REFORM

Investment in infrastructure: making it happen

With Lord Deighton of Carshalton, Richard Bacon MP, Peter Atherton, Professor Nick Bosanquet, Tim Chapman, Chris Elliott, Anthony Hilton, Robert Hingley, John Holland-Kaye, Jonathan Refoy

Association of British Insurers
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08.30 – 13.30

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Programme

08.30 – 09.00	Registration and breakfast	
09.00 – 09.10	Welcome and introduction	**Patrick Nolan, Chief Economist, *Reform***
09.10 – 10.00	Keynote speech, followed by Q&A	**Lord Deighton of Carshalton, Commercial Secretary to the Treasury**
10.00 – 10.50	Panel session: Delivering infrastructure	Spending on roads, rail, and airports, along with utility and broadband infrastructure are all seen as crucial to ensure the competitiveness of the UK economy. With the private sector expected to design, build and operate these facilities, and with over 70 per cent of investment expected to come from the private sector, it is crucial that there is certainty in these markets. This panel will consider the role of the Government in supporting the delivery of new infrastructure in the UK, and assess the role of the private sector in delivering efficiency and value for money across programmes. It will also showcase current examples of successful private sector investment in infrastructure. **Richard Bacon MP, Member, Public Accounts Committee** **John Holland-Kaye, Development Director, Heathrow Airport Limited** **Jonathan Refoy, Director of European Corporate Affairs, CH2M HILL** **Tim Chapman, Director and Leader, Infrastructure London, Arup** **Professor Nick Bosanquet, Emeritus Professor, Imperial College and Member, *Reform* Advisory Board** **Chair: Kimberley Trewhitt, Senior Researcher, *Reform***
10.50 – 11.10	Refreshments	
11.10 – 12.00	Panel session: Financing infrastructure	The pipeline for infrastructure investment in the UK has been outlined in two National Infrastructure Plans, and the Government has announced a range of initiatives to expand sources of finance and encourage investment. However, there is still criticism that the pace and scale of action is not enough. Separately, there are questions over the alignment of incentives between investors and projects. This panel will consider the scope for private investment and discuss the ways in which the Government can support and incentivise private investment in economic infrastructure across all sectors. **Anthony Hilton, Financial Editor, *London Evening Standard*** **Robert Hingley, Director of Investment Affairs, Association of British Insurers** **Peter Atherton, European Utilities Analyst, Liberum Capital** **Chris Elliott, Investment Committee Chairman, Barclays Infrastructure Funds and Member, Advisory Panel, Armitt Review** **Chair: Lauren Thorpe, Research and Corporate Partnership Director, *Reform***
12.00 – 12.05	Close	**Lauren Thorpe, Research and Corporate Partnership Director, *Reform***
12.05 – 13.00	Refreshments	

Reform comment – setting the agenda

Investment in infrastructure is seen as a crucial component to delivering growth in the UK. In the short term, it is expected to offer an economic boost by lifting demand and creating jobs. In the longer term, investment in new infrastructure should provide a strong platform for the UK to prosper. As Geoffrey Spence, Chief Executive of Infrastructure UK, has noted: "we need to move quickly because we do need this infrastructure. If we don't have it we will lose competitiveness; if we lose competitiveness we will lose tax revenue; if we lose tax revenue our debt will be bigger for longer."[1] Yet as Rt Hon Vince Cable MP stated at *Reform*'s major infrastructure conference in 2012, building confidence in infrastructure "isn't straightforward, […] it is not just a question of pressing a few buttons and infrastructure emerging." This issue has been at the top of the agenda since 2010, yet three years on progress has been slow.

Cautious optimism

There are however, a number of reasons to be optimistic about the UK's ability to finance and transform its ailing infrastructure. Not least its strong history in designing and delivering world class infrastructure. Last year the UK showcased its ability to successfully deliver a £9 billion programme on time with London 2012. And right now the UK is home to some of the largest infrastructure projects in Europe; the Heathrow Terminal 2 expansion and Crossrail having both attracted investment and engineering talent to the UK. The challenge for Government is to ensure that the UK offers the right environment to build more.

