

# Infrastructure Finance Review Consultation | March 2019

**Joint Response by**

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Robert Jenrick  
Exchequer Secretary to the Treasury  
Infrastructure Finance Review  
HM Treasury (2 Orange)  
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8th May 2019

Dear Sir,

### **Infrastructure Finance Review Consultation | March 2019**

We are pleased to have the opportunity to present our joint response to the above consultation.

#### **Summary**

In Section A below we make three main recommendations and in section B we set out our responses to the specific consultation questions.

In summary, our three main recommendations are as follows:

1. A series of new, operationally independent, sector or project specific UK infrastructure finance institutions should be established (rather than only one such institution) so that market interventions may more easily be privatised once the infrastructure risks are understood, allowing government capital to be rolled over into the next intervention; with such institutions issuing:
  - 'diversified bonds' where investors will have a pari passu interest in all assets of the institution financed by all series of diversified bonds - such bonds being issued to finance low or medium risk national infrastructure assets; and
  - 'special "S" bonds where holders would only have an interest in the cashflows flowing from the specific assets financed by a particular series of "S" bonds - such bonds being issued to finance higher risk national infrastructure assets or, on the recommendation of a LEP, local infrastructure assets;
2. A more community-oriented approach should be taken to the development financing of infrastructure assets by the direct public subscription of IFISA bonds supported by partial first loss or pari passu government guarantees, with such bonds being promoted through the mechanism of the National Savings & Investments institution and the LEPs acting as local satellite agents of such finance institutions in respect of local infrastructure projects; and
3. There should be an increased award of government procurement contracts to SMEs underpinned by government step in rights to protect the contract in the event of SME failure, again with oversight from the relevant local LEP.

A local community transformed by the economic success of its local SMEs in winning local infrastructure projects is a community which is supportive of those government infrastructure projects.

# A Recommendations

## **A series of new, operationally independent, sector or project specific UK infrastructure finance institutions**

The British Business Bank, and the Green Investment Bank are both examples of successful government financial interventions in the market.

Accordingly we agree with the government's recommendation that the function of a new UK infrastructure finance institution should be to provide finance to economic infrastructure projects in cases of market failure, catalysing innovation and acting as a centre of excellence on infrastructure project development, procurement and delivery; additionally, that it should have a clear mandate, including sound banking, and have a wider economic and social impact.

But we recommend not one but a series of new, operationally independent, sector or project specific UK infrastructure finance institutions so that such market interventions may more easily be privatised once the infrastructure risks are understood, allowing government capital to be rolled over into the next intervention.

Separate UK infrastructure finance institutions may be more costly in terms of the governance and administrative oversight but the additional costs may be offset by the greater potential gains achievable with privatisation of multiple institutions in due course and, additionally, multiple institutions might be more easily aligned with existing market sector regulatory regimes.

We recommend that each project specific UK infrastructure finance institutions should execute a master bond instrument enabling the institution to issue bonds in different series at any time by the publication of much shorter supplementary documents, ("Final Terms") containing details of the specific series such as the term length and the interest rate etc and incorporating by reference all the terms of the master bond instrument.

This ability to issue different series of bonds by the publication of Final Terms will enable an institution to take a flexible approach to the raising of funds at the best rate by adjusting the bond terms on offer from time to time through the withdrawal of an old series of bonds and the publication of a new series of bonds to meet changing market demand.

Master bond instruments should also provide both for the issue of:

- 'diversified bonds' where investors will have a pari passu interest in all assets of the institution financed by all series of diversified bonds - such bonds being issued to finance low or medium risk national infrastructure assets; and
- 'special "S" bonds where holders would only have an interest in the cashflows flowing from the specific assets financed by a particular series of "S" bonds - such bonds being issued to finance higher risk national infrastructure assets or, on the recommendation of a LEP, local infrastructure assets.

## **A more community-oriented approach to the development financing of infrastructure assets by the direct public subscription of IFISA bonds promoted through the mechanism of the National Savings & Investments institution**

Do well to do good. Specialist UK infrastructure finance institutions should raise their debt capital direct from the public subscription of IFISA bonds (as well as from institutional investors on pari passu terms) so that there is public buy into the relevant societal goals of the planned infrastructure, this being a critical condition for climate change infrastructure in particular.

A primary challenge with the traditional model for the financing of public infrastructure is the failure to convince the wider public (or policy preference) that private sector involvement, whether as financiers or operators, in major infrastructure will result in superior outcomes, notwithstanding on-going evidence of weak procurement and ownership of infrastructure when in government hands. Government and public corporations are always likely to have overall better 'sight over the horizon' than any single private sector entity but government and public corporations can almost always also benefit from private sector expertise.

