AUSTRALIAN INFRASTRUCTURE INVESTMENT REPORT 2018

INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

Perpetual

ABOUT US

INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

Infrastructure Partnerships Australia is an independent think tank and executive member network, focused on excellence in social and economic infrastructure. Formed in 2005 as a genuine and enduring policy partnership between Australia's governments and industry, we exist to shape public debate and drive policy reform for the benefit of the national interest.

Infrastructure Partnerships Australia's formation recognises that through innovation and reform, Australia can extract more from the infrastructure we have, and invest more in the infrastructure we need.

Infrastructure is about more than balance sheets and building sites. Infrastructure is the key to how Australia does business, how we meet the needs of a prosperous economy and growing population and how we sustain a cohesive and inclusive society.

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Perpetual

Perpetual is an ASX-listed, diversified financial-services company with a rich history dating back to 1886. Across three businesses – Perpetual Investments, Perpetual Private and Perpetual Corporate Trust – the focus is on protecting and growing clients' wealth with a relentless focus on consistent delivery over time.

Perpetual Corporate Trust (PCT) is the leading independent provider of corporate trustee services to the managed funds industry and debt markets in Australia.

With a deep understanding of the market across Australia and Asia-Pacific, Perpetual has the trustee, fiduciary, legal, accounting, transactional, investment structuring and funds management expertise to offer a range of responsible entity, trustee and custodial services to clients large and small.

We work with sovereign wealth funds, pension funds and fund managers ranging from large, global players to domestic boutique managers. Administering more than A$243 billion on behalf of our clients as at 30 June 2018 across property, infrastructure, equities and alternative asset classes, we simplify administration and minimise the compliance and regulatory burden for our clients.

We act as a trustee for many infrastructure funds and investors, so we have a keen interest in the future direction of Australian infrastructure.

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About the 2018 Infrastructure Investment Report

Infrastructure Partnerships Australia and Perpetual Corporate Trust are pleased to jointly deliver the 2018 edition of our annual *Australian Infrastructure Investment Report.*

This year's report captures the views of sophisticated international and Australian investors who together collectively own or manage circa AUD$380 billion of infrastructure assets across the globe.

Our annual report provides a comprehensive view of investor appetite and sentiment. It reveals insights into the drivers and challenges for infrastructure investors, which include sovereign wealth funds, pension funds, fund managers, banks and other infrastructure professionals.

While almost all participants are Australian-based, just over half have their head offices in Australia, while the others are evenly spread across Europe, North America and Asia.

EXECUTIVE MESSAGE

The 2018 *Australian Infrastructure Investment Report* shows that Australia is still the destination of choice for infrastructure investors, but our hard-won reputation is under material threat. Our research reveals that both international and local investors are alarmed by increasing market intervention, abrupt and recurring regulatory reviews, as well as frequent changes in Australia's political landscape. Confidence and preparedness to invest in energy assets has taken a hit this year, reflecting the high degree of uncertainty about the direction of our national energy policy.

Australia is still the destination of choice

Australia remains globally attractive, with 90 per cent of participants reporting they are 'highly likely' to invest in Australian infrastructure in the next two to three years. This is an increase of 20 percentage points from 2017.

Visibility of transactions and projects in the Australian market has improved over the last few years due to initiatives such as infrastructurepipeline.org and project priority lists published by state and Federal infrastructure bodies. Indeed, only 27 per cent of participants report visibility of the pipeline as a challenge this year.

Roads remain the most attractive asset type, followed by water, social infrastructure and tunnelling projects, reflecting the healthy pipeline of projects within the east coast market.

Energy investment, the victim of policy uncertainty

While interest in almost all types of infrastructure assets increased this year, investor appetite for energy assets took a hit. An overwhelming 87 per cent of participants agreed there is widespread uncertainty in Australia's energy sector.

Participants explained that frequent changes to Australia's national energy policy and a range of regulatory and market interventions has had a real and enduring impact on their willingness to invest in energy assets. Political risk remains a major concern for investors, with 70 per cent of participants citing it as a reason for their lack of confidence in the energy sector.

A reputation hard won and easily lost

This year's *Australian Infrastructure Investment Report* demonstrates that the strength of the Australian infrastructure market should not be taken for granted. While Australia still performs well among its international peers, our reputation as a leading market for infrastructure investment is hard won and easily lost.

If Australia is to maintain its position as one of the world's leading infrastructure investment destinations, policymakers, regulators and the business community must take heed of investors' concerns. Collectively, we need to reflect on what makes Australia attractive to infrastructure investors if we are to remain an international success story.

We thank each participant for their contribution to the fourth *Australian Infrastructure Investment Report.*

Adrian Dwyer
Chief Executive Officer
Infrastructure Partnerships Australia

Richard McCarthy
Acting Group Executive
Perpetual Corporate Trust

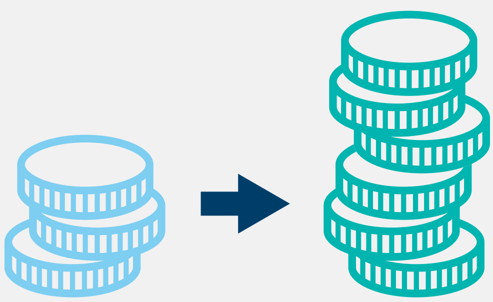
KEY FINDINGS

INVESTOR APPETITE FOR AUSTRALIAN INFRASTRUCTURE IS STRONG

90 per cent are 'highly likely' to invest in Australia, up from 70 per cent in 2017.

INVESTORS ARE BECOMING MORE COMFORTABLE INVESTING A LARGER TOTAL AMOUNT IN AUSTRALIA...

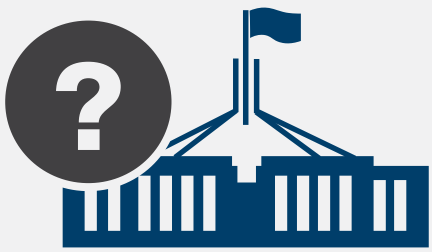
71 per cent are comfortable investing over $2 billion in Australia, up from 50 per cent in 2017.



...BUT CONCERNS OVER POLITICAL AND REGULATORY UNCERTAINTY DAMPEN INVESTOR CONFIDENCE

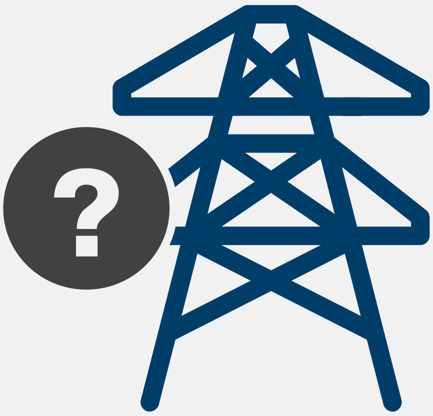
84 per cent agreed that uncertainty in Australia's policy and regulatory settings is limiting their willingness to invest.

Perceptions of political stability in Australia are also at a four-year low, with 50 per cent saying Australia's political landscape is below average or one of the worst.



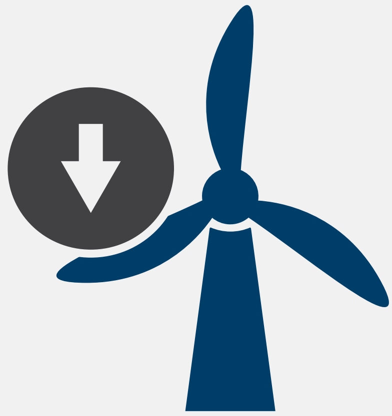
THE AUSTRALIAN ENERGY SECTOR IS FULL OF UNCERTAINTY

87 per cent said the energy sector was full of uncertainty, up from 74 per cent in 2017.



