THE INFRASTRUCTURE FORUM

Private Finance: Press Reset

Rebuilding Trust and Strengthening Partnerships

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Introduction

This paper considers the decline in support for private sector ownership of infrastructure. If not addressed, this could lead at best to increased regulation and contractual controls and at worst to the end of private ownership; to the detriment of both the public and private sectors.

The historic debate has been caricatured as a binary choice between on the one hand private sector high risk transfer, high cost of capital models and/or profit-maximising short-termist behaviour, and on the other pure public ownership, with low cost of capital, strong public ethos but poor cost controls. In practice, there should be a spectrum of possible models, with this binary choice only at the extremes.

This paper argues for two key changes:

- The introduction of radical new governance for private ownership, enshrining a commitment to long-term social objectives as part of its stewardship, and a very different approach to ownership, that clearly aligns shareholder, government, lender and the public's interest in having long-term sustainable infrastructure. This needs to be considered by all private owners of public infrastructure including PFIs, utilities and long-term concessions.

- For investment in new infrastructure, a greater use of the model most likely to build trust; one that combines a structure that allows a low cost of capital with that new strong governance, with clear long-term objectives and a public service ethos.

  Such a model would benefit the public sector, as it would provide an alternative model to procure infrastructure, that retains private sector finance, focus, cost controls and due diligence, but avoids some of the unwelcome features of current models. It would also impact the public sector in the way it should design infrastructure procurement, how it chooses preferred bidders, and the nature and scope of the regulation that would be required.

  Adopting such a new model would open opportunities across energy, roads, rail, franchising and local authorities and put infrastructure on a more sustainable, lower risk path.

It is in the nature of a paper of this kind that it makes generalisations. Of course, its conclusions are not universally true, as there are beacons of good private sector ownership and governance and public sector partnerial behaviour that stand out. But as an industry, there is much the public and private sectors can do together to re-build trust and work together partnerially.

Private sector ownership can deliver huge public benefit. But given the current antipathy, it is only likely to attain widespread public support if it can be achieved with a cost of capital close to that of the public sector, and where its objectives and management pay are aligned to long term performance and public sector values.

Executive Summary

The gulf between private and public sector views on the attractiveness of private sector ownership of infrastructure is huge. While the private sector cites its track record of successful project delivery and cost controls, the public sector seems to have lost faith in private sector delivery; as has the public more generally.

If not addressed, this gulf poses an existential threat to existing and future private sector ownership and delivery of infrastructure, to the detriment of both the private and public sectors.

Issues raised in the recent National Audit Office review of the Private Finance Initiative reflect wider held views about private ownership and need to be addressed by the industry.

But a total switch to public sector delivery is not the answer to mistrust of the private sector; the public sector lacks the breadth of skills across government and where it has delivered projects successfully, it has often relied on importing private sector skills. The Infrastructure Forum's earlier paper on alternative finance models argued for a mixed economy of both public and private sector delivery, to share skills and benchmark performance. For new infrastructure, we need an approach where the public sector can enjoy private sector skills around managing risk, cost controls and technical due diligence but where it can also trust private owners will have a long-term focus and be flexible and customer focused.

There are a number of features of current ownership models that prove particularly toxic to the public at large in the context of providing public services and infrastructure. Wider stakeholders simply do not trust that private ownership is in their interest. The underlying causes of mistrust are structural; if companies focus on maximising shareholder value, with a particular short-term focus, then this mistrust will always prevail.

An increase in contractual controls or regulation would not solve these issues nor re-build trust in the private sector; it would lead to a worse, less stable relationship.

The private sector needs to fundamentally change the governance of its infrastructure companies if it is to build trust and maintain a prominent position in the ownership and delivery of infrastructure. This has two elements to it: for new infrastructure; a change in the infrastructure model to a lower cost long-term model, and for both new and existing owners of infrastructure; a fundamental review of governance and goals, which is the key focus of this paper.

A new approach should ensure a clear articulation of corporate values which must be enshrined into governance so that wider stakeholders can trust performance. Alternative governance approaches can be adopted including through Articles of Association or introducing a Trust Board to uphold corporate values. Each company should evaluate what it needs to do to fundamentally rebuild trust with stakeholders; the public mood suggests in all cases this needs to be quite radical.

The governance of a Trusted Infrastructure Company might enshrine a variety of measures such as a commitment to long term stable returns, investing in infrastructure sustainably, customer

and stakeholder representation on the board, aligning management pay with long term performance, limitations on financial engineering, and a commitment to working with not against the public sector and stakeholders.

Private sector adoption of more trusted governance does not mean diminished returns, but longer term, less volatile returns to investors. Investors in infrastructure can still get enhanced returns through capital gains, but by selling a performing company managed for long term sustainability not to maximise short term value.

The public sector also has to radically change how it works with the private sector and chooses partners on projects; its current approach is not sustainable. The approach has transferred too much risk on contractors who are exiting the market. Instead, it should encourage models that attract long-term investors at lower cost and in evaluation it should favour companies with the governance and commitment it wants in the long term, not simply lowest cost. This approach will strengthen, not weaken, the private sector contracting market.