How then can one obtain the best of what the public and private sectors both have to offer in a way: which improves the corporate governance over the operation of public infrastructure; with an efficient balance of investment in operational as well as capital expenditure; which can flexibly meet the changing environment of the future; whilst also stepping over the cost of private sector risk (aversion) premia and political short termism where politicians have an incentive to “cut the ribbon” for as many projects as possible without considering future costs?

Politically, the answer has to be by involving the body of UK citizens, nationally and locally, not only as tax payers and consumers, but also as direct investors in the financing of our future infrastructure so that they share responsibility for the inevitable trade-offs between the risk to their capital and the quality of the infrastructure constructed and operated in the UK. This would be democratic. This would be moral.

The launch of properly managed specialist UK infrastructure finance institutions with specialised operationally independent fund managers who can harness institutional as well as retail investment channelled through IFISA bonds backed, initially, by partial government guarantees, would also be commercial.

As an incentive to encourage public investment the government should front run the risks, through the provision of a partial guarantee of bond returns; either a pari passu guarantee or a first loss guarantee. The difference would be one of quantum; first loss guarantees being likely to be smaller but likely to leverage a proportionately greater weight of private sector money - a riskier instrument for the government but one that increases the multiplier effect of government support.

Such institutions will initially be publicly owned, but like the successful sale of the Green Investment Bank to Macquarie, once market confidence in prospective returns has been established, an institution should be privatised to a private sector entity willing and able to take over the government's guarantee liability on a sustainable basis. In return for a continuing 'backstop' guarantee liability, if one were thought necessary, the government might retain an equity share in such privatised institutions.

The consultation paper rightly advocates a willingness to explore new ways to use private finance in government projects provided the benefits outweigh the additional cost to the taxpayer of using private capital. Public support is a major benefit.

Public support for local infrastructure projects could be greatly increased if, in addition to the direct offer of IFISA bonds to the national and local populace, partially guaranteed by first loss or pari passu guarantees from the government (as described above):

- LEPs and local councils were mandated to act as the satellite agents of the recommended sector or project specific UK infrastructure finance institutions helping to raise funds for local infrastructure projects, including local sports & leisure facilities, schools, housing and transport so there was a real groundswell of local support for vital local infrastructure projects - some, more established, LEPs might even be delegated their own fund raising powers; and
- more government contracts were directly awarded to SMEs to provide goods and services on public infrastructure projects.

The gilt market is one of the best financing sources in the world, but the ancillary benefits to the use of IFISA funded public debt backed by government guarantees would be:

- Improved engagement by the public in financing the future of public services (and this may be the most intangible, but important benefit);
- Improved choice for retail investors to invest their savings;
- Long term financial products that support responsible saving and investing (such diversified bonds or S bonds could be included within SIPPs as well to aid Pension Freedoms);

- Improved ability of retail investors to invest, with comfort, in more sophisticated investment opportunities that are typically only reserved for sophisticated or professional investors; and
- Continuing reduction of the national debt.

The consultation<sup>1</sup> projects a £600 billion infrastructure investment pipeline for the next 10 years half of which is forecast to come from the private sector. £600 billion is a considerable sum of money. If provided entirely from the government's balance sheet our national debt would rise by approximately 25%. Ensuring that the national debt continues to shrink as a percentage of GDP to a level consistent with that of Germany and at least below the World Bank recommended threshold of 77% is a strategy for ensuring future economic growth.

Focusing on the social and financial benefits to tax payers by giving them the opportunity to do well by investing in IFISA infrastructure bonds and do good by the future proofing of our public infrastructure will also be consistent with this macro financial goal.

The direct involvement of the (national and local) body of UK citizens, not only as tax payers and consumers, but as direct investors in the financing of our future infrastructure would also be commercially, morally and politically astute.

The use of crowded in public IFISA debt could also be used to finance politically attractive projects that might otherwise be difficult to justify on a narrow value for money basis where the short term borrowing costs might only be offset by very long term benefits.

While it can be narrowly argued that gilt-financing is cheaper, capital-starved organisations are in fact raising finance expensively in ways that aren't well examined (e.g. NHS bodies funding capital by sale of land for housing). Localised funding may carry a premium over gilts but the enhanced community involvement (through investment) also de-risk projects by reducing the sort of community rejection or resistance that has been encountered by some onshore wind or waste management infrastructure projects.

Whilst it is difficult to prove that there is a net monetary benefit of using localised public funding, it is obviously the case that the existing approach of sourcing infrastructure "off balance sheet" using DBFO procurement with institutional finance (whether under the PFI or PF2 banner) has failed and that a more community-oriented approach would be more acceptable.

The government could promote and manage the issuance of IFISA bonds to finance national and local infrastructure projects through the mechanism of the National Savings & Investments, a venerable institution that allows retail investors to invest in a safe as well as a useful way.

