



INFRASTRUCTURE FINANCE REVIEW

Issued 5 June 2019

ICAEW welcomes the opportunity to comment on the **Infrastructure Finance Review** published by HM Treasury and the Infrastructure & Projects Authority on 13 March 2019.

Overview

- The UK continues to underinvest in infrastructure.

Finance innovation has the power to transform infrastructure investment in the UK

- An Infrastructure Growth Fund and pooled investment funds would facilitate investment.
- New public-private partnership contractual models are needed now.
- Approved peer-to-peer networks would enable citizens to invest directly.
- The UK should utilise its world-leading professional expertise in infrastructure finance.

Public investment is an enabler

- A new UK Investment Bank to replace the EIB as an anchor investor.
- The British Business Bank should support business to deliver infrastructure projects.
- Direct investment by city-regions and local authorities would engage communities.
- Local industrial strategies must make improving infrastructure a top priority.
- Centres of excellence are needed to support investment decisions and in managing risk.

Capital is available, but it needs to be unlocked

- Long-term pricing would provide certainty to investors, taxpayers and consumers.
- Tax and other incentives need to be gauged carefully, but then should be stable.
- Reforming balance sheet treatment requirements would remove contracting hurdles.
- Regulatory asset base and concession arrangements could be used more widely.
- Early-stage risks need to be tackled to draw in more seed capital.

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KEY POINTS

Overview

1. The UK continues to underinvest in its infrastructure.
 - ICAEW supports the government's efforts to increase investment in UK infrastructure and to facilitate private sector investment. More investment is needed in our transport system, in communications networks, in energy generation, in housing, and in hospitals, schools and community facilities.
 - The government has placed infrastructure at the heart of the Industrial Strategy. The UK is a leader in green technologies. The Patient Capital Review recommendations are being progressed. The Infrastructure Commission is identifying key priorities for investment, and the Infrastructure & Projects Authority is helping deliver a pipeline of over £600bn in infrastructure projects over the coming decade.
 - This momentum needs to be seized upon if the government is to deliver the infrastructure upgrade that the country needs. There is a clear need for greater investment in transport, particularly outside London and the South East. Much of the country still does not have direct access to fibre optic connections. Renewable energy generation is being built, but a lot more is needed to meet climate change goals. New nuclear power projects are not forthcoming, many years after construction should have started. There is no effective contractual model for public-private partnerships.
 - We believe that this underinvestment is not because of a lack of available finance. Our experience is that investors are keen to invest in the UK's infrastructure, and will do so where they are presented with the right opportunities.

Finance innovation has the power to transform infrastructure investment in the UK

2. An Infrastructure Growth Fund and pooled investment funds would facilitate investment.
 - There is a need for a dedicated investment partner for infrastructure businesses, particularly those developing smaller and medium scale projects. This could make a big difference to those trying to innovate, particularly in areas such as social housing and community facilities.
 - One model that could be adopted would be an Infrastructure Growth Fund, operating on similar basis to the BGF (formerly the Business Growth Fund). With a focus on infrastructure, it could attract a wider range of long-term investors than the BGF, including pension funds and other investors seeking long-term returns.
 - Such a fund should work with and complement the Green Finance Institute to support renewable energy and the development of green technologies.
 - Pooled investment funds would also enable investors to participate in larger infrastructure projects and to share risk across a wider portfolio. This would build on recent patient capital reforms aimed at enabling pension funds and other institutions to invest in a wider range of asset classes. It is important investors that would like to invest in infrastructure are provided with the opportunity to do so.
3. New public-private partnership contractual models are needed now.
 - A standard contractual framework facilitates investment by making it easier for both investors and public bodies to agree terms and understand the risks they are each assuming. With the end of PF2, there is no longer a model available for use.
 - It is important that the experience gained from PFI and PF2 contracting is fed into the development of the new contractual model, retaining the elements that worked well at the same time as addressing weaknesses in the previous approach.
 - The design, build, finance and operate (DBFO) approach to constructing infrastructure assets has proved successful in many jurisdictions, and it is important that any successor to PF2 retains DBFO as an option.
 - Greater flexibility to adapt to the circumstances of each individual project would encourage more investment and so the new contractual model should not be constrained by balance sheet treatment requirements (see 13 below).

