

Investing in transport infrastructure

Discussion Paper

September 2012

Association of Superannuation Funds of Australia

ASFA Secretariat
Level 6
66 Clarence Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
Ph: +61 2 9264 9300
Fax: +61 2 9264 8824 or 1300 926 484

Outside Sydney
1800 812 798

Website: www.superannuation.asn.au

The Association of Superannuation Funds of Australia Limited ABN 29 002 786 290 ACN 002 786 290

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INTRODUCTION

The urgent need to address congestion in Australia's major cities is likely to result in renewed focus on the role that superannuation funds can play investing in public transport infrastructure assets.

Australian superannuation funds have a long history of investing in transport infrastructure that has added to the stock of transport options for Australian travellers. CityLink, Peninsula Link, EastLink (VIC), LEM7 (QLD), Lane Cove Tunnel and Cross City Tunnel (NSW) are all examples of projects that superannuation funds have invested in. Unfortunately while transport infrastructure has the capacity to deliver superannuation fund members with long-term, stable investment returns, the experience of superannuation funds investing in toll roads has been mixed, with some very public disasters.

The superannuation industry's transport infrastructure investment experience has implications for future investment. To ensure that investments deliver on the objective of providing Australians with income to support their retirement in the future, the superannuation industry will be much more proactive, not only when it comes to considering individual deals, but in advocating for investments that deliver on their investment return objectives and deliver productivity benefits that improve the environment for other superannuation fund investments, including property and equities, to prosper.

The focus of superannuation fund investment in transport infrastructure has primarily been on the supply side, that is, transport infrastructure investments that deliver additional capacity for travellers.

While superannuation funds can play a continuing role investing in supply side transport infrastructure, a question that should also be considered is whether superannuation funds can also invest in assets that address the demand side.

This paper considers both the challenges for superannuation funds investing in supply side transport infrastructure and whether there are investable demand side solutions that deliver productivity benefits. Melbourne is used as a case study on the basis that its rapid growth over the last decade is leading to significant congestion in parts of the city.

Investment in transport infrastructure can play an important role in ensuring the city is able to manage future growth. The question, from both a public policy perspective and for future investors, is where, and how, should infrastructure investments be made?

Gordon Noble
Director, Advocacy and Policy Strategy
Email: gnoable@superannuation.asn.au

SUPERANNUATION INVESTMENT IN INFRASTRUCTURE

Data provided by Rainmaker Information reveals that specialist infrastructure investment managers currently manage \$48.8 billion.

The actual range of investment by a super fund depends on a number of factors. Some superannuation funds do not invest in infrastructure while others may invest over 10 per cent of their assets. Typical allocations range between two per cent of assets to over 10 per cent.

One of the constraints that may limit the total amount that superannuation funds can invest in infrastructure investments is liquidity. While a number of listed Australian companies invest in infrastructure assets, most Public Private Partnership (PPP) investments are structured as unlisted investment vehicles. Superannuation funds benefit from an 'illiquidity premium' that improves the rate of return on investments. However due to Australia's choice of fund rules, which enable a superannuation fund to transfer their superannuation from one fund to another, in order to maintain sufficient liquidity to meet withdrawal needs only a portion of a super fund's investments can be in unlisted assets.

Infrastructure investment is much more common among larger retail, industry and public sector funds which have reasonably predictable (and positive) net contribution flows. A super fund also has to be reasonably large to achieve sufficient diversification when investing in infrastructure and/or needs to invest through a consortium to help spread the risks of any one investment.

Superannuation funds invest in a range of infrastructure assets. Examples of investments include toll roads, public hospitals, desalination plants, energy transmission and production and public transport. It is important to understand that while State and Federal Government infrastructure departments primarily focus on infrastructure from a transport and logistics perspective, superannuation funds define infrastructure according to the attributes of the investment. Infrastructure investments typically have the following features:

- Diversification – infrastructure tends to have a low correlation over time with other asset classes.
- Low performance volatility – given the long-term nature of infrastructure assets, performance should be less impacted by short-term market sentiment.
- Illiquidity – unlisted investments are considered illiquid with only limited options for investors to realise their investments. Individual funds may have defined liquidity events.
- Cash yield – in the case of mature and operational assets, the predictable and stable cash generative ability of infrastructure assets is likely to mean that the assets can return consistent cash yields to investors

Addressing financing challenges

While superannuation funds have a successful track record investing in infrastructure, ASFA has identified that there are a number of constraints that impact on future investment.