Private finance is ready

From the outset the Coalition Government has made clear that the financial burden for future UK infrastructure investment must lie mostly with the private sector, following a sharp reduction in Government capital spending. By 2017-18, Public Sector Net Investment, which includes spending on infrastructure, is forecast to be 47 per cent lower in real terms than in 2009-10 (at 3.4 per cent of Total Managed Expenditure). Of £310 billion worth of infrastructure spending across 576 projects, on average[2] just 13 per cent of projects are expected to be funded publically.[3] Yet more than halfway into this Parliament, less than one fifth of the investment set out in the National Infrastructure Plan has been made.

Some commentators have argued that it has been wrong to cut public investment in infrastructure at the same time that private investment has been weak,[4] with the International Monetary Fund recently suggesting that state capital investment in road infrastructure and school building should be brought forward to "catalyse private investment and spur much-needed growth." Yet any demands for more public spending must be balanced against the importance of eliminating the deficit. Private investment should be prioritised and the evidence suggests that this is achievable. As Lord Deighton, Commercial Secretary to the Treasury, recently said: "The capital markets are increasingly hungry for these infrastructure projects. There is a lot of interest from domestic and international investors."[5] This is confirmed by various surveys which identify the UK as one of the most attractive countries in Europe for Foreign Direct Investment (FDI), and second in the list of the "world's most desirable PPP models."[6] Further, infrastructure assets represent a good match for the liabilities of institutional investors and pension funds.

So the problem of investment not being forthcoming is puzzling to some. Perhaps the answer can be observed in the fact that European listed companies are thought to be hoarding over €750 billion of cash.[7] This suggests that the perceived level of risk is too high, and the returns on offer not high enough. This could indicate a vote of no confidence in either the UK's growth prospects or the Government's current approach to infrastructure financing, planning and delivery.

To attract private financing there has been a raft of announcements and new initiatives from Government: UK Guarantees, a Cabinet Committee to drive through the most significant infrastructure projects, the establishment of the Green Investment Bank, the Energy Bill to provide long term certainty to

1 Spence, G (2012), public address speech, Public Service Events' Pensions: Infrastructure Investment conference 2012.

2 In energy and water it is estimated that investment will be 100 per cent privately funded, while in transport and waste nearly all investment will be either fully or partially publically funded.

3 HM Treasury (2012), National Infrastructure Plan 2012, Infrastructure and construction pipeline data.

4 McKinsey Global Institute (2012), Investing in growth: *Europe's next challenge*, December 2012, research suggests that the European Union saw a €350 billion fall in private investment between 2007 and 2011.

5 Deighton, P (2012), public address speech, *City Week annual conference 2012.*

6 Deloitte (2012), Partnerships Bulletin, 11 May 2012.

7 McKinsey Global Institute (2012), *Investing in growth: Europe's next challenge,* December 2012.

energy investors, the Growth and Infrastructure Bill to remove red tape, the launch of the Pensions Infrastructure Platform, and the outline of a new private financing model, PF2. The Government is also exploring other models of funding, such as user charging and the extension of the regulated asset based (RAB) models into new areas. Yet these and other initiatives are yet to secure significant private investment in new projects, suggesting that they have not adequately addressed the root of the problem.

Paying for risk

Concerns have also been raised about the level of incentives that Government should be willing to offer in order to secure private investment, with the Public Accounts Committee stating: "A balance has to be struck between encouraging investors to participate in UK infrastructure projects and the reasonableness of their returns for doing so bearing in mind the risks involved." Yet there needs to be an acknowledgement that costs to the taxpayer or consumer may be higher in the long run in order to secure the necessary private investment now.

Risk premiums are expensive, yet these costs can be minimised. One major perceived risk is the lack of certainty and commitment on the part of the Government. Without strong support and a clear mandate, investors are fearful that projects could be kicked into the long grass or the regulatory framework changed, after millions of pounds have already been spent on planning and procurement. This raises the cost of capital of the project, making it more expensive to the consumer or taxpayer. There have been some calls for an external infrastructure planning body to mitigate this, but its effectiveness would be determined by its political independence, which could be difficult to secure when such large sums of public money are at stake.

Intelligent delivery

The pace and scale of project delivery has so far been poor, and has not met investors' expectations. While Infrastructure UK is challenged with helping to remove barriers to investment and aligning the interests of stakeholders, the request from the private sector is to do it faster. Government has also been criticised for bringing too few projects to the implementation stage. Procurement processes are too slow, bureaucratic, and cumbersome. Planning issues, red tape, and a lack of skills within Government are all seen to be holding up projects and slowing the investment pipeline. The UK takes almost twice as long as Canada and Australia to deliver public-private sector projects,[8] and the National Audit Office has noted that planning laws create the highest regulatory costs of any type of regulation. All of these factors increase the riskiness, and subsequently the costliness, of projects. They also diminish the attractiveness of public infrastructure for private investors.