PREFERENCE FOR INVESTING IN ENERGY GENERATION HAS DROPPED

Investors are interested in all asset types, but interest in energy generation has seen a small drop.



INTEREST IN SOCIAL INFRASTRUCTURE EMERGED AS ONE OF THE MOST FAVOURED ASSET TYPES

Social infrastructure made the biggest jump with 76 per cent of investors interested in social infrastructure assets, up from 42 per cent in 2017.

OUR STRONG INFRASTRUCTURE TRACK RECORD AND SOPHISTICATED MARKET PARTICIPANTS STILL ATTRACT INVESTORS

Despite the number of challenges in the market, 70 per cent say our track record of infrastructure business gives them confidence about investing in Australia.

METHODOLOGY & PARTICIPANT PROFILE

Methodology

This report provides a unique insight into the preferences, intentions and sentiments of major market participants about investing in Australian infrastructure.

In September 2018, we conducted a quantitative survey of 33 market participants about investing in Australian infrastructure.

We followed this with detailed qualitative discussions with six market participants to gain a deeper understanding of the issues.

This pool of participants currently own or manage infrastructure investments around the world totalling more than AUD$380 billion.

Accordingly, this report draws on the quantitative and qualitative research to provide insights into the perceptions of investors about Australian infrastructure and the factors that influence their decisions.

As the fourth edition in this series, this year's report builds on the learnings from the previous three editions. It highlights how perceptions around the challenges and attractions of investing in the Australian market have changed over time.

We commenced this survey in the week following the change in Federal Government leadership. Energy policy and the proposed National Energy Guarantee (NEG) were key features of the leadership change, which saw Scott Morrison become the sixth Prime Minister of Australia in ten years. This meant that concerns around political risk and energy policy were common themes for participants in this year's survey

Participant Profile

For the 2018 edition of the report we surveyed a range of large infrastructure players, including fund managers, banks, foreign pension funds, domestic superannuation funds, sovereign wealth funds, as well as infrastructure constructors.

Over half of the participants had their head office located in Australia, with the remainder spread evenly across Europe, Asia and North America. Almost all the individuals we surveyed were based in Australia, reflecting the importance of local presence to effectively participating in the Australian infrastructure market.

Survey participants included Chief Executives, Chief Investment Officers, Fund Managers, General Managers, as well as Transaction and M&A Managers.

PARTICIPANTS' INVESTMENTS

Between them, survey participants owned or managed a total of more than AUD$380 billion in infrastructure investments worldwide. Half of these participants had global infrastructure investments worth more than $10 billion, as shown in Figure 1.

From the survey participants this year, 97 per cent were already invested in Australian infrastructure. Almost two thirds of the participants had more than half of their investments in Australia, as shown in Figure 3.

The participants had existing investment stakes in a broad range of asset types, however some asset types were more prevalent than others. Like previous years, roads and social infrastructure were the most common types of assets invested in by participants, followed by passenger rail and ports, as shown in Figure 4.

Figure 1: Profile of survey participants' global infrastructure investments ($AUD)

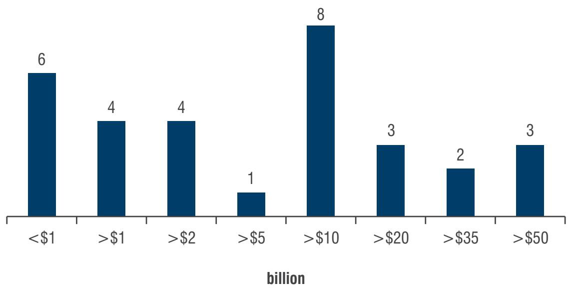


Figure 2: Current investment in Australian infrastructure

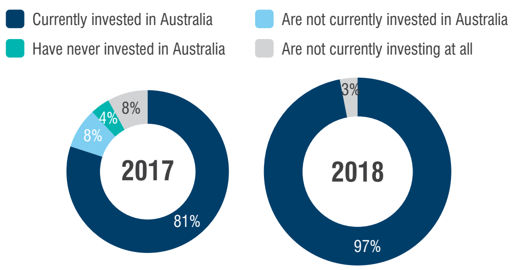


Figure 3: Proportion of total investments in Australia versus anywhere else

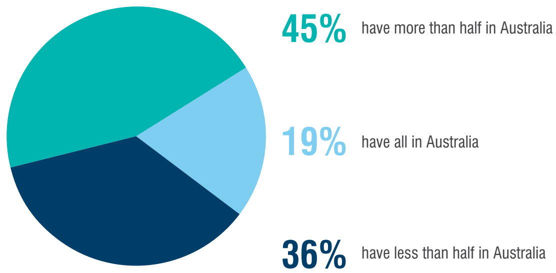
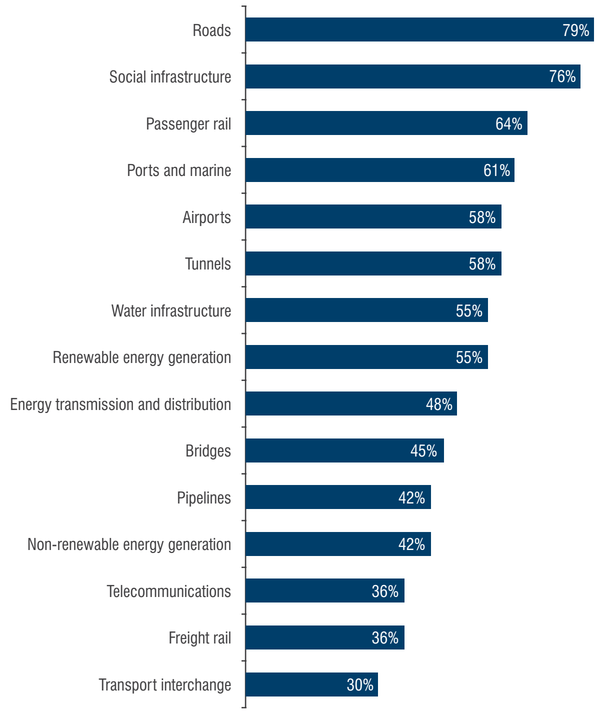


Figure 4: Global profile of participants with an investment in each asset type



INVESTMENT INTENTIONS

Investor appetite for Australian infrastructure rebounded this year with 90 per cent of participants 'highly likely' to invest in Australian infrastructure in the next two to three years, a 20 percentage point increase from 2017 (see Figure 5). When combined with the seven per cent who are considering investing in Australia, the 97 per cent investment intention is a marked increase from 83 per cent in 2017. None of the participants said they are unlikely to invest further in Australia.

In terms of asset types, participants cited roads, water infrastructure and social infrastructure as the most attractive assets for investment (Figure 6). Interest in social infrastructure increased by 34 percentage points from 2017, with participants indicating the increasing volume and value of social infrastructure projects as the key drivers for the increased interest in the asset type.

Renewable and non-renewable energy generation were the only asset types where interest dropped compared to 2017. Meanwhile energy transmission and distribution had the lowest growth in investor interest compared to other asset types, with just a six percentage point increase compared to 2017 (see Figure 6).

These findings are consistent with growing investor uncertainty in the energy sector due to the absence of a clear national energy policy or approach to emissions reduction and energy reliability.

