

## Environmental, Social and Governance considerations in Infrastructure PPP's



**At AMP Capital Investors (AMP Capital), we aim to create greater wealth for our clients through better investment decisions and opportunities. Within our Infrastructure business, we recognise that environmental, social and governance (ESG) issues can impact the long-term performance of our investment portfolios.**

As a result, ESG issues are considered across the full scope of our investment process, from the identification of new opportunities and in active management throughout the lifecycle of an asset. The key tenets of Infrastructure's ESG philosophy are provided in the adjacent box.

In June 2011, AMP Capital conducted a review of ESG-related risks and opportunities across four Public Private Partnership (PPP) assets in AMP Capital's Community Infrastructure Fund (CommIF). The primary objectives of the initiative were to enhance risk management practices, identify opportunities to add value to the investments and share our insights into thematic issues impacting PPP-style assets with our clients and the wider ESG community. From discussion of ESG issues impacting Australian PPP investment and the accompanying case studies, we seek to demonstrate how appropriate performance indicators can enhance ongoing management of ESG issues. We believe this to be an imperative component of an active asset management and a Responsible Investment approach.

### ESG policy guidelines

When investing in infrastructure assets, we view ESG issues in the same way we do any other investment risks, (i.e. risks that have the potential to impact on the performance of an asset). Underpinning this view are five key tenets:

1. Aligning our approach to ESG with our fiduciary duty to act in the best interests of our clients
2. Incorporating ESG considerations into our investment analysis and decision making, active ownership practices and ongoing reporting activities
3. Ensuring a balanced view of broad ESG investment issues and risks that may impact long-term returns (as opposed to adopting specific positive or negative screens common to many socially responsible or ethical funds)
4. Applying our ESG policy across each of the investment portfolios and regions in which we invest
5. Ensuring each member of the Infrastructure team is accountable for ESG integration in accordance with our policy.

\* The above is an excerpt of AMP Capital's Infrastructure ESG policy guidelines, which can be obtained on request.

## ESG in PPP investments

PPP's are generally subject to fixed revenues from availability-based payments, with significant pass through of contractual obligations to operators and other subcontractors such as facilities managers and maintenance providers. While incentive-based payments may encourage value-enhancing initiatives, there is generally a limited ability to capture upside for equity investors in these structured investments. As such, ESG considerations in PPP investments are typically focused on preserving value in two key areas:

1. Mitigating risk associated with the physical features of the investment (e.g. the impact of climate change on buildings and facilities); and
2. Stringent administration of contractual arrangements and managing the performance of counterparties responsible for operational risks.

In most cases, any financial detriment arising from non-compliance of environmental and social factors (e.g. penalties for environmental or workplace breaches) will be borne by the responsible subcontractor. However, this may not always insulate project equity investors from indirect disadvantages such as reputational risk, loss of licence, disruption to services or strained stakeholder relations.

On the other hand, environmental and social initiatives requiring capital expenditure and resulting in a financial advantage (e.g. cost savings from energy efficiency programs) are generally unlikely to benefit equity investors given the cost and profit-share arrangements between operator and state government counterparties.

The ESG review of four PPP assets was conducted in June 2011 and comprised the following assets:

- > **Southbank Institute (Southbank)** consists of eight buildings, east of the Brisbane central business district (CBD), providing capacity for vocational education and training facilities for up to 50,000 students.
- > **Schools II** comprises 11 primary and secondary schools in New South Wales.
- > **Darwin Convention Centre (DCC)** is located on the Darwin CBD waterfront and operates in a highly competitive market to service 12,000 local, interstate and national visitors each year for events and conferences.
- > **Emergency Alerting System (EAS)** comprises 228 sites in the state of Victoria with transmission equipment to manage emergency messaging to over 30,000 emergency services personnel in organisations such as the Country Fire Authority, Ambulance Victoria and the State Emergency Service.

