a local authority may otherwise have delayed due to its financial constraints and/or competing priorities. Bringing forward this investment should increase the amount of land available for development, better aligning the supply of new housing with demand in high growth areas.

Infracom supports the IFF model's objectives to allocate the costs of infrastructure, in appropriate circumstances, to the communities who benefit from the infrastructure and assign risks to the parties best positioned to manage them. Aligning the costs of infrastructure investment with those who benefit should improve incentives for high value investment to occur, improving economic efficiency.

While Infracom can see the potential benefits of the IFF model, we acknowledge it is only one part of the solution to New Zealand's urban growth challenges

Infracom's view is that other funding tools and regulatory reforms are likely to have greater impact on the challenges of urban growth at a national level.

As the RIS acknowledges, the transaction and financing costs of using the IFF model are likely to be higher than the status quo.[2] The IFF model should only be used in circumstances where the additional cost is outweighed by benefits provided by the model, that is, that it provides value for money. As we discuss below, the IFF model will, initially, be best suited to greenfield projects.

The IFF model therefore must be supported by further reform and better use of existing funding tools

The Productivity Commission has recently undertaken an inquiry into local government funding and financing. The Productivity Commission has found that the property rates based system remains appropriate and there is significant scope for better use of existing funding tools.[3] Local authorities currently have the ability to introduce targeted rates, allowing the cost of new infrastructure to be funded by those who benefit from this infrastructure.

[1] Infrastructure Funding and Financing Bill, paragraph 3.
[2] Infrastructure Funding and Financing Regulatory Impact Assessment
[3] Productivity Commission, Local Government Funding and Financing, November 2019

Legislative constraints on borrowing limits and the need to set balanced budgets could be overcome if local authorities were willing to consider rate increases or asset recycling.

Infracom is therefore supportive of further work being progressed on the remaining Infrastructure Funding and Financing workstreams[4]. These are:

- Investigating easing the existing local authority debt constraints, and
- Assessing whether the existing targeted rates/development contributions regime can be utilised more effectively to better recover the cost of infrastructure.

b. The IFF model is likely to have a positive impact on the project finance market

Use of the model will contribute to building depth and capability in the New Zealand project finance market. Over time, this may lead to a reduction in financing costs through increased competition and demand. Increased depth can also provide a systemic benefit to other forms of project and structured financing, such as the PPP model. A more certain financing pipeline allows for the requisite skills and experience to be developed and retained by both the government and capital investor counterparties to such transactions.

New Reserve Bank of New Zealand prudential rules are likely to have a flow on impact on the availability of funds that banks have to invest, including to the infrastructure sector. The IFF model should provide a direct avenue for institutional investors to invest in infrastructure, potentially offsetting any reduction in lending by the banking sector.

Expanding ownership of SPVs will reduce the Crown's risk exposure and deepen New Zealand's project finance market

While the Bill does not restrict SPV ownership to the Crown, background information supporting the Bill notes that "at least initially, the Crown will need to own the SPV and account for its activities".[5]

Infracom believes the IFF model should eventually be open to a diversity of third-party investors. This is critical to deepening the project finance and capital markets and to reducing the Crown's exposure to the risks associated with delivering infrastructure projects.

A strong pipeline of IFF model projects has the potential to lengthen the tenor of debt available in the New Zealand market

In general terms, the aim should be to use the pipeline of IFF projects to extend the tenor at which the New Zealand debt market is able to offer market liquidity. This could be through changes to lending practices of existing market participants or by encouraging new entrants. If successful, this development would have wider benefit to the use of project and structured finance models by local and central government.

In the short term, consideration should be given to the trade-off between long term price certainty and minimising debt interest costs

The background materials to the Bill suggests that the SPV will need to manage two financing risks over the course of SPV operations, which could extend to up to 50 years. These risks are base rate risk and margin risk. However, it may be that early projects need to consider shorter tenors and mechanisms to refinance within the constraints of the model.[6]

The experience on the first eight PPPs has shown that the New Zealand debt market only has liquidity out to tenors of 5-7 years and that there is a lack of pricing benchmarks for longer tenors. There has therefore been a tension between ensuring competitive pricing of debt in these shorter tenors and ensuring long term debt pricing certainty for procuring agencies across the circa 25-year term of these PPP contracts. The solution employed in early PPPs

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[4] T2019/72: Infrastructure Funding and Finance – Infrastructure Levy Model

[5] T2019/72: Infrastructure Funding and Finance – Infrastructure Levy Model at [26].