"There's been a lot of misinformation and now the result is you don't have an energy policy that people can understand, trust or believe in."

Global Investor

"There was a period of extreme enthusiasm last year [around the National Energy Guarantee]. People would have started building in a relative period of policy certainty, that's now been undermined so I understand people saying that their expectations in that sector haven't increased and the fact that they've stayed at this level is probably relatively positive."

Fund Manager

We discuss energy investment further in the *Energy in Focus* section on page 17.

Figure 5: Likelihood to invest in Australian infrastructure

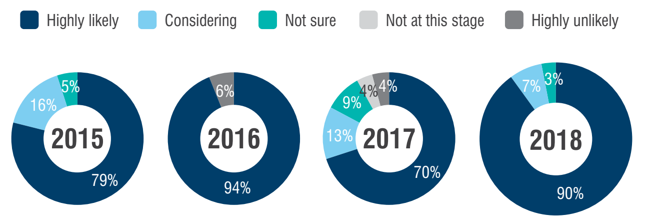
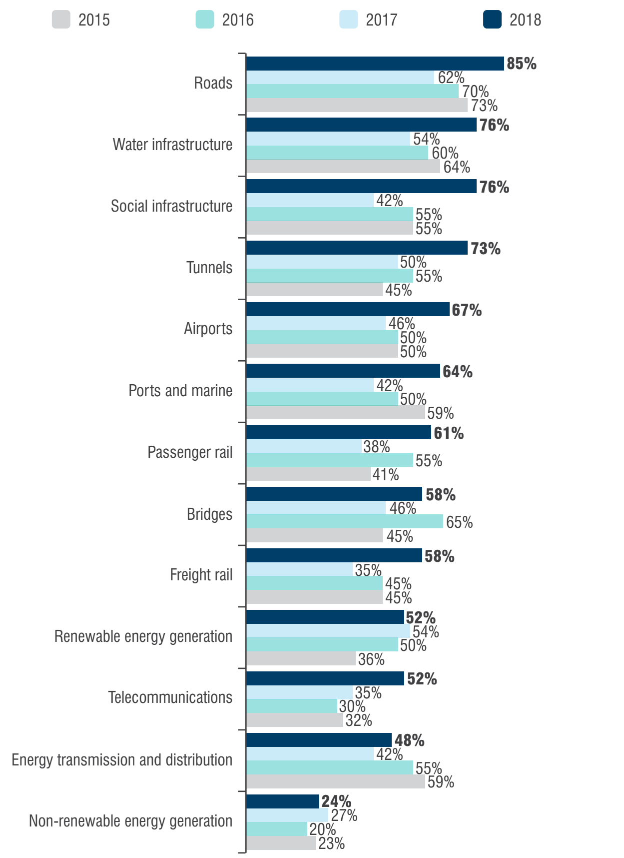


Figure 6: Preferred Australian asset type to invest in



When it came to investment preferences, participants showed an increased preference for unregulated assets, which are substantially more popular than last year when most participants had no preference (see Figure 7).

Participants suggested that the increased preference for unregulated assets can be partly attributed to increased uncertainty surrounding regulated assets and the expected returns on investment. A myriad of regulatory reviews and proposals, some influenced by a perception of political objectives, is making investors rebalance their interest toward unregulated assets.

""Whether it is social housing, telecommunications, airports, it kind of doesn't matter. As long as the assets have some infrastructure-like characteristics, which tends to be a little bit de-risked, then they're investable."
Debt bank

"The reality is that regulated assets are now more subject to critical nuance, interference and influence, and there are risks embedded in that, which the financial investor can do very little about once the tide of opinion turns against them."
Global investor

"People used to say, 'I like regulated assets because it gives me certainty, stability' now if you are on a regulated asset there is a lot of uncertainty because the regulator is really hammering down on returns."
Debt bank

"… You are at the mercy of the regulator and they are influenced by the political climate."
Fund manager

Figure 7: Preferred regulatory model for investments

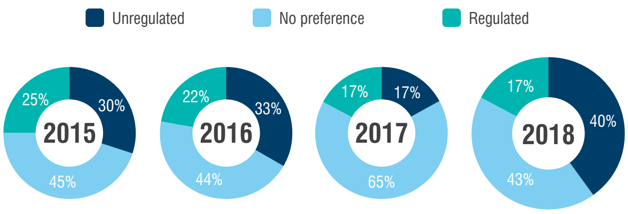
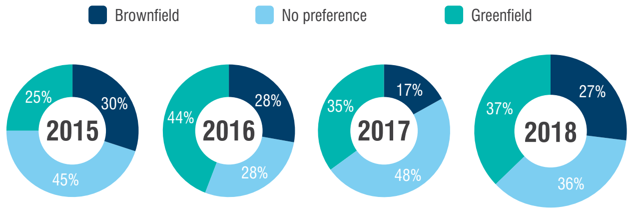


Figure 8: Brownfield or greenfield



Investors also have an increased preference to invest in Australian infrastructure either directly or as part of consortia, with 84 per cent of participants preferring these methods (see Figure 9).

There is an increase in the total amount investors are comfortable investing in Australia. 71 per cent of participants indicated a willingness to invest over $2 billion in Australia, which is a 21 percentage point increase from 2017 (see Figure 10). On the size of single investments, investors continue to consider investments across a range of sizes, with small increases observed across most of the thresholds compared to 2017, as shown in Figure 11.

Figure 9: Preferred method for investing in Australia

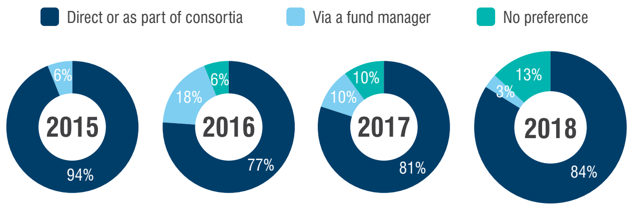
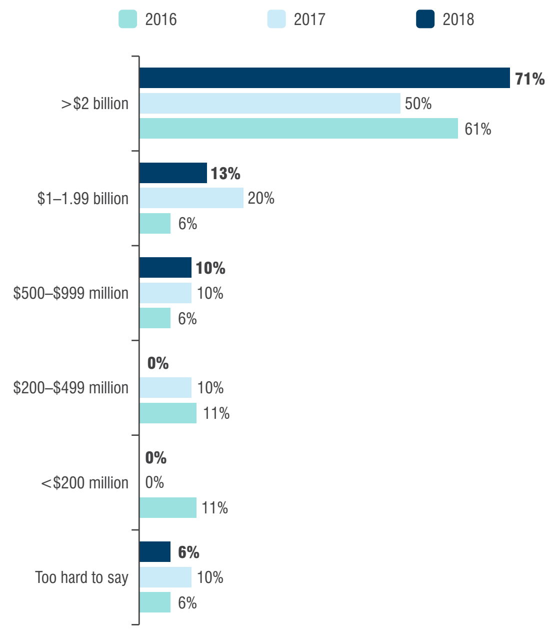


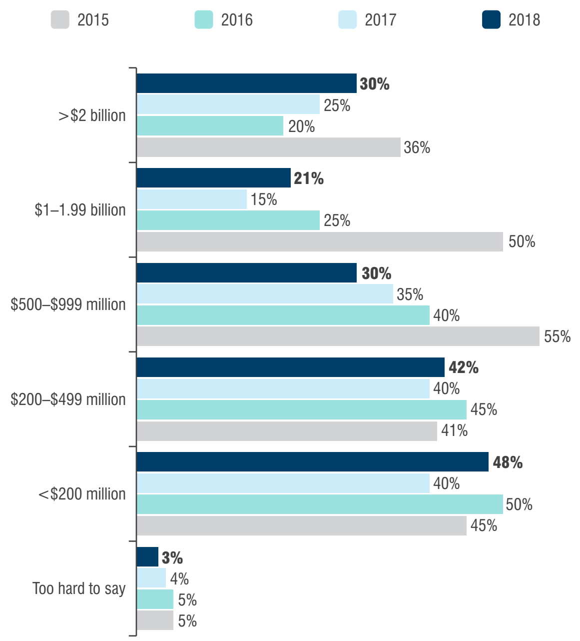
Figure 10: Total amount comfortable investing in Australia



"Notwithstanding all the political issues we've had in Australia, I think everyone, global investors as well as local investors, is still comfortable with Australia as an investment destination."

