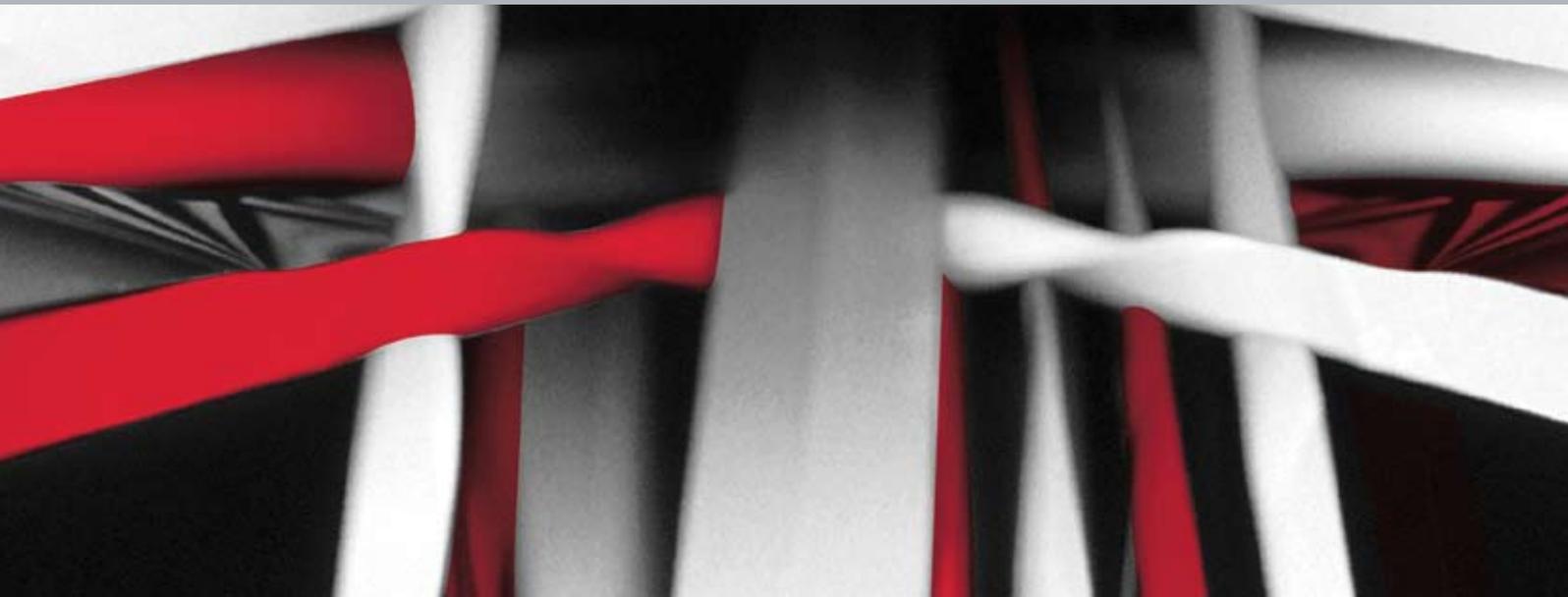


CLAYTON UTZ

Emerging from the Crisis:
Infrastructure Finance Post-GFC

19 October 2010



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At the risk of stating the blindingly obvious, the last few years have witnessed a tumultuous and challenging time for financing infrastructure projects. Just how challenging is reflected in the huge reduction in the dollar value of project finance transactions worldwide. Statistics given by Infrastructure Journal on 16 August 2010 in its "Global Infrastructure Finance Review - HI 2010", show that for the first half of 2010, the total number of project finance deals to reach financial close came in at 220 with a total valuation of US\$99.7 billion versus the first half of 2009 figure of 247 deals with a valuation of US\$84.4 billion. While this constitutes an improvement over the first half of 2009, the figures represent a steady decline from the first half of 2008 and the first half of 2007 where deal counts came in at 380 and 342 respectively with valuations of US\$157.1 billion and US\$143.9 billion.

However, a recovery or at the very least a flat growth trajectory is on the cards for the remaining half of 2010. As such, reports of the death of the finance markets, and the project finance market in particular, circulating during the course of 2008 and early 2009, may have been greatly exaggerated.

The market has shown over the last 6 months, in particular in relation to infrastructure PPPs, that financiers still have significant appetite for the right projects. It has also shown, however, that availability of credit is not simply a commodity that can be taken for granted, as it perhaps came to be seen in earlier, pre-GFC times.

