



## Superannuation investment in infrastructure

### Introduction

The increase in the current account deficit has led to calls for increased spending on public infrastructure.<sup>1</sup> The Deputy Governor of the Reserve Bank, Glenn Stevens, noted that capacity constraints in the rail network and ports were affecting Australia's export performance, which may increase the current account deficit.<sup>2</sup> As at the end of September 2004 total superannuation fund assets were about \$648.9 billion, and net inflows to superannuation funds were about \$5.8 billion a quarter.<sup>3</sup> Easily, superannuation assets represent the largest group of funds available for investment.

Against this background there have been calls for superannuation monies to be invested in infrastructure.<sup>4</sup> The Leader of the Opposition, the Hon. Kim Beazley, has suggested that investment in infrastructure be given special tax concessions to encourage superannuation monies to this sector.<sup>5</sup>

This Research Note will look at what is meant by the term 'infrastructure'. The general guidelines that trustees must follow when making investment decisions will be outlined and the advantages and disadvantages of superannuation funds investing in infrastructure considered. The many avenues for superannuation funds to invest in infrastructure will be surveyed and possible barriers to investing in the sector will also be discussed.

### What is infrastructure?

Infrastructure is a broad term for a range of economic and social assets with some distinctive characteristics. Infrastructure can be further divided into social and economic subgroups. Examples of social infrastructure are schools, hospitals, police stations, day care centres and prisons. Economic infrastructure may include transport and communications facilities, production and transmission of electricity, water and gas or materials handling facilities such as docks. It has been estimated that about 70 per cent of Australia's infrastructure is made up of economic assets.<sup>6</sup>

Because they must invest to earn a return, superannuation funds are most likely to be invested in economic infrastructure assets. Because investment in economic infrastructure has been identified as a key constraint in

Australia's trade performance, governments are likely to focus on ways to boost investment in this area.

### What must trustees do?

Under the *Superannuation Industry (Supervision) Act 1993* (SIS) a fund trustee must observe certain requirements when making investment decisions and formulating an investment strategy. These requirements protect members retirement benefits by minimising the risk associated with reckless, ad hoc or un-coordinated investments and ensure investments are made in accordance with the sole purpose and investment provisions of SIS.<sup>7</sup>

The investment covenant under paragraph 52(2)(f) of the SIS specifically covers the trustee's responsibility to formulate and give effect to an investment strategy that has regard to the whole of the fund's circumstances including (but not limited to):

- the risk involved in making, holding and realising investments, as well as the likely return from the investments having regard to fund objectives and expected cash flow requirements
- the composition of the funds' investments as a whole including the extent to which the investments are or are not diversified and the associated risks
- the liquidity of the funds' investments having regard to its expected cash flow requirements (i.e. how much is expected to be paid out and when it is to be paid), and
- the ability of the fund to discharge its existing and prospective tax liabilities.

The investment strategy covenant is complemented by the other covenants in section 52 of the SIS which require, among other things, the trustee to exercise the degree of skill, care and diligence of an ordinary prudent person dealing with the property of another for whom the person felt morally bound to provide (i.e. the 'prudent man' rule).<sup>8</sup>

The requirements apply to all investment decisions made by a fund trustee. The various characteristics of each asset class, or investment, in combination with the unique profile of each superannuation fund, will determine how much of a fund's money is invested in any particular investment. For example, if the overwhelming majority of

a fund's members are expected to retire within the following 12 months and claim their benefits, a trustee would be negligent if that fund's assets were not highly liquid and highly secure. Basically, only cash (i.e. the short-term money market) meets this requirement. On the other hand, if a fund's members were not expected to retire for many years the trustee would be justified in investing in assets that had the potential to achieve high rates of return over the long-term; such assets may include equities and property, and possibly infrastructure.

The rules were put in place to safeguard members' superannuation benefits. These requirements mean that trustees simply can't invest in just any asset, or take up any opportunity because it presents itself. Put another way, because of the need to invest superannuation assets in a prudent and responsible way superannuation monies cannot only be viewed as a pool of available capital for any and every investment purpose.

### Why infrastructure?

There are several reasons why a superannuation fund may want to invest in the infrastructure sector:

- earnings stability. Infrastructure projects tend to generate steady earnings and a dependable dividend stream.<sup>9</sup> Infrastructure assets such as airports, roads and ports have high replacement costs and may exhibit monopoly-like characteristics in their particular markets. The public may have no option but to pay fees for their use, as there are usually no (or limited) alternatives. Over time this income stream may tend to increase
- tax effective dividends. Depending on how the investment is structured (i.e. through a company, a trust or in partnership) the dividends paid may produce tax-free/tax-deferred income, or imputation credits<sup>10</sup>
- investment performance is not necessarily linked to the performance of other asset classes. Therefore investment in infrastructure can act as a hedge against adverse performance of other assets and increases the degree of diversification within a portfolio,<sup>11</sup> and
- long term maturity. Infrastructure assets produce returns over a long period of time. This suits many superannuation funds as they have a very long-term over which to invest.

From the government's point of view investment in infrastructure by the private sector reduces the call on government funds, these funds can be redirected to other areas; such as investment in social infrastructure.