Debt bank

Figure 11: Single investment sizes considered by participants



The increased interest in individually investing over $1 billion in Australia is consistent with investors growing their local teams. 80 per cent of participants indicated that the size of their teams in Australia was growing, a significant increase from 59 per cent in 2017 (Figure 12). Some participants pointed to the reduced reliance on external investment managers as the main reason for the growth. Others suggested that certain types of investors, such as superannuation funds, are becoming more sophisticated infrastructure investors and are therefore bringing relevant specialist skills in-house.

Expectations on shifts in investment behaviour have changed minimally since 2017. The most notable change has been a skew towards unregulated assets (as discussed above) and greenfield assets, which is attributed to high activity in the greenfield pipeline and the brownfield pipeline slowing down (see Figure 13).

Figure 12: Size of teams in Australia

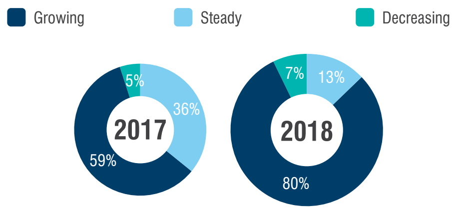
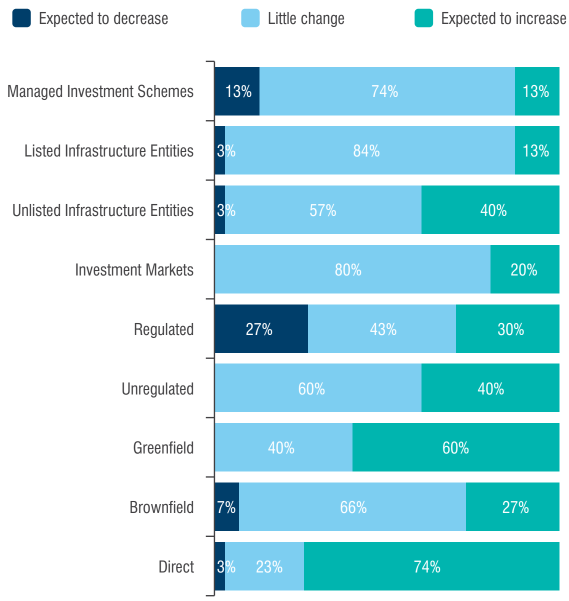


Figure 13: Likely changes in investing behavior



WHY AUSTRALIA FOR INFRASTRUCTURE?

Our strong track record of infrastructure business, knowledgeable market participants, and stable economy continue to attract investors. However, this attractiveness is under threat. Investment certainty fell 17 percentage points to a record low due to the cumulative impact of repeated interventions in energy regulation, taxation policy and foreign investment processes, which are creating an unsettled investment environment (see Figure 15).

The 10 percentage point increase in 'strong knowledge of market participants and partners' this year is consistent with investors becoming more comfortable with investing larger amounts in Australia (see *Investment Intentions* section on page 7). This indicates that investors are becoming more familiar with the local infrastructure market.

However, participants also said the certainty of the Australian pipeline is not as attractive compared to 2017. Only 24 per cent of participants said pipeline certainty made Australian infrastructure attractive, a fall from 35 per cent in 2017 (see Figure 14). Some participants said it is still unclear how some of the proposed greenfield projects will translate into real opportunities, with more certainty required from governments around delivery models. Others commented on the diminishing brownfield pipeline as Victoria and New South Wales have recycled assets, but it is not expected that Queensland and Western Australia will do the same in the near-term.

Concerningly, this year investment certainty took a sharp fall. Only 18 per cent of participants thought investment certainty was an attractive factor in considering investing in Australian infrastructure. This is half of the 35 per cent in 2017. Australian political and regulatory uncertainty, including energy regulation, taxation policies, and a myriad of competition reviews, have contributed to this decline (see Figure 15).

Additionally, 87 per cent of participants agree that project cancellations or threats of contract cancellation make investment in Australia less attractive. This suggests investors have long memories when investing capital in major projects and calculating risk-adjusted returns.

"The ATO is increasingly hard to read and overstepping their role in enforcement versus legislating, so we're finding increased scrutiny of structures which are perfectly legal and the ATO now targeting you as high risk, even if you make investment decisions based on what's in the law. That's happening on a range of funds on tried and tested structures. Staples is the obvious one but it's also on Public Private Partnerships (PPP) investment, and energy investment as well."

Fund manager

Figure 14: What makes Australia attractive for infrastructure investment?

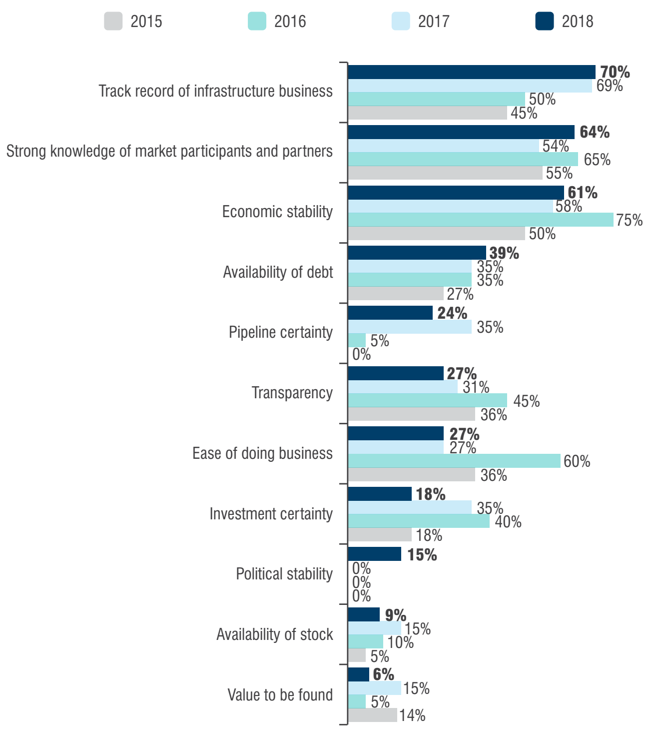
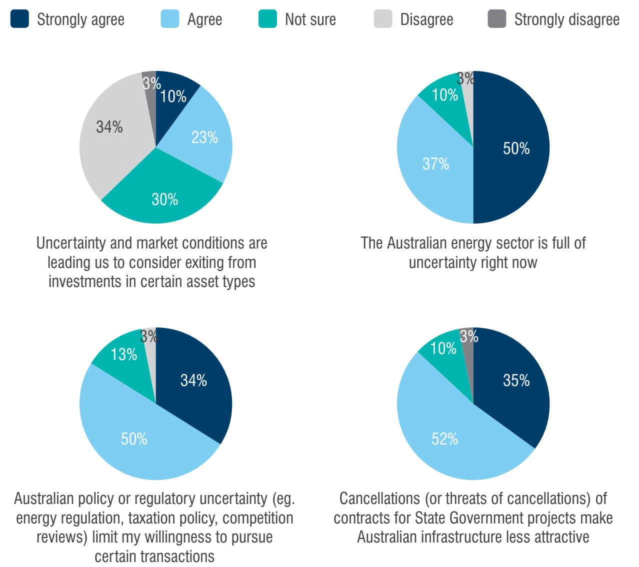


Figure 15: What market conditions are impacting investment?



