How Public Pensions Are Getting Smart About Infrastructure

By cutting out the middlemen, our pension funds are harnessing the power of their capital.

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by Jill Eicher | July 10, 2015

While American politicians talk about changing public policy to increase investment in U.S. infrastructure, America's public pension funds are investing their money in infrastructure overseas.

The largest U.S. public pension fund, the California Public Employees' Retirement System (CalPERS), recently announced a $1 billion deal with Queensland Investment Corp. (QIC), an Australian pension fund, to invest in Australian and Asian Pacific infrastructure.

At first glance, this would seem to be bad news, especially when you consider that 11 other U.S. public pension funds have deployed an additional $5 billion to overseas infrastructure investments over the past five years while collectively investing less than $800 million in domestic infrastructure.

It is bad news that other countries have figured out how to make infrastructure investing attractive to pension funds while, clearly, the United States has not. But looking closer, CalPERS may be leading a new way to finance American infrastructure while earning a rate of return consistent with other competing investments.

What's remarkable about the CalPERS deal is that instead of hiring expensive middlemen to make infrastructure investments with its money -- as was done with the previously deployed $5 billion and is done regularly with the bulk of the $5.3 trillion of U.S. public pension capital -- CalPERS is acquiring the capacity make such investments on its own. That reflects a trend among cost-conscious pension plans around the world that have eschewed the intermediary approach.

Pension funds in Australia and Canada did so long ago. Today, they are forceful market players instead of captive customers. Once they bypassed the intermediaries to harness the influence of the large pools of capital they control, they leveraged that power to form pension-owned infrastructure investment platforms such as Australia's Industry Funds Management and Canada's Borealis. These platforms have collectively deployed more than $50 billion of pension capital into infrastructure investments around the world, and they have realized returns above the 7 percent that U.S. pension funds need to fund future liabilities.

The United Kingdom and Switzerland have now followed their lead. The British government launched policy initiatives in 2011 that led to eight U.K. pension funds pooling their capital for the purpose of making direct in-country infrastructure investments. To date, they have deployed a half-billion dollars of capital. And nine Swiss pension funds came together last May, also for the purpose of making direct investments in local infrastructure. They now are structuring their third such investment.

CalPERS' deal with QIC will enable the California fund to tap into the Australian pension fund's experience in developing internal skill to manage assets as owners. This capacity was best demonstrated last year when QIC made a profit of several billion dollars on the sale of the Queensland Motorways, a broken-down highway, bridge and tunnel network that the Queensland state government conveyed to QIC in 2011 to satisfy pension liabilities.

And CalPERS isn't the only U.S. public pension fund -- or even the only one in California -- tapping into overseas expertise relating to infrastructure financing. This spring, the California State Teachers Retirement System (CalSTRS) announced an investment partnership with a Dutch pension fund, Stichting Pensioenfonds ABP, that will allow CalSTRS to benefit from ABP's skill in negotiating with government project sponsors. This was evident in the 2012 N33 transportation project, which the Dutch government structured expressly to secure equity and debt financing from ABP and Holland's largest pension fund, PGGM.

It's great news that our two largest public pension funds have begun to take steps to acquire the capacity to invest their own money and to end an impoverishing reliance on intermediaries. What's more, they're doing this by forming partnerships with international peers who know how to make money in infrastructure.

Even the most sophisticated pension-fund investors, however, have not figured out how to make money in U.S. infrastructure, given the competition from low-cost capital through the municipal-bond market. It just doesn't seem to make sense for infrastructure-project sponsors to pay pension funds (or any other institutional investors) more for capital than they pay the muni-bond market, currently about 4 percent.

But while capital at 4 percent appears cheap, borrowing costs are only the starting point in public infrastructure projects. Other costs, such as for operations and maintenance, ought to be considered -- and too frequently aren't --- when taking on projects that might stretch out over 30 years. Governments and taxpayers would get far more value from investors willing and able to finance total lifecycle costs than they do from a simple bond issuance.

As the level of new municipal financings continues to decline, the U.S. will increasingly need investors, such as public pension funds, that can add value beyond what is currently available from the capital markets. Infrastructure project sponsors could realize additional value for taxpayers by raising the kind of patient public pension equity capital that is more interested in long-term dividends than up-front fees for advisory and/or construction services.

By working directly with state and local governments to structure pension-right, public-right infrastructure projects, U.S. public pensions could open the most coveted infrastructure market in the world to the global community of institutional investors. This would result in a win for public pension funds, state and local governments and, most importantly, taxpayers and retirees.