4. Approved peer-to-peer networks would enable citizens to invest directly.
 - Peer-to-peer investing provides an opportunity to enable individual citizens to invest directly in infrastructure. This would not only provide a new source of finances for infrastructure projects, but also benefit many individual investors by providing them with new long-term investment opportunities.
 - Direct investment in this way could also provide an opportunity to engage citizens in a positive way in infrastructure projects that affect their local communities.
 - Existing initiatives such as Abundance Investments and Amberside Asset Lending Platform provide examples of how this can work, but these currently operate on a relatively small scale. A government-supported marketplace, with due diligence and stop-loss guarantees, combined with support from regional and local authorities for approved infrastructure peer-to-peer investments, could encourage much greater levels of investment.
5. The UK needs to utilise its world-leading professional expertise in infrastructure finance.
 - The UK is a world-leader in infrastructure finance, with extensive professional expertise developed over the last thirty years – including that of chartered accountants working with and for infrastructure businesses.
 - This expertise has provided a platform for services exports around the world, with many countries looking to UK professionals to advise on infrastructure projects and infrastructure finance.
 - This expertise needs to be put to work in the UK.

Public investment is an enabler

6. A new UK Investment Bank to replace the EIB as an anchor investor.
 - The European Investment Bank (EIB) has been an important source of funding to infrastructure projects in the UK. It has often acted as an anchor investor, unlocking private investment in projects that might not otherwise have been viable.
 - In addition to the direct funding provided, the EIB has brought specialist skills and support to a wider club of funders during the pre-lending due diligence phase of many projects.
 - This capacity and role could be fulfilled by a new domestic development bank, a UK Investment Bank (UKIB), with a similar governance structure and operating model to that of the EIB.
 - The new UKIB should include a diverse shareholder base encompassing the devolved administrations, city-regions and regional groups of local authorities in addition to central government. Shareholders should be represented in the governance structure by professionals with appropriate expertise; they should not be political appointees.
 - Such an institution should complement, and work closely with the Green Finance Institute, to finance renewable energy and in decarbonising the UK economy.
 - It is important that any new UK Investment Bank has a distinct mission dedicated to supporting infrastructure development and is equipped with the skills necessary to invest public funds and manage risk appropriately.
 - Where appropriate, this remit could be extended to international projects where this is aligned with UK interests and/or the UK's support for development goals.
7. The British Business Bank should support businesses that deliver infrastructure projects.
 - Successful infrastructure projects will need well-financed UK businesses capable of delivering them, throughout the supply chain.
 - The British Business Bank, together with the Development Bank for Wales, Scottish Enterprise and Invest Northern Ireland, should work with the new UK Investment Bank to prioritise businesses in the supply chain that together design, build and operate infrastructure.
8. Direct investment by city-regions and local authorities would engage communities.

- Direct investment in infrastructure by all levels of government, including by devolved administrations, city-regions and local government, has the potential to increase the pool of capital available, draw in greater private sector investment, and increase public support for new infrastructure.
 - There is an opportunity to engage communities in major local infrastructure projects by reporting to the public on the performance of investments made in infrastructure.
 - Direct investment would not only provide a return to the public purse from successful infrastructure projects, but also provide assurance to private investors of commitment to seeing projects through to completion.
9. Local industrial strategies must make improving infrastructure a top priority.
- Local enterprise partnerships (LEPs) are well placed to develop and deliver local industrial strategies in conjunction with their sponsoring local authorities.
 - LEPs should make improving infrastructure a top priority in their local industrial strategies.
10. Centres of excellence are needed to support public bodies in investing and managing risk.
- Many public bodies will not have the inhouse capability to handle a small number of (relatively) large infrastructure investments. They will need access to professional expertise to enable them to assess potential investments, to conduct contract negotiations and in how to monitor and effectively manage risk.
 - This is a particular concern for many government departments as experience has diminished over the last few years with the significant reduction seen in the number of new public-private partnerships.
 - The recent Infrastructure & Projects Authority and Department for Transport report 'Lessons from transport for the sponsorship of major projects' highlights many of the project disciplines that need to be followed if projects are to be successful.
 - The government needs to ensure that there is sufficient resource and expertise within the Infrastructure & Projects Authority and in departmental 'centres of excellence' to ensure that public bodies are adequately supported in commissioning and delivering infrastructure projects.