All four of these investments receive availability-based payments from state government counterparties with further contractual obligations in place with operators and facilities managers. DCC also has the additional opportunity to secure incentive-based payments, depending on the number of national and international delegates that attend the facility.

When considering the key ESG issues likely to impact these investments, we considered the physical location of the assets, the likely impact on and by the environment in which they are located, the dynamics of the industry in which they operate and the business practices of related counterparties. Furthermore, we considered the scope of governance arrangements in place to protect the long-term interest of investors.

The following six key themes were apparent across the portfolio:

## What is a PPP?

A Public Private Partnership (PPP) is a facility or service that is funded and operated through a partnership of government and the private sector. PPP's are often used to deliver 'social' or 'community' infrastructure assets and facilities such as schools, hospitals, public health and justice facilities, but have also been utilised to provide a number of transport-related infrastructure projects such as toll roads and rolling stock fleets.

PPP's typically involve a contract between a public sector authority (e.g. a federal or state government counterparty) and a consortium of private sector parties who together form a special purpose vehicle (SPV) to develop, build, maintain and operate the asset for a long-term concession period (often up to 30 years). The consortium is usually made up of a building contractor, facilities operator/maintenance provider, debt financiers and equity sponsors.

In some PPP's, revenue is generated through a user-pays arrangement (e.g. tolls paid by motorists). In others, the government will make regular payments once the facility is in operation based on agreed service levels and key performance indicators, with these payments being at risk for non-performance.



## 1. Climate change (mitigation and adaptation)

Climate change undoubtedly poses a significant risk to infrastructure investments. However, the extent to which various regions and physical assets may be impacted is unknown. We can expect that an increase in the intensity and frequency of weather events may cause significant damage to buildings and modification to maintenance programs and capital expenditure requirements.

To mitigate climate change risk we seek to:

- > Invest in assets that have been built to specifications appropriate for use and the region in which they are located, taking into account the potential impact of climate change
- > Consider natural disaster susceptibility, business continuity planning and recovery
- > Continuously review the cost and adequacy of insurance cover (for property damage, public and products liability and revenue protection).

On an annual basis, CommIF asset managers review and establish appropriate, and market-available, levels of insurance cover. This is in accordance with contractual requirements and the requirements of being a prudent manager. With the exception of EAS, in all assets insurance premium costs are benchmarked and government counterparty service payments are adjusted to meet changes in insurance premium costs.

“ESG issues are considered across the full scope of our investment process and in active management throughout the lifecycle of an asset.”

## Case Study

### 2011 Queensland floods: Southbank Institute

CommIF's Southbank Institute of Technology is located near the banks of the Brisbane River, an area that can be subject to flooding. The asset mitigates the risk of financial loss from damage to buildings and disruption to business with insurance coverage that address the natural environment in which it is located.

In January 2011, Queensland was subjected to widespread flooding which resulted in loss of life as well as significant damage to property. The Institute experienced some disruption to service and minor damage to property and landscaping in the vicinity of A\$1.5 million (well within the asset's insurance sub-limit of A\$25 million in relation to flood-related property damage).

Early engagement with the Queensland government and insurance assessor was a positive step in ensuring the asset's insurance claim is progressed without any unnecessary delay.

While the asset holds industrial special risk (revenue protection) insurance for up to 36 months loss of income, CommIF suffered no adverse impact to date to its revenue receipts from the asset or investment returns due to the floods, given the effective risk



management controls in place, insurance coverage and active management of the asset recovery, and contractual matters with both the Queensland State Government and the facilities management subcontractor, Spotless P&F Pty Ltd.

Certain contractual protections, such as insurance benchmarking and uninsurability provisions in the contract with the State Government, provide comfort from materially adverse premium increases or reduced coverage/scope being offered in the insurance market. To the extent a risk is uninsurable the State Government is required to underwrite that risk.

