Institute and Faculty of Actuaries

Private Finance for Public Infrastructure

Chris Lewin, Chair, Infrastructure Working Party

19 February 2021

Introduction

1. This memorandum sketches out a possible new framework to stimulate private sector investment in UK public infrastructure, following the discontinuance of the Private Finance Initiative. The essence of the idea is that there would be a stable and enduring partnership between the new UK National Investment Bank (NIB) in the public sector, as recently announced by the Government, and a newly-formed company, which we will call Infrastructure Investment Limited (II Ltd), operating in the private sector. II Ltd would have some defined statutory obligations, but would otherwise exist as an ordinary private company, providing a recognised channel of investment and management in UK public infrastructure, and it would build up a substantial centralised capability of money and expertise to enable it to do so. The availability of private finance, which could be deployed alongside public finance where necessary, would probably enable a greater number of worthwhile projects to go ahead than if only public finance were available, and projects would benefit from private sector inspiration, management, experience and talent. Efficiency would be increased, as much of the wasteful effort which goes into competitive tendering for projects would be avoided, and the whole process of getting projects off the ground would be significantly speeded up. This would be in the national interest, since many infrastructure projects are badly needed.

Attracting substantial investment flows

2. It is important that II Ltd should operate on a large scale, investing in many projects, so that there would be a good spread of investors' risks, as well as good liquidity for investors, arising from a listing of II Ltd's share capital through the Stock Exchange. As well as spreading risks and providing liquidity, which will be of the greatest importance to investors, there is also the point that investors will not have to carry out costly and time-consuming due diligence themselves on individual projects – in effect these costs will be shared between all investors. It is anticipated, therefore, that II Ltd would be able to attract a growing and ultimately substantial flow of investment monies. The investors in II Ltd would include insurance companies, pension funds, banks, investment funds, infrastructure companies, and members of the public, from the UK and overseas. Consideration could also be given to an investment in II Ltd by the UK Government itself of up to (say) 20% of the issued equity capital.

Initial Legislation

3. For those projects deemed suitable for private sector finance and management, there would be a presumption that the first refusal would be given to II Ltd, though whether II Ltd went ahead would depend on whether appropriate terms could be negotiated by them with other interested parties. The existence of these arrangements would not prevent the Government from entering into a transaction with other investors instead if the NIB was not able to negotiate satisfactory terms with II Ltd on a project. Giving first refusal to II Ltd might seem at first sight to run counter to principles of free competition, but in return for this privilege II Ltd itself would have an obligation to put out all its contracts with third parties (other than the Government) to open competititve tender. The arrangements would probably require legislation and this would place various duties and obligations on II Ltd to ensure that the public interest would be safeguarded. This could perhaps be part of the legislation establishing the NIB.

The Company

4. II Ltd would raise capital (bonds and equities) in the normal way through the Stock Exchange, where its capital would be listed in order to provide liquidity to investors. New issues would be

needed from time to time, to finance fresh investments. It would also be open to the company to accept short-term deposits and to borrow. The company's board would be chosen by shareholders, except that there would also be one board member (not the chairman), chosen by the Government to represent the public interest and to facilitate the smooth running of the arrangements but who would otherwise have the same duties and responsibilities as the other board members. It is for consideration whether another director should be appointed by the National Infrastructure Commission. The company's principal objectives would be to invest in UK infrastructure and to make a reasonable and stable rate of return for shareholders. Dividends would be declared annually and paid to equity shareholders. The company would employ its own staff and contractors and would not be subject to public sector constraints on their pay and conditions. Outside experts could also be employed on short-term contracts for specific projects. II Ltd would determine its own policies and the Government would not control it.

The National Infrastructure Bank

5. The NIB would be staffed by civil servants and would draw in expertise from sponsoring Departments, including the Infrastructure and Projects Authority. The NIB would have access to the project risk assessments which had been made and would have the ability, at its discretion, to share those assessments with II Ltd during negotiations. Projects might be financed partly by the NIB and partly by II Ltd, or wholly by II Ltd.