PPPs pre-GFC

During the pre-GFC "good old days" infrastructure finance in Australia and worldwide was characterised by:

- debt being readily available with financial institutions having "surplus" capital;
- highly liquid capital markets allowing financial institutions to easily source balance sheet funding to lend out;
- risk being progressively re-priced downwards by this weight of money;
- very strong competition for available infrastructure deals;
- increased structural complexities for the financial "solution" as competing bidders sought a competitive edge;
- increased use of derivative instruments in the "solution" - for example, credit wrapping of debt, CPI swaps, accreting interest rate swaps, etc;
- aggressive bidding of key risk factors (eg patronage risk) for new greenfield PPPs;
- aggressive leverage in transactions with sometimes multiple debt layers; and
- longer agreed lending terms.

PPPs during the GFC

However, the GFC resulted in unprecedented changes in the global financial market and led to an environment where the market moved from the characteristics just described to a market where the capacity to secure the debt needed to deliver PPPs in Australia was severely constrained. As a result, very few PPPs were able to reach financial close in the last six months of 2008 and the first six months of 2009.

At the height of the GFC, PPPs faced funding issues as a result of:

- tighter lending controls by banks;
- the reduced presence of foreign banks as they retreated to their domestic markets;
- the closure of bond markets;
- the closure of the syndication market, resulting in banks only being prepared to lend what they were willing to hold and resulting in club bank arrangements replacing syndications; and
- a general lack of confidence.

These funding issues meant:

- less debt was available for any given project and therefore a club of banks was required for all but the smallest projects;
- increased margins and credit committees became more risk averse with a consequential rise in the cost of project financing;
- greater conditionality relating to the debt during the procurement phase. For example, market disruption became a reality and is now a standard clause on loan agreements. Market flex provisions also became hotly negotiated;
- State funding support being sought in the event that there was not sufficient capacity in the market;
- markets, both equity and finance, became more risk averse. This included an aversion to taking market/patronage risk on infrastructure projects; and
- banks were prepared to finance infrastructure with only short funding periods (for infrastructure projects in the PPP market which typically have terms of 20 to 30 years), thus leading to refinancing risk and hedging issues.

These funding issues/constraints on liquidity in the debt markets led to certain projects being postponed (eg the Sunshine Coast hospital PPP) or cancelled (eg the South Australian prisons PPP).

PPPs post-GFC

Since mid-2009, well structured projects have been proceeding albeit with more due diligence and analysis than in recent years as financiers take a more conservative approach to the structure and funding of projects.

During this time a number of PPPs have closed, including:

- Victorian biosciences project - \$230 million advanced medical facility;
- South East Queensland Schools PPP - \$1.1 billion project to develop seven new schools in south-east Queensland;
- South Australian schools PPP - \$323 million project to develop six new 'super-schools' in the Adelaide area;
- Victorian desalination project - \$5.7 billion project to develop a desalination plant in Victoria;
- Victorian Peninsula Link project - \$759 million freeway connection between EastLink and the Mornington Peninsula Freeway; and
- Ararat Prisons project - A\$394 million project to develop a prison.

Victorian Desalination Plant Project

- The Victorian desalination project was hugely significant for the Australian market given the size of the funding requirement (\$3.671 billion) and the fact that it was being raised at the height of the GFC. Many were sceptical that such an amount could be raised in a competitive bid situation, and the Victorian Government ultimately agreed to provide unprecedented underwriting support for part of the debt package to secure a fully-financed project.
- Government funding support was provided by a guarantee of syndication. The government agreed to be the lender of last resort for any debt that could not be syndicated after financial close. The syndication was oversubscribed, so the guarantee was never called on.
- Government funding support extended to a sharing with the private sector of additional financing costs for certain market disruption events and a sharing of the risk of losses on a scheduled refinancing (50% shared with the State) (the debt finance was for a term of only 7 years, for a project with a term of 30 years).
- The government also gave some support for increased costs if long term hedging was required for the project.
- However despite these concerns and with the support of the Government, syndication for the Victorian desalination plant was achieved in just over two months after financial close in September 2009, without any need to call on the Government support. This reflected not only the international interest in the financing of large-scale infrastructure in Australia post-GFC, but also the rapid improvement in the markets over the course of 2009.