Additionally, the annual ISA allowance could also be increased so that an additional £10k per annum could be saved in an IFISA account, so that the maximum one could save in an annual ISA allowance would either be £20k S+S and/or cash and £10k IFISA bonds or £30k in IFISA bonds only. Direct financing from retail investors / citizens could also be used to go hand in hand with government grants & lottery funding.

To support the inclusion of elderly investors, the government could also look to make the IFISA bonds exempt from inheritance tax. This would maximise their appeal to older investors and financial advisers, whilst also help to unlock the substantial value of cash ISAs held by older investors.

The HMRC August 2018 ISA statistics (Page 23) disclose that approximately £271 billion is currently held in cash ISAs earning practically nothing; an amount which approximates to almost half of the projected spending on infrastructure assets.

<sup>1</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/785546/infrastructure\\_finance\\_review\\_consultation\\_web\\_version.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785546/infrastructure_finance_review_consultation_web_version.pdf)

The ISA regulations' define a 'company' widely to include: 'any body corporate having a share capital', subject to some exceptions which are not relevant for present purposes. This goes beyond entities which are merely incorporated under the Companies Act 2006 and includes public corporations whose shares are held by the government. Thus, because of this wide definition, debentures issued by publicly owned corporations or bodies corporate with a share capital owned by Local Enterprise Partnerships ("LEPs"), are eligible for inclusion within an IFISA account. Accordingly, government owned public corporations or LEP owned finance companies can raise capital by the issue of bonds eligible for inclusion in IFISA accounts.

The government can very easily crowd in private sector investment for the development and operation of infrastructure by directly raising or alternatively by supporting long term retail investor IFISA bonds issued by private sector and government owned infrastructure finance institutions with a first loss or pari passu guarantee from the government over a proportion of the capital invested.

Some of the 'Direct to Consumer' digital platforms now provide digital access to very large numbers of retail investors.

The use of government return guarantees should greatly multiply the purchasing power of public money in stimulating potential 'new to market' infrastructure, as any provisioning for calls on a guarantee need only arise mid-term and might in any event be offset by equity returns to the government charged across a portfolio of such guarantee supported bond offers.

In our experience, while retail investors may be indirectly supporting the development of infrastructure through investing in products such as NS&I, they are not marketed as doing so (c.f. "war bonds") and no positive perception has been created through this 'below the radar' approach. There is however consistent feedback from local fundraising for infrastructure (e.g. by organizations such as Abundance, Allia, Amberside Capital & Ethex) that engaging the community through the investor role directly builds higher levels of engagement with, and acceptance of, local infrastructure projects, both at the development stage and long after, into operation. Using trusted local brands - such as local NHS bodies - could amplify this effect.

**Direct Public 'buy in' to local infrastructure through an increased award of government procurement contracts to SMEs underpinned by government step in rights to protect the contract in the event of SME failure, with oversight from LEPs.**

A key challenge to SME contract award is the fear that the responsible procurement manager might be 'sticking his neck out' in awarding a contract to an SME; but this challenge could be overcome if, in making a contract award, the government were to do so on the basis that it would enjoy 'step-in rights' so that the contract can be protected and the continuity of the relevant workforce preserved in the event of SME failure; the costs of a step in being funded by government self -insurance.

If local SMEs were also funded through the agency of the local LEP then local knowledge could be brought to bear as to whether a local SME had competent management or not, thus reducing the risk of failure.

Each year the government spends ~£45 billion pa on procuring goods and services from non-public sector organisations and the government has reported increases in its spending with SMEs each year since 2010 from 6.8% in 2010-11 to 27.1% in 2014-15. In relation to these government statistics, The Public Accounts Committee report of May 2016 - Procurement & SMEs<sup>2</sup> commented that the government had changed its approach to measuring SME spending in four of the last five years and consequently it wasn't possible to tell whether government spending with SMEs has truly increased.

<sup>2</sup> [https://publications.parliament.uk/pa/cm201516/cmselect/cmpubacc/882/88205.htm#\\_idTextAnchor007](https://publications.parliament.uk/pa/cm201516/cmselect/cmpubacc/882/88205.htm#_idTextAnchor007)

The 2018 OECD Public Governance Review on SMEs in Public Procurement<sup>3</sup> reported that engaging SMEs in public procurement is beneficial both for the companies and for the public sector. On the one hand, public procurement contracts give SMEs better access to markets and help them strengthen their own capacities. On the other, the public sector can better meet its procurement needs by working with innovative, responsive and flexible SMEs. However, specific characteristics of public procurement - such as the complexity of procedures, administrative burden and high technical and financial capacity requirements - disproportionately affect SMEs and hamper their access to the market.

The government also anticipates that increasing the proportion spent with SMEs will lead to a more diverse provider market for government contracts and better value for the public purse through increased choice, competition and innovation. The government's target is for SME spending to reach 33% of this spend by 2020 but the split between direct and indirect spending through larger providers' supply chains remains unclear.

