

Partnerships USA

A New Model for Creating Direct Infrastructure Investment Opportunities for Public Pension Plan Investors

A growing number of institutional investors — including most notably U.S. public pension plan investors — want infrastructure assets in their portfolios. This demand appears likely to grow further. Watson Wyatt (now Towers Watson) estimated that in 2008 the top 10 managers in infrastructure alone managed \$72 billion on behalf of pension funds, up from \$43 billion in 2007. In January 2010, Probitas Partners estimated that nearly 100 closed-end funds were in the market for more than \$110 billion in additional commitments, with the majority of such investment to be targeted on brownfield assets in developed countries. State pension systems in Alaska, California, Illinois, Maine, New Jersey, New York, North Dakota, Texas and Washington have already made infrastructure allocations, and more states are likely to follow.

At the same time, however, these institutional investors have serious concerns about the investment vehicles that are currently available to them:

- An investment mismatch exists because most investment managers are utilizing closed-end funds of limited duration, which means the general partner is more exit-driven than are the fund's limited partners. This is an issue not only for many LPs but also for the fund's potential strategic deal partners, such as a toll road operator that wants to remain involved in the project for the full term of the concession.
- Private equity-type management fees are not appropriate for infrastructure investments.
- Due in part to their exit-driven emphasis, most of the existing infrastructure funds have more of a brownfield focus than do the public pension fund LPs, which tend to believe that numerous attractive

opportunities involving greenfield assets are being missed.

- Public pension fund LPs are more concerned with social considerations; they do not want to put their plan participants out of work through poorly structured infrastructure investments.

Given these concerns, a group of public pension plans has been exploring alternative approaches and vehicles through which to make infrastructure investments. Potential alternatives discussed have included: strategic partnerships with infrastructure developers such as ACS, Skanska and Fluor; formal pooled vehicles in which a number of public pension plans would engage an investment manager and would invest jointly in infrastructure projects and assets; and informal alliances, where the members of the "club" share intelligence, deal opportunities and due diligence resources, and then invest severally in infrastructure projects and assets.

RECENT DEVELOPMENTS

In the past year alone, there have been several notable developments in the ongoing effort to establish alternative infrastructure investment approaches and fund vehicles for public pension plan investors:

- The publicly owned Houston Airport System announced that it had entered into a joint venture (on a negotiated basis) with a private development company and with financial backing from the Ontario Municipal Employees' Retirement System (OMERS) to pursue P3 deals.
- The Dallas Police & Fire Pension System agreed to become an equity investor in the two Cintra-sponsored managed lanes projects in Texas (North Tarrant Express and I-635/LBJ Freeway), which

marks the first time a U.S. pension fund has directly invested in a U.S. toll road project.

- In March, OMERS unveiled its "Global Strategic Investment Alliance." This initiative involves OMERS co-investing with other long-term prudent investors in large infrastructure and real estate transactions. These investors, which may include the California Public Employees' Retirement System (CalPERS), Singapore's GIC and Dutch pension fund APG, will work with the two existing OMERS investment teams — Borealis Infrastructure and Oxford Properties — to identify and develop direct investment opportunities. In return, Borealis and Oxford will receive an annual fee equal to 50 basis points on the value of the assets that are under its management. No additional financing fees, acquisition fees or fees on committed capital will be permitted.
- In August, Pension Consulting Alliance issued an RFI for infrastructure investment management services on behalf of a number of public pension plans, including CalPERS. The purpose of this effort was to identify ideas about novel fund structures or compensation arrangements from existing and newly formed investment management firms and infrastructure service providers. More than 60 responses were received.

PARTNERSHIPS USA

To overcome their concerns while putting funds to work, public pension plans and other institutional investors will likely need to utilize a variety of different approaches and services involving infrastructure funds and direct investment. No one model

for such infrastructure investment is likely to be adequate for the foreseeable future given planned infrastructure allocations. As described below, the “Partnerships USA” approach can play an important role in this mix of approaches by more quickly generating additional long-term infrastructure investment opportunities and helping the U.S. infrastructure investment model to evolve away from its current reliance on private equity-linked infrastructure funds.

THE CONCEPT

The purpose of Partnerships USA is to develop direct equity investment opportunities for public pension plan investors on a proprietary basis, while facilitating such transactions for governors and mayors.