Capital is available, but it needs to be unlocked

11. There needs to be a long-term approach to pricing, providing clarity to investors, consumers and taxpayers.
- While investors are willing and able to accept and manage risks associated with construction, operations and demand, they often need more assurance around pricing if investments are to be viable.
 - This has been demonstrably the case with new nuclear and renewable energy generation assets, where investment has flowed – or not – depending on the pricing mechanism established for each asset.
 - We believe that a long-term stable approach to pricing has the potential to encourage significant additional investment, while still protecting the interests of consumers and taxpayers.
 - Pricing arrangements need to be designed intelligently, retaining flexibility to ensure that prices come down when capital costs reduce significantly.
12. Tax and other incentives need to be gauged carefully, but then should be stable.
- Incentives can be an important element in the decision of investors to fund infrastructure projects. They need to be carefully targeted and intelligently designed to ensure that additional investment is encouraged while protecting the taxpayer interest.
 - Government could do more to publicise social investment infrastructure funds, as many investors are unaware of the tax incentives available to investing in them.
 - There should be a review of the eligibility of solar power generation projects for the Enterprise Investment Scheme (EIS). With the withdrawal of subsidies, the rationale for their exclusion from the EIS no longer applies. Similarly, automatically including all

- infrastructure projects that meet the public infrastructure exemption test (PBIE) within the EIS has the potential to encourage significant investment.
- The level of business rates that are payable on infrastructure assets is an important factor in investment decisions. Reviewing the rates and scope of business rates could support greater investment.
 - It is important that tax and other incentives are not changed too frequently, providing investors with a stable framework in which to make investment decisions.
13. Reforming balance sheet treatment requirements would remove contracting hurdles.
- The fiscal reporting framework under ESA10 permits debt used to finance assets used for public purposes embedded within long-term service contracts (such as PFI and PF2) to be excluded from public sector net borrowing and public sector net debt if certain criteria are met.
 - The government has generally sought to comply with these criteria in order to obtain 'off balance sheet' treatment. In doing so, they have imposed significant constraints in how commissioners and providers allocate risk.
 - A policy decision to amend fiscal targets to permit future public-private partnerships to be recorded on balance sheet, would remove these constraints and provide much greater flexibility to the contracting process.
 - A consistent on balance sheet treatment for private finance and traditional public sector financing would also enable the different approaches to be compared more easily, providing ongoing benchmarks on value for money.
14. The government should consider extending the use of regulatory asset base and concession arrangements to a wider range of infrastructure assets.
- The regulatory asset model has been very successful in encouraging significant levels of investment into energy and water network infrastructure in the UK, without significant levels of public subsidy.
 - With appropriate regulation, this approach could help increase investment in other types of assets. For example. Ofcom has proposed adopting this to encourage investment in rural broadband networks.
 - Concession arrangements for constructing assets should also be considered. These have been successful in many countries in attracting private investment into infrastructure assets, with the benefit that they revert to public ownership after a period of private operation.
15. Early-stage risks are too high and more needs to be done to draw in seed capital to fund the initial stages of new projects.
- The initial stages of many infrastructure projects require seed capital to fund the costs of design, applying for planning and environmental approvals, and establishing project delivery teams. In some cases, millions of pounds can be expended before it is known whether a project is viable. If the necessary approvals are not granted that initial investment can be completely lost.
 - A range of tools should be available to public sponsors to support projects in their early stages in addition to the traditional approach of providing grant funding. Sharing risk as a co-investor, funding a proportion of bid costs, providing limited guarantees to reduce capital at risk, and pooling projects under development within a wider portfolio of projects are all options that could encourage greater private funding in the design and approval stages of infrastructure projects.
 - This should complement reforms to the planning process to provide greater certainty to investors about the prospects for approval.
 - Reducing early-stage risks in this way should increase the flow of projects capable of attracting more conventional investment, as well as also saving money for the taxpayer by lowering the premiums demanded by seed capital investors.

ANSWERS TO SPECIFIC QUESTIONS

1 Do you agree with strengths identified of the UK infrastructure finance market?

- Yes. The UK has strong financial markets that have the capacity and willingness to invest in infrastructure projects.
- Financial markets in the UK have been flexible in delivering funding through a range of different infrastructure financing models, from PFI and other forms of private-public partnerships, concessions and regulated asset base models.
- Although there was a reduction in capacity following the 2008 global financial crisis, infrastructure has since returned to a position where it is able to access funds on a competitive basis.