Other Government support for PPPs

As just described in relation to the Victorian desalination plant, during the GFC support from the federal and state governments was required on a number of projects in different ways. Examples of other PPP funding models with increased government support which have emerged include:

The supported debt model (government as lender)

- This model has been used on the South East Queensland Schools Project.
- The private sector funds the riskier construction phase of an infrastructure project.
- The government then takes out an agreed proportion (60-70%) of the private sector debt on completion of construction.
- The government becomes the main senior debt funder in the less risky operational phase of the project (for social infrastructure certainly, although query if the operational phase is less risky for economic infrastructure projects).

Peninsula Link (government removes market/patronage risk)

- The failure of some high profile economic infrastructure projects, such as the Lane Cove Tunnel and Cross City Tunnel in Sydney and more recently the Clem 7 Tunnel in Brisbane, to meet patronage expectations with actual traffic at least 30-40% below forecast have increased concerns in the market over optimism bias in traffic forecasting by consortium bidders. This coupled with the impact of the GFC on debt markets has resulted in both debt and equity being loath now to finance infrastructure assets which have demand risk attached. This was addressed in the Peninsula Link Project by an availability model similar to social infrastructure:
 - The private sector designs, builds, finances, operates and maintains the freeway.
 - Payments are made by the government based on the availability of the freeway after construction.
 - There is no tolling. Government payments are used to repay the private sector funding and provide equity returns.
 - The payments are reduced if the freeway is not available in an agreed condition at all times.
 - The private sector therefore does not bear patronage risk. Its incentive for good performance is the abatement of the government payment stream for non-availability of the freeway in the prescribed condition.
 - If the Peninsula Link project is a success, the use of the availability model could potentially kick-start a pipeline of other road deals that are needed across the country.

It is interesting to note that while Peninsula Link closed less than 6 months after the Victorian Desalination Plant Project, the final project documentation included significant developments in the market position for state financial support in relation to refinancing and market disruption risk, returning much closer to pre-GFC positions on many issues. The State was able to remove refinancing risk by obtaining optional pricing from tenderers, based on which party took the risk. The State adopted the "No GFC" option which involved no sharing of Refinancing Losses.

Challenges ahead

Support from the federal and state governments will continue to be required. Governments may be less likely to be required to provide financing solutions to fill funding gaps, but it is likely that the private sector will continue to push back on issues such as patronage risk and market disruption costs. Beyond the commercial and contractual terms, Governments will need to continue to show a strong commitment to seeing a project through to financial close to ensure they attract maximum committed financing.

Recent trends and options available for the financing of infrastructure

New thoughts and models for a sharing of market/patronage risk

Given the wide acknowledgement that the recent experience with toll roads in Australia has had the result that both debt and equity are loath now to finance infrastructure assets which have market/patronage risk attached, are there solutions other than the availability payment structure as used in the Peninsula Link project?

Martin Locke, a partner of PricewaterhouseCoopers in an article published in the Infrastructure Journal on 9 June 2010 looks at possible new models for addressing demand risk in infrastructure projects which structure public funding alongside private sector capital, with a sharing of patronage risk between the public and the private sector. They are models which allow the public sector to provide capital that can earn a potential return and be recycled and which also incentivise the private sector owner/operator to generate upside returns and not narrowly focus on maintaining assets and delivering services to meet a specific contract's obligations.

He gives examples of ways to mitigate the impact of demand risks and allow both parties to share in the upside. The public sector might agree that it will not provide mandates to other providers on preferential terms, or there will be reasons to protect the private sector investment against specific possible events which can be influenced by the public sector and which affect demand.

The models suggested are:

Public sector subordinated notes - Once traffic has stabilised and construction risk has been overcome, toll road projects present stable cash flows with limited risk.

The government would provide its funding to a toll road by issuing subordinated notes, a model used for Portuguese toll roads. The subordinated notes give the public sector the right to receive returns from toll revenues, together with a share of any refinancing gains on a favourable refinancing of the toll road once operationally stable and profitable.

A public sector development company - The government could take responsibility for a project during the development stage, with the intention to refinance the project with private sector capital after it is built and revenue streams have been proven. This model has been used by the Queensland Government with Queensland Motorways to fund projects like the Gateway Bridge Upgrade, and it is now turning to the private sector through the asset sale process.

The project would be financed with public sector debt and equity and be structured along commercial lines aiming to replicate the private sector. Tolls would be set to provide a viable finance plan.