The combined approach of a model designed to deliver long-term, lower, less volatile returns, combined with governance that enshrines and builds trust offers radical alternatives to current approaches. It could be adopted in a wide number of sectors such as roads, rail franchising and construction, nuclear, electricity storage and distribution, and could be rolled out more widely at the local authority level, and in health and accommodation sectors.

The historic focus by Government on achieving 'off balance sheet' deals as a prime driver for advocating private ownership has been a major contributor to the use of the high risk transfer and contractually rigid approach of the PFI market, with a high cost of finance as a consequence. On the one hand, if balance sheet treatment were a secondary consideration, it could allow a more collaborative, low-cost model to evolve, getting the best from both sectors. On the other hand, as recent deals have proved, the long-term model described in this and TIF's earlier paper can be off balance sheet for the right deals, so would be attractive to those that still prioritise balance sheet treatment. The public sector can enjoy low-cost private ownership, which if combined with long-term public-ethos governance, offers an attractive alternative to public sector ownership.

There is an opportunity to overhaul the relationship between the public sector and private sector, to the benefit of both parties. The public sector needs to consider how to get the best from the private sector, developing long-term, more trusted relationships. In turn, the private sector has the opportunity to radically change the way it behaves and is seen to behave, with a stronger more trusted, less regulated relationship with government; it needs to take the initiative to demonstrate how both sides can benefit from a longer-term, more trusted working relationship. The breakdown in trust and confidence in private ownership is widespread; it needs to be addressed now.

1. A Difference of Opinion

The gulf between private and public sector views on the attractiveness of private sector ownership of infrastructure is huge. While the private sector cites its track record of successful project delivery and cost controls, the public sector seems to have lost faith in private sector delivery; as has the public more generally.

It sometimes feels as if we inhabit two parallel and unconnected universes! The universe of private sector infrastructure companies and investors, convinced in the efficiency of private sector ownership and management versus public sector alternatives, and the universe of the public sector and more importantly the public at large, convinced that the private sector has a higher cost of finance and focuses on profit to the detriment of customers.

In the eyes of the private sector:

- The private sector delivers huge efficiencies – post privatisation the utilities have an extensive track record of reducing and controlling costs inherited from inefficient public sector bodies; Public Private Partnerships (the Private Finance Initiative in particular) have a long track record of successful delivery, with the vast majority of the 700+ PFIs procured delivered to time and budget

- Those who advocate public sector delivery have a short memory – privatisation came in response to unresponsive public sector monoliths, both inefficient and not customer friendly

- Just look at the radical transformation that private ownership has brought about in telecoms, rail usage, water, airports and roads and across the PFI sector

- Where there have been defaults or problems with private sector entities, from historic collapses to the recent administration of Carillion, the losses have been predominantly absorbed by the private sector - both debt and equity - not government. This demonstrates the strength of risk transfer to the private sector, not the weakness of the system

In this view of the world, the only thing missing is better data and measurement of successes and more publicity about decades of successful delivery.

For many in the public sector an alternative world view prevails; in particular in relation to Private Finance Initiative ("PFI") deals:

- They don't believe in the value for money arguments for private ownership, which rely on counterfactuals that can't be proved ("this is better than would have been the case if delivered by the public sector")

- Risk transfer to the private sector is limited; government ends up being the backstop, picking up the pieces on corporate failure. And the risk transfer tends to fall on the underlying contractors, not on the debt and equity financiers of each project

- Private sector windfall gains through share disposals or debt refinancing are unacceptable in the world of delivering public services

- Too many companies are seen to deliver poor services, at best bumping along the bottom of what is contractually stipulated or required by the regulator

- PFI asset management has often been poor and contracts are inflexible

- The public sector could deliver equal efficiencies if public project companies were allowed to borrow, as is the case with Transport for London

- Motivation for entering private sector deals has often been to get expenditure off balance sheet, which is increasingly difficult under revised accounting. So, the 'additionality' rationale for a private sector approach is diminishing

- The recent failure of Carillion suggests there are systemic risks in relying on the private sector to deliver infrastructure

Where the public at large sits between these extremes is perhaps unclear, but if the popular press is representative, it would be closer to the second end of the spectrum.

And the debate around how infrastructure should be delivered should be set within the context of a world of increasing disquiet with big business; a distrust of whether the private sector with its focus on shareholder value in priority to everything else actually produces better results. That context is particularly significant in infrastructure, where large private sector profits sit uncomfortably with companies delivering what are viewed as public services. There is certainly political popularity for the notion of moving back to a world of public sector delivery.

2. An Existential Threat

If not addressed, this gulf poses an existential threat to the existing and future private sector ownership and delivery of infrastructure, to the detriment of both the private and public sectors.

Given this context, recent Labour Party pledges that envisage the nationalisation of large parts of the industry, the end of rail franchising and the early termination of PPPs, are not unrepresentative of a general mood of antipathy towards private sector delivery.