A real increase, say an additional 10% so that an extra £5bn is spent every year on SME procurement, would be transformative for local communities, as the award of a large government contract is the best type of funding an SME can receive, as all else follows. And, most critically, this is finance that could be diverted to UK companies employing UK citizens and paying UK tax, and would also deliver good value for money in the process.

A local community transformed by the economic success of its local SMEs in winning local infrastructure projects is a community which is supportive of those government infrastructure projects.

#### **Other benefits from the direct public funding of local infrastructure projects**

The government often seeks to consider the equality and diversity impact of any initiatives and there is very strong reason to believe that the use of publicly subscribed IFISA Bonds to finance national infrastructure projects would enable national and local governments to positively engage with lower income, lower wealth and less financially experienced citizens who could be offered investments that support their investment objectives and offer financial choice.

It is acknowledged that the government could issue listed bonds, which would be bought through stockbrokers and broking platforms, but the social good of supporting a local infrastructure project would be obscured by the array of other investments on offer whereas the alternative of promoting a project specific IFISA bond investment opportunity through the mechanism of the National Savings & Investments and, where appropriate, also with LEP support, would highlight the social good.

To unlock the potential of the financial adviser community, the government could partner with infrastructure focused asset managers to raise funds. For example, there could be a scenario where government guarantees are given on certain infrastructure projects so long as investment managers crowd-in retail investors through the issuance of pari passu or first loss government backed. These managers would be able to engage with financial advisers and unlock the >£1trn of retail funds looked after by financial advisers.

National savings are lower in the UK than in any other OECD county and low rates of national savings will lead to future disappointment with living standards. Professor Martin Weale of King's College London, a former external member of the BoE's Monetary Policy Committee has commented that 'happy countries tend to be those with high national savings rates<sup>4</sup>.

The UK also needs to strengthen its own balance sheet with investment from UK residents not from foreigners to avoid trouble in a future downturn.

<sup>3</sup> <https://www.oecd-ilibrary.org/docserver/9789264307476-en.pdf?expires=1556886431&id=id&accname=guest&checksum=684D5B9024D100B2263306F98CD352B2>

<sup>4</sup> <https://www.ft.com/content/9afd1596-61d3-11e9-a27a-fdd51850994c?shareType=nongift>.

## B. Consultation questions

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

Largely.

The two primary challenges with the traditional model for the funding, financing, delivery and operation of infrastructure were summarised well in the discussion paper written for the International Transport Forum by Dejan Makovšek and Daniel Veryard<sup>5</sup> as being the: difficulty in finding sufficient government finance, either because of weakness in tax revenue or a reluctance (or inability) to increase government borrowing; and evidence (or policy preference) that government ownership and operation of infrastructure assets results in worse price and/or quality outcomes compared to the private sector.

Under government ownership, infrastructure is financed with public funds or through government borrowing, which has a lower cost than private financing. The government also has greater flexibility to respond to changes in future circumstances without contractual penalties and complicated renegotiations. Against these advantages the main challenges for the traditional model of infrastructure delivery and management is the weak incentives to maximize a project's value across delivery and operation (including a lack of certainty of on-going funding).

### 2. What are the weaknesses in the infrastructure finance market?

Sector support mechanisms such as Feed in Tariffs and PFI credit support to local authorities can deliver infrastructure at scale, but do not necessarily buy in the consumers of infrastructure.

Perceived imposition on local populations of other infrastructure such as fracking have furthered reduced local acceptance to many forms of new infrastructure. The Private Finance Initiative (PFI) regime delivered significant long-term investment by largely democratically-empowered Local Authorities - but that regime ultimately failed as it did not gain widespread voter support. Its rejection was due to its lack of transparency; rigidity; perception as a means of privatizing by the back door; and perceived profiteering by financiers, contractors and operators.

Weak advocacy by government and industry meant this narrative was never effectively resisted. Addressing these shortcomings head-on could create a new, community-centred approach, to deliver investment that has broad support. There is a growing body of evidence that involving the local populace - as direct investors - leads to high levels of engagement and acceptance. Novel forms of infrastructure, such as for EV charging, lack the maturity to attract institutional infrastructure. Ad hoc department support (DIIF, CIIF, HNIP) has assisted, but generally failed to engage the wider populace and so secure citizen acceptance. Some Infrastructure sub-sectors that are key to societal cohesion, e.g. flood defence and air quality, lack funding regimes that can attract sufficient finance to address known needs. Local authorities facing short term pressures struggle to prioritise these. Extension of RAB funding to these sub-sectors, could attract (retail) investment.