## 2. Environmental legislation

During the construction of a PPP asset, obligations to comply with environmental legislation requirements are generally contracted to the builder. In the operational phase of the asset, environmental compliance is generally an obligation of, and is therefore primarily managed by, the operator and facilities manager.

To mitigate risks associated with environmental legislation we seek to:

- > Obtain verification of legislative compliance by independent certifiers upon the construction completion of PPP investments to ensure any environmental or sustainability measures have been adhered to
- > Appoint service providers with strong track records of legislative compliance and policies and protocols that support robust environmental performance
- > Determine accountability for legislative compliance under programs such as the National Greenhouse and Energy Reporting Scheme and the Energy Efficiency Opportunities program
- > Ensure financial risk of non-compliance is contractually transferred to the facilities manager or operator of the facilities
- > Establish reporting arrangements that provide transparency of environmental issues and performance relating to all facilities' operations
- > Consider environmental legislative compliance at board level via standing reporting requirements.

## 3. Workforce dynamics and OH&S

While workforce requirements relating to the operation of PPP facilities are typically outsourced to a specialist operator, the credentials and performance of subcontracted service providers should be thoroughly assessed and closely monitored to mitigate any risk to equity investor interests. Workforce dynamics, employment conditions and occupational health and safety (OH&S) can have a significant impact on the competence and productivity of staff and efficient operation of an asset. Furthermore, failure to ensure a duty of care for subcontractor health and safety has the potential to result in legal and financial liability.

To mitigate risk associated with workforce requirements we seek to:

- > Understand workforce dynamics relating to a subcontractors' requirements (e.g. availability and skill set of staff, nature of employment, supervision and turnover)
- > Assess and monitor subcontractor policies relating to employment conditions (e.g. staff benefits, disciplinary practices, and OH&S measures)
- > Determine appropriate lead indicators to provide advance warning of operational risks that may impact equity returns.

## Case Study

### Liability for OH&S: Schools II

While it is generally acknowledged that common law does not impose a duty on principals to independent contractors as it does between employers and employees, there are some situations where such duties are imposed on principals in respect of their contractors. Accordingly, it is important for principals to satisfy their own requirements under the relevant OH&S legislation and ensure they engage competent contractors and implement reasonable systems to ensure obligations are met.

In the case of Schools II, the Government is responsible for OH&S arising from core service delivery (i.e. provision of teaching curriculum and supervision of students). While Schools II has no direct employees and facility management is outsourced to Spotless, Schools II remains the principal contractor under OH&S legislation. Through contractual arrangements, Spotless is obligated to comply with all employment and OH&S legislation. AMP Capital has completed a comprehensive review of policies and procedures relating to workforce and OH&S and considers Spotless to be a competent Tier 1 facilities manager.

AMP Capital undertakes regular reviews of Spotless' risk management practices and seeks continuous disclosure of performance metrics through monthly reporting.



AMP Capital performs quarterly site visits to each of the 11 facilities and OH&S is a standing item for quarterly board reports.

Following the recent ESG review of Schools II, the AMP Capital asset management team is seeking to augment OH&S monitoring through review of the issues/complaints log of the facilities manager's help desk and regular audits of Spotless' site staff and subcontractors' OH&S risks.

#### 4. Stakeholder management

PPP assets typically impact a wide range of stakeholders and have strong links to the communities in which they operate. Maintaining positive relationships with subcontractors and government counterparties can support efficient resolution of issues and achievement of investment objectives.

For each of the CommIF investments, regular and active engagement by the AMP Capital asset management team is fundamental to reinforce partnering behaviours and ensure a continuous common understanding of project objectives. Contact is maintained through:

- > Monthly Project Control Group and Operations Group meetings between respective government clients, each Project Company and Operator to achieve project objectives and monitor progress on current issues
- > State Project Director and Project Company Representative issues meetings
- > Partnering workshops to maintain project objectives and promote principles of cooperation between participating organisations.

While the CommIF asset management team seek to minimise formal disputes through strong stakeholder relations, there may be some circumstances that require referral to formal dispute resolution processes.