The first significant issue is the lack of a national infrastructure investment pipeline. ASFA acknowledges the work that Infrastructure Australia has done to create a national construction schedule but in our advocacy with Government we have repeatedly made the point that a forward plan of construction activity provides no certainty for superannuation funds as to whether private investment will be a component of the infrastructure asset build. There are a number of reasons why it is important for there to be greater investment certainty. Firstly in order for asset managers to build specialist investment teams in Australia they need to have confidence that there will be enough work to keep the team busy and to justify the cost of maintaining the team. Secondly one of the characteristics of infrastructure assets is their lumpiness. A case in point is the proposed infrastructure projects in NSW (Epping to Chatswood Rail Link) and Victorian Government (East-West Link). If these projects come on-line at the same time then Australian super funds will find it challenging to accommodate significant investments in both projects without changing existing asset allocations.

The second significant issue is the structure of PPP deals. Superannuation exists to invest funds for the retirement of fund members. PPP processes require consortiums to invest considerable resources on the hope that their tender will be successful. While superannuation funds may ultimately become the final asset owner, PPP consortiums mostly consist of banks and constructors that have short-term focus.

ASFA has proposed a number of possible options that could be explored to reduce bid costs:

- The establishment of an independent body that could oversight bids, establish standardised conditions and seek to remove error risk on forecasts out of bidding processes, which it is argued leads to an adverse selection process

where the consortium with the highest traffic projection (in regards to a toll road) is prepared to make the highest bid.

- A process could be established for governments to deal with preferred parties. This could be appropriate in the case of smaller amounts of money.
- Consideration of separating the tender process of design and construction from financing in the case of projects where design is an important element of the tender process.

There are a number of ways that the PPP framework could better represent the interests of long-term investors:

1. PPPs should be designed to address the potential for additional long-term investments in an asset. As an example this could be in the form of establishing corridors in respect to future rail or road expansion or room for extra classrooms or hospital wings in the case of social infrastructure. It is very difficult and prohibitively expensive to try to retrofit investments in the future and this detracts from the long-term social and economic benefits that the infrastructure asset can deliver.
2. Sustainability considerations should be factored into the PPP frameworks. As long-term investors, superannuation funds integrate environmental, social and governance factors into their investment processes. There are a number of ways in which sustainability can be factored into infrastructure. In particular ASFA notes the work being done by the Australian Green Infrastructure Council to develop a series of green rating tools, in a similar way to the green star ratings developed for the built environment.
3. Key project metrics can reflect the interests of consortium members rather than long-term investors. It is preferable to have long-term investors at the table in tender processes, however existing bidding costs (unless reformed) will continue to act as a significant deterrent. An alternative is to develop standardised long-term metrics, perhaps as best practice standards. If the PPP framework considers the long term interests of investors then it is not necessary that 'capital' is represented at the table of every deal.

Infrastructure and productivity

While superannuation funds invest in infrastructure to deliver sustainable investment returns for super fund members, they are also interested in the extent to which infrastructure assets can improve productivity.

Superannuation funds are diversified investors. In the context of Australian investments, superannuation funds invest not only in infrastructure but in Australian equities, venture capital, corporate bonds and property. Improvements in productivity have the capacity to improve the operating environment for other investments.

This concept is known in academic literature as the Universal Owner Hypothesis. According to a report by the United National Environment Program Finance Initiative and the Principles for Responsible Investment, the Universal Owner Hypothesis is based on the idea that there are clear links between the performance of large, diversified investment portfolios and the economy overall.

“A portfolio investor benefiting from a company externalising costs might experience a reduction in overall returns due to these externalities adversely affecting other investments in the portfolio, and hence overall market return. For a diversified investor, there is no place to hide from these costs: they come back into the portfolio as taxes, insurance premiums, inflated input prices and the physical cost of disasters. In theory, Universal Owners recognise that they own a share of the economy and therefore adapt their actions to promote a prosperous, sustainable future¹.”

The Universal Owner Hypothesis would suggest that it is not only in the interests of superannuation fund members to engage on issues of productivity, it is essential if super funds are to deliver long-term sustainable investment returns.