Negotiating terms for investment

6. It is envisaged that the asset classes most suitable for private finance would initially include social infrastructure, energy, biotech and transportation, but any type of infrastructure could be considered, apart from ones which had sensitive security implications and were best handled by the Government acting alone. For each project being considered for investment, there would first be a pre-feasibility study based on established front-end thinking principles, conducted jointly by II Ltd and NIB. There would then be a negotiation between II Ltd and NIB officials to agree on the terms of investment. Broadly speaking, the usage-forecasting, construction, commissioning and operating risks would usually be transferred away from the central government or other sponsor, and this would be an important factor to be taken into account in fixing the financial arrangements. If agreement proved impossible, both parties would have the right to walk away from the negotiations, in which case it would be open to the NIB to finance and manage the investment itself or in conjunction with another partner if it wished.

Principles of the investment contract

7. Although each set of negotiations would be separate and the terms of each investment contract would have to be tailored to circumstances, the broad principles of an agreement would normally be as follows:

- The contract would be signed before construction commenced, and would bind the public sector user, the NIB and II Ltd. (The public sector "user" could be a Government Department, a Regional Health Authority, a Local Authority, or another public authority which needs the infrastructure.) Every effort would be made by II Ltd to get accurate up-to-date construction costs, and to understand construction and commissioning risks, before the terms of the contract were agreed.

- II Ltd would be responsible at its own cost for design, construction and (usually) the commissioning of the asset, to specifications and designs agreed with the user, the operator and the regulator, using contractors chosen by II Ltd after an open competition.
- The contract would include provisions governing the resilience requirements which have been agreed between the parties, and alterations to specifications and designs.
- Specified penalties would be levied on II Ltd if delivery of the asset in a state fit for operation is unduly late.
- The asset and land would be leased to II Ltd on a long lease (e.g. 30 years), at the end of which period the asset would revert to public sector ownership. Either II Ltd or the NIB might be required to pay a capital sum to the other at the start of the lease, or the lease could be granted in return for an annual rent (or both).
- The maintenance of the asset and equipment would be undertaken by II Ltd, using contractors of its choice after open competition (subject to penalties imposed by the user on II Ltd if availability falls below specification), or maintenance could be undertaken by the user at its own cost.
- In a case where the user is not itself the operator, an operator will be appointed by the user with II Ltd's agreement, subject to regulatory approval and after open competition. The Government would have the right to require the dismissal of an existing operator if performance proves unsatisfactory, in which case either a new operator would be appointed, or the asset would revert to public ownership with compensation paid to II Ltd.
- The user would pay II Ltd an annual rent, which may or may not be dependent on usage and may or may not be price protected; alternatively (or in addition) II Ltd would receive revenues collected by the user or operator from members of the public.
- The allocation of risk between the various parties would be specified (normally on the basis of which party is best able to manage each risk), both during construction and later.
- Renewals and updating of equipment could be undertaken by II Ltd when required, at the cost of the user.
- The NIB could make specified loans and grants to II Ltd to help with construction, commissioning and maintenance costs, or these costs could be financed solely by II Ltd.
- Any payments to be made from the project to the NIB would be specified (for example a proportion of the project's net receipts if that was agreed).
- II Ltd might be granted rights to improve the asset, for example by developing a shopping centre as part of it.
- Information flows between II Ltd and the NIB would be specified, including timescales.
- II Ltd would undertake to behave in a socially responsible way, taking account of social and environmental considerations and acting to stimulate positive social impacts, which could be specified. (The company would be expected to report annually on its achievements on such matters.)
- Consideration could be given in suitable cases to setting up project boards supervising the construction and operation of particular assets, and individuals representing affected communities could be invited to serve on those boards alongside staff of II Ltd.
- Compensation calculated on specified principles would be paid to II Ltd by the NIB for any loss of income stream due to nationalisation of the asset or any price controls imposed by the Government, or if the asset is no longer required by the public sector user.

