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THE ILLUSIONIST

Although considered Europe's economic powerhouse, Germany's infrastructure pipeline is starting to look a bit thin. Can things be fixed, asks **James Kenny**

The future looked interesting and there were possibilities

A lack of large-scale projects and committed pipeline, as well as a recent public backlash against the PPP model, has soured Germany's once-proud reputation as an infrastructure leader.

Behind its shiny façade and the traditional stereotyping of German efficiency, all is not well in the country and there is a growing need for new investment in infrastructure.

Marcel Fratzcher, head of the German Institute for Economic Research, has referred to this phenomenon as "The Germany Illusion". He explains that while most of the country's citizens and many outsiders see Germany as an engine of employment and model of reform for all of Europe, in reality it has barely made up for its own economic slump triggered by the financial crisis. He warns that, at its core, the economy is crumbling, its infrastructure is becoming obsolete and investors are looking elsewhere.

In the PPP market, at least some of Fratzcher's suggestions appear to be accurate. On the surface, things appear to be pretty positive for projects in the country. In August, financial close was reached on the A7 highway PPP. The deal marks the latest in a number of high-profile A-road projects currently being procured. And the following month, financial close was reached on the Schleswig-Holstein University Hospital.

In fact, a recent report from the European PPP Expertise Centre on the European market for the first half of 2014 placed Germany as the second most active country in terms of deal number, behind only the UK.

And institutional investors are eager to invest in the country. In August, the General Association of German Insurers (GDV) backed government plans for increased infrastructure investment, saying they are "ready to be a reliable and long-term investor".

However those within the industry warn that the recent success of the autobahns is masking a lack of new work coming through, arguing that there is not an adequate pipeline for the future.

"You have current projects like the A94, A7 and A6," says Frank Roth, partner at DLA Piper in Cologne. "But 10 years ago we advised on the first wave of model A projects, at that time the only big ticket was the road infrastructure market. The future looked interesting and there were possibilities. Well now it's 10 years later and the second wave of projects has not really materialised. Has the market significantly improved since? I would say no."

This stagnant pipeline is especially concerning, because although the country experienced a huge reform both economically and politically throughout the 1980s and 1990s – including significant investment in infrastructure – since then many of these schemes have been left untended and are now in ruin.

Juergen Bufka, managing director at fund manager Amber Infrastructure's German operations, concedes that past mistakes are now coming back to haunt the country.

"There has been an historic lack of investment in public infrastructure in Germany, as efforts at all administration and government levels sought to minimise public deficits and reduce overall public spending," he explains. "This has resulted in an investment lag in the country's large-scale infrastructure development. More private capital will inevitably be needed to meet the funding requirements demanded by an economy the size of Germany's."

Despite this need, however, there remains a lack of urgency from the German government to deal with the problem, and little apparent strategic direction. Roth points out that the rate at which projects come to market can be disjointed, with a wealth of small schemes having come to market in the past that would have benefited from being bundled together.

"What I think has reached a limit is the hundreds of smaller PPP projects in the €5-€15m range that we see coming through, things like schools, fire houses and other public buildings," he says. "A full large pipeline just isn't there."

This lack of direction is worrying looking forward, as the need for new infrastructure is growing. Christian Scherer-Leydecker, partner at law firm CMS in Munich, says: "Roads and particularly bridges have not sufficiently been cared for, most bridges in western Germany were built 30 to 50 years ago, with little planning for today's traffic loads, numerous structures need renewal but no new projects are being developed besides the few A-model road works."

However, Hansjörg Arnold, public sector partner at PwC Germany, says the federal government is slowly waking up to the issue and has expressed its willingness to promote private capital in infrastructure projects. Two commissions have been introduced by the government to develop ideas, although any conclusions remain some way off.

Public Backlash

Exacerbating the problem – and no doubt explaining the Merkel administration's reluctance to press on with a large PPP programme – is the fact that Germany is now wrestling with a recent public backlash against the PPP model.

The Federal Audit Office (Bundesrechnungshof) conducted a study of the PPP industry in September 2013 and concluded that costs may be higher for PPP projects than they are for conventionally funded enterprises.

The auditors examined several of the large A- road construction projects and found that five of them would have been cheaper had they been paid for in the usual manner with taxpayer money. The total savings were estimated at €1.9bn. In the A1 expansion project, the Transportation Ministry had assumed that the PPP would be 40% cheaper than tax financing, but the final cost was a third higher.

PPP projects "did not achieve significant goals" and projects conducted to date have been "uneconomical", the report concluded.

Following this audit the thread was picked up by the mainstream media and publications such as Spiegel, which has seen the public rally against the model, insisting it is a waste of time and hurtful to the country's economic future.

Another issue seen to contribute to the public's distaste of the model is the long procurement times and the costs involved. Many countries have had this issue in the past but have overcome the problems. Ireland for example, has recently reformed its bidding processes to keep development times down and cut out costs, while Scotland is currently looking at ways to further increase standardisation of documents and push down procurement times.

"Fundamentally the people that don't like PPPs are shouting a lot louder then the ones who do. This public opinion is key: people need to get behind the concept, not just politicians," says Christian Knütel, a partner at Hogan Lovells' Hamburg office.

Institutional interest

Arnold explains the Catch-22 situation for the German authorities: "The dilemma is that public funding is still cheap due to low interest rates, but federal rules hinder authorities from borrowing new debt. After the financial crisis, privately managed projects still have a bad reputation."