The gulf between these two views of the universe could not be greater and presents a growing existential risk for private sector delivery of infrastructure; both for existing PFIs, franchises and utilities and for the probability that future infrastructure will be procured through the private sector.

It is true that the private sector as a whole could benefit from better data, presentation and the public getting a better understanding of what they have achieved. But to think that this would bridge the gulf in views described above would be to fail to understand the distance between the two universes. Even if data 'proved' the efficiency of private sector delivery, this would not address some fundamental issues the public and public sector have around inflexibility, service levels, high windfall gains on public assets, reduced employee loyalty and incidences of the private sector performance being poor, unresponsive and short termist.

Despite what the private sector believes it has delivered in the decades since privatisation and with the use of PPPs, it has lost the battle for the hearts and minds of the public; ultimately the taxpayers that underpin most infrastructure investment.

Given the apparent public antipathy to private ownership, it is perhaps not surprising that there is no longer an obvious strong advocate of private sector ownership in government. This should be surprising given privatisation was a cornerstone of Tory policy and Labour embraced the use of PFI in the Blair-Brown years, but this shows there is a growing unease with current models; something needs to change.

This paper argues that a fundamental change in governance, purpose, and structure of private sector companies delivering public infrastructure is necessary if there is to be a hope of upholding the legitimacy of private ownership and garner support for future private sector delivery, where government clearly sees the benefits of private ownership. This in turn will need government to think about how it procures from, works with, and regulates the private sector in a fundamentally different way.

3. Improving PFI

Issues raised in the recent National Audit Office review of the Private Finance Initiative reflect wider held views and need to be addressed by the industry.

Contrary to how it was reported, the NAO report is relatively balanced. It describes how 700+ projects have been delivered, that PFI projects were delivered to time more often that non-PFI and it points out how PFIs deliver cost certainty; key reasons why PFI was adopted against a history of poor performance in the public sector.

But it also summarised a number of concerns about PFI that need to be addressed. In particular:

- Operational inflexibility is a drawback of PFI
- If Value for Money is reviewed using Government's actual rather than notional cost of finance, the VFM of many PFIs becomes questionable
- Scope changes are only agreed if it improves the PFI's return
- There has been a lack of transparency that might improve if Government takes an equity stake in future PF2 deals

These point to a need for a more flexible, lower cost solution, with greater partnership between public and private sectors.

4. Rebalancing the Approach to Private Finance

A total switch to public sector delivery is not the answer to mistrust of the private sector; they lack the breadth of skills across government and where they have delivered public sector projects successfully, they have often relied on importing private sector skills. The Infrastructure Forum's earlier paper on alternative finance models argued for a mixed economy of both public and private sector delivery, to share skills and benchmark performance. For new infrastructure, we need an approach where the public sector can enjoy private sector skills around managing risk, cost controls and technical due diligence but where it can also trust private owners will have a long-term focus and be flexible and customer focused.

Some commentators hold the position that any element of profit should not form part of the delivery of public services. An extreme position, which doesn't dwell on the difficulties with public sector ownership and delivery that the last 25 years of privatisation and PPPs were largely introduced to overcome; publicly-owned infrastructure suffered from cost overruns on major projects, lack of cost control, budget annuality, and a lack of experience where in contrast the private sector has a greater volume of project experience and international precedents to draw upon.

In practice, few have faith that if there were a full transition to public sector delivery, the public sector would deliver more effectively, efficiently or responsively than the private sector. Distrust in the profit motive would be replaced with distrust in political processes, lack of market signals, and centralised bureaucracy.

A mixed economy of public and private sector delivery is the way to raise everyone's game and give comparability between a range of public and private models.

While this does not logically have to be the case, in large parts of the public sector there would not be the skills to take over this ownership and delivery challenge. So, the public sector does have to rely on private sector delivery in some shape or form. The question becomes what form; whether that should be with full risk transfer in a PPP, or a traditional short-term contract managed by the public sector, or whether it would actually be better to work closer together, using private sector skills and focus but with a governance that aligns the parties, not sets them on a course of mistrust.

The combination of lower cost delivery and better governance recommended in this paper could bring in private sector cost disciplines, focus, risk transfer and independence but in a way that allows flexibility, aligns objectives, allows less regulation and a lower cost of capital and builds trust.

5. Institutionalising Trust

There are a number of features of current ownership models that prove particularly toxic to the public at large in the context of providing public services and infrastructure. Wider stakeholders simply do not trust that private ownership is in their interest. The underlying causes of mistrust are structural; if companies focus on maximising shareholder value, with a particular short-term focus, then this mistrust will always prevail.

It could be argued that the private sector method of delivering infrastructure is wholly rational; looking for opportunities to reduce costs of delivery, refinancing completed projects and taking capital gain, performing at the contractual or regulatory minimum to reduce costs and increase profits, to the long-term benefit of taxpayers come the next regulatory review or post PFI contract. Indeed, the whole purpose of both privatisation and PFI was to introduce that cool-headed efficiency into the domain of public services.