<u>Cases where construction is not required</u>

8. These arrangements could be adapted to cover cases where the asset already exists or where construction has to be undertaken by a party other than II Ltd. In such a case, II Ltd might be willing to pay a capital sum or an annual rent for a long lease once the asset is operational.

Cases where assets will be sold after construction

9. There are some circumstances where a long lease for II Ltd would not be appropriate, for example in a residential housing or student accommodation project, if the intention is to sell the assets to third parties when completed. However, there is no reason why II Ltd could not undertake the construction of the assets if required.

Working arrangements

10. It is envisaged that there would be frequent meetings and exchanges of information between officials of the NIB and of II Ltd. Both sides would be instructed to behave in an open and transparent way as far as possible. II Ltd would produce investment “pipeline” plans from time to time for the guidance of potential investors, after consultation with the National Infrastructure Commission and the NIB. II Ltd would report annually to shareholders in the normal way, including a report on overall performance, but it should not be obliged to give details of the performance of individual investments. These annual reports would be accompanied by statements of the social impacts which have been achieved, both positive and negative.

Audits

11. II Ltd would employ its own internal and external auditors. The NIB would be subject to audit by the National Audit Office, which could report publicly on the progress of projects and on the contracts entered into by the NIB with II Ltd (subject to any confidentiality constraints imposed in the contracts), but would not have access to II Ltd’s books.

Sponsors other than central Government

12. It should be open to II Ltd to enter into contracts with any public-sector sponsor of a project, including central and local government bodies and their agencies. It is for consideration whether II Ltd should also be able to invest in the projects of private-sector utility companies, such as those running airports or providing water distribution.

Dispute mechanism

13. A dispute resolution mechanism should be established to prevent any need for legal action about the interpretation of contracts or the allocation of investments.

Conclusion

14. A partnership framework on these lines would produce a clear pipeline of projects and would facilitate progress on them without unnecessary delays. It would give investors in II Ltd a broad spread of risks and excellent liquidity, and would save them from the necessity of doing individual due diligence on each project. Because of likely benefits from private sector inspiration, ideas, expertise and management, it ought to be possible for II Ltd to make a reasonable rate of return on its equity capital, for the benefit of shareholders, without having to seek agreements which would look unattractive from a public sector viewpoint. Hence it is likely that many potential investors will be tempted to participate, though perhaps only to a limited extent until they can be assured that the arrangements are working well. From the viewpoint of central Government, the availability of private

finance might enable a greater number of worthwhile projects to go ahead quickly. There would be considerable flexibility when agreeing the financial basis of each project, without having to adhere to any predetermined template, and the risks for the sponsor could, to some extent at least, be transferred from the public sector to the private sector. It would also be possible for social impact targets to be agreed where appropriate, thus benefiting the members of the public who will use the infrastructure.

Chris Lewin, Chair, Infrastructure Working Party, Institute and Faculty of Actuaries, 19 February 2021

Email: thirlestane1903@aol.com

Institute and Faculty of Actuaries

London

7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP
Tel: +44 (0) 20 7632 2100 · Fax: +44 (0) 20 7632 2111

Edinburgh

Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA
Tel: +44 (0) 131 240 1300 · Fax: +44 (0) 131 240 1313

Oxford

1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD
Tel: +44 (0) 1865 268 200 · Fax: +44 (0) 1865 268 211

Beijing

6/F · Tower 2 · Prosper Centre · 5 Guanghua Road · Chaoyang District · Beijing China 100020
Tel: +86 (10) 8573 1000 · Fax: +86 (10) 8573 1100

Hong Kong

2202 Tower Two · Lippo Centre · 89 Queensway · Hong Kong
Tel: +11 (0) 852 2147 9418 · Fax: +11 (0) 852 2147 2497

www.actuaries.org.uk