Infrastructure Investor

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PUBLISHED: 11 December 2023

TRENDS

The changing ways of investing in UK infrastructure

Britain's infrastructure reputation has taken a beating in recent years thanks to changing governments, Brexit and water utilities in disrepute, to name but a few reasons. But there is a silver lining.

Britain's infrastructure is ageing and insufficient. Though there is a plethora of funding models available, there is room for improvement, particularly for nascent technologies. That is the very short summing up of the UK's current infrastructure-investment climate, according to industry experts.

For the more established assets, public-private partnerships have languished in the UK since the cessation of the private finance initiative in 2018. While some smaller PFI-like schemes exist, many of the newer financing models such as the Regulated Asset Base are narrowly defined or must be built more or less from scratch with each new investment opportunity. Presently, the troubled water and offshore wind industries are sore infra spots.

On the upside, none of the issues are ignored, and bad press may have made the UK seem a little less investable than is perhaps fair. The proof is in the pudding, as the saying goes, and there is both excitement about investing in the UK as well as challenges to the ambitions dreamt up in various government offices.

PFI's demise

It is an endearing but perhaps also mission-defeating fact that the British are not averse to a bit of self-deprecation. The issue of foreign direct investments is a case in point, with a report commissioned by the UK government in early 2023 to reverse the decline of fresh pools of money pouring into the UK. A different spin could have been put on this as the decline was global, and the $2.7 trillion-worth of total 2022 FDI stock for the UK was topped only by the US and China, according to FDI Intelligence.

Equally, a more optimistic observer might note that the UK's offshore wind capacity is second only to China's and that the impact of the British way of financing infrastructure is felt across the world in the form of PPPs and contracts for difference, the latter being the UK's main mechanism for supporting renewable power generation.

However, being the first one off the block has had its downsides. PFIs, which were introduced in 1992 to primarily help build public hospitals, are under continued scrutiny following reports that the service provided is not always what is needed and that many schools, hospitals and other facilities are bogged down by the high costs.

The scheme was shut down in 2018, and England's 550 remaining inflation-linked PFIs are fraught with disputes, as documented in this summer's UK government-commissioned White Fraiser Report into the PFI sector. But lessons have been learned and will be taken on board for the future, according to Julia Prescot, deputy chair of the National Infrastructure Commission and co-founder of Meridiam.

"The words PFI have become quite toxic in their own right. I do think, going forward, we could use these types of PPP models as a way of delivering infrastructure. It won't look like PFI, which was very rigid and not capable of evolving, but we can develop really good models that take into account what the needs of all the parties are in a much more adaptive way.

"What was continually identified in the PPP model as being very beneficial was the financial discipline that it provided."

Today's investments in traditional social infrastructure often employ local improvement finance trusts (LIFT) – a PFI-light model – while new schemes such as the Welsh mutual investment model (MIM), which has also been introduced in Scotland, have sprung up.

"The MIM model is actually very much based on the LIFT model and this idea that if you get public and private ownership at a development level, you get full transparency," says Prescot.

Even so, a planned cancer centre in Cardiff has been besieged by controversy over costs and fraudulent consortium members. Not all partnering is easy. Nor necessarily wanted, as in the case of new public hospitals that are wholly publicly funded.

Troubled UK waters

Crucially, despite the strong impact of PFI on the discussion around infrastructure, the scheme only formed a relatively small

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part of private sector investment in the UK, and for new investors, they are water under the bridge. Worse for the UK's infra reputation is arguably the ongoing discussion around the status of water utilities and the not-so-clean water under the bridges and off the nation's coastline.

As ageing, leaking pipes and sewage overflows have hit the news, Britain's privatised water utilities have been berated and ridiculed. Worse, some have even made losses and a couple of utilities came close to re-nationalisation over the summer.

Brave people can and will argue that British water utilities are not poorly performing on delivery by comparison with European peers, but this is little comfort to those investors looking at a decade of no dividends and no obvious means of recourse. Which, incidentally, also does not entice new investors to the sector. With billions of pounds needed to upgrade the system, the situation is unsustainable.

"I think people have seen a reduction of trust. The water companies are under awful pressure on whether there will be reasonable regulatory returns in the future. And I think there are major concerns. But looking at the longer-term perspective, we need significant investment into standalone projects and, because of that, I think we will see a rebalancing of relationships," says Prescot.

"I do have a strong trust in common sense because we have seen it work over the years with adjustments made on the regulatory side. There is a need, and it is going to have to be paid for in some form or another."

It should be noted that, according to Moody's, nearly half of the UK's water utilities outperformed the dividend assumption of 4 percent between 2020 and 2023. They tend to keep quiet about it.

Following nuclear's lead

Generally, UK utilities fund new investments via the regulated asset-based (RAB) model, guaranteeing a regulated revenue stream from the onset and hence reducing the cost of capital. This flow of cash comes courtesy of consumers, and the RAB model is so enticing that it is increasingly being used for other kinds of infrastructure. One such notable project is the Thames Tideway project, whereby London's wastewater will travel underneath the river Thames in a tunnel. An Allianz, Amber Infrastructure and Dalmore Capital consortium owns the Tideway.