He suggests that this could be where the institutional investment community is able to play an important role. "New players such as the insurance companies can step into the market. It will be crucial to develop new structures to stimulate the market. The demand exists, the money as well; still projects do not come to the market."

The insurance and pension industries in particular have shown themselves to be eager to bolster the market. German insurance giant Allianz went on record in September stating its desire to invest more of its funds in domestic infrastructure projects, but says the government in Berlin must improve the regulatory environment first.

Board member Maximilian Zimmerer said the German economy was suffering from a lack of private investment and urged Chancellor Angela Merkel's coalition to take steps to address the shortfall.

However so far Merkel and her cabinet have been reluctant to free up additional public money, because doing so might make it more difficult for them to deliver on the promise to balance the federal budget next year.

Zimmerer, who is responsible for the investments of Allianz's substantial portfolio, said Germany could tap the vast funding power of the insurance sector to improve its energy and transport networks if only the conditions were right.

"The time has never been cheaper for states to modernise infrastructure," said Zimmerer. "This must be tackled urgently."

However, there are those in government positions who seem more open to the concept and are keen to open up the opportunities for investment.

Federal Minister of Finance Wolfgang Schäuble recently announced he wished to check whether there are "unnecessary regulatory hurdles" for institutional investors when it comes to infrastructure investments. Likewise, Minister for Transport Alexander Dobrindt has also stated his desire to increase PPPs for public infrastructure to avoid having to take on more loans.

Alexander Erdland, president of the GDV, says the best way to go about setting up a clear investment pipeline is increased dialogue between the public sector and private investors.

"It would make sense to sit all key players down at the table so that they could discuss their respective interests and formulate realistic goals." He adds that legal

SHORT SUPPLY

Projects signed and in procurement across Germany in 2014

State	Project	Status	Value €m
Baden-Württemberg	Autobahn 6 Wiesloch-Rauenberg to AK Weinsberg	Advertised	N/A
Bavaria	Nuremburg Johann-Pachelbel-Realschule/Staatliche Fachoberschule II	Advertised	N/A
Bavaria	Autobahn 94 Pastetten to Heldenstein	Shortlist imminent	N/A
North Rhine-Westphalia	Nordhorn Bentheim County municipal archive	Advertised	1.6
North Rhine-Westphalia	Düsseldorf Deutsche Oper am Rhein PPP	Project Signed	25.7
Schleswig-Holstein	University Hospital Schleswig-Holstein PPP	Project Signed	520
Schleswig-Holstein	Budelsdorf school PPP	Shortlist imminent	N/A
Schleswig-Holstein and Hamburg	Marschbahn rolling stock PPP	Project Signed	140
Schleswig-Holstein and Hamburg	Autobahn 7 Bordesholm to Hamburg PPP	Project Signed	600

security, above all else, is important for insurers. "As long-term investors, they have to be able to trust that the rules are not going to change retroactively once established."

He says that the insurance industry is ready to play its role in rebuilding Germany, but the government also has its part to play. As part of this, a key feature would be greater control from the centre, with Erdland suggesting that it would be desirable for politicians to prepare a schedule of future infrastructure projects and inform investors early on about them. This is something that is becoming increasingly prevalent in mature infrastructure markets today, with national infrastructure plans being developed as a way to entice investors.

"More planning security would make it easier for insurers to provide the financial resources necessary for infrastructure projects within the framework of their long-term investment strategy," says Erdland.

However, the new risk capital rules for Europe's insurance sector that are due to come into effect in 2016 could prove to be a stumbling block to the appetite of institutional investors to get involved in infrastructure projects. Under the new rules, infrastructure could face capital charges of up to 70%, while real estate investments only around 25%, something that could turn many investors away from the sector as an asset class.

Insurance regulators are being lobbied to allow infrastructure to be considered an asset class of its own and treated similarly to real estate when it comes to the capital buffers insurers must hold to cover investment risk.

"Up to now, no project has been rejected on grounds of regulatory risk charges but we could face bottlenecks if this business really starts to take off," one insurance expert warns.

Michel Barnier, the EU's financial services chief, proposed last year that funds meeting minimum EU criteria on governance and strategy should be designated as European Long-Term Investment Funds. As such, they would be designed to increase non-bank financing for companies and be given a passport to market themselves throughout the 28-nation bloc.

The commission's plan is that lower risk weighting will be attached for investments into those funds, which would in turn keep down insurers' capital requirements.

Most agree that should the pathway for institutional investors be made clearer then this would also facilitate more foreign players into the market.

Amber's Bufka says both institutional and foreign investors have a large role to play in the future German market

"With such a strong export market, Germany's relationship with the global investment community is pivotal to the health of the country's economy."

A good example of the culture of collaboration with foreign investors is the new headquarters of the Federal German Ministry of Education and Research in Berlin. The project was truly international, with International Public Partnerships, a UK-based fund (managed by the British arm of Amber Infrastructure) a Dutch construction company and a Japanese bank all co-operating.

"The project was the first civil construction project developed under a PPP model by the federal German government," says Bufka. "Key to its success was ensuring foreign investors had a trusted local partner to manage the asset's construction and operation."

Infrastructure investment fits perfectly to the needs of these investors. But without a varied pipeline containing projects of sufficient scale, the institutional market may well find its opportunities in Germany frustratingly restricted. Until the country can coordinate a national policy for infrastructure investment – and communicate it to investors – Germany's future programme will continue to look rather thin.

That will ultimately prove bad news for the whole of the eurozone. With former reliable economies such as France also struggling to find any growth, Germany's lack of new infrastructure threatens to hold back the entire continent.