As the procuring authority for large scale infrastructure investment, the Government needs to be an intelligent client. The Government has identified infrastructure as an area where internal skills and experience are lacking. It aims to remedy this through an enhanced central group of commercial infrastructure specialists who can be deployed to projects across government, alongside the establishment of Infrastructure Capacity Plans to drive forward progress in key departments. Skills and competencies should also be transferred across projects to deliver efficiencies on future projects. To achieve this the Government might have to be prepared to pay more for the right people with the right skills. In addition, standard products and designs which ensure economies of scale would speed up procurement. Of course, the private sector also has a responsibility to reduce the costs of projects in the same way.

The UK must learn from successful projects and ensure that experience is integrated into our infrastructure strategy going forward. By having a clear pipeline of projects, the UK could ensure that knowledge and skills are transferred between consecutive projects and deliver economies of scale. The UK is recognised by the world as a global financial centre, a hub of innovation and creativity, and a home for global talent. The challenge is for the Government and the private sector to bring together its respective expertise to deliver a world class infrastructure.

8 "How Canada took the if out of PFI", http://www.building.co.uk/analysis/features/how-canada-took-the-if-out-of-pfi/5040552.article; Accessed 10 August 2012.

Delivering infrastructure

Richard Bacon MP
Need for a clear vision of necessity

Economic infrastructure is a key part of what keeps Britain running. Roads, railways, ports and airports move people, goods and services throughout the country, while power generation keeps the lights on and keeps us warm, at work and at home. The designing, building and maintaining of infrastructure is a key component of our economy. However, projects often cost much more than expected, especially in the public sector. The Private Finance Initiative has not been a panacea in solving these problems although it has made some people extremely rich.

The National Infrastructure Plan is a large list of various projects without clear prioritisation. The Treasury's 40 priority projects in fact covered 200 individual projects. Some schemes will take decades to complete and the 2018 start-work date for High Speed 2 is probably optimistic. Large projects such as HS2 should be based on transparent and justifiable cost benefit analyses since they reduce available funds for smaller projects that could be delivered more quickly with more immediate effects.

Infrastructure UK wants to see £310bn invested in infrastructure with 64 per cent of this from the private sector. However, investors are wary as government changes priorities. Investors need more certainty in the investment environment while taxpayers need to see more transparency. These goals are not necessarily incompatible but taxpayers and voters need to know that they are not being taken for a ride. High levels of private funding mean that citizens will often be paying for infrastructure as consumers, not taxpayers. For example, offshore wind energy appears to putting a heavy toll on consumers and when household budgets are so stretched, it is not obvious that this is justified.

Government cannot be a panacea to solve all problems but it can create more certainty and thereby reduce risk. With a clear vision of necessity, infrastructure can be targeted for greatest benefit, investors can feel more secure and consumers will see the benefits as the economy grows.

Richard Bacon MP, Member of Parliament for South Norfolk and Member, Public Accounts Committee

John Holland-Kaye
Investing in Britain's success

Heathrow is the UK's only hub airport and the busiest international airport in the world. Millions of people rely on Heathrow for travel, for adventure, visiting family and friends and forging strong business links, placing Heathrow at the heart of the UK's worldwide connections. Our success is critical to Britain's success.

Since 2003 we have invested £11 billion in upgrading, replacing and refreshing facilities within and around Heathrow. Over the next five years, we're planning to invest a further £3 billion in airport redevelopment. Terminal 5 was the springboard for upgrading Heathrow, but that was just the start. The redevelopment of Terminals 1 and 3 has provided improved facilities and services. And at Terminal 4, a new check-in area and forecourt have added an extra 6,000 square metres of space giving passengers more space to disembark from cars and taxis before entering the terminal.

Now we have turned our attention to Terminal 2, which after more than half a century of service needed a new vision, a new space, designed around the needs of the passenger. This is the centre-piece of our vision to rebuild Heathrow for the 21st century, replacing old, congested terminals with new world class facilities.

At a cost of £2.5 billion, Terminal 2 is one of the largest privately funded construction projects in the UK, and is supporting the economy across the UK by creating direct local jobs and indirect jobs nationwide – with around 35,000 jobs in total. We want to keep investing, to keep improving the passenger experience, but to do so we need a regulatory regime that encourages that investment, over the short term and for the longer term.

