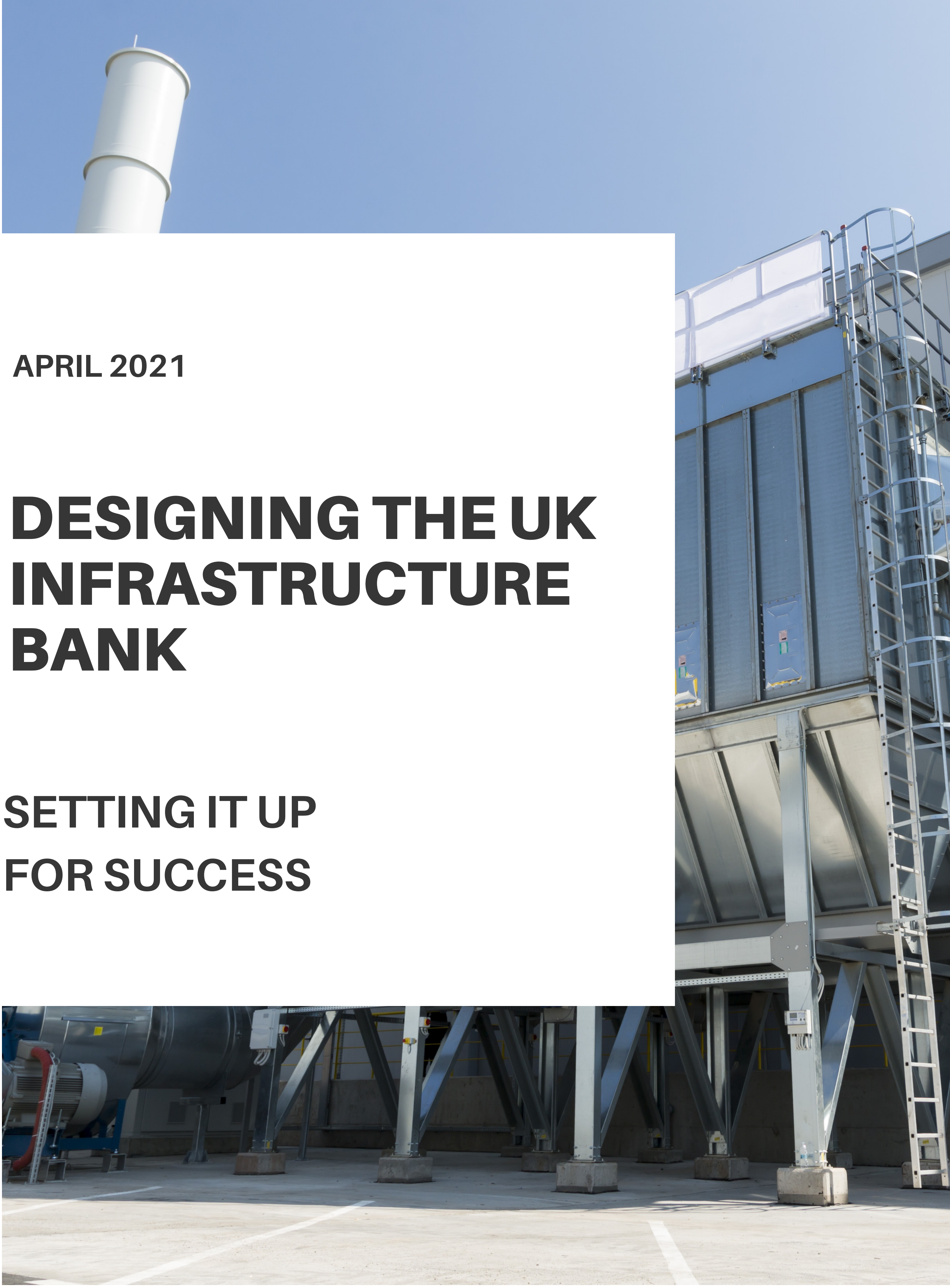

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DESIGNING THE UK INFRASTRUCTURE BANK

SETTING IT UP FOR SUCCESS

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Author biography

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Charlotte joined Flint Global in October 2019 and advises infrastructure companies and investors on policy, political and regulatory risks. She has worked across the infrastructure and energy sectors, with a particular focus on developing financing models and regulatory approaches to private investment. Charlotte was previously Policy Director at The Infrastructure Forum where she led work on the future of the European Investment Bank and the UK's infrastructure finance framework.

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Introduction

Several years of debate ensued after the UK's decision to leave the EU on whether a direct replacement for European Investment Bank (EIB) lending was necessary. In Autumn 2020, the Government finally brought the debate to an end, announcing the creation of a UK Infrastructure Bank (UKIB). But Government does not intend the Bank as a direct replacement for EIB lending to the UK which peaked in 2016 at approximately €7 billion. Following a series of consultations, including the Infrastructure Finance Review, Government believes private capital can fill much of the gap left by the EIB.

Instead, the UKIB will focus on developing new markets and technologies central to realising Government's two core political priorities – supporting the climate change agenda and promoting regional and local growth to level up the country. Government has doubled down on these priorities as part of its plan for a green industrial revolution to support the economic recovery from COVID-19. The Bank will be essential to unlocking the investment in infrastructure necessary to get the economy back on its feet and meet the Government's ambitious net zero by 2050 target.

The Committee for Climate Change estimates that annual capital spending to reach net zero alone will peak at £50bn a year by 2030. As set out in the National Infrastructure Strategy, Government expects private capital to contribute potentially as much as half of the total investment required. Moreover, if this investment is also to deliver social value, both the Cabinet Office's Procurement Green Paper and ongoing revisions to the Green Book make plain that this is unlikely to be achieved with the lowest cost options. A new approach to infrastructure investment will need to recognise that value is not solely defined by economic factors, justifying increased spending.