But perhaps we are now in a more mature market where the private sector is a victim of its own success. Utilities may have massively reduced their cost base and invested in new infrastructure, PFIs may have delivered a large swathe of projects, but now the public are seeing a second, mature phase and are asking whether it is time for a new model; just delivering what the contract or regulator stipulates is not enough, profits through re-gearing sit poorly with infrastructure, inflexible contracts and high costs to change specification are not acceptable. The public are now asking whether they can retain the benefits of that private sector delivery but do so without the disbenefits of private sector ownership.

And in general, the public do not trust that private ownership is in their interest. They see profit as being at their expense rather than for their benefit. This is to the dismay of so many in the private sector, who are dedicated to the delivery of successful infrastructure. But despite their good intentions, the public perception is unlikely to change because the underlying causes are structural rather than the fault of particular individuals or companies.

What are these structural issues?

A key feature of the UK infrastructure sector is the dominant focus on shareholder value; rather than managing the company to maintain its value for the life of the asset/long term, the focus is on how to maximise immediate shareholder value, largely for investors who do not necessarily envisage holding the investment long term. While of course this is an over-generalisation and there are many exceptions to prove the rule, it is a dominant feature and has fundamental consequences:

- **Financial engineering** – irrespective of the long-term impact on the utility or PPP's flexibility or ability to absorb risk, they are incentivised to refinance post construction or regulatory settlements to pay dividends, adopting aggressive, highly-leveraged finance structures. This is a particular problem with infrastructure which delivers long-term stable cashflows which are particularly suitable for aggressive refinancing. But it is precisely these windfalls that are seen as so invidious in the context of public assets.

- **Return requirements** – much of the UK's infrastructure is owned by investors whose return requirements far exceed the returns that could be earned by infrastructure companies themselves in the long term. Those investor returns can only be delivered therefore through high capital gains, through a sale once risk has been reduced or earnings increased or through refinancing gains. Management is similarly incentivised.

- **Drive to increase short term earnings** – new investors buy at a multiple of the earnings evidenced at the time of purchase, so management will look to maximise short term earnings in a lead up to a sale. But with infrastructure this could lead to a risk that it can be under-maintained; short term this will not impact performance – it takes years for problems to manifest themselves – but may not be sustainable long term.

  Similarly, striving to increase earnings will encourage aggressive outsourcing and use of lower cost labour, to the detriment of longer term loyalty, training and employee trust.

  It is hard to engender trust if employees perceive companies prioritise short term profit over a commitment to the long-term health of the company and assets.

- **Focus on compliance not customer satisfaction** – to maximise profits, companies aim to just meet contractual or regulatory requirements; 'what is the lowest cost at which these are satisfied?', rather than on customer satisfaction; 'what is the best service we should deliver?' This is seen as a particular issue of PFI contracts.

All of these could be described by the private sector as simply being economically efficient; it is what the private sector does. But all of them are increasingly less accepted by the public in the context of public sector assets and delivering public services.

An increase in contractual controls or regulation would not solve these issues nor re-build trust in the private sector; it would lead to a worse, less stable relationship.

Over time we have transferred the ownership of large swathes of infrastructure assets to shareholders who either have no institutionalised commitment to long term ownership or have an explicit short-term investment horizon. In turn, this has led to a toxic combination of investors looking to profit maximise set against increasing levels of regulation or contractual controls, introduced to monitor and control such behaviour.

The impact of increased regulation has been for the regulated to increase focus on how to minimise or circumvent the impact of past or impending regulation; the regulator has more impact on the bottom line than customers. We have slowly transitioned to a world of regulation, standards, contracts, compliance and a focus on what the regulator will think or the contract stipulates, rather than one of corporate purpose, compassion, integrity and a focus on what the customer wants. The impact of increasing regulation and onerous contracts is to distract management further from the true purpose of their respective companies.

Would a more onerous contract make you focus on the goals of your company more or on ensuring the contract is met? Are the two the same? Clearly not.

But this leads to a regulatory conundrum. With less contract or regulation, companies have the opportunity to profit maximise with the risk of the short-term behaviour described above. With increased regulation or contractual controls, that will be management's focus, rather than on running the business.

With the current direction of travel, the regulated model feels close to the edge; increased regulation has not addressed many of the perceived failings of utilities and has soured the relationship and public perception of utilities, whilst aggressive financial engineering by utilities may test the solvency of some of the largest amongst them and short-term profit maximising behaviour is still seen to prevail.

Now that most PFIs are in the operational phase, the successful delivery of each project is easily forgotten, and the focus is on how well they perform against contract, or how flexible and customer focused they are, rather than just satisfying the contract, where by design the PFI structure or actual performance is falling short.

How can change be introduced so that management focus is on the goals and values of the company, its customers and stakeholders, not its shareholders, contracts or regulators?

6. A New Finance Model

The private sector needs to fundamentally change governance of its infrastructure companies if it is to build trust and maintain a prominent position in the ownership and delivery of infrastructure. This has two elements to it: a change in the infrastructure model to a lower cost long-term model and for both new and existing owners of infrastructure, a fundamental review of governance and goals, which is the key focus of this paper.