The building of the new Terminal 2 has meant new quality infrastructure, engineering and construction jobs being created across the country. For example, Slipstream, a large 75 metre sculpture that will greet passengers travelling from Terminal 2, was built entirely by a factory in Hull, bringing jobs and investment to the region.

Terminal 2 has capacity for 20 million arriving and departing passengers who will experience a space designed with passengers at its heart to provide a spacious, light and airy terminal, with new technology and plenty of staff to help passengers travel through the airport more smoothly. This bright and contemporary space with its striking entrance, two-level departure lounge, ten-metre-tall viewing windows and twelve new aircraft stands, will be modern and dynamic.

Terminal 5 was awarded the best terminal in the world by Skytrax this year, but having one award-winning terminal isn't enough for us. By giving passengers the best airport experience in Europe, we're cementing Heathrow as the UK's gateway to the world and Europe's hub of choice – providing direct connections between the UK and markets and tourist destinations overseas.

John Holland-Kaye, Development Director, Heathrow Airport

Tim Chapman
Innovation in the construction industry needed

The demands for lower cost, increased reliability and greater resilience – as well as reduced environmental impact both during construction and operational use – mean that fresh approaches to planning, design and construction are urgently needed. Such changes mean that the construction industry must become more welcoming to the use of innovation than it is at present. There must also be a more structured approach so that innovations can be applied in a safe, overt way that allows confidence to be developed and the results to be disseminated more widely.

In the past, organisations such as the Building Research Establishment (BRE) and the Transport Research Laboratory (TRL) and the Construction Industry Research and Information Association (CIRIA) were tasked and funded by government to do just that: push research ideas into practice in a controlled manner and assure that standards kept pace with these evolutions in technology. At that time, the government directly funded most infrastructure-related services and directly reaped the benefits from such innovations in terms of reduced costs in its on-going renewals and upgrade programmes, so those taxpayer-funded investments were well made. Now, as the provision of infrastructure comes from a plethora of suppliers in each sector, the link of benefit-led investments has been broken – yet the taxpayer still pays for the same infrastructure services.

To enable rapid change in our industry we need to again embrace a paradigm of innovation. On a single project, the business case for innovation is difficult to make. But for longer programmes of work, such as those of Network Rail or the Highways Agency, a compelling business case can be made, with innovations successfully trialled on one project directly leading to significant savings and improvements on later ones.

In January 2013, the Institute for Government produced its report "Making the Games – what government can learn from London 2012". Despite the Games having been used as a catalyst for many fundamental shifts in our industry with the fields of safety and sustainability driven by a clear and forward thinking client, lesson six in this report is hugely disappointing. It proposes to "limit innovation" and "avoid the temptation to use a big project to showcase or catalyse innovation". This is surely the opposite of the lesson that our industry deserves?

Government is the construction industry's biggest client and is the ideal body to reap as it sows and directly benefit from wise investments in construction innovation it facilitates. We need to lobby to ensure that the flame of UK infrastructure innovation remains lit and that the fruits of ingenuity can be showcased and successfully implemented on forthcoming projects. These innovations are good, both for the UK in terms of providing infrastructure services more efficiently and for the success of the UK in terms of exports.

Tim Chapman, Leader, Infrastructure London, Arup

Professor Nick Bosanquet
A market approach to infrastructure

The current approach to infrastructure is descended from Adam Smith's dictum about lighthouses—projects which bring high social benefit in the long term but cannot be financed privately in the short term: but not all infrastructure planning is about mega projects. Underneath the Smith level we need a lower level of investment where the consumers of today count. The market approach to infrastructure would promote innovation, choice and delivery of lower cost services. It would deliver low cost rail services as we have low cost airlines.

The present policies are forcing up fares (now £50 return from Liverpool to York for example) to pay for the investment and there will then be further rises in fares (or subsidies) to pay for running costs. The fares resulting from these projects are never set out in advance. They will have to be very high which will mean little use beyond the corporate sector.

Official documents and even the recent independent LSE growth report have a blind spot on the one form of infrastructure which is used by low income people to get to work - the bus services. These have been in decline outside London. There is also a total ignorance about improvements for pedestrians even though improved conditions could assist mobility and health.