#### 5. Community safety

As community assets that are used by the public, each asset is exposed to the potential consequences of an adverse incident that has the potential for illness, injury, or even death. Together, government clients, project companies, operation contractors and individuals are all accountable for ensuring a safe environment is available to those using the assets.

To mitigate financial risk associated with community safety we seek to:

- > Determine appropriate levels of public liability insurance in order to protect against potential claims
- > Manage insurance renewals to comply with specific contractual obligations
- > Increase policy coverage to provide additional protection, where prudent and cost effective

“Regular and active engagement is fundamental to reinforce partnering behaviours and continuous understanding of project objectives.”

### Case Study

#### Community Support: Darwin Convention Centre

Maintaining positive community perception is important to the success of a PPP's ongoing operation and often referred to as a 'social license to operate'. We encourage our operators and facilities managers to maintain good relations with local communities.

The Darwin Convention Centre provides ongoing support to the Darwin community through numerous initiatives including:

- > Providing low risk food leftovers to Darwin charities such as the Salvation Army
- > Providing special room hire waivers for fund raising events (e.g. the Starlight Foundation)
- > Donating leftover conference materials such as paper and pens to local schools
- > Active involvement in community events by Darwin Convention Centre staff and management (e.g. St. Vincent de Paul's CEO Sleepout)
- > Providing work experience for special needs students of Henbury School
- > Providing career development opportunities to a hearing-impaired apprentice chef.



## 6. Sustainable practices and resource conservation

Due to the expected lifespan of the assets and rigorous building specifications, PPP facilities are generally designed to high standards of sustainability and resource efficiency. Financial risks and incentives relating to sustainable practices (such as energy conservation and waste management) are often passed through to the operator or retained by the government counterparty. Where the financial risk relating to energy consumption resides with the government counterparty, a risk and benefit share may incentivise an operator to invest capital for technological improvements and efficiency.

**“The contractual nature of PPP arrangements can provide strong accountability and financial incentives for ESG considerations”**

### Case Study

#### Energy saving initiatives: Darwin Convention Centre

In the case of the Darwin Convention Centre, energy saving principles were utilised during the design and construction phase. Building orientation and shape, passive shading and ventilation, material selection and colour all contribute to an energy efficient facility. While energy consumption risk was retained by the government, the operator is incentivised to optimise efficiency through incentive payments in meeting operational budgets.

The operator has undertaken a number of energy efficiency initiatives including the installation of light-emitting diode (LED) lights (to reduce usage from 18 to 3 watts per unit), and awareness campaigns such as turning air conditioning and escalators off in areas of the Centre when there are no events. These initiatives have resulted in a 3.7% reduction in electricity usage.

While cost savings from energy efficiency has no direct impact on equity value, we believe there is an indirect benefit due to competitive venue and conference pricing from operational efficiencies. Furthermore, there is anecdotal evidence to suggest that sustainable policies and practices are considered favourably in conference venue selection which may also have a positive impact on delegate numbers to the Centre.

## Conclusion

The contractual nature of PPP arrangements can provide strong accountability and financial incentives for ESG considerations to be appropriately managed by responsible counterparties in the delivery of a successful PPP investment. Ensuring that the contractual arrangements and accountabilities are executed with competency and regularly monitored for lead indicators of poor performance or non-compliance is an essential component of active asset management.



Other sustainable initiatives undertaken by the operator include:

- › Installation of reduced capacity size dual flush cisterns, urinals and flow control taps, in order to aid water conservation
- › Recycling of used printer cartridges and toners and purchase of recycled products
- › Recycled biodegradable ball point pens used for client functions
- › Catering services utilise an on-site herb garden and 80% locally-grown and organic ingredients for events
- › Use of suppliers who use recyclable products for packaging.

## Contact us

For further information regarding AMP Capital Infrastructure's approach to ESG, please contact:

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