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Canadian pension fund investors in transport infrastructure: A case study

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ABSTRACT

Policy makers and scholars have increasingly identified pension funds as an important source of private capital to finance the next generation of critical investment in infrastructure. However, to date pension funds globally have not been significant direct investors in infrastructure. This paper examines the opportunities and barriers to pension funds taking on a more significant role in the financing, delivery and operation of transportation infrastructure. This assessment is based on a case study of seven large Canadian pension funds, which have been at the forefront of a new wave of institutional investing in infrastructure. Drawing on key informant interviews with fund managers as well as an examination of annual reports, industry studies and media coverage, I illustrate how pension funds have specific characteristics that direct the types and locations of projects that they will invest in, as well as the models of deal structuring that are appealing. The results show that Canadian pension funds have focused primarily on investing in operational projects in established marketplaces, where they have demonstrated a willingness to assume traffic volume risk on projects that have demonstrated suitable demand in early operations.

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1. Introduction

Policy makers and scholars have increasingly identified pension funds as an important source of private capital to finance the next generation of critical investment in infrastructure. Not only do pension funds hold massive capital reserves; they also favour investments that provide stable, low risk, long-term returns which are aligned with the natural characteristics of infrastructure projects (Orr, 2009; Clark et al., 2011; Ottesen, 2011). Despite the potential match, to date pension funds globally have not been significant direct investors in infrastructure.

Canadian pension funds, however, stand out from their international counterparts. Over the past decade, Canada's largest pension funds have become among the most active institutional investors in infrastructure in the world, and now typically hold a bigger share of their total assets in infrastructure than similar funds from countries such as the United States and Britain (OECD, 2011). Indeed, some of the most economically important and iconic transportation facilities globally are now owned or operated by Canadian pension funds. This includes Britain's lone high-speed railway line, airports in Copenhagen, Brussels and Sidney, toll roads in Melbourne, Toronto and Santiago, and seaports in Vancouver, New York and New Jersey.

At the same time, Canadian pension funds also illustrate the challenges that institutional investors have when investing in infrastructure globally. Developing the staff capabilities and networks to evaluate, execute and monitor deals in a global marketplace has been a lengthy process, as has gaining an understanding of the unique performance and risks associated with infrastructure as an asset class (Torrance, 2008). Investing in private infrastructure deals can bring large public sector pension funds into conflict with the interests of their unionized beneficiaries that often oppose privatization. And pension funds have faced particular political pressure to focus on economically targeted or socially responsible investments in their home jurisdiction that may not necessarily deliver the highest risk adjusted rate of return.

The purpose of this paper is to examine the opportunities and barriers to pension funds taking on a more significant role in the financing, delivery and operation of transportation infrastructure. Drawing on a case study of Canada's seven most active pension fund investors in infrastructure, the paper is particularly interested in examining the characteristics of pension funds as equity investors in order to understand the types of transportation

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assets, deal structures and jurisdictions they most commonly invest in. Such an analysis is important because as policy makers and scholars increasingly identify pension funds as favoured investors in infrastructure, the Canadian experience is broadly instructive as it points to the possibilities and tensions associated with such a move. To be certain, pension fund structures, benefit plans, and regulatory environments vary by country, meaning that caution should be exercised when generalizating lessons from the results of this study. Nevertheless, there are commonalities in the investment profiles and interests of the largest pension funds internationally. Focusing on the experience of Canadian pension funds as infrastructure investors is particularly relevant given that they have among the longest running experience as institutional investors in this asset class, now hold some of the largest stakes in infrastructure projects, are widely recognized as having developed extensive in-house expertise that enables them to act as direct investors in infrastructure, and are garnering international attention as a potential model for large pension funds in other countries to emulate (OECD, 2011; Macdonald, 2013).

More broadly, the general issues identified are relevant to other institutional investors such as sovereign wealth funds and insurance funds that share similar characteristics in terms of their size, return expectations, investment time horizon, and appetite for risk. In fact, four of the seven investors examined in this paper are independent Canadian investment boards that operate at arm's length from government and administer some of the largest public sector pension funds, as well as state insurance program funds and sovereign wealth money as well. As such the paper contributes to our understanding of pension funds as part of a broader class of institutional investors that are taking an interest in infrastructure assets.