The ghost of Adam Smith has pointed us towards mega long term infrastructure projects rather than towards steady improvements at the margin delivering the services which consumers can actually afford and use. Ironically the improved UK growth record since 1980 has been the result of greater choice and competition in consumer led services such as low cost airlines and mobile phones. All too often the mega projects have to restrict choice and competition in order to pay for the services which they have chosen to provide. Times may change around the plans as has happened with the NHS hospital building programme. Some Adam Smith type projects will be with us – but we need a more consumer and community led approach which will deliver local improvements in the here and now. As a first step, City regions can develop local plans using their new found power.

Professor Nick Bosanquet, Emeritus Professor, Imperial College and Member, Reform Advisory Board

Financing infrastructure

Anthony Hilton
Sort out the system of government

It is becoming increasingly obvious that Britain will never sort out its problems of infrastructure till it sorts out its system of Government.

Infrastructure is about building for future generations, in putting in place the facilities which a modern economy needs to run efficiently and effectively. By definition this means looking to the longer term, and indeed putting long term interests before short term convenience. This is something to which politicians are unsuited because of the nature of the electoral cycle and voters whom they believe are interested only in near term gratification.

This however is a challenge faced to a greater or lesser extent by all democracies. What makes it an especially difficult problem for the UK is that other countries have non-political institutions of government dedicated to the longer term which can push back against the short-termism of politics. The UK might once have had such structures but the evolution of Whitehall in recent times has led to their emasculation.

The core of the problem lies in the Treasury. The Whitehall system is unique in that Treasury not only controls the day to day finances of the country but it is also the department which creates and directs the long term growth strategy. The two have conflicting objectives; the casualty is the long term strategy.

This would not matter if the Treasury believed in planning but the entire intellectual thrust of the organisation is against it, and worse than that it imposes its thinking across Whitehall and actively thwarts other departments when they do try to plan for their specific areas of responsibility. Allowing its Treasury effectively to veto the policies of all the other departments leads to frustration and cynicism across Whitehall and is another reason why we are now so poorly governed.

Nothing sums up the problem more than the approach taken by the Treasury in assessing spending proposals. Infrastructure is about making a sacrifice in the short term to create something worthwhile for tomorrow. But the Treasury Green Book applies a rule which says that the further into the future a benefit occurs the less valuable it is to society today. You only have to look back now at the value and use of the infrastructure bequeathed to us by our ancestors – London's sewers for example would cost £50 billion to build today – to realise what a nonsense this approach is.

But it is how the Treasury decides. It believes in relentless incrementalism. It is entirely about make do and mend, never about taking a major step to get ahead of a problem. Hence the fiasco of airport capacity, nuclear power, and high speed rail and gas storage. Hence the fact that the entire economy is always playing catch up.

Anthony Hilton, Financial Editor, London Evening Standard

Robert Hingley
Unlocking the potential for investment

Infrastructure projects are in principle an attractive investment proposition for insurance funds. Insurers are keen to find a way to channel more of the investments they manage – c.£1.6 trillion in the UK – into infrastructure projects but there remain significant challenges in making that a reality.

Infrastructure investment is long term in nature, providing a good match for insurers' long term liabilities, such as annuities, and it is less correlated to traditional business cycles. The quality of revenue is generally high and stable and, relative to unsecured corporate bonds, the default rates are generally low while the recovery rates are generally high. Finally, they may offer higher returns than non-infrastructure related bonds. However, concerns remain among investors about continued regulatory uncertainty, the lack of a visible deal flow coming into the market and the need for a longer-term view from the government.

The on-going issue of Solvency 2 remains a particular difficulty for insurers. While crucial elements of this European Directive remain to be agreed, the impact of the consequent uncertainty on insurers' ability to invest in the wider economy is significant. In particular, insurers are keen to ensure that the final Solvency 2 agreement sees no restriction on the maximum amount of triple B debt that a relevant portfolio may hold (the capital charge is sufficient protection), that there should be no “forced sale” requirement in the event that a particular bond’s rating falls below triple B and that the measure aimed at preventing short term changes in asset values flowing through to company balance sheets, known as the Matching Adjustment, should apply to infrastructure portfolios.

Investors require long term certainty and, beyond the prudential regulatory challenges, greater certainty is also required on the government’s long term plans and the nature of credit support potentially available. The changing political landscape is a risk for long term investors – any means of providing greater long-term certainty would be welcome.