Public sector - supported superannuation fund vehicle - This model aims to tap into superannuation funds. They are conservative investors more inclined to invest in brownfield assets, as they do not like to take construction or early start up risks. However economic infrastructure projects are a logical investment for these funds with their long-term investment horizon.

Under this proposed model, the public sector might co-invest equity alongside superannuation funds and provide revenue guarantees over the asset for a period of time. Guarantees would fall away once certain revenue thresholds have been met.

The Royal Bank of Scotland in a presentation to the IPFA International Association in August 2010 also looked at some new commercial structures based on the tollroad model.

Quebec's Autoroute 30 - A PPP project where the private sector will finance, design, construct, maintain and operate about 42 kilometres of road, including a tunnel and 2 bridges and will finance, operate and maintain a supplemental 35 kilometres of road. One of the bridges is to be tolled. Payments to the private sector are made by the government, with deductions for failure to comply with required standards, as in the availability model. In addition, the private sector collects the toll revenues from the bridge for the government but with a revenue sharing beyond established limits.

Puerto Rico's Toledo Moscoso Bridge project - The private sector has an option to cancel its contract with government, with reimbursement of its equity investment and the government taking over its debt if certain traffic forecast levels are not met. The option expires if traffic meets or exceeds forecast levels over 5 consecutive years. There is also a sharing of additional profits by the private sector with the government if toll revenues exceed pre-determined levels. Such a model would require that traffic forecasts be provided by, or at the least endorsed by government.

Trends and options for the public funding of infrastructure - some overseas models

Public funding through special purpose government owned investment banks or agencies

The GFC has seen a trend towards such banks and agencies picking up what otherwise was expected to be a funding shortfall for projects in the UK, Europe and USA.

- The European Investment Bank (**EIB**). This bank is the long term lending bank of the European Union. It is tasked to contribute to the integration, balanced development and economic and social cohesion of the EU member states. It raises substantial funds on the capital markets and lends them on favourable terms to projects furthering EU policy objectives. It is owned by the member states of the EU. It has continued to provide substantial funding throughout the GFC to EU projects, particularly transportation projects (for example London's M25 redevelopment).
- The European Bank for Reconstruction and Development (**EBRD**). Established in 1991, it is the largest financial investor in the region of operations stretching from central Europe and the Western Balkans to Central Asia. It is owned by 61 countries, the EU and the EIB. It helps countries in the region to become open, market economies. It prices its funding on a commercial basis but differs from the commercial banks in its willingness and ability to bear risk, which allows it to act at the frontier of commercial possibilities, as a "demonstrator". It has funded roughly 20% of the €1.166 billion Slovakian R1 Project (a PPP road) for example.

- The US Transport Infrastructure and Innovation Act (**TIFIA**) program. The three largest infrastructure PPP projects reaching financial close in the USA in 2009 all featured subordinated debt from the TIFIA Credit Program, hailed as a stalwart of project finance since its introduction in 1998. It offers a deferred repayment schedules, capitalisation of interest and subsidised pricing to eligible service transportation projects of regional and national significance. It is administered through the US Department of Transportation with eligibility determined according to criteria developed by Congress. Its goal is to finance large scale capital intensive projects which otherwise might be delayed or not completed at all because of their size and complexity and the market's uncertainty over the timing of revenues. It fills market gaps and leverages private co-investment by providing supplemental and subordinated capital at fixed interest rates equivalent to treasury rates and typically lower than private market rates.
- TIFIA funding often goes hand in hand with the issue of Private Activity Bonds (**PABs**) by a US government conduit entity for the purposes of new infrastructure projects which are supported by federal funding. PABs are tax-exempt municipal bonds, traditionally used by States and Municipalities to finance public transportation infrastructure, but which can be used for private business purposes if they fall within defined categories of infrastructure and become qualifying projects. PABs were favoured over bank debt for two recent US projects, North Tarrant Express and the Texas LBJ Freeway Managed Lanes Project because they had a 30 year maturity (with an option to refinance at year 10) where bank debt was being offered for only 10 years.
- Statistics given by Infrastructure Journal on 16 August 2010 in its "Global Infrastructure Finance Review - HI 2010", reflect the increase in infrastructure funding support from governments and multilateral agencies over the past 3 years. In the first half of 2010, of US\$99.7B of infrastructure financing committed to projects, equity accounted for US\$17.4B, bonds for US\$2.28B, loans for US\$62.31 B and government and multilateral agency support for US\$17.88B (18% of the total). For the second half of 2007, of total funding of US\$168.68B, equity accounted for US\$28.82B, bonds for US\$16.8B, loans for US\$120B and government and multilateral agency support for US\$3.06B (a mere 1.8% of the total).