[6] Clause 9 of the Bill specifies the categories of cost that the SPV can recover through the levy, which include 'the costs of refinancing'. Infracom assumes that this definition includes both the transactions costs of refinancing and any increases in debt interest costs.

was for the Crown to retain the risk of base interest rate movement at each of the refinancing points. This was later replaced by an interest rate swap provided by a Crown counterparty from the first refinancing point. In effect, this represented the Crown addressing a market failure to provide the procuring agency with debt price certainty at a specified cost.

The IFF model will face the same debt market dynamic. Revenue to be raised from the levy will be capped, however, the underlying base interest rate will continue to fluctuate over the circa 30-year term of a typical IFF transaction. Most lenders currently operating in the New Zealand market are unlikely to be able to issue debt for the length of the IFF projects. A small number of parties, particularly institutional investors, may be able to lend but the margins charged will be at an ‘over-the-counter’ price rather than one derived from a liquid market. However, to keep levies as low as possible and ensure uptake of the IFF model it will be essential to maximise competition, and thereby minimise the cost of debt capital, across the longest possible tenors.

A solution will need to be developed to resolve these price/certainty tensions with the objectives of the model. This solution may be addressed in the guidelines accompanying the implementation of the IFF model. Infracom’s preference would be for there to be alignment between the PPP programme and the IFF model.

c. The IFF model will, initially, be best suited to predominantly greenfield projects

Infracom recommends that lower risk projects, or projects with well understood risk profiles, are prioritised when introducing the use of the IFF model. In the urban development context, these projects are more likely to be greenfield in nature. With greenfield projects, it is likely to be easier to allocate risks appropriately and identify beneficiaries. Beneficiaries will be opting into a development and will likely be more accepting of the annual charges than a beneficiary who feels that the levy is imposed on them (as may be the case in a brownfields development).

In contrast, predominantly brownfield developments are likely to present complex and unpredictable construction risks that are difficult to both identify and quantify. These risks cannot easily be mitigated or allocated to a particular counterparty. Examples of these risks include, ground contamination, ground conditions, the quality of existing infrastructure, and/or the cost of new infrastructure required to meet the new service requirements. Beneficiary identification and allocation is also likely to be significantly more challenging in the brownfield context.

Starting with greenfield projects has many benefits; it is likely to maximise the chances of a successful outcome, encourage development of the project finance market and support the utilisation of the IFF model. To encourage local authorities to support the model, candidate projects should also be aligned to local authority spatial and urban plans.

The RIS acknowledges that the IFF model may incentivise development away from brownfield to greenfield sites, which may work against wider urban development objectives. This reinforces the need for alignment between spatial planning and for implementation of the model to occur in parallel with other pillars of the urban growth agenda, particularly the Urban Development Bill and Resource Management Act reform.

Greenfield projects are likely to offer best value for money

Infracom’s PPP experience is that project finance vehicles are more likely to provide value for money for projects where risks can be reasonably well understood and quantified. This is more likely to be the case in greenfield development projects.

The IFF model is a form of project finance with an SPV used to quarantine and allocate project risks. These vehicles are typically non- or limited recourse, that is, lenders and investors are only liable for the amount of pre-agreed financing provided to the SPV. If the SPV takes on risks that it cannot manage from its fixed financial resources, it runs the risk of becoming insolvent.

When assessing the suitability of the use of project finance for PPP investments, the candidate project is analysed against a set of characteristics known as hurdle criteria. Hurdle criteria are largely common across all forms of project finance and include the assessment of whether risks can be well understood upfront and where key project risks can be assigned to the parties best able to manage them at least cost.

When a project does not meet the hurdle criteria, alternative delivery models may be more appropriate. For example, where a proposed project involves high levels of uncertainty, (for example, unknown levels of ground contamination), it may be more effective for a local authority to procure the project through an alliance contract rather than the IFF model. The use of these alternative models could be funded by better use of existing local authority funding tools.