There is significant potential demand from insurers for infrastructure debt. For this potential to be unlocked, insurers need regulatory clarity, a regular deal flow and an approach from government that looks to the longer term. If the right conditions can be created, there could be considerable appetite to invest in the UK’s infrastructure.

Robert Hingley, Director of Investment Affairs, Association of British Insurers

Peter Atherton
A Crisis in UK energy policy looks inevitable

When the crisis hits there will be three possible casualties: the government of the day, the consumer, and the investors who have funded the government’s radical energy policy. Whilst no doubt there will be plenty of pain to go around, in our view investors should be under no illusions that the government of the day will seek to protect itself and the consumer (who are also the electorate) by heaping most of the financial pain on to investors.

In our view successive UK governments have grossly underestimated the engineering, financial and economic challenges posed by the drive to decarbonise the electricity sector by 2030. Moving from a largely fossil fuel based power system to one dominated by renewables and nuclear in just a decade and a half, whilst keeping the lights on and consumer bills affordable, may simply be impossible.

We estimate that the total required investment to deliver policy goals is £161 billion from now to 2020 and up to £376 billion by 2030. Even with the large increase in public support provided by the Energy Bill it is extremely hard to envisage that this finance will be forthcoming given that the large European utility companies are actually reducing capex. If the investment does take place we see electricity bills rising by at least 30 per cent by 2020 and 100 per cent by 2030 in real terms.

The fundamental economic argument for the EU’s energy policy is that fossil fuels are scarce, and will therefore become ever more expensive. The belief is that those that move first away from fossil fuels will gain a substantial competitive advantage. But the arrival of unconventional gas and oil makes this assumption look shaky at best. Without clear economic benefits it is not at all certain that the public will be willing to bear the costs. Without public support the policy is bound to fail at some point.

The decarbonisation agenda has required the government to intervene in the energy market in ever more aggressive ways. The Energy Bill takes this to a new level and effectively re-nationalises the investment-making decision process in the power sector. But it is not clear that policy makers yet appreciate that this also means that the risks and costs associated with these decisions must also transfer to the public. Political risk looks certain to rise sharply in the UK energy space in the coming years as the implausibility and contradictory nature of policy is exposed by events.

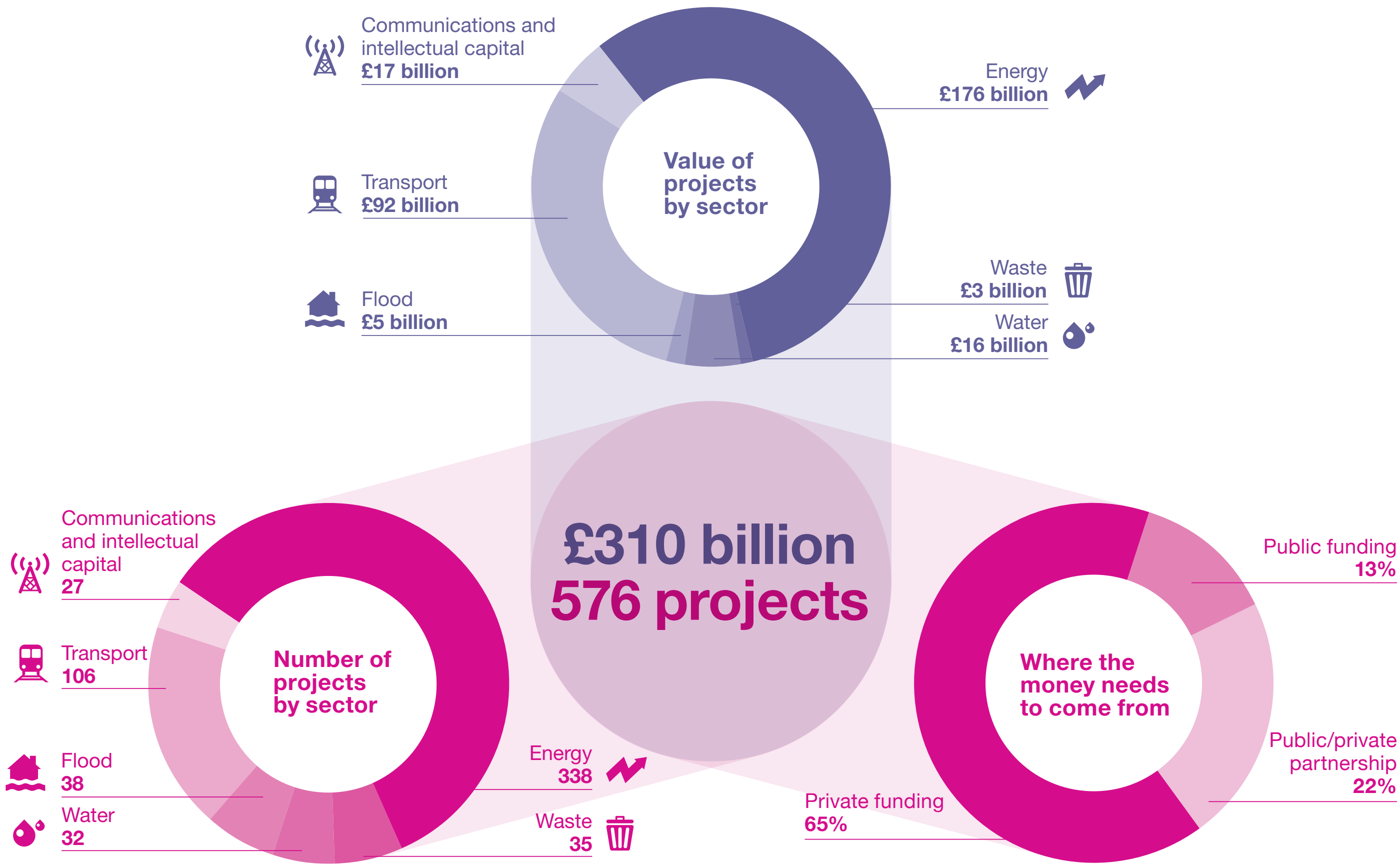
Peter Atherton, European Utilities Analyst, Liberum Capital