The RAB model has also been used for Heathrow's Terminal 5, and the upcoming 3.2GW Sizewell C nuclear power plant in Suffolk will likely be partially funded through RAB.

With its periodic price reviews, the RAB is far from a direct substitution for the clean long-term contracts in a typical PPP, but it seems the most likely way forward for larger projects outside the renewable energy sector where CfDs reign supreme. Indeed, such is the strength of the CfD scheme that, though it has been a difficult few months for offshore wind in the UK, the recently announced amendments of the conditions for future auctions may suffice to revive the stagnated roll-out.

Nonetheless, the government might do well by reviewing the price of carbon too, says Adam Berman, deputy policy director at trade body Energy UK.

"The UK, for the last 20 years or so, has had a carrot-and-stick approach. We've had subsidies and specific financial mechanisms to bring forward low-carbon alternatives. But we've also had the stick, which is a carbon price, to be able to disincentivise the fossil fuel usage and to also help to incentivise low carbon. The US has no carbon price and has gone for the carrot-only approach. Certainly, the companies we represent are very much in favour of the dual approach."

Taxation is another issue. "What we see is a reluctance from the government to come up with a taxation system with the accompanying capital allowances and investment allowances that would serve to complement the financial mechanisms that are already in place, like the contracts for difference," says Berman. "And at the moment, the treasury lacks that mechanism, which is a pretty key one to ensuring that we can green the taxation system… For me, it is of equal importance to some of the specific financial mechanisms."

Keep it stable

The Second National Infrastructure Assessment, published in October, stated that the scale of the private investments needed into UK infrastructure must increase in the 2030s and 2040s from the current yearly level of around £35 billion ($43.6 billion, €40.0 billion) to between £40 billion and £50 billion a year. Part of the necessary decarbonising will involve the greening of public services.

One such example is I Squared's recent investment in bus company Arriva, which provides services to London among other places. I Squared senior partner Mohamed El Gazzar has nothing but praise for the co-operation with the public side of the deal: "We, through our portfolio company Arriva, will continue to invest in sustainable public transportation, including electrification of the bus fleet, and enter into long-term contracts with public authorities such as Department for Transport, Transport for London and others. This is a model several local authorities are very keen on replicating with private operators."

Another area where the UK is attracting investment is in flexibility assets. EQT recently acquired Statera Energy and a 16GW flexible generation pipeline and, through two portfolio companies, I Squared has invested close to £1 billion of capex in grid stability, storage, renewable energy and flexible distributed power.

"[This investment] is a result of a very stable relationship with National Grid and SONI in Northern Ireland, and of the National Grid facilitating models that

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Infrastructure
Investor

enable you to put that capex in and earn the return required from a cost of capital point of view," says El Gazzar. "A stable regulatory regime gives a lot of confidence to investors."

Furthermore, the cap and floor regime encourages investments in interconnectors. The Neuconnect interconnector, where Meridiam is the lead developer, and Partners Group's Greenlink interconnector both use this regime.

"If I can put my Meridiam hat on, one of the reasons we put development money into the Neuconnect interconnector was the very clear cap and floor business model. That model was a clear signal from Ofgem, it was a structure, it was financeable, it was deliverable," says Prescot.

While the UK has been at the forefront of introducing flexible generation and storage solutions into the system, this is no time for complacency. "We are excited about the UK, but there has to be a continued effort to have clear, long-term policies. We have to focus on reducing planning barriers that tend to delay projects and sometimes deter investments," says El Gazzar.

Giving nascent technologies a boost

The one area where the UK is most lacking in clarity is in the support of nascent technologies.

Sean McLachlan, co-head of Octopus Sustainable Infrastructure Fund, says: "The challenge is the emerging technologies that are not yet scaled and how to get them to a point where they're ready for institutional investment. There is a serious funding gap in the market for technologies like long-duration energy storage and others, which will support net zero including the decarbonisation of industry, homes and transport. Those are things that we need to do better.

"It is difficult for us to take that first-of-a-kind risk as infrastructure investors, so perhaps a different type of investment vehicle which includes public finance is needed. This could include trade players as well because they tend to be more involved in earlier stage R&D."

Prescott says: "We need to push forward business models that will take onboard onshore transmission, hydrogen transport and engage with longer-term storage."

Berman laments the lack of clarity on how decisions on government co-investments are made: "You have seen not necessarily a kind of coherent strategy that defines exactly why [the UK] is [co-] investing into particular technologies. What are the financial structures, is there a level of transparency to ensure that this is available to everyone and not just simply a few favourites?"

While the UK authorities could and should act sooner rather than later to address the snags in the system, investors are still looking to the UK for opportunities with a will to invest. It would make sense not to stand in their way. ■

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