¹ PRI Association and UNEP Finance Initiative, Universal Ownership, *Why environmental externalities matter to institutional investors*, 2011

MELBOURNE'S TRANSPORT CHALLENGE

Because each city is unique and has its own set of challenges, a case study provides the best way to illustrate the challenges of financing transport infrastructure.

Melbourne has been chosen as the subject of this paper's case study on the basis that not only does it have a mix of public and private transport options, but it also has a long history of involvement of superannuation funds through the development of CityLink. The city is also considering a new road project that is likely to require significant private investment.

Melbourne's transport system can be summarised as being made up of private toll roads, public roads and integrated public transport consisting of trains, buses and trams.

According to the latest Census, Melbourne's population is 3,999,982, up from 3,647,021 in 2006; an increase of 9.7 per cent. Melbourne's continued growth is leading to congestion problems in parts of the city. An AustraliaSCAN study has revealed the number of Melburnians dissatisfied with public transport has increased from 32 per cent to 49 per cent over the last ten years. Importantly almost 90 per cent believe traffic congestion will get worse in the next decade. According to the Royal Automobile Club of Victoria the cost of congestion will rise to \$6 billion a year by 2020.

As Melbourne's population has grown, demand for public transport has also grown. The number of trips taken on Melbourne's metropolitan trains has increased by 94 per cent over the last 12 years, with a 58 per cent increase from 2004-05.

Much of Melbourne's public transport demand occurs in the morning weekday peak. According to the Victorian Government's own statistics in the last year there was a 3.3 per cent increase in the morning weekday peak and a 3.5 per cent increase in the afternoon peak. To address the increased demand the Government has increased peak hour capacity by 5.3 per cent by introducing additional services. This has kept the overall level of travellers per train at a relatively constant level.

In terms of road traffic there is anecdotal evidence that the peak hour is pushing forward.

As Melbourne's population continues to grow the significant question is how increased demand can be accommodated.

SUPPLY SIDE TRANSPORT INFRASTRUCTURE INVESTMENTS

East-West Link

The Victorian Government is currently considering constructing the East-West Link in Melbourne. The project, which depending on the extent of tunnelling required could cost around \$10.5 billion to complete, would connect the Eastern Freeway to CitiLink, enabling commuters to by-pass the city when moving from east to west.

The Leader of the Opposition, Mr Tony Abbott, recently announced that a Coalition Government would provide funding of \$1.5 billion to finance the East-West Link. The Victorian Government still needs to decide the precise details of the project, including whether it will be tolled.

A challenge for investors in assessing the merits of investing in a future East-West Link is that demand for the new road is likely to be highest in peak periods. The potential for road users to use other options in non-peak periods makes projecting traffic flows particularly challenging.

The road project is also likely to involve extensive tunnelling. From an investor perspective tunnelling provides additional construction risk, with a history of projects across the globe that have cost over-runs. Feedback from international advisers is that some investors will not take on projects that involve tunnelling due to this fact.

The nature of the project means that there will undoubtedly be challenges financing the East-West Link. This is not to say that investors will not be prepared to invest in the project. A key issue will be the extent to which the Victorian Government addresses the concerns of investors in the final negotiated deal.

The experience of superannuation funds is that the structure of PPPs has resulted in some cases with the winning tenderer being the one that has had the highest traffic projections. Providing investors with independent traffic forecasts

is one mechanism that would provide investors with greater certainty around future bids for road projects and reduce the bias where the winning tenderer is the one with the highest traffic projections.

Victoria has a strong record in financing infrastructure projects through the private sector. It is important to note that we are in a different market environment than that which operated when projects such as CitiLink were developed.

On the positive side, pension funds globally are increasing their allocations to infrastructure. This provides an opportunity to fund projects through international investors and not just Australian superannuation funds.

On the negative side, Basel III will have a significant impact on the operations of Australia's banks. Whereas banks were previously very willing to provide debt for infrastructure projects, the new Basel III capital adequacy requirements will essentially increase the cost of capital and make funding large scale projects more difficult.

The East-West Link may also have to compete against other infrastructure projects. In particular there is the potential that Sydney's Epping to Chatswood rail project may come to market around the same time as the East-West Link. The combined size of these two projects will make it difficult for Australian superannuation funds alone to digest investments into their portfolios in the short term.