Text originally appeared in a Liberum Capital marketing communication on 30 April 2013

Infrastructure in focus

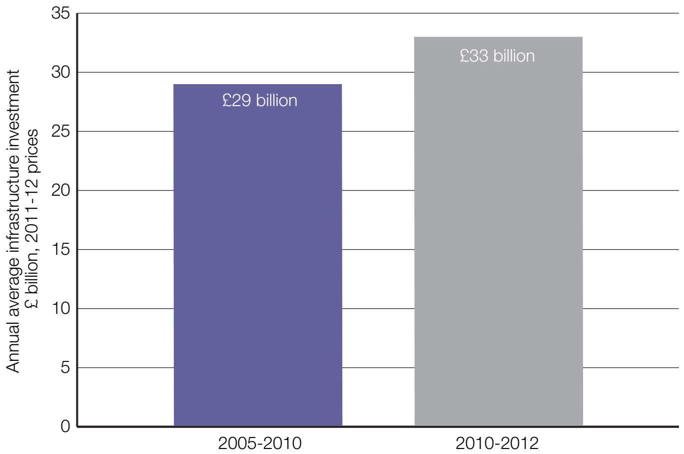
Infrastructure investment pipeline

Source: Infrastructure and construction pipeline data, National Infrastructure Plan 2012, 2011-12 prices



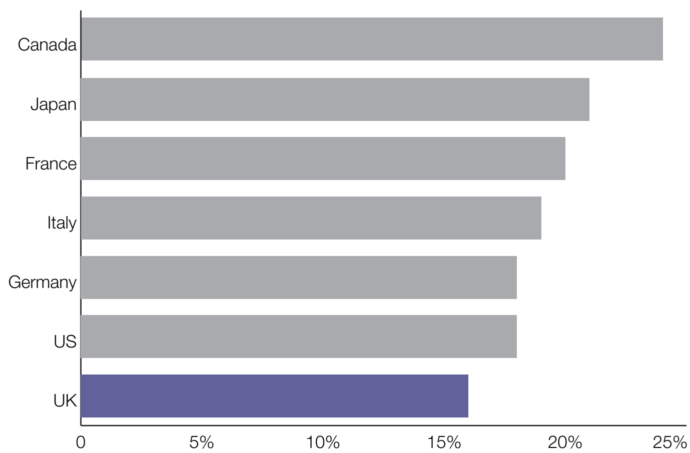
Average annual infrastructure investment in the UK, public and private

Source: HM Treasury (2012), National Infrastructure Plan: update 2012



Estimated average annual total investment 2010 – 2018 (as a per cent of GDP)

Source: International Monetary Fund, World Economic Outlook Database, April 2013



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