EMERGING CONDITIONS IN THE MARKET

This year, participants also expressed views about social licence, adoption of technology and community influences on private ownership and operation of public infrastructure assets (see Figure 16).

Social Licence

The results show comprehensive agreement that investors are increasingly recognising the importance of environmental, social and governance (ESG) objectives of their investments.

"Environmental and social objectives are becoming more important, your social licence to operate in a particular country or in a particular sector is very relevant. If you don't have a social licence to operate you don't have a licence to operate because that social pressure of the community influences politicians and regulators."

Overseas bank

"We invest in socially beneficial projects. Our projects in this region are hospitals, rail infrastructure, prisons, renewable energy, and our business is generally very positive on ESG metrics, but we don't necessarily market that or capture the information very well."

Global investor

Adoption of Technology

On the impacts of technology on assets, nearly half the participants said there was a risk of technological advancements stranding certain assets. However, participants also expressed that, on the whole, technological change is seen through the lens of opportunity, with the trend likely to extend over time.

"Technological disruption is actually more an opportunity than maybe an existential threat."

Local investor

"The impact of technological change will definitely be a bigger issue over time… Everybody is trying to think ahead about whether there is some risk I may have to factor in and change my view on the rates of return. By and large, it's becoming part of the thought process but there's not enough evidence to support a hard reaction at this point in time."

Global investor

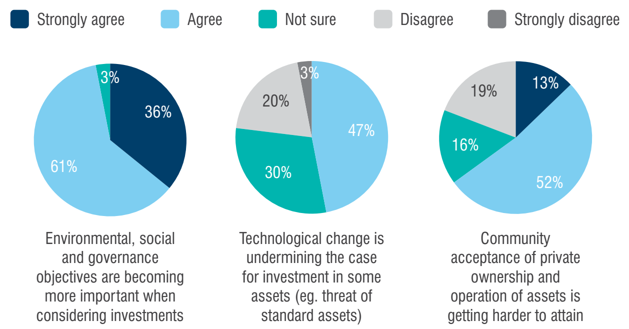
Community Influences

Attaining community acceptance of private ownership of assets was also identified as an emerging challenge. Participants noted that while some sectors are more sensitive than others in this respect, community perceptions change once consumers see direct benefits in service quality. But the responsibility to communicate these benefits to the community should be shared by industry and government.

"I don't think enough is being done by the industry or owners of assets to provide the benchmarks or evidence supporting the concept that private ownership maintains and delivers a better quality of service at a lower cost than the government is able to under public hands"

Global investor

Figure 16: Emerging themes for investors



AUSTRALIA VERSUS OTHER MARKETS

Europe and North America have overtaken Australia as a preferred region for investment. Australia's solid track record of infrastructure business and strong knowledge of market participants make Australia an attractive investment destination, which is enhanced further by our stable economy. However, the political backdrop and regulatory settings that have been Australia's strength are increasingly vulnerable to erosion.

A cumulative 96 per cent of participants said that Australia is one of the better markets when it comes to a track record of infrastructure business, including half who consider Australia to be 'a clear leader' (see Figure 17). The strong knowledge base of market participants and our economic stability further reinforce Australia's infrastructure reputation.

However, participants raised concerns over the regulatory and policy settings which have underpinned Australia's infrastructure record. The increasing uncertainty from the changing political, regulatory and taxation environments have not gone unnoticed.

Half of the participants said Australia does not provide the desired level of investment certainty. This is further underlined by taxation benefits being either 'below average' or 'one of the worst', a reflection of the suite of changes to stapled structures and foreign investor tax concessions announced by the Federal Government this year.

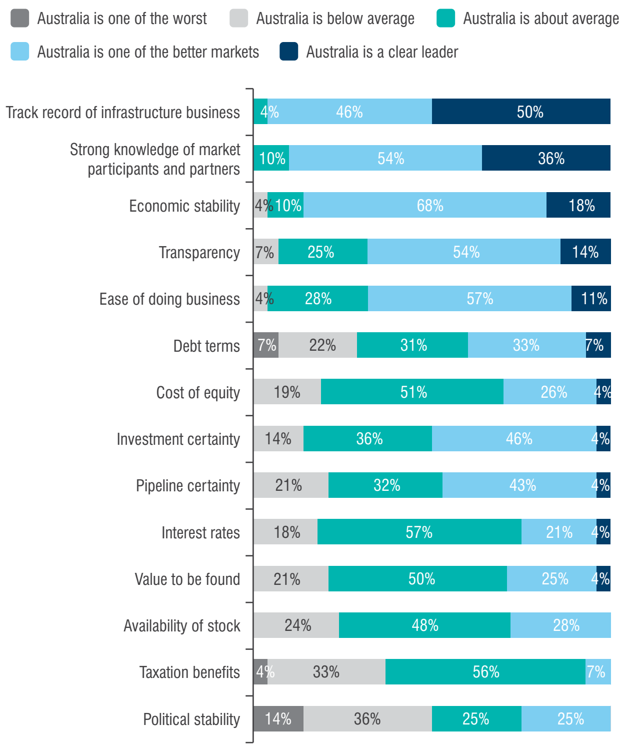
"Taxation is a huge issue, particularly for foreign investors. Four years ago, the playing field was probably skewed a little bit in favour of the foreigners, within a year it got sort of levelled out through moves from the Tax Office and then these last changes have shifted the balance materially in favour of domestic investors, to the point where foreign investors are really going to struggle to compete."

Local investor

"I think you could see foreign investors exiting the market. They're not wasting their time competing against locals because of the taxation disadvantage. Some of the locals are concerned about the secondary valuation of their assets because if they are going to sell their assets they want to have a nice competitive market to sell to."

Local investor

Figure 17: How does the Australian infrastructure market compare to other infrastructure markets?



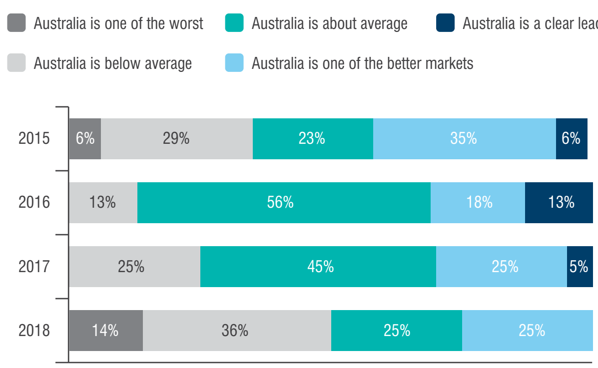
"It has impeded the longer-term growth of the country. Energy is a classic example, where governments have for the last 10 years just confused everybody."

Overseas bank

"It's all relative. How does Australia look versus Myanmar? Even with the changing prime ministers, Australia will always be a relatively stable destination. There's no shortage of money on the side lines both domestically and internationally wanting to invest in Australia."

