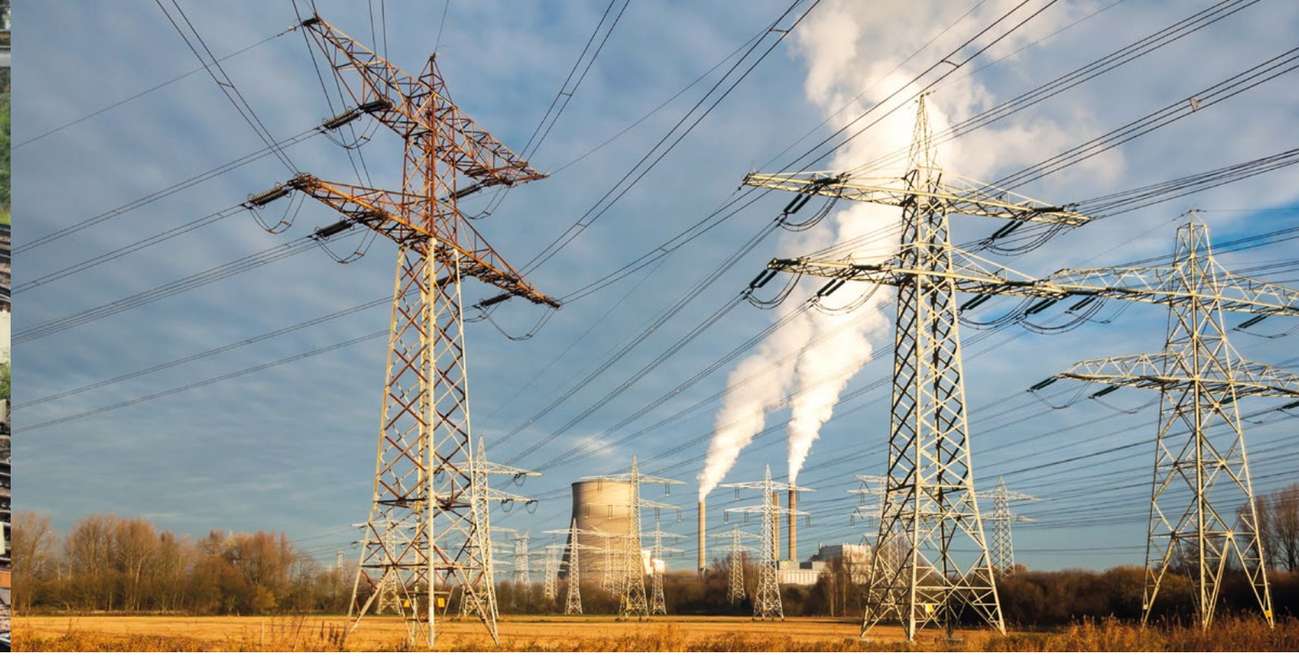
LONDON FIRST

Infrastructure Funding and Financing Working Group

The role of private capital in securing London's future infrastructure

in partnership with

ARCADIS



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The role of private capital in securing London's future infrastructure

The National Infrastructure Assessment, published by the National Infrastructure Commission (NIC) last year, set out a series of ambitious infrastructure targets for the UK. Meeting these will be important in ensuring London maintains its status as a global capital.

The capital's population is expected to grow to 11 million by 2050[1], requiring huge investment in new transport projects such as Crossrail 2 and market-led proposals to provide new links to London's airports. The UK's growth will require expansion in the South East's aviation capacity that is currently at, or near to, full capacity. And new innovations will mean that London's other infrastructure sectors will need to increase resilience. It is estimated, for example, that 1.2 to 1.9 million additional electric vehicles will be connected to UK Power Networks' electricity distribution network by 2030[2] – and London's infrastructure must facilitate this market.