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

The EIB has been a very substantial provider of finance for UK projects. As Chart 2 in the Consultation shows, new project loans and approvals have declined sharply since the referendum notwithstanding that the Withdrawal Agreement is still to be completed.

The EIB has brought a number of benefits which can be categorised as additionality. These include:

<sup>5</sup> [https://www.itf-oecd.org/sites/default/files/dp\\_2016-01\\_makovsek\\_and\\_veryard.pdf](https://www.itf-oecd.org/sites/default/files/dp_2016-01_makovsek_and_veryard.pdf)

- EIB is a long-term lender offering terms of up to 30 years., longer than is generally available in the project finance market and, on larger projects, its lending rates tend to be finer than the commercial market. The longer term inevitably obviates refinancing risk which can be especially problematic in times of financial disruption;
- EIB has a reputation for capable (if sometimes rigid) due diligence. Its presence in a lending group gives comfort, especially to smaller lenders;
- It can act as a catalyst to bring in other private sector lenders particularly on what are initially perceived to be higher risk projects such as Thames Tideway;
- It is able to stay in the market when commercial lenders lose their appetite in times of market turbulence, as in the Manchester Waste Project;
- It has played a role in financing developing sectors of the project finance market at an early stage and in this way has helped to establish the market;
- It has shown itself to be less transparent than equivalent UK democratic institutions when distributing - and so undertaking the role of procuring authority - EU funds that address market failure initiatives such as the JESSICA programme (addressing regeneration or decarbonisation).

It is hard to overstate the importance of the EIB to large scale UK infrastructure financing.

Two examples illustrate this:

- the £1 billion loan towards the Crossrail project; and
- the £700 million in support of Thames Tideway.

But it is not just projects that have a high profile with the general public. National Grid's Networks Upgrade Scheme secured £1.7 billion of EIB funding towards this project in 2014.

It cannot be shown conclusively that these projects would not have happened without EIB funding, but they would undoubtedly have been materially more difficult to take forward without the EIB.

#### **4. To what extent can the private sector fill any gaps in infrastructure finance when the UK leaves the EIB?**

There has been some suggestion that the EIB can, on occasion, crowd out the private sector and that lending would have been provided by the private sector had EIB not been involved, e.g. its continuing presence in the OFTO market may have crowded out capital market solutions. To the extent that this is so, the private sector could replace EIB. Inevitably, given the terms on which the EIB lends, there would be an increase in financing costs, even in those projects where private sector lenders would be able to replace the EIB.

Generally however, it takes a state backed body such as the EIB to provide the additionality referred to in our response to consultation question 3 precisely because it is not a private sector lender but has the long term economic objectives of the state (or in its case, the EU). The roles fulfilled by the EIB would best be substituted by a UK body, an Infrastructure Investment Bank, - or as this paper argues, a series of new, operationally independent, sector or project specific UK infrastructure finance institutions - set up along similar lines as (but with a different remit to) the Green Investment Bank.

To the extent that replacement private sector debt is competing with higher returns available in other markets e.g. corporate bond activity, then it should be expected that the gap is likely to be filled at a higher margin

The effect of leaving the EIB will be substantial. It will leave a gap which the private sector cannot wholly fill. Government should be prepared to replace EIB funding with a similarly focussed body or bodies at the earliest opportunity.

**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?**

Some of the infrastructure funding opportunities that are likely to arise in the coming years can be readily identified:

- The decarbonisation of the power sector is mentioned in the consultation;
- Flood protection is likely to require substantial investment in the medium term in consequence of global warming and rising sea levels;
- Electric vehicle charging infrastructure is a current issue. The interplay between the number of electric vehicles and the availability of charging points has not yet reached a tipping point where both will expand rapidly together.

Standardisation of this infrastructure is likely, in the long run, to be provided by the market, but it may not produce the optimal result and is being delayed by the limited current demand. This is an example of the way in which a government promoted Infrastructure Investment Bank could serve as a pump primer when new technologies are being developed.

Banks and other financial institutions are inherently conservative when it comes to the financing of new technologies. This means that financing can be difficult to source and the limited availability of financing may drive pricing to a level which inhibits the growth of the technology. National Infrastructure Investment Banks could fill a gap in the early stages and withdraw as the commercial market gains experience and becomes comfortable with the risks involved.

New technologies give rise to financing difficulties simply on account of their novelty. Whilst such technologies lack a track record, and therefore remain unproven, financiers will be wary of investing or, if they are prepared to do so, they will look for higher returns to compensate for the higher risk involved.

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

Financial institutions from around the world would be willing to finance UK infrastructure projects if the risk is perceived to be manageable and the returns commensurate with the risk. That is to say that financing capacity should not be viewed in isolation. There is virtually no project that is not capable of attracting finance. At the same time the nature of the finance and the level of the support and security from the state needed to get projects away will increase with larger and more innovative projects. The New Nuclear programme illustrates the point.