The use of value capture finance

Value capture finance is where Governments are able to leverage some of the financial value created by new developments to help finance the infrastructure needs of those new developments.

Examples of value capture finance programs in the UK are:

- the Milton Keynes greenfields development, where fixed amount tariffs based on a fully budgeted infrastructure program are payable by all developers at milestone dates to the local authority to help fund the infrastructure required for the development. Developers have the certainty of knowing the amount of their contributions up front and have time to pay the full amount;
- the establishment of business improvement districts. Businesses in closely defined areas vote to pay additional levies on top of the national business rate to fund local projects to meet their needs. Business improvement districts have a maximum life of 5 years;

- the London Crossrail Project:
 - the Greater London Authority will raise £4.1 billion of its £7.7 billion contribution to the Crossrail Project by a compulsory business rate supplement:
 - at the rate of 2% per pound of the rateable value of all non-domestic properties across the 32 London boroughs with a rateable value over £55,000;
 - which is expected to be levied for between 24 and 31 years (until the debt borrowed by the Greater London Authority has been repaid); and
 - which is levied on the principle that London's non-domestic rate payers will be the biggest beneficiaries of the increased capacity and decreased congestion on the Tube, Docklands Light Rail and National Rail Services.

Of the remainder of the cost of the London Crossrail £5.1B will be provided by the Department of Transport and the balance by Network Rail and other private partners such as British Airports Authority and Canary Wharf Group.

Tax Increment Financing (TIF)

This is another form of land value capture finance, but without the levying of an additional tax or charge.

- TIF has been used in the USA for the past 50 years, particularly for funding urban regeneration projects.
- Infrastructure and service improvements are planned in a defined area (a TIF district) by the local authority.
- Private developers are attracted to invest in the TIF district.
- The increase in real estate taxes which the local government can expect over time through a revaluation of land in the TIF district after its development are set aside from general tax receipt funds and allocated to the TIF district.
- The additional real estate tax revenue is allocated to fund repayment of the finance the local authority has had to raise to build the infrastructure and services for the TIF district or is used to fund the ongoing costs of the local authority in the TIF district.
- In the Australian context, the real estate taxes would be land tax and stamp duty (at the State level) and municipal rates (at the local government level).

The growth of superannuation (and insurance) funds as an option

The need for major structural and long-term reforms

In April this year, Infrastructure Partnerships Australia published a Report: The role of Superannuation in Building Australia's Future IPA estimated that Australia's superannuation funds collectively hold between \$40 and \$65 billion in infrastructure assets. Recent projects with significant superannuation investments include the Desalination Plant (Unisuper provided 26% of the total US\$646M equity) and Peninsula Link (Australian superannuation funds

contributed in aggregate two thirds of the US\$137M equity). But IPA states that infrastructure represents an average investment of just 6 per cent of available superannuation funds, with investments like domestic and international shares representing 29 per cent and 23 per cent respectively.

IPA's paper argues that a range of structural reforms to the superannuation sector - and the national infrastructure marketplace - will allow Australia to create a stable link to better harness superannuation for major projects. Specifically, the paper argues that investment can be enhanced by:

- Developing a three-tier superannuation industry, comprising pre-retirement (accumulation), retirement (transition) and post-retirement (preservation);
- Considering reforms toward the provision of annuity products by superannuation funds, better matching the life cycle of superannuation outflows to the return profile of infrastructure assets;
- Consolidating super funds to reduce fees to superannuants and provide funds with the scale required to participate in mega-projects;
- Building the in-house and external skills and knowledge of Australian super funds to allow them to better assess and leverage investment opportunities in infrastructure assets;
- Establishing a coherent national strategy to streamline the tender process, including further refining the take up and application of the National PPP Guidelines to promote inter-jurisdictional harmonisation and developing a workable solution to reduce the cost of bidding for major projects;
- Developing long-term (20 to 50 year) integrated land use and infrastructure plans to provide a clear and transparent pipeline of future investment opportunities; and
- Reforming investment risk profiles - a flexible approach to risk allocation, tailored to industry appetite for risks within a specific project.