Fulfilling these ambitions and UK-wide targets set out by the NIC will require greater investment in infrastructure. Sir John Armitt, Chairman of the NIC, has rightly called on the Government to make a long-term commitment to public sector spending of 1.2% of GDP per year[3]. But this alone will not be enough: the private sector will need to play its part. Of the UK's £600bn infrastructure pipeline over the next ten years, around half of this investment is expected to come from private sources[4]. Moreover, private sector firms involved in the supply chain will be responsible for delivering infrastructure financed from both private and public sources.

Britain has historically been viewed as a stable environment by investors in infrastructure, but recent developments are challenging this perception. There are questions as to whether investors and, for that matter, supply chain industries will be willing or capable to fulfil the planned £600bn infrastructure pipeline and beyond.

It is expected that the Government will respond to the National Infrastructure Assessment and HM Treasury's Infrastructure Finance Review towards the end of this year or early next year. In advance of this, London First, in partnership with Arcadis, assembled a group of members covering a wide range of stakeholders involved in the delivery of London's infrastructure, including operating companies, contractors, investors and professional services. We asked for their views on what role private capital should play in delivering future infrastructure and the risks that need to be mitigated in order to ensure the delivery of London and the UK's future infrastructure needs.

1 *London Councils, Infrastructure Investment Plan for London to 2050, February 2014*

2 *UKPN, UK Power Networks Response to 'the London Plan', March 2018*

3 *National Infrastructure Commission, Letter to the Chancellor on four tests for a successful National Infrastructure Strategy, May 2019*

4 *Infrastructure and Projects Authority, Analysis of the National Infrastructure and Construction Pipeline, November 2018*

Positive role of private capital

When financing infrastructure, it is a well-established fact that the cost of public sector capital is lower than the cost of private sector capital. The 2010 National Infrastructure Pipeline estimated an indicative cost of capital for PFI as 2% to 3.75% above the cost of Government gilts[5]. However, our Working Group highlights that this crude analysis ignores the benefits that can be brought about by the use of private finance across all types of infrastructure. These benefits include stable investment streams that are not subject to political cycles, the transfer of risk to the private sector and the promotion of the right incentives that encourage good management of infrastructure assets. For example, a study published by First Economics showed that, in the water sector, the additional cost of capital associated with private investment was more than offset by the avoided inefficiency[6].