### Some problems

Given the factors that trustees have to take into account, some characteristics of infrastructure make it less suitable for investment by a superannuation fund:

- liquidity constraints. If the investment is structured through a trust or a partnership it may be difficult to reduce the size of a fund's holdings if required
- difficult pricing. If the investment is structured through a trust, or a partnership, it is difficult to determine its current value. Valuations are usually done on the basis of recent sales for a similar asset in the same market, (always difficult if there are no similar assets), or on the basis of their earnings (which may not adequately capture its capital appreciation). Valuations may not be undertaken on a regular basis
- difficulty in attributing increases in value, or losses, to departing members. Because valuing an infrastructure asset may be difficult before it is sold or disposed of, attributing the growth in its value to the members' account may also be difficult. The member, when they take or transfer their benefits, may not be able to share in the increase in the value of the asset to the same extent that another member might who takes their benefit after the asset is sold
- selling the asset. If the asset is not listed on a stock exchange there may be a limited market for the asset if a fund needs to dispose of it
- the fees for the entity setting up the initial investment, and later managing that investment, tend to be high compared to fees charged by fund managers in other asset classes
- initial investment usually requires large amounts of capital. Infrastructure assets are not cheap. They require large amounts of capital and this usually means that only large funds can invest in infrastructure projects that are not listed on a stock exchange, and still meet the prudential guidelines outlined above<sup>12</sup>
- uneven supply of quality infrastructure assets. A number of projects have not performed as expected<sup>13</sup>
- where fees for use are regulated by government there is regulatory risk. Government may enforce a level of fees that make it uneconomic to operate the asset, or do not justify investment in repairs, maintenance or expansion of the asset,<sup>14</sup> and
- ownership reversion. In some projects the company or consortium has a right to own and operate the asset for a considerable length of time. But, once that time expires, the ownership of the asset reverts to the relevant government. Over the long-term such

conditions decrease the capital value of the asset in question.

### **How do superannuation funds invest in infrastructure?**

Superannuation funds can invest in infrastructure in four ways:

- by debt financing, that is lending to the owners or operators of the infrastructure
- through direct partnership with other entities to own and operate the asset
- through managed unlisted investment trusts, and
- through listed infrastructure investments.

Interest received from debt finance provided to certain infrastructure projects before 14 February 1997 enjoys concessional tax treatment.<sup>15</sup> Further, up to May 2004 the interest received from debt used to finance certain land transport projects was also concessionally taxed.<sup>16</sup> Information on how much, if any, monies invested by funds in infrastructure via debt financing is unavailable.

Superannuation funds sometimes become members of consortiums to purchase and operate infrastructure assets. For example, the Motor Trades Association (MTA) Superannuation Fund was part of the successful consortium bidding for the lease of Sydney airport. The MTA superannuation fund is amongst the best performing industry superannuation funds. Industry Funds Management (one of the investment arms of the Industry Superannuation Funds group) is part of a consortium that bought and operates the Wales and the West Gas Distribution Network (UK).

There are a number of managed funds (not super funds) specialising in infrastructure investment. Hasting Funds Management operate a number of funds specialising in Australian infrastructure.<sup>17</sup> Macquarie Bank and AMP also operate a number of unlisted trusts specialising in infrastructure investment. The extent to which funds invest in this sector via these unlisted trusts is unknown.

According to the Australian Stock Exchange, Australian listed infrastructure funds were valued at more than \$13 billion by market capitalisation in October 2004.<sup>18</sup> Again, information on the extent of fund investment in infrastructure via listed trusts/companies is also unknown.

### **Current superannuation fund investment in infrastructure**

In 2002, infrastructure investment by superannuation funds was estimated at \$8 billion, or about 2 per cent of then total fund assets. By 2012, projected investment in infrastructure is about \$65 billion or about 5 per cent of projected superannuation assets.<sup>19</sup> Other estimates suggest

that currently superannuation funds as a whole invest between \$5 and \$6 billion. However, there are reasons to doubt the accuracy of such figures:

- funds may invest via pooled superannuation trusts which in turn may invest in infrastructure, but for reporting purposes their investment in this sector is not reported as such
- funds may invest via listed infrastructure entities, but for reporting purposes this investment is classed as investing in shares, not in infrastructure as such, and
- some investment in the property sector is really investment in infrastructure. Again it is not reported as investment in the infrastructure sector.

The industry fund sector provides the best overall information on levels of investment in infrastructure. During 2003 the average proportion of an industry fund's portfolio invested in infrastructure equity was about 4.3 per cent.<sup>20</sup>

If anything, these difficulties suggest that the superannuation sector's current investment in economic infrastructure is likely to be understated and may substantially exceed these figures.

### **The future**

As noted, it appears that only large funds invest in infrastructure assets. The size of such funds allows them to invest in this sector and still maintain the liquidity necessary to meet the necessary prudential requirements.

Currently the superannuation sector is undergoing a process of consolidation: smaller funds are merging, corporate funds are closing, with existing large superannuation providers (both industry and retail funds) taking over the management of most of these monies. Further, the net inflows into the superannuation sector continue to increase. This means that there are fewer, but much larger, superannuation funds operating in the industry. This trend looks set to continue (leaving aside the growth in the number of small self-managed funds).