Debt bank

Figure 18: Perceptions of Australia's political stability



As Australia's population grows, the community is becoming increasingly aware of the role that well-functioning infrastructure plays in raising standards of living. This growing need for transport links, affordable utility prices and access to social services has seen many infrastructure policies and projects become highly politicised.

This connection between political stability and policy certainty is a cause for some concern amongst investors, with perceptions of Australia's political stability halving this year. Half the survey participants said Australia's political stability was either 'below average' or 'one of the worst' (see Figure 18), a 25 percentage point increase from 2017.

Despite the concern over political stability, some participants were keen to emphasise that Australia remains an attractive investment destination, highlighting that there is still a great deal of domestic and foreign capital looking for opportunities.

"Infrastructure is very sensitive. Politics and infrastructure are inherently linked. Infrastructure is all about where politicians want to prioritise their investments…so political stability and decision-making have an inherent influence."

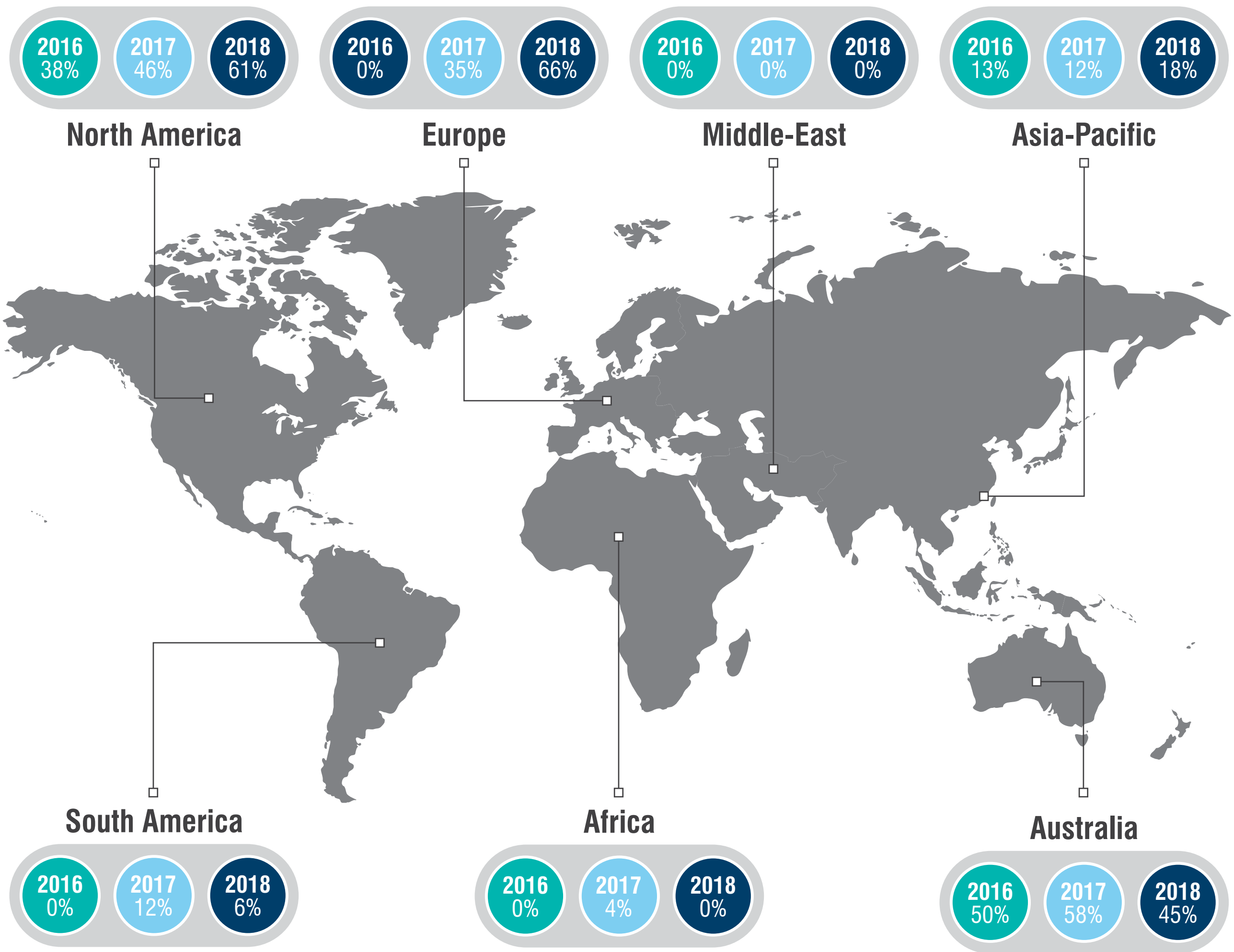
Local investor

When compared with other regions, preference for Australia has declined by 13 percentage points since 2017 (see Figure 19). Investors indicated growing preferences for Europe and North America.

Interestingly, 66 per cent of participants indicated that Europe provided compelling investment opportunities. This is a near two-fold increase from 2017. During the qualitative interviews, some participants suggested that the increased interest in Europe is due to the growing need to redevelop and replace some of Europe's ageing infrastructure systems.

Less surprising is the increased interest in North America. With the backlog of infrastructure upgrades in the region and the United States reducing its corporate tax rate from 35 per cent to a globally competitive 21 per cent, there is a shift towards the region with investors seeking opportunities in that market.

Figure 19: Regions with the most compelling opportunities



"The US market is also proving to be very active and the fundamentals around that market are very strong, everybody knows about the infrastructure backlog and the desperate need for investment. We have a team in North America and in LA and we have got something like 11 shortlisted PPPs we are lining up on, plus a very active renewable energy sector."

Global investor

"The theme around North America is very strong. Right now, we are increasing the size of our US team. In Europe, if you are a brownfield investor, looking to invest in an existing asset, there's a lot of existing infrastructure there that does get turned over reasonably frequently, so there are opportunities."

Global investor

STATE VERSUS STATE

New South Wales (NSW) and Victoria continue to top the rankings as the most attractive states for infrastructure investment. The Australian Capital Territory (ACT) followed with a slight increase. However, interest in other states has declined, with Queensland taking the biggest percentage point hit.

This year's state rankings for investor preference saw Victoria jump up 16 percentage points from 2017, to tie in first place with NSW, as shown in Figure 20.

These results illustrate the two-speed economy divide in the Australian infrastructure market. Both NSW and Victoria have capitalised on asset recycling policies to substantially increase their infrastructure funding levels over recent years, ensuring a strong pipeline of projects. While there is little to separate the top two states, the increased interest in Victoria can be attributed to the State's high volume of transport projects.

Conversely, interest in other jurisdictions (except the ACT) has fallen. This year, Queensland has experienced the biggest percentage point fall in investor preference with only 21 per cent of participants naming the State as a preferred investment destination, compared to 35 per cent in 2017 (see Figure 20). While the Queensland Government significantly increased its infrastructure funding levels in the 2018-19 State Budget, the Government's continued rejection of asset recycling was identified by participants as a deterrent to future investment.