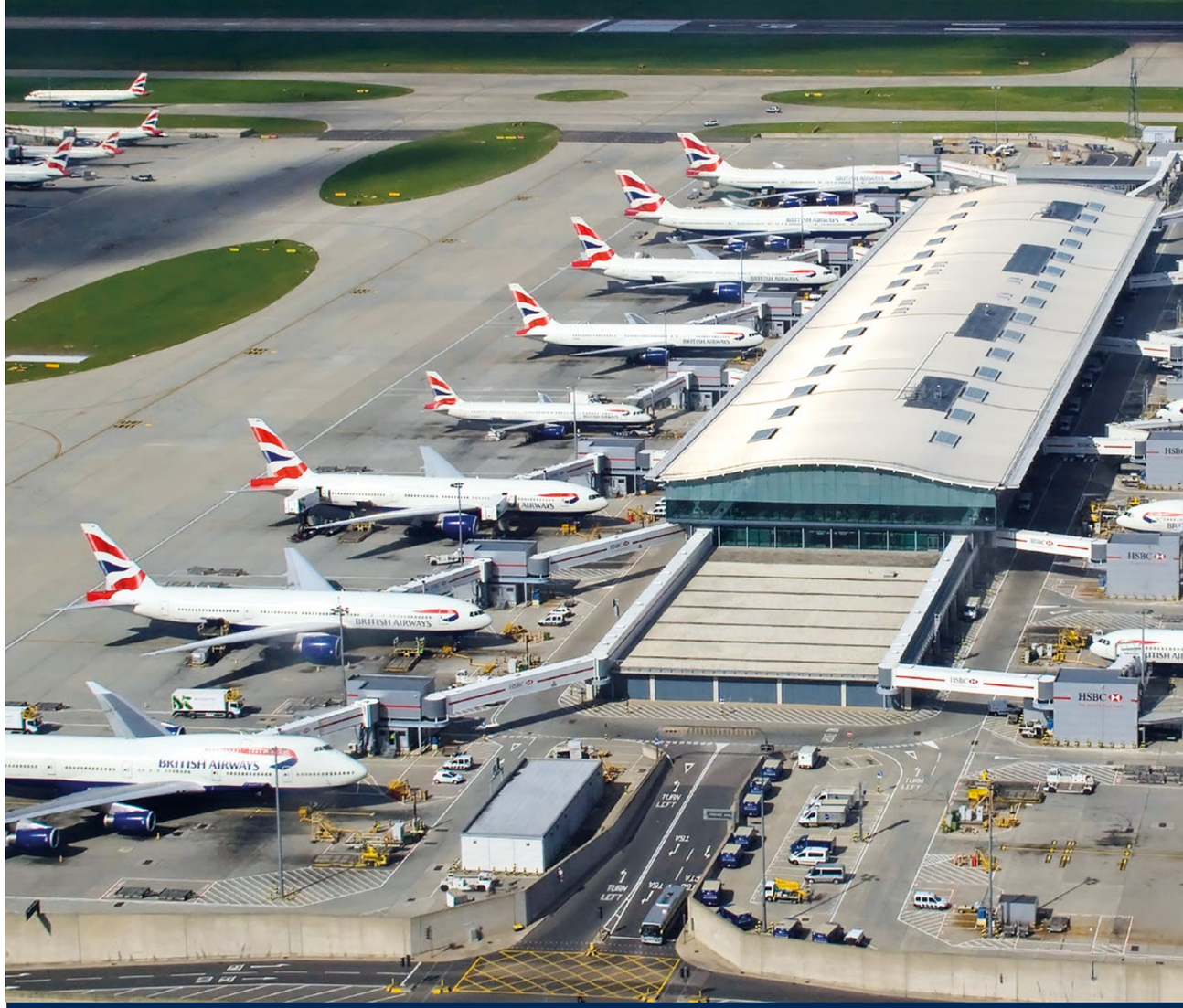
A variety of models have been used to promote private investment in infrastructure across UK. These include:

- **The regulated asset base (RAB) model**, which has been used to promote investment in sectors such water, energy network and airport industries. Investors are typically offered stable returns, which are based on the regulators' calculations of their investment's capital value and weighted average cost of capital.
- **The concession model**, which is a time-limited franchise whereby a private company enters into an agreement with the Government for the exclusive right to operate, maintain and carry out investment for a given number of years.
- **Public Private Partnerships**, whereby a public sector provider procures a private sector provider to deliver outcomes normally associated with creating a building or other asset.

London has experience in deploying all of these private capital models to deliver infrastructure. When looking at specific case studies, it is often difficult to make direct comparisons to theoretical alternative scenarios of public sector capital being used. There are, however, a number of examples of private capital delivering good outcomes for London and Londoners.