Where scale is matched by capabilities, expectations and suitable structures, no natural upper limit exists.

Size constraints typically occur in relation to contractor risk where historic weaknesses among UK contractors (which tend to be highly sub-contracted and hence have weaker margin generation and consequent balance sheet strength) are exacerbated when combined with exploitative “austerity era” public sector procurement practice, requiring EMEA or global players.

Development phase risk, interconnectors, pipeline projects etc with long lead times before positive fund flows, carry significant financial risks. Differing forms of development finance exist but can become diminished if particular risk profiles deteriorate permanently e.g. political risk.

Flexibility - whether projects can accommodate the inherent need for flexibility in scope and / or cost - price reopeners have assisted (Price Control Regimes, Thames Tideway, benchmarking) competing alternatives - large scale projects require focus from sponsors and supply chains (and so finance).

Where the UK has benefited from consistent intervention (e.g. FiT, CfD for offshore wind), other jurisdictions may create more rewarding markets, which will result in semi-permanent switches of activity, and hence finance sponsor or supplier concentration - funders will seek to avoid overconcentration. If long term, solutions such as syndication, intermediation, (re) insurance will address high demand.

There will be infrastructure sectors and projects in the future which would benefit from government providing financial support either at an early stage to get them off the ground or on an ongoing basis on account of their size or complexity.

Government should recognise this rather than seeking for too long to look for the private sector to provide a solution. The Channel Tunnel Rail Link (now HS1) was not completed until fourteen years after the French had opened the LGV Nord to Calais. There were many factors involved, but the original determination not to use public money to support the project was undoubtedly one of them.

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

For a short period the Global Financial Crisis resulted in an almost complete shutdown in the availability of long term finance for new projects. The market returned relatively quickly, although with many fewer participants. But the tenors available were substantially reduced which made refinancing risk very significant. There is no reason to think that the infrastructure finance market would be immune from a severe financial shock in the future.

Absent such a major shock, the infrastructure finance market is probably in as good a shape as any other financing market to withstand a downturn. The position might be more challenging if government were to adopt a Keynesian approach to any downturn and promote a large volume of infrastructure projects. In such circumstances a larger volume of debt and equity capital would be required to support such projects. That would likely have a pricing effect.

Over recent decades the UK has been seen to be an attractive place to invest in infrastructure. The reasons are well rehearsed: a stable economy, the rule of law and strong contractual underpinning of investment, innovative financing methods, a transparent and fair regulatory regime, and government support for the sector. Any undermining of these factors would undermine the attractiveness of the UK as a place for infrastructure investment and render infrastructure financing more vulnerable in the future.

Our experience of the 2008-9 financial crisis was that "good" i.e. well-structured and funded infrastructure projects could secure senior debt credit approval (e.g. M25 and Enniskillen PFI projects both closed in May 2009) but at a materially higher cost of finance (and later successfully refinanced), while weaker projects were wholly vulnerable.

Also, the cycle to design & implement public sector-led efforts to devise (low cost) replacement capital e.g. UK guarantees scheme or EU Juncker scheme, is sufficiently slow that that these typically crowd out higher cost (reflecting market conditions), but available, private sector capital. This is a disincentive for non-government parties seeking to allocate capital well.

Perceived conventional wisdoms in public sector finance formed prior to downturns (e.g. as to the superiority of bond over bank finance in years prior to 2008) can be quickly disproven in fact but are slow to be adopted by non-private players without strong education by informed public participants.

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

Bringing private finance into infrastructure delivery has a wide range of benefits.

Notwithstanding that the PFI/PPP model will no longer be employed there are benefits which can be identified and will still be useful in the future. Government can certainly borrow more cheaply than the private sector but the private sector brings benefits to infrastructure investment outside the confines of the financing model.

A regime which results in the private sector being paid for delivery of a service over twenty five years means that the private sector is incentivised to build and maintain to optimal standards and minimise whole life costs. The Edinburgh Schools saga produced bad publicity for private sector involvement. However, ultimately it demonstrated that well-structured public private partnerships can produce effective risk transfer to the private sector. In that instance the private sector picked up the cost of rectifying serious problems rather than those costs being left with the public authority after the end of the defects liability period under the construction contract.

Where the private sector has an interest in the whole life costs of a facility it will seek to minimise those costs. By contrast the public sector has had a reputation for often procuring at the lowest possible price and paying higher long term running costs.

Private finance linked to a particular asset and repaid over its useful life either by the users or the state effectively allocates the cost to the users and to the generation which benefits from the asset.

The private sector has developed expertise in infrastructure assets on account of its serial acquisition/funding of them. This results in improved risk analysis at the inception of a project and professional asset stewardship during the life of the project. Public authorities may not have this concentration of experience and may only undertake a limited number of infrastructure projects over a lengthy period.