The Infrastructure Forum's recent paper 'Alternative Models for Funding and Financing Infrastructure' gave an overview of public and private sector models for procuring infrastructure, arguing for a mixed economy of public and private sector delivery, where each sector benefits from the other. For each project, the correct model should be determined depending on the particular objectives around risk transfer, flexibility, cost of capital and cost certainty.

The TIF paper advocates, in particular, a greater use of the approach used on Thames Tideway Tunnel, whose key features include:

- A lower level of risk transfer to underlying contractors, with cost risk shared between the TTT company and customers, as outturn costs are added to a Regulated Asset Base, the return of which appears in customer bills

- A cost of capital at 2.497%; a small premium over Government's cost of capital but which allows the introduction of private sector experience, management, cost controls and separation

- Levels of government support in areas such as liquidity, to help improve credit rating

- Pricing not completely fixed at the outset but reflects actual outcomes

- TTT is classified as off Government's balance sheet

This approach on new infrastructure has allowed TTT to achieve a cost of capital akin to regulated utilities, whose structure is already attractive to investors with long-term investment horizons, and therefore can attract low cost finance.

But in the case of both the utilities and the TTT model, those companies are still susceptible to the structural short-termism identified above. To make the radical change necessary to change the public's perception of private sector ownership, the models need to come hand in hand with completely revised governance that looks to demonstrate that companies will act in a long-term sustainable way.

7. Trusted Governance

A new approach should ensure a clear articulation of corporate values which must be enshrined into governance so that wider stakeholders can trust performance. Alternative governance approaches can be adopted including through Articles of Association or introducing a Trust Board to uphold corporate values. Each company should evaluate what it needs to do to fundamentally rebuild trust with stakeholders; the public mood suggests in all cases this needs to be quite radical

Healthy relationships are built on trust not contracts or regulation. But why should any stakeholder – government, employee, supplier – trust an infrastructure company? And is that trust for the long term; can anyone be confident that corporate values of today will be consistently upheld?

If the owners of infrastructure and management are driven by short term objectives and pressures; share price, maximising shareholder returns, increasing apparent earnings; then how confident can anyone be that the company will behave in ways not detrimental to other stakeholders and the long-term health of the infrastructure assets?

The answer lies in Trusted Infrastructure Companies putting in place structural reasons why that long-term trust is merited; a demonstration of intent to stakeholders. Its stewardship of public infrastructure is valid if it can give clarity of what the company stands for, its social values and long-term objectives and how, institutionally (not by fine words), these will be upheld and not be over-shadowed by short term pressures.

To build trust, it is important that trusted behaviour is enshrined in governance; how the company is structured and monitored that ensures it will respect those overriding values. There are several ways this could be done. For instance:

- Articles of Association – Writing social objectives into the Articles of a company, so institutionalising how it will work. For instance, The Green Deal Finance Company ('TGDFC'), set up to finance Government's national home energy efficiency programme, was established with Articles that defined its strategy to provide low cost finance to everyone, at one price. This inclusive policy flies in the face of normal lending practices, where the individual should be charged at a rate that reflects their personal credit rating. But by constraining itself to these social principles, TGDFC gained cross industry support, with public and private sector members. Its governance led to that support.

  Actually, despite not differentiating by credit history, its bad loan experience proved to be exemplary; the social good of energy efficiency seemed to attract the best bill payers.

- Trust Board – under this structure, a company articulates the principles it stands for and elects a Trust Board above the executive management, to hold them to account to meeting those principles. This approach is described in detail in Professor Colin Mayer's excellent book *Firm Commitment – Why the corporation is failing us and how*

to restore trust in it. A key part of the trust company is a trust board made up of individuals that engender trust; that stakeholders would believe will uphold those values. Numerous examples of successful trust companies exist; the BBC is obviously one that has successfully combined a successful business with upholding its broadcasting values; or Siemens, with its Supervisory Board, more representative of a European stakeholder-focused approach, or the Tata group, with trust boards and philanthropy baked into its corporate structure.

- Partnership – By definition partnerships are less susceptible to short term pressures (but not wholly exempt). The more inclusive the partnership, the more its employees are involved and invest in its long-term future and customers can see the values for which it stands; the highly successful and admired John Lewis being the most cited example.

There is no one size fits all; what trust model a company might adopt needs to suit its particular industry and circumstances. But if you run a company where trust is low (as it now is in infrastructure, to the extent that it is fundamentally to the detriment of the business and the future of the sector), then could adopting a radically new approach change your relationship with regulators, government and the public?

This paper suggests that without the combination of adopting low cost of capital models for new infrastructure and new governance for all infrastructure to address the fundamental decline in trust in private ownership of infrastructure, the existential threat to the industry will not go away.