5 *National Audit Office, PFI and PF2, 2018*

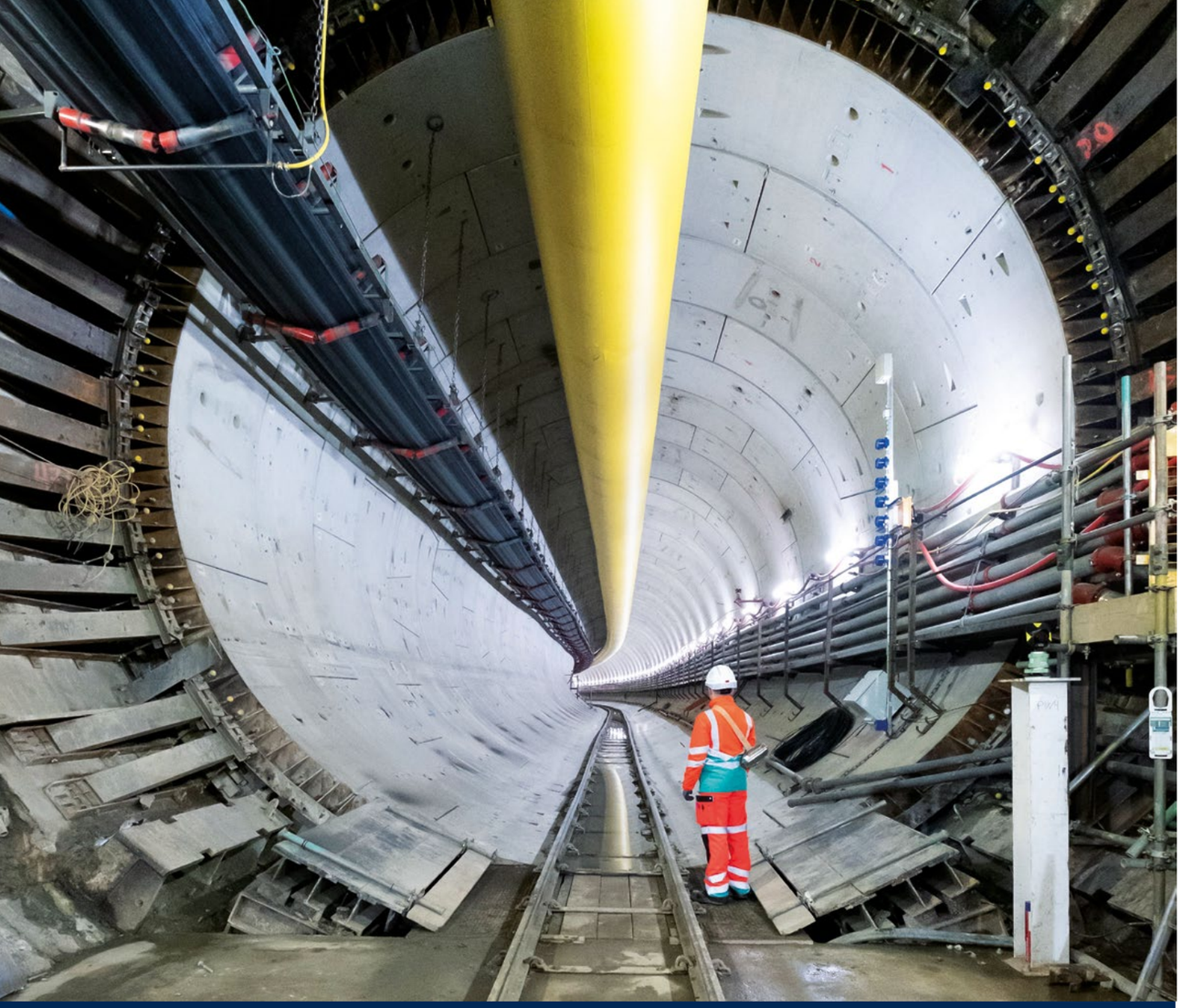
6 *John Earwaker (for First Economics), Private vs Public Ownership of Water and Sewerage Companies, January 2018: http://www.first-economics.com/privatepublicwater.pdf*



Case Study: Privatisation at Heathrow

RAB model: stable investment streams delivering improved outcomes for customers

The RAB model is often used to promote investment and improvements in existing infrastructure assets, such as the UK's airports. The £12bn of stable investment flows by Heathrow's international owners since 2006 has transformed passengers' experience. Heathrow has invested this money to streamline the airport's operations, which has led to the airport being one of the most punctual in Britain. And in terms of passenger satisfaction, Heathrow has been transformed from being one of the poorest performing airports to one of the top ten in the world.



