Best Practice in **Infrastructure Asset Management**

Creating and maintaining value for all stakeholders

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Introduction

By Jeffrey Altmann, First State Investments

The ability to create enhanced operational performance in the infrastructure industry through stakeholder management, herein defined as asset management, is now widely acknowledged by both limited partners (LPs) and general partners (GPs) as a necessity in creating alpha (that is, a source of value uncorrelated to market movements by gaining additional returns without additional risk) as well as reducing risk. In addition, regulators, consumers and other stakeholders increasingly require greater accountability from owners of infrastructure assets in creating more efficient, reliable and competitive pricing of services during this time of austerity. This book provides active stakeholders in infrastructure with comprehensive understanding of what constitutes best practice in analysing, acquiring and managing infrastructure assets from an asset management perspective.

As infrastructure develops into an asset class in its own right, asset management is also developing into its own management discipline. Unlike portfolio management, which requires skills in assessing financial performance and how various assets will behave or correlate under various scenarios, effective asset management requires skills in finance, operations, project management, government, privatisation, regulation and corporate development. It also require strong, traditional board skills including setting strategy, key management appointments and succession planning, risk oversight and governance. Asset managers are proactively engaged with respective portfolio companies throughout their investment cycle, using their industry expertise to work with the management of the respective portfolio companies to maximise value creation and minimise downside risk.

Until recently there was a heavy predominance of infrastructure funds solely relying on value creation generated by very highly geared financial and fee structures, along with the notion of letting the assets run themselves with reduced capital investment. The global financial crisis has abruptly brought this approach to an end for the foreseeable future. New requirements of needing a club of banks to provide debt financing, more stringent industry gearing ratios as well as tighter debt covenants mean GPs now have to focus on creating value through enhanced operational performance.

Asset management has always been an underlying discipline within the infrastructure industry. The key issue has been under what ownership (public or private) and regulation (or no regulation) these assets have been managed. Under government ownership the focus is on public service, whereby the provision of services is provided to all. These services have been historically cost-inefficient as the respective owners (that is, governments) were not focused on profitability, but rather on attempting to provide quality services at a price that was essentially subsidised by all taxpayers. Consequently, large corporate overheads were developed and infrastructure assets were typically ‘over-engineered’ and ‘gold-plated’.

Under private ownership, conversely, the key differentiating focus is on profitability and high quality of service, which is contingent on the type of regulation (such as cost-plus regulation or incentive-based regulation) applicable to the asset. It should be noted that private owners will implement their respective differentiated incentives to

create short-term and/or medium-term and/or long-term value depending on their respective investor base (such as publicly traded strategic players, private equity funds and unlisted infrastructure funds).

The global financial crisis has recently created a mutual focus, for both publicly and privately held infrastructure companies. Asset management is now a requirement for all infrastructure owners to create enhanced operational efficiencies that can no longer rely on government subsidies or highly geared financial structures.

There is a great misnomer among some observers outside of the infrastructure industry that the asset class is boring and changes are very slow to implement. However, considering the confluence of privatisations, technological changes, regulatory changes and growth of emerging markets over the last 15 years, it has become evident that this period has been the most dynamic since many countries spent years rebuilding their infrastructures out of the ruins of the Second World War. Nevertheless, recent events, including the fallout from the global financial crisis, indicate that the next two decades at least could be even more dynamic. Various factors, both regionally and globally, could put various pressures on infrastructure companies, which could have the potential to positively or negatively impact these entities. These factors include those outlined below.

Enormous build-out requirements

Booze Allen Hamilton's report entitled *Lights! Water! Motion!* estimated in February 2007 that the global build-out requirements for the next 25 years would equate to some $40 trillion, while the OECD's *Infrastructure to 2030* report, published in January 2008, estimated it could be high as $65 trillion. The numbers are extremely large and investment will be required from both public and private sectors around the globe.

Many OECD countries now have large refurbishment requirements to replace their existing infrastructures that were built directly after the Second World War. In emerging markets, particularly China and India, there is an enormous need to provide appropriate infrastructure for these fast-growing economies. Paradoxically, while many governments view these infrastructure build-outs as an opportunity to create jobs, other governments are postponing projects indefinitely due to financial constraints and concerns over large cost overruns. Herein lies one of the greatest opportunities for institutional and private infrastructure investors: to work with both publicly and privately held owners that require capital.

Constrained capital markets

The global financial crisis has impacted the capital markets for the foreseeable future, with the resulting flight to quality credits. Well-structured issues from infrastructure companies have been a beneficiary of this. However, in general, tenure has been shortened, the spreads have increased, loan-to-value (LTV) ratios have decreased and covenants have been tightened. This creates challenges and opportunities for investors to acquire new assets to work with infrastructure companies whose debts are becoming due and/or their respective balance sheets require restructuring.

Changes in regulation and political risk

With the exception of a few countries with a long-term history of stable and predictable regulatory regimes, many countries' regulations have been rapidly evolving, relatively speaking, over the last 20 years. Recent regulatory determinations indicate a trend towards incentive-based regulations with a focus on operational-efficiency targets. With respect to political risks, infrastructure assets are generally strategic in nature. As such they are likely to be surrounded by nationalistic issues when foreign investors (including strategic investors, infrastructure funds and sovereign wealth funds) seek to acquire these assets. In addition, with regards to current economic conditions, infrastructure investors need to actively monitor various countries with large fiscal difficulties that may ultimately consider an increase in taxes or perhaps could even implement a windfall profit tax.