2 What are the weaknesses in the infrastructure finance market?

There are a number of weaknesses that need to be addressed:

- Early-stage risks are too high, with investors reluctant to provide the seed capital needed to get projects through the planning and initial design process. These risks need to be reduced and shared, increasing the likelihood of success and reducing the potential losses if projects do not proceed.
- Public investment is often the key that unlocks private investment, but this has been declining until recently. There is an opportunity for public bodies to take a greater role in projects as an investor, sharing in the risks and rewards together with private investors.
- Any successor contractual model to PFI and PF2 will struggle to be successful if the objective of obtaining 'off balance sheet' treatment is retained. This model creates a conflict between obtaining an appropriate allocation of risk and rewards that meets the objectives of both government and contractors and meet the accounting criteria necessary to achieve off balance sheet treatment. Revising fiscal targets to accommodate on balance sheet contractual models would simplify the contracting process significantly and enable many more projects to be viable.
- Long-term prices can be a significant issue for many infrastructure assets, and getting the balance right can be challenging, as has been seen with Hinkley Point C for example. A new approach is needed, providing greater confidence to investors, while still protecting taxpayers and consumers. Greater use of regulatory asset base (RAB) and concession models could help support more investment.
- It is important that policies and processes emerging from the National Security and Investment Review are properly thought through and implemented sensibly, as set out in ICAEW's response to that review. It should be possible to protect national security without introducing unnecessary administrative hurdles or increasing costs significantly.

3 What is your assessment of the European Investment Bank's role in addressing market failure? Where has the EIB provided additionality?

- We believe that the EIB, and the European Investment Fund (EIF), have been extremely valuable sources of funding for both economic and social infrastructure in the UK.
- The EIB has been particularly valuable in providing finance for renewable energy generation, transport and housing sectors, as well as in supporting the growth of the university sector in the UK.
- The EIB and the EIF have been able to support the development of new and improved technologies by assuming some of the risk, while also provided technical input and support during the due diligence phase of project. Together, these have unlocked private investment that might not otherwise have been possible.
- The EIB and EIF have been profitable, with returns re-invested to increase the pool of capital available.

4 To what extent can the private sector fill any gap in infrastructure finance left when the UK leaves the EIB?

- The private sector can fill some of the gap, however, one of the key roles of the EIB has been to provide ‘anchor’ finance to projects, unlocking private investment that might not have otherwise been possible. It is therefore important to ensure that this investment capacity is not lost if the EIB withdraws from the UK.
- Many ICAEW members have been involved in due diligence on EIB-funded projects and know the positive difference that it has made.
- This lost capacity could be replaced, if not increased, by the establishment of a new UK Investment Bank with a similar mandate and approach to financing infrastructure to that of the EIB. This would complement more local initiatives such as the Development Bank for Wales and provide greater capacity to deploy across the country.
- Rather than a solely central government-owned institution, there is an opportunity to involve the devolved administrations, English combined authorities and local enterprise partnerships as shareholders, enabling a diversity of interests to be represented in determining investment priorities and to share in the financing of infrastructure across the UK.

5 What new types of assets or technologies do you see coming to market in the next few years and what kind of financing issues might they raise?

- It is difficult to foresee how technological developments might affect future generations. For example, self-driving vehicles and long-distance hyperloop transport networks could completely transform how people and goods move around. The best response is to retain flexibility to adapt to change, especially where entering into very long-term contracts. More use of short- and medium-term contracts may make sense given that yield curves are not rising sufficiently to provide significant affordability benefits from longer term financing.
- There may also be a role for government in providing or facilitating some form of obsolescence insurance to make it easier for businesses to invest in assets that might be stranded by technological developments.

6 Does the market have capacity on a long-term basis to finance very large projects?

- Yes.

7 What is your assessment of the vulnerability of infrastructure finance to a downturn in market conditions?

- Infrastructure is likely to remain a popular asset class even in the event of a market downturn, absent a very severe market shock.
- However, there is a risk that seed capital investments could reduce even further in a downturn, with a consequential reduction in the flow of new projects.

8 In the long-term, what lessons or models from established tools could be applied to different contexts?

- The regulatory asset base (RAB) model could be applied in a wider range of circumstances, providing greater confidence to investors about the ability to generate revenue.
- There is also potential for greater use of concession arrangements, such as that used to fund the construction of the Queen Elizabeth crossing, and which has been successful in supporting infrastructure investment in other countries around the world. These have the advantage to the taxpayer of the asset reverting to public ownership at the end of the contract.
- The UK Guarantee Scheme is underutilised and has the capacity to support a wider range of infrastructure investments. One option might be to allocate guarantee capacity

to the devolved administrations, city-regions and local enterprise partnerships within an appropriate framework, rather than requiring each project to be approved centrally.