Case Study: Thames Tideway Tunnel

RAB model: keeping cost of capital low, transferring risk to the private sector and promoting good performance

A form of the RAB model has also been used to deliver new greenfield projects such as the Thames Tideway Tunnel. An innovative financing package using the RAB model, underpinned with a Government support package, has led to a low cost of capital for the Thames Tideway Tunnel project, meaning Thames Water consumer bills will only increase by between £13 and £25 per year – rather than the original estimate of between £70 and £80 a year. The contract also transfers risk to the private sector. The contractual arrangements provide Tideway, the company constructing the tunnel, and its contractors with financial incentives to deliver on time, or before, and manage the risks of cost overruns.

Reform and further evidence base is required

While there are case studies highlighting that private capital can deliver positive benefits for consumers, stakeholders from both the private and public sector accept that, in some cases, value for money could be improved. Models promoting the use of private capital into infrastructure need to ensure that contracts are not too inflexible and that appropriate risk is transferred to the private sector. Moreover, the NAO has stated that there is a lack of data available on the benefits of private finance[7].

Private capital can lead to value for money in the delivery of infrastructure, but there remains little analysis comparing the use of private capital to public sector counterfactuals. It is therefore difficult to determine on a case-by-case basis whether the advantages of using private finance offset the cost of capital differential between public and private capital. If we are to combat public scepticism about the private sector profiting from key infrastructure projects, further work is needed to inform the public of the rationale behind long-term private finance projects and the whole-life benefits that arise from them.

The risks to the future infrastructure pipeline

The Government has outlined a very ambitious £600bn pipeline over the next decade for economic and social infrastructure. It is expecting the private sector to finance around half of the pipeline and for private sector supply chains to deliver infrastructure financed by the public and private sectors.

However, our Working Group highlights that there are a number of risks to the delivery of London's and the wider UK's infrastructure pipeline that need to be addressed by policymakers. These include:

1 **Political and regulatory risk:** proposals from the Labour Party to renationalise the UK's utilities and rail companies, potentially at below market value; continuing Brexit uncertainty; and the cessation of private capital models such as PFI are making the UK's infrastructure sector less attractive to investors. Moreover, there is a perception that Britain's historic reputation for stable regulatory frameworks is being undermined. There is already evidence that these risks are affecting the market – for example, the reports that the recent £2bn auction for one of the UK's distribution network operators has been "derailed" by Labour's re-nationalisation proposals[8].

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7 *National Audit Office, PFI and PF2, 2018*

8 *Financial Times, UK £2bn power grid auction derailed by Labour Party pledge, July 2019*

2 **Lack of an identifiable pipeline:** the Government's National Infrastructure and Construction Pipeline is not viewed as investable by investors and supply chain industries. For example, The Infrastructure Forum's research highlights that just 8% of the 276 projects were sufficiently certain for contractors to invest to deliver them[9].

3 **Concerns about UK construction firms' capacity:** our Working Group highlights that there is a lack of capacity in the domestic construction supply chain to participate in effective risk transfer. This is both a reflection of the relatively poor balance sheet strength of contractors operating in the UK and contractors suffering from a misallocation of risk in some PFI projects.

4 **Concerns around economic regulation:** utility economic regulators must ensure that future investment needs are met so that there is adequate infrastructure in place to support innovation, such as the growing use of electric vehicles. Unfortunately, the regulators' default position is too often to bear down on investment allowances to keep short-term prices low. While it is crucial that regulators should promote maximum efficiency, this must not be done at the expense of London's utility long-term investment needs.

5 **Replacing the European Investment Bank (EIB):** while the EIB has provided a substantial amount of finance to UK infrastructure, it is not clear whether it was offering much additionality: in other words, providing additional finance that could not have been raised from the private sector. The Government should be clear that any replacement UK-based body should offer help to high-risk projects that would struggle to attract private finance without any mitigating measures.