While incumbent infrastructure companies have always been active in stakeholder management, infrastructure investors would be remiss today if they were not to take a proactive role in monitoring and/or engaging with na-

tional and regional government entities, regulatory entities and other special-interest groups that can influence these entities.

Macroeconomic factors

The first decade of the 21st century has been relatively benign with regards to interest rate fluctuations. However, since the global financial crisis there is prevailing uncertainty, at least for the foreseeable future, as to what extent inflation or deflation will take hold in various countries and regions. In addition, there is also greater uncertainty about foreign exchange risk as investors invest across regions. How governments will respond to these challenges, through measures including quantitative easing and increasing inflation rates, and correspondingly how infrastructure owners manage their assets in this uncertain climate, could be the defining factors about whether value is created or destroyed.

Demand-profile changes

Over the last couple of years, various infrastructure sectors have been subject to changes in demand trends that could be short-lived, will continue for some time to come or possibly even become a permanent pattern. As an example, several countries are seeing their first-ever decreases in energy consumption due to energy conservation, higher energy prices and/or economic downturn. GDP-correlated assets, such as airports or ports, have witnessed downturns attributed to the global economic crisis as well as from occasional *force majeure* events, such as pandemics and volcanic eruptions, and other unexpected events such as terrorism. Taking a view of how the next two decades could develop, it becomes readily apparent that there will be impending structural shifts in demand as various emerging markets grow exponentially, while some developed economies contract or record slower growth rates. Going forwards, infrastructure investors clearly need to expect the unexpected and plan accordingly.

Technological change

Over the last two decades there have been profound transformational changes, most notably in the telecoms and energy sectors with the advancement of technologies in mobile networks and gas-turbine generation as well as renewable energy. There will also likely be technological advancements in the coming decade that may also prove to be transformational or perhaps even disruptive to various sectors. Just how an infrastructure owner embraces technological change could determine whether its company is at the top or bottom of the food chain.

Carbon reduction and renewable energy

While the Copenhagen Accord did not commit countries to a binding successor agreement to the Kyoto Protocol, there are nonetheless numerous countries focused on reducing the intensity of carbon emissions through carbon-emissions certificates, renewable energy and other measures. Yet there remains some level of uncertainty as governments are faced with mounting fiscal pressures and may be required to postpone or change various carbon-emissions mechanisms and/or subsidies for renewables in the near term and possibly later. The recent announcement in Spain to consider introducing a 30 percent retroactive tax on solar photovoltaic generation asset owners sent shockwaves through the industry. The actual outcome was the Spanish government approved legislation that did not retroactively reduce existing tariffs but did cut feed-in tariffs by between 5 percent and 45 percent for new photovoltaic plants. Thus, infrastructure investors need to revisit their assumptions with respect to this area in the intermediate-to-near term.

Volatility of commodity prices

In recent years there has been an increase in the volatility of commodity prices including oil, gas, electricity, steel, copper and other materials essential for operating various infrastructure sectors. Moreover, efforts demonstrated by various countries to ensure security of supply will likely increase volatility in various regions. Infrastructure companies will therefore need to enhance their planning and operations appropriately to minimise the downside risk from these commodity price swings by hedging, managing their costs more efficiently or changing to various other sources of supply.

Revival of labour unions

With the recent economic downturn in many economies and the introduction of government-initiated austerity programmes, labour unions have become more vocal, as exemplified by a large number of sizable strikes across Europe and elsewhere in the second half of 2010. It remains to be seen precisely how much influence the unions will have on infrastructure assets and the industry at large. Irrespective of any future developments, infrastructure investors can no longer ignore the need to build relationships with workers and their representatives and must communicate with them regularly.

Greater influence of end-users

Unlike most other industries, infrastructure has always had proactive end-users (comprising large industrial to residential customers) that have often been able to influence the appropriate regulators and politicians regarding matters such as those concerning tariff rates, emissions and renewable energy. Investors should expect that these end-users will continue with their respective agendas and should therefore regularly monitor, and where appropriate, engage with these important and influential customers.

Therefore, the future success or failure of investments in infrastructure is likely to rely on an investor's asset management skills and its respective capabilities to engage with the various key stakeholders to create enhanced operational efficiencies that maximise stakeholder value while delivering appropriate levels of service. The key critical success factor is having a team of experienced individuals who have respective infrastructure industry backgrounds, and therefore the skill-sets and experiences that facilitate the careful monitoring and where appropriate, management of the aforementioned factors.

The above factors highlight that every infrastructure asset is unique and features its own specific legacy; to assume each asset can perform similarly and be managed similarly to other infrastructure assets is a recipe for value destruction and stakeholder backlash. Therefore, the purpose of this book is to provide insight into the best practices and lessons learned from a number of leading experts with practical advice about investing in and managing infrastructure investments. The first half of the book provides multiple perspectives on asset management and its best-practice methods, which are discussed in detail by seasoned experts with considerable experience in investment, change management, due diligence, insurance, pensions, legal, banking & finance and ESG-related matters. The second half of the book features a series of in-depth case studies across various infrastructure sectors around the globe, written by infrastructure funds and industry managers, which reveal how financial and non-financial value has been created. Collectively, this book provides a valuable toolkit for the reader of best practices in global asset management of infrastructure assets with the goal of creating and maintaining value for all stakeholders.

I would like to take this opportunity to express my deep gratitude to the authors for their invaluable contributions. In addition, I would also like to thank Anthony O'Connor and PEI Media for all their immense professional support. It has been a true honour and pleasure to work with these individuals on this special publication. ●