8. Enshrining Values of Trust

The governance of a Trusted Infrastructure Company might enshrine a variety of measures such a commitment to long term stable returns, investing in infrastructure sustainably, customer and stakeholder representation on the board, aligning management pay with long term performance, limitations on financial engineering, and a commitment to working with not against the public sector and stakeholders.

What measures should be enshrined to build trust? Obviously, these will be company specific, and need to address the issues that are of concern in the sector, but they need to be transparent and reflect the duties of stewardship that private ownership of public infrastructure implies. They could include:

- *To provide long term stable returns to investors* – The point being management will not focus on measures to create short term gain, such as aggressive refinancing or maximising earnings unsustainably to increase sale price, but on building long term value and relationships

- *To invest in the upkeep of infrastructure on a long term sustainable basis* – management would be endorsing the 'inter-generational bargain', i.e. to leave infrastructure in as good a condition at the end of a concession as the beginning, or constant upkeep in the case of utilities – this would institutionalise companies having a clear focus on long-term asset management

- *To provide customer flexibility* – this would imply a greater focus on finding the needs of customers or cooperation where government is the client, with a capital structure that can price in and easily accommodate change

- *To ensure customer representation in management decisions* – this might imply customer appointments on the board or in a supervisory position, or perhaps shared equity stakes with public sector clients, where the taxpayer therefore benefits equally with good performance or capital gains

- *To widen share ownership* – to address the public's mistrust of profit, a commitment to making customers part owners of the business. For instance, offering shares to long term customers of the business; gas and electricity payers, so that they share and associate with corporate profit

- *To engage with communities* – this could involve co-planning and extensive consultation

- *To link management pay with long term outcomes* – the level of management pay is a constant source of controversy and is particularly toxic when excesses seem to shortly precede problems. If a material portion of management pay were not paid in year but only in later years, following continued satisfactory performance, there would naturally be a greater management focus on long term performance, asset management and

controls that ensure this will be the case. This might similarly include the incentives of the immediate fund managers with controlling interests in infrastructure companies, whose incentives should echo the long-term investment horizons of both the infrastructure company and the long-term investors sitting behind them

- *To maintain a prudent financial structure* – Such a constraint might limit the degree of financial engineering undertaken

The measures should be designed to institutionalise resistance to corporate excess, short term shareholder pressures and demonstrate commitment to the long-term asset management. Their introduction could avert the perceived need by the public sector to resort to increasingly onerous contractual and regulatory levers, which it is argued here will in fact worsen performance in the long term.

To emphasise, where a company chooses to enshrine such long-term goals in its governance, it is still very much a private sector company, able to take risk, pay dividends, and where shareholders can rightfully exit from ownership, with gains relative to performance. But the company's ethics, its primary purpose, is to deliver sustained infrastructure. Its employees, management, stakeholders and shareholders will be aligned to that goal.

With more aligned governance, regulators could focus more on systemic risks and less on individual company performance. There could be a less adversarial regulatory and contractual relationship between the private sector and government.

What is being proposed here is not unprecedented. Examples already exist in the likes of Community Interest Companies, cooperatives and social impact investing. It is simply a question of how extensively such public-sector, customer-oriented ethos should be adopted across the infrastructure sector.

9. Trust Needs Long Term Investors

Private sector adoption of more trusted governance does not mean diminished returns, but longer term, less volatile returns to investors. Investors in infrastructure can still get enhanced returns through capital gains, but by selling a performing company managed for long term sustainability not to maximise short-term value.

The mistrust of private sector models comes from a system that focuses on measures to maximise short term shareholder value. But such short-termism is likely to be self-defeating in the long term if it results in greater regulation and contractual control or if private ownership models fall out of favour.

Building trust into governance is actually economically rational.

The pain for shareholders is to forego some short-term opportunities such as refinancing or asset stripping that could be realised (at the expense of other stakeholders), but the gain is the enhanced and stable returns that a company that is trusted by stakeholders can realise. It will appeal to a different set of investors with a far longer investment horizon, who invest in a company to derive sustained, involatile returns from assets over their life.

This model is absolutely not recommended for all infrastructure investment. In many infrastructure sectors, the private sector takes substantial risk and when it delivers projects successfully it should expect to maximise its returns in the traditional way. Very successful infrastructure funds have created huge value to society in so doing.

But where the infrastructure is being commissioned by government and paid for by the taxpayer or in the case of utilities where a natural monopoly/oligopoly exists, then a radical change in governance is needed to restore trust. This should not necessarily imply lower returns, just different returns for different investors over a longer period.

10. Reforming the Public Sector

The public sector also has to radically change how it works with the private sector and chooses partners on new infrastructure projects; its current approach is not sustainable. The approach has transferred too much risk on contractors who are exiting the market. Instead, it should encourage models that attract long-term investors at lower cost, with structures that can absorb risk such as through the introduction of a Regulated Asset Base, and in evaluation it should favour companies with the governance and commitment it wants in the long term; not simply lowest cost. This approach will strengthen not weaken the private sector contracting market.