Fewer but larger funds, experiencing strong net inflows, favour continued and growing investment in infrastructure, if the right investment projects come along.

Funds will only invest in infrastructure assets that generate income and possess the right risk and return characteristics. Funds will not generally invest in schools, hospitals or other, vital, projects that are unlikely to produce commercial returns.

It may still be argued that there is a need for specific incentives to boost investment in economic infrastructure. As noted above, some have suggested increasing tax incentives available to superannuation funds to invest in

economic infrastructure. This only makes sense where there are good projects available to invest in.

## Endnotes

1. For example, Lenore Taylor, 'Push for infrastructure summit', *Australian Financial Review*, 7 March 2005, p. 1.
2. Glenn Stevens, Deputy Governor of the Reserve Bank of Australia, 'Address to the Australian Business Economists and the Economic Society of Australia (NSW Branch) Annual Forecasting Conference Dinner', Sydney, 14 December 2004 at [http://www.rba.gov.au/Speeches/2004/sp\\_dg\\_141204.html](http://www.rba.gov.au/Speeches/2004/sp_dg_141204.html) (accessed 11 March 2004).
3. Australian Prudential Regulation Authority, *Statistics – Superannuation Trends*, September 2004, released 11 January 2004.
4. For example, The Hon. Craig Knowles MP, NSW Minister for Infrastructure and Planning, 'Planning for Sydney's Future—Towards a Metropolitan Strategy', Speech to Sydney University's Planning Research Centre 22 April 2004 and Doug Cameron, Secretary—Australian Manufacturing Workers Union, 'Growing Super and Building the Nation' address to the ACTU Fund Managers Conference 26 November 2004, and the Hon. Kim Beazley MP, Leader of the Federal Opposition, 'Speech to the Australian Council for Infrastructure Development (AusCID)', 1 March 2005.
5. The Hon. Kim Beazley MP, Comments made on SKY TV Australian Agenda, 7 March 2005.
6. Senate Select Committee on Superannuation, *Investment of Australia's Superannuation Savings*, December 1996, Chapter 3.
7. See Australian Prudential Regulation Authority (APRA), *Superannuation Circular II.D.1*, paragraph 4. This document can be found at <http://www.apra.gov.au/Superannuation/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=1727> (accessed 14 March 2005).
8. APRA, *ibid*, paragraphs 7 and 8.
9. Australian Stock Exchange, Infrastructure Funds Fact Sheet.
10. *ibid*.
11. Industry Fund Services, *Report to Industry Superannuation funds*, February 2003, pp. 8–9. For the technically minded the Develop Australian Fund Infrastructure Fund's returns have had a low correlation to the domestic equity market (0.3) and to the domestic bond market (0.0). Between 1995 and 2002 the DAF Infrastructure Fund has achieved a return per year of 14.8 per cent p.a. with a standard deviation of 8 per cent, c.f. the 8.7 per cent p.a. return of the All Ordinaries index and a standard deviation of 11.8 per cent over the same period.
12. Senate Select Committee on Superannuation, *Investment of Australia's Superannuation Savings*, December 1996, Chapter 3.
13. Senate Select Committee on Superannuation Report, *Investment of Australia's Superannuation Savings*, noted that there was plenty of capital to invest in the infrastructure sector, but a shortage of suitable projects. The recent track record of some projects suggests that the shortage of suitable projects continues. For example, The Sydney Airport Rail Extension and the Brisbane Airport Rail link have not performed in line with initial expectations. Further, a number of Macquarie Bank infrastructure funds have produced ordinary performances. See Brian Robins, 'Fat and hungrier than ever', *Sydney Morning Herald*, 12 June 2004.
14. The level of fees charged for the use of the Dampier to Bunbury natural gas pipeline have been blamed for the collapse of its operator Epic Energy, see Neil Wilson, 'Regulator denies blame in Epic failure', *The Australian*, 1 June 2004, p. 21. Regulatory pressure on rates of return from the Queensland Competition Authority has also been blamed for inadequate investment in the Dalrymple Bay coal loader, owned and operated by the listed Prime Infrastructure Trust. See Lenor Taylor, 'Costello in move on coal loader', *Australian Financial Review*, 17 March 2005, p. 3.
15. CCH, *Australian Master Tax Guide 2005*, pp. 23–280.
16. *ibid*, pp. 23–275. These concessions have now been repealed. See The Hon. Helen Coonan, then Minister for Revenue and Assistant Treasurer, Press Release No CO32/04, *Phasing down of the Land Transport Facilities Borrowings Tax Offset Scheme*, 11 May 2004.
17. The Utilities Trust of Australia and Queensland Infrastructure Fund are unlisted trusts run by Hastings Fund management.
18. ASX, *op cit*. There are 8 listed infrastructure funds on the Australian Stock Exchange.
19. ABN–AMRO, Private Financing and Defence Infrastructure, June 2004.
20. Access Economics, Survey of Asset Allocations of Industry Superannuation Funds, February 2004.

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