9 In what new ways could private finance be used to improve the delivery, management and performance of government-funded infrastructure projects?

- In the right circumstances, private finance can help provide infrastructure on a cost-effective basis for taxpayers and society. For example, private finance is a key element of many major public infrastructure projects in Canada that has helped expand the economy there.
- Peer-to-peer networks are a welcome development that could enable citizens and local communities to participate directly in the financing of infrastructure projects.
- Utilising 'on balance sheet' contractual arrangements would help facilitate a more competitive market for government to access for finance by reducing constraints in how risk is allocated between commissioners and providers.

10 What is your view on the effectiveness of the existing government tools to support the supply of infrastructure finance?

- UK Government Investments (UKGI, formerly the Shareholder Executive and UK Financial Investments) and the Infrastructure & Projects Authority (IPA) should together be in a position to support the supply of infrastructure finance.
- Centres of excellence are needed to support central government departments, regional and local government in specifying infrastructure assets, negotiating contracts, attracting equity and debt investors, and managing risk. Models such as the EIB's European PPP Expertise Centre (EPEC) should be considered.
- Many public bodies will not have (or need) the inhouse capability to initiate and deliver large scale complex infrastructure projects. It is therefore important UKGI, the IPA and departmental centres of excellence have the staff and resources to provide the corporate finance and infrastructure planning support necessary.

11 Should the government change, expand or reduce the levers it uses to support the supply of infrastructure finance?

- We believe that addressing early-stage risks, for example through a range of measures including joint public investment, grants, insurance or projecting risk pooling could encourage more seed capital investments into new projects.
- There may also be a role for government in providing or facilitating some form of obsolescence insurance, that could make it easier to deal with assets stranded by technological developments.

12 Should the government consider any alternative forms of finance support for sectors such as higher education or housing associations?

- Yes – direct investment by individuals through government-backed peer-to-peer networks could provide significant amounts of new capital, assuming investments could be structured appropriately to provide an appropriate risk profile to attract small investors.
- There is an opportunity to raise finance from specific sectors of society to fund infrastructure investments of direct interest to them.

13 Which sectors or types of infrastructure may need support from government to raise the finance they need, particularly in light of major technological changes?

14 In your view, how effective is the current institutional framework at ensuring good projects can raise the finance they need?

- The government's Industrial Strategy sets out the need for greater investment in infrastructure across all sectors of the economy.

- However, there are significant issues in the way some industries are structured in the UK and the institutional frameworks that might support the raising of finance.
- For example, there is substantial investment going into the UK's electricity, gas and water networks. These have regulatory mechanisms that provide assurance around pricing risks, and an industry structure that provides straightforward opportunities for both equity and debt investors to provide finance.
- In other sectors, institutional frameworks and industry structures are less effective or are not open to private finance. For example, the bulk of investment into the railway network is through the state-owned Network Rail or HS2, and there are currently only very limited routes through which finance can be raised from other sources.
- Other examples include energy generation (where long-term pricing is a significant issue), social housing (where restrictions on local authorities make it difficult to encourage private investment) and broadband roll-out (where existing infrastructure will become redundant as it is replaced by more modern technology).

15 Is any reform to the UK's institutional framework needed to better provide support to the market?

- A new UK Investment Bank could replace capacity and expertise currently provided by the EIB as it withdraws from the UK market.
- New institutional arrangements and industry structures are needed to facilitate private investment in the railways, social housing, hospitals and schools in particular.
- New models are also needed to facilitate direct investment by citizens in infrastructure through government-backed peer-to-peer networks.

16 In the event that the UK loses access to the EIB, do you agree with the NIC that the government should establish a new, operationally independent, UK infrastructure finance institution? If so, what should its mandate be, and how should its governance be structured?

- Yes – a new UK Investment Bank, with a structure and mandate similar to that of the EIB, would be an appropriate model to adopt.
- There is an opportunity for greater involvement by the nations and regions in the UK in establishing investment priorities and engaging with local communities with devolved administrations, combined authorities and local enterprise partnerships as shareholders in a UKIB.

FURTHER INFORMATION

This response of 5 June 2019 has been prepared by ICAEW with the support of the ICAEW Corporate Finance Faculty, in consultation with members from across the UK.

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