The above benefits should be preserved in any new models.

Offering widespread, understandable, subsidy support, is proven as a method of addressing market failure / kick starting infrastructure finance (e.g. EIS, FIT, ROC, CfD for energy). Later tapering or withdrawal of relief when markets are operating or relief is deemed burdensome is also proven, especially when clear, time-bound, rules are adopted. This is preferable to financial caps (as competition between applicant projects for a finite pot favours the timely at the expense of quality, typically defeating policy objectives).

Straightforward Tax reliefs available to many (individual) investors with clear, simple rules - overseen by a visible appealable entity such as HMRC - that apply across many sectors have opened significant financing streams for investment in the UK economy (SEIS, EIS, VCT).

More complex schemes with many restrictions - often reflecting ambivalence by the public sector to them - have been shown to struggle e.g. Community Investment Tax Relief, SITR (whose success is limited merely due to the presence of a de minimis cap).

Taking advantage of its supranational status, the EIB has been a valuable addition to the infrastructure landscape as a "likely match" for senior infrastructure debt, but at a lower cost.

Similarly, the GIB was useful in using private sector lending practices to support / pump-prime under-financed markets, such as anaerobic digestion and energy efficiency, while profiting from its access to larger, commercial markets such as offshore wind. More bespoke sector-specific investment offers (such as JESSICA, DIIF, CIIF, HNIP) have supported pump-priming of infrastructure finance across a number of sectors, however the bespoke nature of the approved intervention measures, and the specific departmental approval processes have limited their ability to attract finance at speed and be rolled out more widely.

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

See the Recommendations in section A above.

Pension funds are an obvious source of finance for infrastructure. Infrastructure requires long committed funding and pension funds look for long term predictable returns. So in theory the two should readily align. At government instigation the Pensions Investment Platform was established in 2012 with the stated aim of channelling £20 billion into infrastructure projects. In practice this has not happened and only £2 billion has been attracted. Barriers to this investment need to be investigated and removed.

The Financial Conduct Authority is expected to announce changes which will permit unit-linked funds (which are used in defined contribution schemes) to invest in illiquid infrastructure assets.

Defined contribution schemes are becoming increasingly significant and the ability of such funds to invest in infrastructure (subject to appropriate protection for the pension investor) is potentially a good source of long term funding.

A number of pension funds have in recent years starting investing in the building and owning long term of rental domestic property. This illustrates their willingness to invest in new sectors if the regulatory environment is right.

Government should seek to ensure that regulatory barriers, perceived or otherwise, to pension fund investment in infrastructure are removed and the major players in this sector are encouraged to make their own internal changes to allow this infrastructure investment to take off. The pensions industry in other countries invests in infrastructure in a material way. This should be happening in the UK.

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

We refer to our response to consultation questions B1 and B2 above.

There are a number of government tools which operate independently and which are not all being fully exploited to the extent desired.

The UK Guarantees Scheme is intended to promote private sector investment in infrastructure. The Infrastructure (Financial Assistance ) Act 2012 allowed for the issue of guarantees of up to £40 billion. After six years only £1.8 billion of guarantees have been issued for non-housing infrastructure (with £10m relating to PF2). This is a missed opportunity. HM Treasury say that the £1.8 billion issued guarantees generated £4billion in private sector investment. If the same multiplier were applied then the issue of a full £40 billion of government guarantees would generate private sector investment of £89 billion.

Government rightly sets conditions to the issue of its guarantees and charges a fee. It is not suggested that it should be otherwise, but experience to date suggests that obtaining a guarantee is too difficult and too costly.

The Infrastructure (Financial Assistance) Act 2012 also gave HM Treasury the ability to provide loans for infrastructure of up to, at the present, £50 billion. Thus far no such loans have been made. There is clearly scope for promoting infrastructure investment, potentially on a co-lender basis with the private sector.

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

Local Enterprise Partnerships have responsibility for setting Local Industrial Strategies (due later this year), which can be expected to identify new infrastructure demands requiring financing. For example, as part of the evidence base for the Herts LEP Industrial Strategy, the

Herts Local Infrastructure & Funding Prospectus identified an infrastructure requirement of £3.6bn over the next 12 years.

Infrastructure that is key to societal cohesion, e.g. flood defence, air quality, climate change mitigation has historically lacked local or national champions ( c.f. cholera outbreak / Bazalgette) and hence ready access to finance. Responsible government (bolstered by findings from the National Infrastructure Commission) should expand the levers in these areas e.g. RAB funding for flood defences or housing infrastructure spending.