6 **Promoting new technologies:** new technologies, such as low-carbon innovations, will face funding issues and barriers to market. In particular, many of these technologies may face demand-side risks, which will need to be mitigated. For example, in the early stages of electric vehicle uptake there may be an underutilisation of public charging points. It is also notable that the use of data is also likely to be critical to ensuring the full utilisation of assets. If the UK is to pioneer new technologies, this will require more funding from Government, and Government-mandated private capital models will need to become more agile in order to support innovation.

7 **Funding challenges:** as demands for central government resources grow, London's infrastructure will likely require new localised funding streams: in other words, local funding to pay for new infrastructure over time. This may require new, innovative funding models, such as land value capture measures, and greater devolution of power to regional bodies.

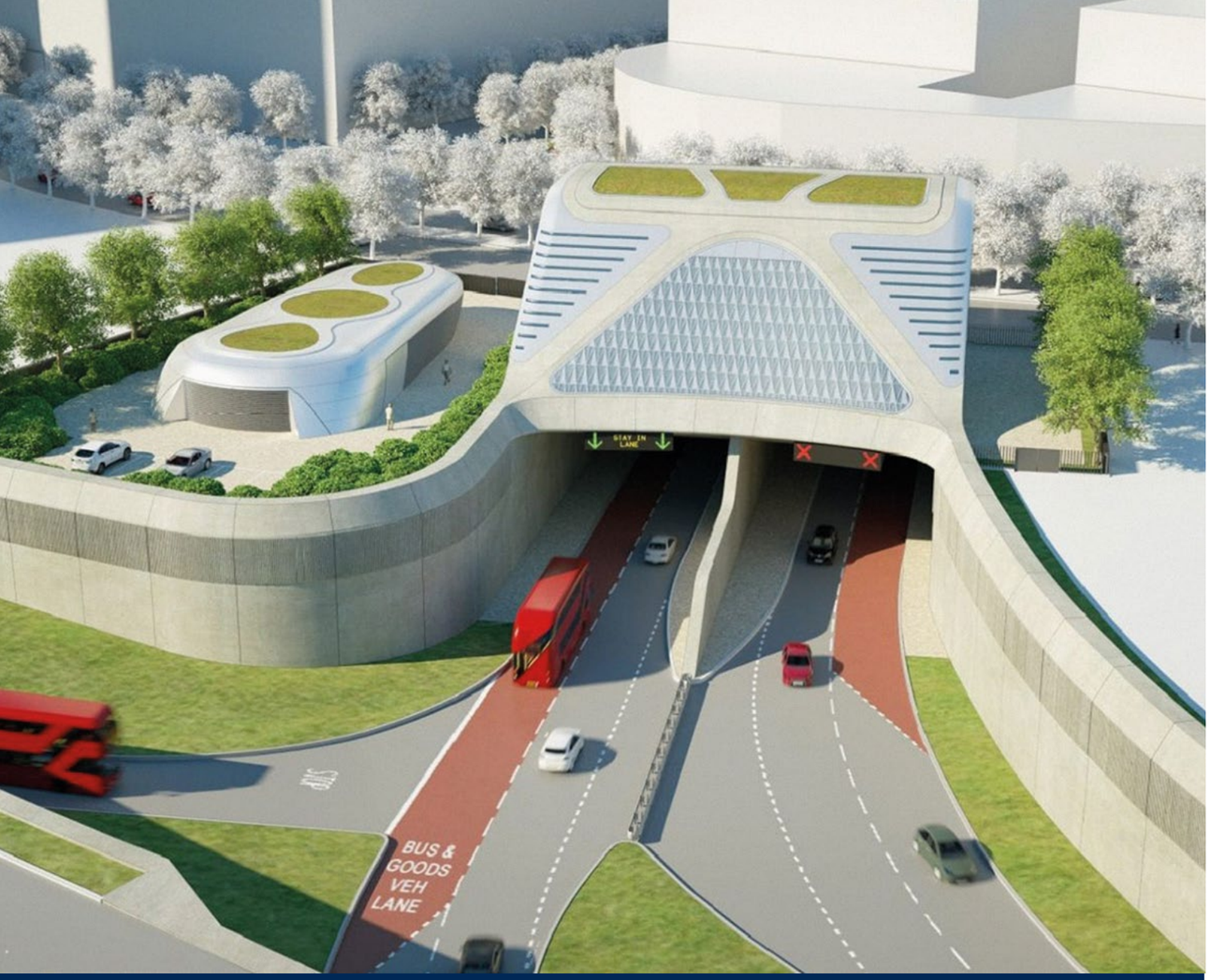
9 *The Infrastructure Forum, Sustainable procurement: A vision for UK infrastructure, 2017*