The Infrastructure Forum's recent paper on alternative models for infrastructure mentioned that history might show that too much risk has been transferred under the Private Finance Initiative. The subsequent demise of Carillion is a demonstration of the point. A large part of Carillion's problems was due to mis-priced construction contracts under PFI in an increasingly competitive market with fewer deals available, as the model has been used less extensively.

The structure of PFI is that government awards a long term fixed price contract to a PFI company to deliver and operate an asset and service. The risk is fully transferred to the private sector as they are the most qualified to price and take the risk. In turn, the PFI has financed itself with relatively high cost finance to be able to absorb this risk and puts in place sub-contracts to pass the bulk of the risk to underlying contractors.

The PFI approach therefore assumes that the private sector has the expertise to accurately price construction risks and by inference that PFI projects inherently can be accurately priced. It encourages contractors to take as much risk as possible to win deals and the PFI companies to use the most aggressive capital structures to reduce costs, which are inflexible and highly geared.

The model absolutely can work, as the success of the PFI programme has proven. But what we have also seen is contractor margins have been progressively falling, the level of risk accepted increasing and large mis-priced contracts have materially impacted contractors. We have seen as a result the demise of both Jarvis and Carillion, Laing exiting the contracting market, and Balfour Beatty sustaining losses.

The number of contractors able and willing to underpin the high risk transfer required under traditional PFIs has diminished; particularly UK contractors. This high risk transfer model no longer seems sustainable if it were to be used widely as it has been in the last two decades.

To give another example where risk transfer is too onerous, in rail franchising, franchises are awarded to the lowest cost bidder (or the one with the highest purchase price where the franchise is revenue earning). The most attractive bidder will be the one with the thinnest equity that takes the greatest risk on future revenue. But pursuing that high risk transfer model has led to an increased number of franchises getting into trouble. Does this demonstrate private sector incompetence or is government simply clinging to a model that encourages high risk taking with low equity, increasing the probability of default? The answer seems self-evident.

Government needs to think about how it procures assets and services and question whether models that have very high risk transfer and where lowest cost trumps all other criteria in bid evaluation, may not be a sustainable approach, nor in their long-term best interest.

Models that share the risk, allow a cost of capital closer to government's and have governance aligned to public sector values would be a far more sustainable outcome for much of infrastructure procurement.

This should impact both how government designs competitions for future infrastructure – is maximising fixed price risk transfer the best approach? – and also the evaluation criteria it uses to choose its partners. Rather than simply lowest cost trumps all, criteria could give equal weight to governance and structures that suggest performance will be sustained, such as financial flexibility, commitment to long term ownership, ability to work with government, representation of government and consumers within governance. In essence, criteria designed to ensure not just lowest cost delivery but a long-term partner with an acceptable cost of capital.

11. Using the New Model

The combined approach of a model designed to deliver long-term, lower, less volatile returns, combined with governance that enshrines and builds trust offers radical alternatives to current approaches. It could be adopted in a wide number of sectors such as roads, rail franchising and construction, nuclear, electricity storage and distribution, and could be rolled out more widely at the local authority level, and in health and accommodation sectors.

In many infrastructure sectors, the current approach does not seem sustainable; short-termism from the private sector does not sit well with long term infrastructure investment in public assets, the public sentiment is against private ownership, the level of risk transfer under PPPs is too great, and the cost of capital is too high relative to public sector alternatives. But a switch to public sector delivery is also undesirable; the capabilities do not exist, the approach would not foster a strong contracting industry, the focus on costs and clarity of objectives would be lost.

The lower cost model and revised governance described in this paper offers an alternative approach.

For existing infrastructure companies and utilities that already have lower costs of capital, their focus should now be on governance; what should they do to demonstrate their long-term commitment to infrastructure and customers, to align incentives and build public trust in private delivery?

For new infrastructure, the new model could be applied in a number of sectors. For instance:

- New nuclear – rather than the high risk transfer/high cost of capital required to deliver Hinkley, a RAB-based approach could reduce the cost risk transfer to the new entity and importantly its underlying contractors, and reduce its cost of capital substantially, materially reducing the electricity price required to make it economic. Governance should ensure refinancings are kept within the company to lower prices and retain flexibility. The RAB approach with charges going to end users, could still deliver an off-balance sheet treatment for government.

- Regional roads – there is a disparity between the maintenance regimes of Highways England and regional roads, with budget constraints materially impacting the latter. Could the two be brought together in regional trusts and funded to ensure consistent quality? Governance could be more regional and focus on the links and access necessary to help regional growth and address issues at the local level.

- Road maintenance - Could existing road maintenance contracts be on a longer term, more trusted basis, with joint ownership, allowing certainty of revenues, investment and training, with a commitment to shared working practices to deliver cost efficiencies?

- Rail franchises – the current system of short term franchises with high levels of revenue risk transfer does not seem sustainable. Could long term franchise companies be established with a governance committed to growth in passengers and service quality? What would be the impact on employees who wouldn't be changing employer every few years; what would it mean for training, allegiance and career progression? Governance could focus on obtaining the lowest possible price consistent with low levels of return but evaluate other key measures of customer satisfaction, with management paid on a long-term basis aligned to those objectives. The sector could be self or soft-regulated rather than using contractual risk transfers that currently are not effective.