Overview

A nonprofit corporation called “Partnerships USA” would be formed by 10 to 15 public pension plans. The executive director of Partnerships USA and his or her staff would generate direct equity investment opportunities on behalf of these members by providing public-private partnership (P3) program and transaction management services on a subsidized basis to governors and mayors. The services, which would include technical, financial and legal advice, would enable states and cities to more easily access private investment to improve infrastructure service delivery. The concept is similar to the types of services that are provided by Infrastructure Ontario or the International Finance Corp., but modified to account for the highly fragmented U.S. system through which most infrastructure services are provided at the state and local level.

In return for providing these services on a subsidized basis to governors and mayors, such public officials would agree in their P3 procurement documents to require any preferred bidder selected thereunder to offer a 10 percent to 25 percent share of the investment opportunity to the public pension plan members of Partnerships USA. This offer would be made to the members of Partnerships USA near commercial close and on a right-of-first-refusal basis subject to the same terms and conditions as apply to the existing equity investors. Partnership USA members would then be free to accept or reject this offer within a cer-

tain time period following commercial close and before financial close. The members would agree among themselves how to allocate the equity made available to them, subject to certain internal guidelines that would be agreed upon in advance by the members. The executive director and his staff would not be involved in this member decision-making process.

Proposed Scope of Services

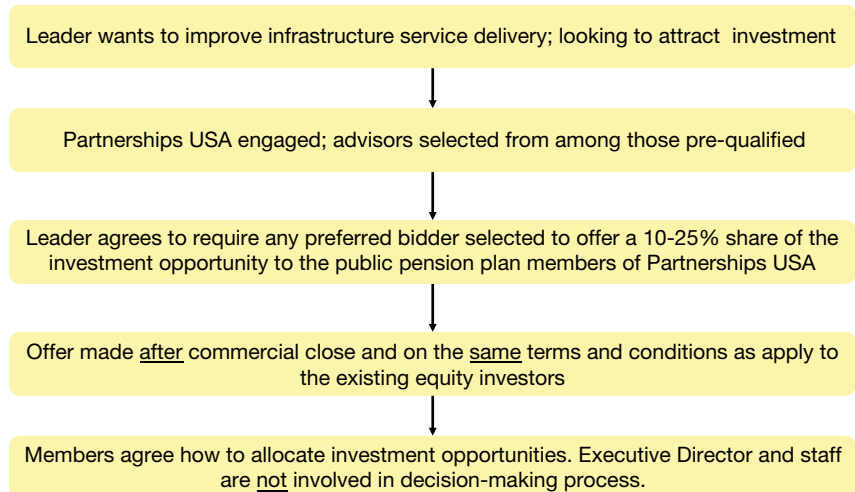
Partnerships USA would enter into a contract with the government owner of the relevant project or asset to provide P3 program management and transaction services. In consideration for a 10 percent to 25 percent share of the project being reserved for the members of Partnerships USA, Partnerships USA would pay for up to 50 percent of the government owner’s transaction costs related to its external financial, legal and technical advisers on the deal. To help control such costs, Partnerships USA would establish a pool of qualified advisers from which the governors and mayors could then select. Each of the government owner’s and Partnership USA’s external deal costs would be reimbursed by the preferred bidder at the financial closing of the transaction. If the financial closing does not occur, then both the government owner and Partnerships USA’s members would be financially responsible for their portion of such “dead deal” costs.

This structure would be attractive for several reasons to the government owners of infrastructure

projects and assets. First, because the U.S. market is highly fragmented, it has been difficult for such government agencies interested in P3s to internalize the lessons that have already been learned from previous transactions in other jurisdictions such as Florida, Texas and Virginia. It has likewise been difficult for them to develop standardized procurement documents, evaluation procedures and P3 agreements of the type that are used at the national, provincial or state level in places such as Australia, Canada and the United Kingdom. The use of such standardized documents, policies and procedures is important because it reduces deal costs for both the public and private partners, accelerates the procurement process because everyone knows what to expect regarding the principal terms and conditions and increases private sector confidence in the project timeline. As a result, the P3 is more competitive, so the governor or mayor is more likely to get a good deal. Moreover, because there is a more open and transparent process with increased competition, the general public is more likely to accept as legitimate the process and specific deals reached thereunder.