Figure 20: Preference to invest on a state by state basis

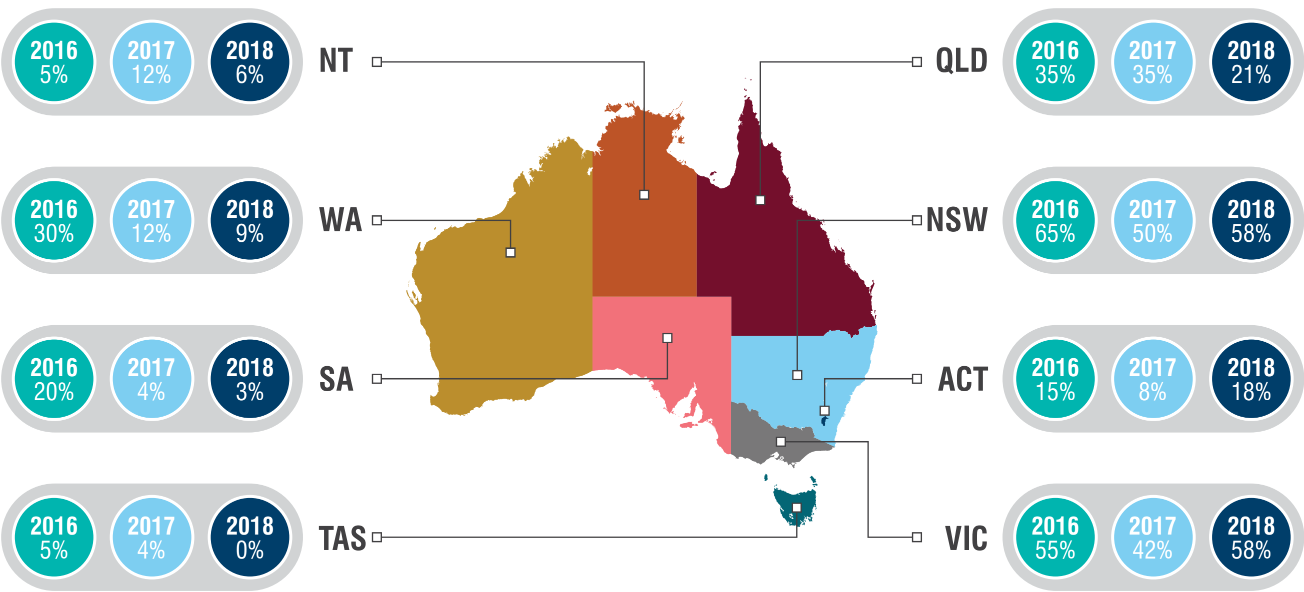
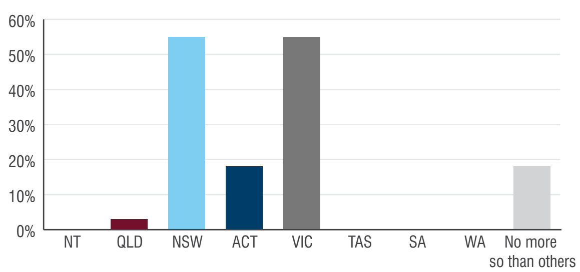


Figure 21: Ease of working with state governments and public administration



"If you look at New South Wales and Victoria and the type of people that they've got in New South Wales Treasury, in Transport for New South Wales, in the Victorian Treasury, they're people that they've attracted out of industry to go into the public sector who better understand how to deal with the private sector."

Overseas bank

CHALLENGES FOR AUSTRALIAN INFRASTRUCTURE

Participants pointed to political risk and competition for assets as key challenges faced in the Australian market. This corresponds with investors expecting fewer opportunities to come to market in the next two years.

Specifically, participants highlighted a correlation between the amount of capital in the market and the limited opportunities available. 42 per cent of participants said the market lacked opportunities, which is an 11 percentage point increase from 2017 (see Figure 22).

This year, 27 per cent of participants also said that competing with incumbents presented a challenge. Most participants agreed that with a substantial level of capital available in the market, there is a high degree of competition which reduces the opportunity to acquire assets.

"There is less opportunity and there is more competition, the number of funds is not going away. They are looking and the capital that's looking is not dissipating so as soon as an opportunity comes up everyone wants to go at it."

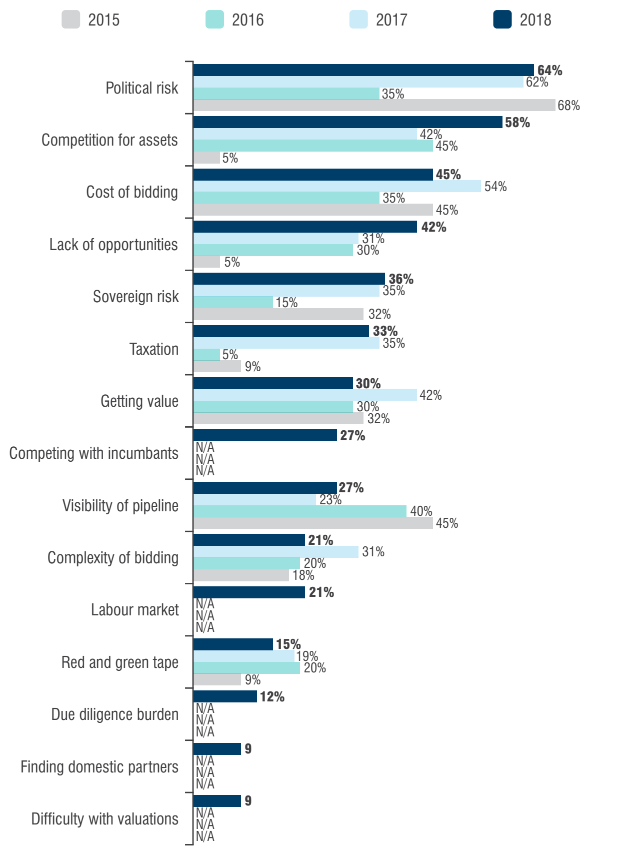
Global investor

"It would have to take a material increase in the number of opportunities before competition became less of an issue because there's just so much money chasing stuff. People are bidding very, very aggressively on their assumptions and the returns."

Local investor

Notably, perceptions of sovereign-type risk continue to climb. This seems to be the cumulative impact of past decisions to block two foreign bids for Ausgrid in 2016 and cancel (or threaten to cancel) some projects in previous years. This result demonstrates the material and lasting impacts of such interventions over time. This is further exacerbated by the emergence of regulatory uncertainty, as we discuss in the *Navigating A Changing Investment Landscape* section on page 18.

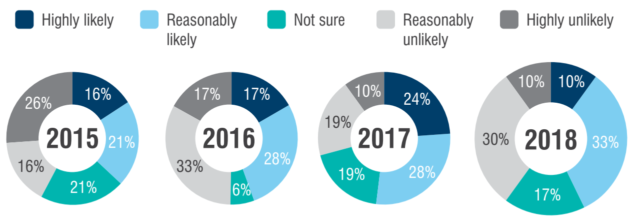
Figure 22: Most significant challenges to investing in Australian infrastructure



*N/A denotes these factors were not surveyed in past years

Referring mostly to brownfield transactions and secondary markets, the trend in opportunity scarcity is expected to continue over the next two years. Participants this year were split about whether the market will provide sufficient opportunities in the coming few years, a fall of nine percentage points from 2017 (see Figure 23).

Figure 23: Likelihood Australia will provide sufficient opportunity in the next two years



ENERGY IN FOCUS

For over a decade, energy policy in Australia has been uncertain and subject to intense public debate, which has damaged investor confidence. A substantial 87 per cent of participants said the Australian energy sector is 'full of uncertainty' right now, as shown in Figure 24. This is a 13 percentage point increase from 2017.