- Rail restructuring – there have been several recent reviews of Network Rail calling for regional vertical franchises; but on what basis? High risk transfer and short-to-medium term concessions may not be consistent with the risk appetite and strength of the contracting industry. Would it be better to have lower risk companies with a governance aligned to developing the interests of the railway? Companies that will invest long term and not profit maximise short term? Where they can and will accommodate change and work with other parts of the industry for a better collective output, not look to maximise or protect its position according to a complex web of interacting contracts?

- HS2 – if this is to be sold post construction of phase 1, could it be owned by a utility with long-term governance in place, that will keep a prudent capital structure in preparation for investment in the next phase, and governance focused on working with franchises and Network Rail?

- Regional PPPs – could this new model be used regionally for accommodation, health and local authority projects, rather than using PF2 or public procurement? An approach that aligns with the aims and make-up of Local Enterprise Partnerships?

12. Rethinking Balance Sheet Treatment

The historic focus by Government on achieving 'off balance sheet' deals as a prime driver for advocating private ownership has been a major contributor to the use of the high risk transfer and contractually rigid approach of the PFI market, with a high cost of finance as a consequence.

On the one hand, if balance sheet treatment were a secondary consideration, it could allow a more collaborative, low-cost model to evolve, getting the best from both sectors.

On the other hand, as recent deals have proved, the long-term model described in this and TIF's earlier paper can be off balance sheet for the right deals, so would be attractive to those that still prioritise balance sheet treatment. The public sector can enjoy low-cost private ownership, which if combined with long-term public-ethos governance, offers an attractive alternative to public sector ownership.

The historic focus on PFIs in the UK has been as much driven by their ability to get the investment off Government's balance sheet as by any belief in optimal risk transfer and private sector delivery. The so-called 'additionality' meant that it allowed deals to proceed which Departments would not otherwise have been able to afford.

But this has forced private sector procurement down a particular path to pass the high bar of off balance sheet treatment, with high levels of risk transfer covering construction and operation under fixed priced 30-year contracts. The private sector has had to finance itself with relatively high cost of capital to absorb that risk, and financiers have passed key risks to their contractors, who have sometimes struggled to deliver.

Just because one can transfer such risks, does not mean one should. The approach has led to many of the difficulties described earlier in this paper.

If balance sheet were not a prime driver, it would more readily allow consideration of when private sector ownership is attractive because of their delivery skills, focus, detailed due diligence and costing, cost controls, lack of annual funding constraints and clarity of purpose. If these disciplines could be introduced at a cost of capital not much above Government's, combined with attractive governance, then this premium could be worth paying even if the assets were on balance sheet. It would make it clear that the option to use private ownership is being considered because of its efficiency, not its balance sheet treatment.

If balance sheet treatment were secondary, the low-cost model could be considered as an option even for projects where a Department has the budget available to finance them on balance sheet and where the model would not achieve off balance sheet classification, because government, not consumers, is paying directly for the project.

But at the same time, being pragmatic, this 'additionality' of off balance sheet treatment is still a key consideration for Government and where it could be satisfied could lead to more deals

being undertaken. So, if the new model can achieve off balance sheet treatment, then that is a bonus.

The Thames Tideway model did achieve an off balance sheet status. This was for a variety of complex inter-related reasons, first amongst which was that a degree of cost risk could be absorbed by the project company (whose cost of finance was therefore lower), by adding it to a Regulated Asset Base on which a return will be paid by customers (not Government). So, where a new deal can be structured where consumers, not government, partly absorb risk, deals may be capable of being classified as off balance sheet, as the risk is more evenly shared by parties other than Government.

In addition, the use of TrustCo or similar institutionalised public ethos governance actually increases the likelihood of an off balance sheet treatment. This is because if such governance could reduce Government's direct control (e.g. less onerous contracts, less intrusive, high level regulation, or no need for golden shares) then the assets are more likely to be deemed as separate from Government.

It is not hypocritical on the one hand to strongly recommend that balance sheet treatment is a poor reason to advocate a particular procurement route, but on the other to recognise that the model described here may still be capable of satisfying that condition, appeasing those who still think it important.

In conclusion, there is an opportunity to overhaul the relationship between the public sector and private sector. The public sector needs to consider how to get the best from the private sector, developing long-term, more trusted relationships. In turn, the private sector has the opportunity to radically change the way it behaves and is seen to behave, with a stronger more trusted, less regulated relationship with government. It needs to take the initiative to demonstrate how both sides can benefit from a longer-term, more trusted working relationship. The breakdown in trust and confidence in private ownership is widespread; it needs to be addressed now.

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Paul specialises in large, complex transactions and advises both the public and private sectors, focusing on finding models of how business and government can work better together. His current projects include advising the Department for Transport on IEP trains, Highways England on the new Lower Thames Crossing, and the Civil Aviation Authority on the financing of Runway 3.