Use of the IFF model should expand over time

The use of the IFF model for more complex projects could be considered once the use of the model has been proven, and market participants (including developers, contractors, financiers, local authorities and central government) have experience implementing the model. This will allow time for both the considered evolution of the IFF model, and to explore other options to improve the delivery of infrastructure to support urban growth (such as optimising the existing local government funding toolkit).

It is also possible that components of a brownfield project may be able to be delivered using the IFF model. Elements of a larger project could be packaged into smaller sub-projects. One or more of these sub-projects may have well understood risk characteristics that make it suitable to deliver using a project finance vehicle. An example of this may be the delivery of a discrete transport project through the IFF model, alongside the delivery of upgrades to a brownfield water network directly by the local authority.

d. The roles of the Recommender and Monitor will be crucial to implementing the IFF model successfully

The Bill sets out the process for the assessment of a levy proposal and the recommendation of the use of a levy. This function will be undertaken by the Recommender (a government agency yet to be defined by Order in Council). Supporting information discusses the importance of the role of the Recommender.[7] Infracom sees this role as critical to the success of the IFF model.

The Recommender will need to ensure that proposals are feasible

Robust feasibility analysis is essential to ensuring that the model is only used for projects that meet project finance hurdle criteria. The criteria should to be tailored to the context of each proposal, and could include consideration of:

- Whether the size and scale of the project are likely to justify the additional transaction and financing costs associated with the use of the model.
- Whether the size and scale of the project are likely to result in a levy that is affordable to beneficiaries.
- The relationship between affordability, allocation to beneficiaries, acceptability by beneficiaries, costs that will be included in the levy and the need for a government equity contribution or GSP.
- The circumstances in which a GSP would be considered, and the scope of the GSP.
- Whether the relevant local authority has capacity on its own balance sheet to finance the project.
- The complexities inherent in the ownership of the land within a project's scope, particularly where multiple owners or interests are present.

[7] T2019/72: Infrastructure Funding and Finance – Infrastructure Levy Model.

- How well project risks and costs are understood and whether they can be efficiently allocated to those best placed to manage them at least cost.
- The stability of the service requirement and therefore infrastructure solution and cost.
- Whether a fixed price and delivery date procurement model is likely to offer better value for money than other procurement models.
- The degree of market interest and extent to which price elements can be made subject to competition.
- Options for structuring the SPV. This should include the consideration of minimum equity requirements and equity ownership options.
- The level of contingency that may be factored into costs, and how this varies with the expected risk of the project.
- The acceptable range of returns on equity, and how this how this varies with the expected risk of the projects.
- Whether any refinancing arrangements are required.
- The project's fit with priorities identified in central government agency infrastructure planning and local government spatial and urban plans. This will help to ensure that the project is supported by wider infrastructure investment. Alignment with local authority plans is also likely to influence a local authority's willingness to support a project using the model.

The RIS acknowledges the need for transparent and clear supporting guidelines to avoid misconceptions and assumptions and increase the likelihood of uptake of the IFF model.[8][9] The development of these guidelines will be a key role for the Recommender. The guidelines will be also crucial in enabling the Recommender to provide high quality advice to Ministers. Transparency on how and when the IFF model will be used should also help build market confidence.

The guidelines could draw on the PPP guidance suite, focusing on specifying the hurdle criteria for using an IFF model approach and ensuring that the model's use provides value for money.

The two-step process is sensible

The RIS implies that proposals for the use of the IFF model will be assessed through an initial feasibility assessment and a more detailed proposal assessment.

Infracom is supportive of a two phased approach where both an indicative and detailed business case are prepared. This provides an opportunity for a proposer to get feedback on the viability of the use of the model at the feasibility stage, without incurring the significant cost associated with a detailed assessment.

The Monitor will also be an important feedback loop

The Bill sets out the process by which the SPVs will be monitored. This role will be undertaken by the Monitor, who like the Recommender, will be a government agency appointed by an Order in Council.