The consequences of long-term energy market uncertainty have emerged in the form of energy reliability and security concerns, combined with rising consumer prices. In response to this, governments at both state and Federal levels have made multiple interventions into energy markets and regulatory frameworks.

The decline in investor confidence caused by the abolition of the Limited Merits Review regime in 2017 has been added to this year by reviews into the guidelines for calculating the rate of return and the regulatory tax approach for energy networks. Similarly, recommendations made by the Australian Competition and Consumer Commission (ACCC) to intervene in retail and generation segments of the energy market have further dampened investor confidence.

Significantly, this year also saw Australia fail to secure a cohesive national energy policy through the proposed National Energy Guarantee (NEG) – a failure which contributed to a change in Prime Minister and key ministerial positions within the Federal Government. Participants commented that this has stifled investment in energy generation because there is no clear policy on integrating renewables into a reliable and cost effective energy system.

The lack of policy stability, combined with market interventions, has increased uncertainty for energy investors this year, with survey participants citing political and regulatory uncertainty as the two key factors limiting investor interest in the energy sector (see Figure 25).

Figure 24: Uncertainty in the Australian energy sector

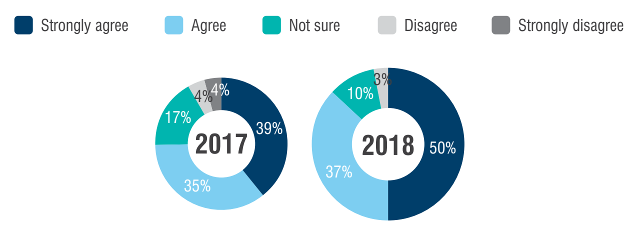
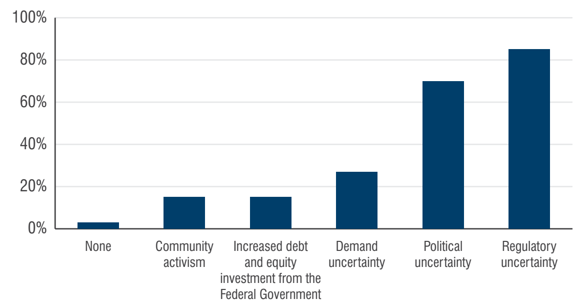


Figure 25: Factors limiting investor interest in the energy sector



"Governments are constantly changing the rules and it seems to be driven by very short-term reactionary policies impacting much longer-term investments. One needs to be pretty brave to underwrite investments predicated on a policy which could change."

Local investor

"Around the transmission and distribution space there are big concerns about the policy changes over the last couple of years. Things like the removal of Limited Merits Review, the rate of return review, and talk of writing off Regulated Asset Bases, elements which are sacrosanct to the fundamentals of investing in these sectors are currently coming under question. It makes people really pause for thought, not just about that sector but the broader theme of investing in Australia."

Local investor

"Energy has become a multi-headed beast. The Federal Government is sitting over a system which is driven by the behaviour of state governments so not only do you have one level of politics driving misadventures and bad policy, but you've got two levels of politics faulting each other with different policies."

Local investor

"Different political parties are playing off against each other so it's a disaster. The fundamental issue is that governments are just reacting and changing policy and regulation to get an outcome rather than making the harder more material decisions which would actually fix the problems."

Local investor

"Where there is uncertainty, we will find other things to invest in."

Global investor

NAVIGATING A CHANGING INVESTMENT LANDSCAPE

Australia's infrastructure investment landscape has undergone significant regulatory and policy change over the course of two years. While some of these changes have sought to provide greater transparency and clarity on investment processes (such as the establishment of the Critical Infrastructure Centre), others have resulted in material uncertainty for investors.

The acceleration of infrastructure asset recycling across various states attracted significant foreign investor interest, exposing some shortcomings of the Australian Foreign Investment Policy and attracting a measure of negative public debate. As a result, this year, we saw:

- the Federal Government pass the *Security of Critical Infrastructure Act 2018*, which gives effect to the Critical Infrastructure Centre;
- increased scrutiny of the use of stapled structures, including the tax treatment for foreign investors; and
- increased activity from regulators on brownfield and secondary market deals.

In March this year, the Federal Government announced a package of changes to the tax treatment of stapled structures, despite these being the most widely used investment vehicle by infrastructure investors in PPPs and privatisation transactions in Australia.

The Package, *Stapled Structures – Details of Integrity Measures*, proposed increasing the Managed Investment Trust (MIT) withholding tax rate from 15 per cent to 30 per cent. It also included changes to certain concessions available to foreign investors, including changes to the tax treatment of foreign pension funds and sovereign wealth funds.

These changes would make Australian infrastructure investment less attractive to foreign investors as substantial tax increases would increase their cost of capital and put them at a competitive disadvantage when competing with domestic investors. For domestic investors, the proposed changes would make it more challenging to find suitable partners to form consortia, as well as potentially reduce the equity value of their assets because of a leaner appetite in the secondary market.

This year, we also saw the decision to block Huawei from participating in the roll out of Australia's 5G mobile network, and the ACCC increase its scrutiny over Cheung Kong Infrastructure's (CKI) bid to acquire the APA Group.

With large deals in the Australian brownfield and secondary infrastructure markets, including the sale of a 51 per cent stake in Sydney Motorway Corporation (SMC), there was a re-emergence of sovereign-type risk as most investors required approvals from the ACCC, the Foreign Investment Review Board (FIRB) and the ATO before progressing. In the case of SMC, this saw a surprise delayed decision from the ACCC disrupt the transaction process, further adding to uncertainty for all bidders.

"We generally have a positive view of investing in Australia, but we also recognise that things are becoming more difficult. Be that through FIRB or ACCC or the recent changes by the ATO which removed a certain advantage I suppose international capital had over some of the domestic capital. But now that situation has essentially not just been neutralised it's been reversed. There's now an advantage from an after-tax perspective to the local players versus the international players so we'll have to think twice around future projects in Australia."

Global investor

"We certainly relied on some of these features which gave us a comparable taxation treatment to locals and as a foreign investor, it's increasingly hard to get a like-for-like treatment with local investors."

Fund manager

"There is increasing noise around foreign investment in Australia. The Government's established the Critical Infrastructure Centre to review foreign investment in our most critical infrastructure, there's just a lot more red tape that foreign investors need to go through, which is becoming harder."

Debt bank

CONCLUSION

The 2018 *Australian Infrastructure Investment Report* shows that Australia is still the destination of choice for infrastructure investors, but our hard-won reputation is under material threat. Investors are alarmed by the growing willingness of governments to intervene in markets, and the lack of policy and regulatory certainty.

The absence of a cohesive national energy policy has translated into dampened investor interest in energy assets. Moreover, fragmented regulatory reviews and frequent changes to Australia's political landscape continue to constrain investor confidence in the sector.

This year also saw investors emphasise the growing importance of environmental, social and governance objectives when making investment decisions, while also noting that community acceptance of private ownership and operation of assets is becoming harder to attain.

Despite some emerging challenges, investors showed increased interest for almost all asset types, with a large number of participants highly likely to make an Australian investment in the next two to three years. This positive sentiment reflects a considerable pipeline of projects and Australia's long track record of infrastructure innovation and delivery.

Overall, this year's *Australian Infrastructure Investment Report* demonstrates that we have much to celebrate. However, it's important that we don't take the strength of Australia's infrastructure market for granted. While Australia still performs well among its international peers, our reputation is hard won and easily lost.

If Australia is to maintain its position as one of the world's leading infrastructure investment destinations, we must take heed of investors' concerns and reflect on what makes Australia an international success story.

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