If investor concerns around independent traffic forecasts, financing and construction risk can be satisfied, then it will be possible to finance the East-West Link. The question for investors is whether the East-West Link represents the best way to address traffic congestion or whether there are other alternatives that can be considered.

Railway crossings

Melbourne has 177 road level rail crossings. One of the challenges that Melbourne faces is that if more train services are run during peak hours, this can impact on traffic congestion on local roads simply because roads stay closed for longer when boom gates are down. The Victorian Government has promised to remove 12 crossings, with planning commencing on three immediate priority crossings.

One of the solutions proposed is for private investors to finance development of Melbourne's railway crossings. There is the potential that land above railways can be utilised for development, with proceeds funding infrastructure. Increased council rates are one option for funding development.

While it makes sense to address particular railway crossings that significantly contribute to congestion, there are considerable challenges if the whole network of crossings is to be addressed, not least of which is the disruption to services in the construction phase.

Each railway crossing will have its own unique community and logistical issues to consider. During construction phase travellers down the line will have the frustration of having to transfer to bus services, increasing journey times for potentially long periods of time. This is likely to act as a significant deterrent for Government to invest in large scale projects particularly as the chief beneficiaries of development of a railway crossing are not the commuters who experience the delays.

Supply side solutions such as the East-West Link project and investing in railway crossings have the challenge that infrastructure is being built to address peak hour traffic congestion. In the case of the East-West Link, the expenditure of \$10.5 billion, whether tax payer funded or through private investment, needs to be considered from an economic perspective. The concept of opportunity cost that is, that an investment should be considered against alternatives that are not chosen should be applied to all infrastructure investments. In this case the question is whether supply side projects can achieve the same or even greater benefits, to Melbourne? The important metric here is not the number of passengers that may use a road, but the higher order challenge that a road project is trying to address, which is the overall efficiency and productivity of the city. Is there the potential that demand side solutions can play a role in increasing the efficiency and productivity of the city, and if so, how might they be financed?

DEMAND SIDE SOLUTIONS

There are a number of models that have been popularly discussed to address the demand side for public transport. These include congestion charging, free travel to incentivise travel before the peak and teleworking. Each option is considered in turn below.

Congestion charging

The City of London introduced a congestion charge of 10 pounds in 2003 for vehicles that travel in Central London between 7am and 6pm. Reports indicate that by 2006 the overall level of traffic in the congestion zone had reduced by 16 per cent.

While London's congestion charge has been successful, the challenge of introducing a congestion charge in Melbourne is that traffic congestion is dispersed over a large geographic area. While London's public transport system was able to cope with increased patronage, the impact of a congestion charge on Melbourne's transport flows would be to transfer a portion of travellers to a public transport system that is already experiencing congestion issues at peak times. The positive of such a scheme could be that the revenues from the congestion charge could be used to finance investment in public transport infrastructure and services. However, in the absence of increased flexibility at work, many workers will not have any option but to continue their existing commuting patterns. A congestion charge is therefore likely to be interpreted as a tax on work. For this reason alone it is unlikely to be popular among the electorate and is unlikely to be supported politically.

Free travel to incentivise non-peak travel

Melbourne operates an Early Bird Travel Initiative which provides commuters that arrive in the CBD by 7am with free travel. In effect the scheme is a 50 per cent discount as travellers need to pay for the return journey. The scheme has had some success in shifting travel behaviour with the benefit of reducing stress on peak load services. However research has revealed that one of the main obstacles preventing commuters from taking advantage of the Early Bird Ticket is the absence of flexibility in work arrangements. The scheme itself does not currently work with Myki (Melbourne's smart card ticketing system that is replacing Metcard) and has an overall lack of flexibility in that individuals cannot change their travel practices to suit daily circumstances. While a commuter may have a saving of 50 per cent on their journey cost this must also be balanced against the lack of express trains that run before 7am, meaning that the journey time for those travelling extended distances is longer than if they journey was conducted later in the morning. The challenge for public transport providers is that there is no great incentive to increase demand for the service as there is a revenue cost that must be borne.

Teleworking

As information technology has improved there has been a focus by transport planners on the role that teleworking can play to reduce traffic congestion. A recent research paper by Grace Corpuz from Transport for NSW examined the potential for teleworking to play a role in transport management in Sydney. The paper discussed the fact that journey to work trips comprise 27 per cent of all trips during the morning peak, arguing that teleworking therefore provides a relatively easy and low-cost option for reducing these trips during this period.