Case Study: High Speed 1

Concession model: raising revenue for the Treasury and transferring risk to the private sector

In 2010, HS1 was sold to the private sector for £2 billion on a 30-year concession, with the Government guaranteeing payment for a baseline level of domestic services. According to the National Audit Office, the Department for Transport handled the sale well and raised more money than was expected. Most operational risk has been transferred to the private sector, but the Government retains a residual risk as the ultimate owner of the high-speed line.

Domestic services have also played a major role in providing economic benefits to the region of Kent, by catalysing regional regeneration, attracting investment in businesses and property, and increasing the number of visitors to Kent from further afield. Since domestic services began in 2009, HS1's total economic contribution to Kent's visitor economy is estimated at over £311 million.



Case Study: Silvertown Tunnel

Public Private Partnership: risk transfer to the private sector and incentivising good performance.

Devolved bodies such as TfL are exempt from the Government's ban on the use of PFIs. The Silvertown Tunnel, procured by TfL, will be delivered through a design, build, finance and maintain contract. This means that the financial risk for construction and initial maintenance period will sit with the private sector rather than TfL. User charges will fund the construction and maintenance costs, and TfL will be able to reduce payments should the tunnel fail to meet certain key standards.

Next steps

London has benefitted from private capital working alongside the public sector to deliver key infrastructure projects. But it is clear that a better case for increased private investment needs to be made – and policymakers must address key risks to the delivery of the infrastructure pipeline in the UK and London.

London First will continue to promote the positive role of private sector capital in meeting London's infrastructure needs, and work with members and the Government to analyse the future of financing and funding models to promote economic and social benefit. Reforming Government-mandated private capital models will involve improving best practice within existing models and, in some cases, may mean creating replacement or new models.

To analyse and examine this over the coming months and years, London First, along with members including Arcadis, will develop a number of potential workstreams as part of its Funding and Financing Working Group, following publication of the NIC's report on future regulation, the Government's National Infrastructure Strategy and the HM Treasury Review into Infrastructure Finance later this year. These potential workstreams will examine:

1. **Economic regulation**, looking at the utility, digital, airports and ports industries in London.
2. **Project finance and delivery**, looking at the future of project finance and project delivery for London's new infrastructure.
3. **New Technologies**, looking at how existing private capital models should be adapted to incentivise private investment in new technologies that will be pioneered in London.
4. **Future funding models**, looking at new innovative funding models to pay for London's future infrastructure projects over time.

If you would be interested in participating in London First's infrastructure Funding and Finance Working Group – or in any of the specific roundtable opportunities – please contact Daniel Mahoney at dmahoney@londonfirst.co.uk (Programme Director for Economy and Infrastructure).

London First is a membership group which campaigns to make London the best city in the world to do business.

Our membership comprises over 200 leading employers across a wide range of sectors. We convene and mobilise business leaders to tackle the key challenges facing our capital.

We have been instrumental in establishing a **Mayor of London**, pioneered **Teach First**, driven the campaign for **Crossrail**, lobbied for government action on airport capacity, leading to the approval of a new **Heathrow** runway and achieved a win for business when Government announced a review of the **Apprenticeship Levy**.

Now we are focusing on key priorities to keep our capital working for the UK: **people, place, competitiveness** and **connectivity**.

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