The reforms recommended by IPA are major structural, long-term reforms. In the meantime, the investment of the superannuation funds in the Desalination and Peninsula Link Projects is indicative that Australian superannuation funds will be interested in investing in the future in availability-based projects, with long-term visible cashflows and "quasi government guarantees" of income.

Australia is not alone in the reluctance of superannuation funds to invest in infrastructure projects. As traditional sources of debt funding to infrastructure projects have contracted during the liquidity crisis, attention has focussed on pension funds as a new wall of cash into infrastructure projects. With a clear duty to invest in the interests of their members and a traditionally cautious approach to investment strategies, it is not surprising that there has been little movement of pension funds to invest where the banks have only cautiously dared to tread during the GFC. The equity investment by the Dallas Police and Fire Pension System in the recently executed Texas LBJ Freeway project (it invested 10% of the US\$700 million equity in this project) was claimed to be the first investment by a pension fund directly in infrastructure development in the USA.

The forward funding model an option?

An alternative funding method that had been used in the past in the UK construction market by pension funds has again been raised as a possible procurement model for the funding of infrastructure projects by UK pension funds. It is the "forward funding" model, under which pension funds would buy a property from a developer and lease it out. The pension fund would purchase the undeveloped land, a development management agreement would be entered into and the developer would develop the land, with funding from the pension fund. Hence the pension fund, as owner, although it took construction risk, would have the benefit of the increase in capital value of the land, and a predictable future income from tenants who would be signed up to agreements to lease before the development commenced.

Applying this model in the social infrastructure context, the pension funds would have pre-lease agreements for long-term leases with government agencies and therefore long-term stable cash flows, with a government department standing behind them - almost as good as a government guarantee. A model to float in Australia going forward?

Return of the CDO model?

Collateralised debt obligations (**CDOs**) have been used as a means by which infrastructure lenders can refinance their portfolio of infrastructure project loans, thus freeing up funds for future infrastructure investment. The infrastructure lender would sell a portfolio of its PPP infrastructure loans to a special purpose vehicle, which obtains the finance for the purchase by the issue of loan notes or other debt instruments collateralised by the infrastructure loan portfolio (and any supporting securities).

CDOs have attracted criticism generally because of their use in the Residential Mortgage Backed Securities (**RMBS**) market, where the subprime RMBS market in the USA has been blamed for bringing on the GFC. However CDOs collateralised by a range of infrastructure project loans would be more attractive investments than RMBS for institutional lenders such as superannuation funds, particularly if the refinancing occurs at a time when projects have been constructed and operational for several years, with a clear history of operational stability and profitability.

The CDO model can be used by an infrastructure project financier to refinance a bundle of its loan participations in various projects across various industries and to various project sponsors or by all financiers in a particular infrastructure project once operational success of the project can be demonstrated. It may be that such a model will be used when scheduled refinancing takes place of some of the infrastructure projects financed only out to 7 years during the GFC.

Options available to investors throughout a project's life cycle

Traditionally investors in projects have committed to make their investment upfront in projects as part of the equity requirement imposed by both governments and lenders to ensure the project sponsors have money at risk. However it is highly likely that greater innovation will ultimately develop as a consequence of the GFC. For example:

- During the 1990s Ontario developed highway 407 as a public toll road (the first in the world to use electronic tolling) and subsequently sold ("privatised") the asset to a Macquarie led consortium. Conceivably this could occur with Northern Link in Brisbane and potentially the government owned toll road assets in Sydney.

- The proposed sale by the government of Qld Motorways (which operates a number of Brisbane toll roads), as a corporate entity.

The creation of long term operating asset classes within the public infrastructure sector but with private investment also has opened the door to creating value out of the long term services required by these assets. Indeed many well known companies have branched out of their core construction activities to provide long term services (maintenance and refurbishment) to these asset classes.

Also another development is the creation of funds holding a portfolio of infrastructure assets and issuing market listed securities in the funds as a way of creating a broader pool of investor opportunities for smaller players.

Conclusion

A positive to emerge from the GFC is its stimulation of creative problem solving, as we have had to examine new funding models and financing options. For example, how can we attract our superannuation funds to greater investment in infrastructure and what options are available to governments to refinance their investment in infrastructure (if for particularly large projects governments might be required to co-fund with the private sector)? And although we cannot say that the effect of the GFC has passed, recent projects indicate that the climate is improving and investor confidence in the infrastructure market is growing.

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