The remainder of the paper proceeds as follows. The first section provides a global overview of pension funds as equity investors in the infrastructure sector, and explains the institutional characteristics and investment interests of pension funds. Then I document the pattern of direct investments in transportation infrastructure made by Canada's seven most active pension funds in the sector, and explain the rationales for these choices. The paper concludes by reflecting on the types of transportation infrastructure projects that are attractive to pension funds, and the particular possibilities and tensions associated with an expansion of pension funds as infrastructure investors.

2. The rise of pension fund investors in infrastructure

Around the world, many stakeholders involved in the management and provision of public infrastructure have identified the vast need for spending to maintain, upgrade and expand critical municipal, provincial/state and federal transport facilities. This includes roads, bridges, tunnels, urban transit lines, inter-city railways, airports and seaports (CFM, 2007; ASCE, 2013; Planning Commission of India, 2010). One response has been for governments of all ideological stripes to increasingly turn to private sector investors to finance and deliver the design, construction, operations and maintenance of infrastructure projects. The private sector investment in the provision of the infrastructure is repaid from two broad sources of funding: government payments backed by tax revenues, and tolls and other user fees.

Private participation in infrastructure is particularly attractive politically when it enables cash strapped national, state and local governments to build high quality infrastructure without taking on additional public debt, in cases where user fees or other new revenue streams can be pledged to repay initial private sector investments. In practice it is economically unfeasibly, socially undesirable or politically unpalatable to charge user fees at cost recovery rates on certain types of infrastructure and they thus require ongoing government funding, even when privately financed. As such private financing can but does not necessarily minimize the need for ongoing government funding for infrastructure. In recent years another common government rationale for engaging private investors in infrastructure is to achieve value for money. It is argued that investors with an equity stake in a project are incentivized to design facilities to maximize efficient lifecycle asset management, and then actively manage key project risks such as construction cost overruns, operational deficiencies, and facility unavailability (Grimsey and Lewis, 2004).

Pension funds, in particular, have been identified as potentially a 'perfect match' as investors in infrastructure projects (Ottesen, 2011; Bain, 2012). Pension funds hold very large pools of capital, valued within the OECD at over $17 trillion, which could be tapped into to finance the delivery of critical public infrastructure projects. To date, however, pension funds have only had limited involvement as investors in infrastructure. Historically, pension funds have participated in the provision of infrastructure as the purchasers of government issued bonds. More recently a growing number of pension plans have invested in infrastructure assets through intermediary funds that specialize in the sector, but this approach typically has high management costs. As direct equity investors in infrastructure project finance, less than 1% of all pension fund capital globally is invested in infrastructure (Croce, 2011).

Nevertheless there are national variations in pension fund participation as investors in infrastructure. While European and American pension funds have been slow to embrace infrastructure as an asset class, Canadian pension funds alongside the largest Australian superannuation funds have become leaders in investing in the global infrastructure marketplace, and have been recognized as among the most prolific and sophisticated pension fund investors in infrastructure (Torrance, 2008; Croce, 2011). Of the 30 largest institutional investors in infrastructure globally as identified in a 2012 survey by *Infrastructure Investor Magazine*, Canada had the largest number of pension funds from any country. Three of the top 15 and 6 of the top 30 funds on the list were Canadian public sector pension funds and state owned financial institutions that operate at arm's length from government and manage pension plans as well as other government investment funds.[1] OPTrust is another Canadian pension plan that while smaller and therefore not ranked as one of the world's biggest institutional infrastructure investors, has invested a significant share of their holdings in infrastructure, and is thus included in this analysis. As shown in Table 1, these seven funds that invest the pensions of public sector workers as well as other government capital have emerged as significant investors in infrastructure, with nearly $30 billion directly invested in domestic and international projects as of 2012.

To date, Canadian private sector pension funds have not been as substantial direct investors in infrastructure. The pension funds of private sector trade unions and employer organized funds are typically smaller and less consolidate across multiple employers than the largest public sector funds, which have pooled the pension savings of multiple employers across an entire province to create very large investment funds. Given their smaller size, most private sector funds lack the large amount of capital and internal staff expertise to make direct investments in large ticket sized infrastructure assets. In recent years, private sector pension funds

[1] In Canada, some state owned financial institutions manage investment funds for a variety of purposes, including pensions of public and private sector workers, sovereign wealth funds, and state run insurance policies. This includes the British Columbia Investment Management Corporation; Alberta Investment Management Corporation; Caisse de dépôt et placement du Québec; Canadian Pension Plan and Investment Board. These organizations operate at arm's length from government and are overseen by an independent board of directors.

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