While the Monitor will act as a regulator, Infracom also sees the Monitor as an important feedback loop – and therefore an important part of fully realising the benefits of the IFF model. The Monitor will be overseeing the performance of the SPVs over time and, through this oversight role, it should pass lessons learned back through to the Recommender (and to any separate Facilitator)[10] on what has made IFF model projects successful or not.

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[8] Infrastructure Funding and Financing Regulatory Impact Assessment, p52.
[9] See, for example, the Infrastructure Funding and Financing Regulatory Impact Assessment, T2019/72: Infrastructure Funding and Finance – Infrastructure Levy Model.
[10] T2019/72: Infrastructure Funding and Finance – Infrastructure Levy Model at [42]-[48].

Infracom sees parallels with the PPP programme, where a centralised a PPP team was established to ensure a consistent approach across transactions. In the PPP context, Infracom is involved both in the business case phase, validating whether the PPP model is the correct way to delivery procurement method for a project, and in supporting agencies once the projects are underway. There is real value in being across all phases of the project lifecycle and Infracom wishes the institutional framework supporting the IFF model to replicate that feedback loop.

e. Infracom can assist with developing public sector capability

The agencies appointed to support the implementation and regulation of the IFF model, including any GSP, will need a very specialised skill set, including understanding of project finance. There are analogies between these roles and PPP contract management. In our experience, PPP contract management is a challenging and specialist discipline. It is particularly important that both the Monitor and the Treasury have the skills to understand the appropriate escalation pathways in managing the Crown's interest when a GSP is in place.

Infracom has deep experience and knowledge of project finance and plays a leadership role in sharing this knowledge with the wider project finance community. We look forward to including IFF institutions in this community of interest.

f. The design of the GSP requires careful consideration

Information prepared in support of the Bill acknowledges that for some projects a GSP and/or Crown equity investment will be needed to support the levy. While the GSP sits outside of the Bill, Infracom wishes to reinforce its view that any GSP be limited to low likelihood and high consequence risks that are outside of the control of the private sector and potentially local government (such as the cost and timing impacts on the project of a natural hazard event).

An expansive GSP, encompassing a broad range of residual risks, would introduce concerns that the Crown is financially liable for risks that could be better managed by other parties. If not carefully managed, the Crown taking on additional risk and granting requests for additional funding could set a precedent that this support will be provided for any SPV that is not able to meets its obligations. Infracom notes that in the context of PPPs, the Crown has only retained risk for low likelihood and high consequence events, as these are the risks that the Crown can manage more cost effectively.

Infracom acknowledges that a GSP is an important mechanism to facilitate the use of the IFF model when it is first implemented. As the model evolves and is used in a sufficient number of transactions, it may be that the scope of the GSP can be reduced.

Infracom also notes that government support is not necessarily the most relevant factor investors look at when deciding whether to invest in infrastructure. More important factors are a clear institutional framework, transparent processes for bidding and awarding projects, stable rules and regulations and a lack of political interference.[11]

Background documents note that the Treasury will be responsible for providing independent advice to Cabinet on the use of the GSP, and that any GSP will be provided on a case-by-case base.[12] The Treasury should be well placed to perform this role as it manages other Crown indemnities, including in relation to certain PPP projects.

[11] OECD, Private Financing and Government Support to Promote Long-Term Investments in Infrastructure, September 2014

[12] T2019/72: Infrastructure Funding and Finance – Infrastructure Levy Model at [101].

4. SPECIFIC COMMENTS

We note that the Bill is generally of a permissive nature. We support this approach as it provides scope for innovation and development in the use of the IFF model. We have one specific comment on clause 31 that could be addressed in supporting guidelines.

Clause 31 of the Bill specifies the content of the levy order, including that:

b) the description of the levy must:

   i. specify the maximum amount of levy revenue that may be collected under the levy order; and

   ii. include the intended annual levy for each year of the levy period.

This allows for many variations in how the levy is allocated and calculated each year. We are supportive of the need for flexibility. However, unexpected year on year variations in the levy may have affordability implications for some beneficiaries. We therefore recommend that the guidelines consider mechanisms to address this issue.

Yours sincerely,

Jon Grayson
Establishment Chief Executive