From the perspective of the public pension plan investors/members of Partnerships USA, this structure is beneficial because it will generate investment opportunities for them on a semi-exclusive basis. It also should help accelerate the pipeline of potential U.S. investment opportunities and help build overall public acceptance of P3s in this country.

How It Would Work in Practice



Source: Castalia LLC

Aside from its P3 program and transaction management services, Partnerships USA would also eventually provide educational and training workshops on a fee-for-service basis to government agencies interested in establishing P3 programs, and disseminate lessons learned from previous U.S. transactions with which it was involved. This work would be similar to the types of services that Partnerships UK currently provides in India and elsewhere.

COMPETITIVE ADVANTAGE

Due to the way most state public procurement laws are drafted, the approach proposed above would create a competitive advantage for Partnerships USA and its members that is not currently available to most of them or other private infrastructure service providers and private equity funds.

Some have worried about potential conflicts of interest created by the

Partnerships USA structure because affiliated staff of the public pension plans at Partnerships USA would be working with the government owners of assets in which their members intend to invest. No such conflict of interest would exist, however, under applicable U.S. law because pension plans are typically considered to be public agencies under state and local procurement codes and are thus not subject to the conflict-of-interest rules that apply to private equity funds and other private sector participants. Moreover, the public pension plan investors would not be involved in the transaction until a preferred bidder had been selected, and they would only have a minority investment in the transaction. Politically, it is unlikely that the general public would oppose allowing public pension plans and their beneficiaries to participate in investment opportunities designed to improve infrastructure service delivery and bol-

ster the limited financial resources of many public pension plans. Within 15 years, for example, public systems on average will have less than half the money they need to pay pension benefits, according to an analysis by PricewaterhouseCoopers.

CONCLUSION

The proposed structure is innovative and could create some attractive investment opportunities for its public pension fund members that would otherwise not be available to them through existing fund investment vehicles. Similar to their Canadian colleagues, this structure also would help such pension plan investors to become more familiar with and skilled at direct infrastructure investment. ♦

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Partnerships USA Snapshot

PARTNERSHIPS USA: STRUCTURE

The 10 to 15 members of Partnerships USA would provide intelligence and leads on potential transactions in the United States. Staff would then follow up on and develop these and other opportunities. The members would have the right (on a majority basis) to approve or reject a proposed P3 project and its relevant terms and conditions before any contract was signed with a governor or mayor. Members would also agree among themselves how to assign rights to any infrastructure investment opportunities generated through this structure. To avoid the appearance of any conflict of interest, the staff of Partnerships USA would not be involved in the members' investment decision-making process.

BENEFITS

The Partnerships USA structure has a number of important benefits for all of the relevant stakeholders, including public pension plan investors, governors and mayors, private investors, and the general public.

Governors and mayors: As discussed above, they would have the opportunity to attract much-needed private investment in a more streamlined manner that is more likely to result in a good deal for them through increased competition. Politically, aside from the subsidy of deal costs, public pension plans as quasi-public investors are also likely to be viewed as more attractive compared to a private consortium consisting solely of foreign investors.

Private investors: They would receive better and more standardized P3 documentation, a faster procurement process, more deal opportunities, co-investment

from long-term and politically attractive public pension plan investors, and the opportunity to work closely with and establish good working relationships with these important LP investors for their future infrastructure funds.

General public: The general public would receive better infrastructure services, more jobs would be created, and the local economic region would become more competitive and dynamic. A new alternative for public pension plans to invest in infrastructure would be established to help them meet their obligations to retirees and their families (which, if not met, will in turn require taxpayers to pay for these benefits).

INITIAL FINANCIAL COMMITMENT

The financial commitment of the 10 to 15 members of Partnerships USA would be relatively modest. Assuming two to three P3 deals in the \$500 million to \$1 billion range undertaken during the first 12 months of its existence, and administrative and staff overhead expenses, a preliminary budget suggests a per member fee of around \$1 million, depending on the exact number of members and types of projects to be pursued (greenfield or brownfield). The initial staff would consist of a small team of highly experienced advisers and investment managers that have already been identified.

The key project assumptions and the proposed budget are available upon request. In summary, though, these costs would be significantly lower than the various financing fees, acquisition fees, management fees and carried interest currently being paid to infrastructure funds to make similar investment opportunities available to their LPs.