Corpuz's analysis showed that the incidence of teleworking in Sydney was small but growing:

- Teleworkers were more likely to be: males; aged 31 to 50 years; in couple with children households; in the highest income bracket; managers, professionals and administrators; and employed in the property and business services industries.
- Workers who worked from home made less trips overall, travelled less distance and generated less vehicle kilometres travelled (VK) than those that went to work.
- When considering expanded application, the following types of workers were likely to generate more transport benefits: those with fixed-hour work schedules; those working in non-centres; and those with longer home-to-work distances, especially those who travel by private vehicle².

² Grace Corpuz, *An empirical assessment of teleworking using the Sydney Household Travel Survey data*, Bureau of Transport Statistics, Transport for NSW, Australasian Transport Research Forum 2011 Proceedings 28 - 30 September 2011, Adelaide, Australia, Publication website: <http://www.patrec.org/atrf.aspx>

The Federal Government includes telework as a part of its National Digital Economy Strategy. The Government's Digital Economy Goals include that by 2020 Australia will have at least doubled its level of teleworking so that at least 12 per cent of Australian employees report having a teleworking arrangement with their employer.

According to the National Digital Economy Strategy:

It is also estimated that the value of a 10 per cent increase in Australian employees that telework 50 per cent of the time is between \$1.4 billion and \$1.9 billion a year. By reducing the need for people to commute to the office at the same time each day, teleworking can also reduce transport congestion, leading to reduced impact on our natural and built environment. It is estimated that a 10 per cent increase in Australian employees that telework 50 per cent of the time would save an estimated 120 million litres of fuel, avoiding 320,000 tonnes of carbon dioxide (equivalent to \$6 million worth of emissions) and would reduce traffic at peak periods by five per cent, resulting in a reduction of \$470 million in congestion costs, which would have a flow-on benefit of reducing strain on infrastructure.

While the National Broadband Network offers increased capability for employers to offer teleworking arrangements, the research of Corpuz illustrates that the current uptake of the telework arrangements by employees has not been remarkable with only 7.3 per cent of Sydney workers with access to the teleworking actually availing of it on an average day.

There are a number of potential reasons why there appears to be a limited demand by workers to access teleworking even where they have the capacity to. While teleworking at home may be attractive for some people it is likely that the home environment itself is for many people not an attractive work environment. This is an area where more research is required.

Another area that needs greater exploration is the difference between an employee who works from home and an employee working in a teleworker centre.

There are a number of commercial organisations that have established teleworker centres, often providing an environment for mobile employees to be able to link into a work environment. The challenges of such centres is that they can be established to address the range of health and safety and data protection concerns that can inhibit employers offering teleworking arrangements.

INNOVATIVE THINKING REQUIRED

The Victorian Government is currently facing the difficult decision as to whether to invest in additional road capacity, principally through the East-West Link. In the debate about alternatives to the East-West Link the temptation is often to look at another road or rail project.

While there is merit in governments investing in additional capacity, from an opportunity cost perspective if there are alternatives that can achieve the same objective of reducing traffic congestion and improving efficiency and productivity then they should be considered.

In particular can the National Broadband Network be utilised in a way that opens up new potential for teleworking? If so, how could this structured and financed?

The Government's National Digital Economy Strategy specifically recognises the potential for telework to address congestion. The question is, even if the Government's objective of 12 per cent of all employees having access to telework arrangements is met, will this actually result in a shift in work practice?

Telework centres may provide an alternative for employees who do not like to work at home. There is the potential that teleworking centres can enable employees to work in a comfortable, secure and safe work environment. Most importantly telework centres can provide employees with a communal environment with the potential to engage with groups of employees.

While teleworking centres are part of the lexicon in teleworking debates they are mostly seen as individual commercial arrangements. There is the potential to think about telework centres from a network perspective. Instead of isolated telework centres there is an opportunity to create a network of telework centres that could consist of individual centres distributed across the whole of Melbourne.

Each centre would be equipped with security protocols to address data security concerns. Centres would be modern office environments and would have a local manager. Addressing health and safety issues will provide potential clients of the centre with confidence that their employees are working in a safe environment.

From a commercial perspective Government departments and commercial businesses would be able to contract with the network manager. Contract arrangements can allow for flexibility in terms of the number of employees that can access the network.