Victorian infrastructure has often stood the test of time. It reflected a unity of civic purpose, local investment and local supply chains that gave a legitimacy to much civic infrastructure. We contend that local populaces would, with the extension of existing tax reliefs, strongly support investment in infrastructure they also benefit from, particularly if overseen by civic / asset locked / non-distributing entities that comply to high standards of transparency. Specifically, we would like to see direct retail equity investment in Infrastructure Trusts, which attract VCT / SITR-like reliefs and retail debt investment in publicly owned corporations or LEP owned finance companies which are eligible for inclusion within IFISA accounts. Institutions could also benefit from an extension of the existing CITR relief available to Community Development Finance Institutions (CDFIs) on-lending to local borrowers across to on-lending by Local Infrastructure Finance Institutions (LIFIs) into local infrastructure projects.

Broadly, government should intervene where necessary to stimulate the market and when confidence has been built sell out its intervention stake and roll over its capital into the next market intervention.

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

Housing - switching investment in infrastructure that supports housing from biddings rounds into MHCLG (Single Growth Fund, Housing Infrastructure Fund etc) to a Regulated Asset Base (RAB) model would bring the greater certainty that plan-based programmes bring to other sectors (PR plans for gas and electricity entities, AMPs for water etc). Funding to recover the financing cost could form part of a levy arrangement that supports - and legitimises - the role of Local Enterprise Partnerships / Combined Authorities. LEPs could, perhaps with additional economic oversight from a regulator (the Regulator of Social Housing), oversee the implementation of these plans.

Education, Housing & Energy - mandating substantive carbon reductions (CRC league tables with teeth) could support uptake of low carbon measures within Education & Housing.

The issue of IFISA bonds to finance Salix Finance Ltd could also be considered.

**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?**

Assurance (demand) and cost incentive (tax) mechanisms could significantly support the following sectors / infrastructure types:

- Focus Sectors of Local Industrial Strategies - LEP-determined investment areas addressing themes such as the grand challenges (clean growth, ageing population & mobility) could benefit from central finance mechanisms particularly if they support new technologies;
- Heat Networks - demand assurance on connectable parties through planning obligations or concession awards (as achieved at Queen Elizabeth Park) would support financing (Green Deal is exemplar of path to avoid);

- Health & Energy - mandating substantive carbon reductions (CRC league tables with teeth) could drive innovation in health economy - which has strong fundamentals but weak governance / weak economic actor behaviours.

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

Strong and stable funding regimes, including clarity in the event of default, help deliver finance for good projects. The impact of regulatory intervention on investor confidence should be considered; especially in the context of large scale, long term payback infrastructure projects. Aggressive price (cost of finance) reviews, such as PR19 in the water sector, reveal an anti-investor sentiment (even if a response to over lax regulation that permitted earlier excessive financial engineering).

More specifically, the withdrawal of the Triad benefit for embedded generators, the lack of clarity about the required standard to meet the Medium Combustion Plant Directive standard and the failure of the Capacity Mechanism. All have dramatically lowered IRRs for projects in ways that could not have been anticipated and led to the withdrawal of low cost funders. Remembering that many of these facilities ultimately sell services into the National Grid, there is direct link between the resulting higher cost of capital and the cost to the consumer.

One of the government's tools for supporting private investment is its regulatory context for investment. Consideration should be given as to how to lower the high premium that funders now place against regulatory risk by adding coordination between those who have responsibility to regulate these sectors and giving them increased accountability for investor confidence.

Smaller projects have been consistently ignored by policy (SITR cap left at de minimis), yet most progress has been achieved (delivery of climate change reduction) by smaller projects that have scaled up.

The health sector possesses neither a strong borrowing framework nor secure revenue streams (and a weak default regime) to support capital activity, and instead relies heavily on land sales to fund capital markets, leading to sub-optimal decisions that do not maximise VFM.

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

See A above.

**16. In the event that the UK loses access to the EIB, do you agreed 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?**

See A above.

We would be delighted to advise further.

## C. Background information on the responders

**RW Blears LLP** is a specialist firm of solicitors providing corporate, tax and regulatory advice to fund managers on the equity and debt financing of assets. The firm has substantial experience of IFISA bond issues as well as VCT, EIS, SEIS, IHT and LP/GP funding including for energy and infrastructure investment.

**Goji** is a leading provider of platform technology to the Direct Lending Sector. Goji manages £160m for over 10,000 investors.

**Amberside Group** comprises a group of complementary advisory and capital management businesses targeting infrastructure and renewables business. Equally adept in servicing retail and institutional investors, the Group has a long track record in raising SEIS, EIS, VCT & SITS funding as well as accessing over £5bn of project finance debt and equity from institutions. With a specialism in reporting to investors and lenders on assets in operation and having advised across more than 1,000 mandates, the Amberside Group brings a deep knowledge of both infrastructure projects and what investors are seeking.

Thank you for this opportunity to participate in this consultation. We would be pleased to contribute further as may be thought helpful.

Yours faithfully

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