From an employee perspective the network would open up the ability for an employee to work in a telework centre close to their own home. Rather than commuting long distances this would provide teleworkers with the ability to benefit from the facilities and community that an office environment can provide, while still being close to home.

From an environmental perspective a network of centres, by encouraging those who are not attracted to work from home on a permanent basis to telework from centres, would result in reduced carbon emissions.

From a superannuation perspective rather than investing in a multi-billion dollar toll road, the establishment of a network of telework centres offers a different kind of investment that has the potential to achieve the same result: reduced congestion. Because superannuation funds are already significant investors in property they already have the skills and experience to analyse the potential for investing in a network of telework centres.

As long-term investors superannuation funds are conscious that climate change and carbon pricing can impact on the value of assets such as toll roads. A network of telework centres can offer superannuation funds the opportunity to invest in an asset that facilitates lower carbon emissions for an economy. Given a choice of investing in a toll road, a network of telework centres enables a superannuation fund to diversify their portfolio of investments, enabling the fund to earn better risk adjusted investment returns over the long term.

The challenge for super funds in considering investing in such a project would be similar to the challenges of investing in a toll road. The key to unlocking the potential for super funds to invest would be the willingness of Government to underwrite the future success of the network by, for instance, contracting with the network on the usage by Government employees of the network's facilities.

The project would enable the Government to utilise the power of being one of the largest employers in the country to achieve the objective of reducing traffic congestion. Creating a network of telework centres does however require a shift in thinking, not just from investors but from policy makers, employers and employees. There is no doubt that there is resistance to telework in some parts of the business community. The reasons for this are complex. There may be legitimate obstacles to telework, including health and safety and data security concerns. These concerns can be removed through a professionally managed telework centre. A harder obstacle to remove is habit. Businesses are used to operating in a traditional structure, where employees are all under the same roof. But more and more evidence is suggesting that the global business environment is shifting and that in the future telework arrangements are going to be much more a part of dynamic workplaces.

There is of course a great deal of uncertainty about building a network of telework centres. But this uncertainty is no less than investors face projecting traffic on a toll road. Ultimately the success of a telework network would be based on whether people use the centre. Over time, as businesses become more accustomed to teleworking as a normal part of business operations, the demand for teleworking arrangements by employees is likely to grow.

CONCLUSION

Currently infrastructure investment managers invest around \$48 billion in infrastructure assets; compared to the size of the superannuation pool at \$1.4 trillion, this is a drop in the bucket.

Superannuation funds are increasingly being called upon to invest in ways that address national economic and social objectives.

Current examples of ways in which it has been suggested that superannuation funds can invest include:

- Invest in Australian corporate bonds to assist in development of Australia's corporate bond market;
- Invest in innovation venture capital to challenges that start-up companies face raising capital;
- Invest in housing to address homelessness; and
- Invest in infrastructure to address congestion.

As the size of the superannuation pool grows, and with continued fiscal constraints by State and Federal Governments, it is likely that policy makers will only focus more attention on the superannuation sector.

In this environment it is important that the superannuation sector actively participates in discussions around ways in which the superannuation pool can be used to address economic and social objectives. It is important that policy makers have a detailed understanding of how superannuation funds actually make investment decisions, and what is possible, and what is not.

Superannuation funds are not only interested in investing in infrastructure assets that deliver upon the ultimate objective of delivering Australians with adequate retirement incomes, as Universal Owners they are also interested in the way in which different investments contribute to the nation's productivity.

ASFA has been actively participating in the policy debates around impediments to infrastructure investment. As a member of the Federal Government's Infrastructure Finance Working Group ASFA has contributed thinking around the obstacles that superannuation funds face investing in infrastructure, including the lack of a long-term investment pipeline and challenges with the way PPPs are structured.

ASFA believes that the demand for infrastructure by superannuation funds will continue to grow. The way in which superannuation funds invest in infrastructure and the actual assets that superannuation funds invest in will ultimately be determined by how deals are structured.

As this paper demonstrates, in addition to investing in transport infrastructure that addresses supply side challenges, superannuation funds also have the capacity to invest in assets that address demand side challenges. Because superannuation funds are diversified investors that invest in assets across the real economy there can be more than one way to 'skin the cat' that can deliver the same objectives.