Not only is the scale of investment unprecedented, but the market will need to operate at extraordinary speed to deliver on this level of ambition. Despite the political and regulatory uncertainty experienced in recent years, the UK infrastructure market has remained highly liquid. However, there are significant barriers to private investment in some sectors, particularly due to the construction and demand risks inherent to new technologies and major projects. To move at speed, capital would need to take greater risk, often in nascent markets, where the policy remains uncertain. Projects with such risk profiles are often not compatible with the investment mandates of private investors, or certainly not at a cost of capital that would be value for money.

Government therefore has an essential role to play in removing specific obstacles to investment and aligning policy and regulation to accelerate progress, successfully finance projects and help to bring down the cost of private capital. As many of the interventions required to reach net zero directly impact on peoples' lives, work must start now to allow the time to secure public buy in and the behaviour changes necessary to deliver on Government's objectives. The creation of the UKIB presents an opportunity for infrastructure investors to deploy capital alongside UKIB support in a way that better fits their investment mandates.

But the creation of the Bank will not in itself resolve these challenges. At a time of considerable fiscal strain, the Government and industry cannot afford for the Bank to become a blunt instrument. Government will need to carefully think through the design of the Bank and how it should be operationalised in order for it to make a real impact.

This paper considers several of the key questions that will be core to designing the Bank to be successful in supporting the UK infrastructure market:

- What should be the scope of the UK Infrastructure Bank?
- How should the UKIB balance its commercial and policy priorities?
- How should the Bank use the tools at its disposal most effectively?
- How will the Bank decide in which projects to invest?
- What role could the UKIB have in shaping infrastructure finance frameworks?
- How could the Bank be governed to set it up for success?

The Chancellor provided some further details on the design of the UKIB in the Spring Budget 2021. We know, for example, that it will be based in Leeds, and we have a timetable for more information, but we are still light on specifics.

According to the announced timetable, in Spring 2021, Treasury will publish a Framework Document setting out operational detail for the UKIB and a set of investment principles that will guide the projects in which it invests. Clearly, there is much detail still to be decided on how the UKIB will interact with the infrastructure market even in its interim form. It will be important for Treasury to consider these key questions as part of this work and as the Bank grows and evolves.

By Spring 2024, Government will review the Bank's progress and performance to ensure it has sufficient capital to deliver its ambitions. At this point, Government envisages that the Bank will be established in statute, have closed a number of investments and developed a strong pipeline of future projects. Ahead of this, the Bank will need to prove its effectiveness to secure its future.

What should be the scope of the UKIB?

Treasury outlined at the Spring Budget that the Bank will have a total potential capitalisation of £22 billion. It will raise £12 billion equity in part through £5 billion direct funding from Treasury and also have the ability to raise up to £7 billion from the Debt Management Office (DMO) or private markets, depending on which proves best value for money, at a rate of £1.5 billion a year. This approach, similar to that used by the EIB, will afford the Bank greater independence and make sustainable operations a prerequisite for it to be able to secure a credit rating to raise operational capital.

The Bank will also have a £10 billion guarantee facility, but it will not be able to issue more than £2.5 billion in guarantees each year. This is a considerable scaling back of the UK Guarantee Scheme (UKGS), for which the UKIB will take on full responsibility from the IPA, given that that scheme's current capacity amounts to £40 billion of which only some £2 billion has been utilised in total. At first it might seem unnecessary for the UKIB to have a larger guarantee facility when it has previously been underutilised. But if the UKIB is to be front-footed in identifying projects to support and unlock the scale of investment required, it will likely need access to a much larger guarantee facility to prove effective in the market. Although there should be some competition for the Bank's resources to ensure the best projects rise to the top, its resources should not be so scarce that projects are discouraged from engaging on the basis that support is a distant dream.

Overall, compared to other major schemes available to support infrastructure investment in the UK and international counterparts, the capitalisation of the UKIB is modest.

Once fully operational, the Bank will have two operational arms – public and private. The private arm will have a mandate to provide loans and make investments that deliver on the Bank's central objectives, provide a financial return, and offer good value for the taxpayer. The public arm will provide finance to local authorities for high value and complex projects, as well as act as a convenor for collaborative projects across regions. The main difference is that local authorities, unlike private developers, will not have to prove their own profitability to raise finance but the project itself will have to be able to provide a return on investment. Government is yet to decide how closely the two arms of the Bank will operate.

Supporting local authority infrastructure projects will be a key priority – £4 billion of the Bank's £12 billion equity will be allocated for local authority finance. Until the Bank is put on a statutory footing, the Bank will act as a proxy for DMO lending to local authorities at a reduced rate of gilts +60 bps for high value and strategic projects of at least £5 million. This represents a considerable increase in the expectations on local authorities to drive infrastructure investment.

However, Government will need to be consider how the UKIB, local authorities and private investors could work together to finance projects. For many local authorities, COVID-19 has compounded financial pressures. This might mean that a project solely sponsored by a local authority is ineligible for UKIB support if the local authority is unable to prove it can provide a return on finance. It will therefore be critical for Government to guard against a quarter of the Bank's equity resource lying dormant by thinking creatively about how local authority projects could be viably financed in partnership with the private sector. By closely coordinating the operation of its private and public arms, the Bank could help to structure finance for local authority projects that might otherwise never go ahead. The Bank's advisory function could add particular value by helping local authorities understand what drives investors and developers in order to meet local infrastructure objectives.

How should the UKIB balance its commercial and policy priorities?

Central to the UKIB's success will be achieving the right balance of risk in its investments. Government intends the Bank to be a commercial institution able to bridge gaps in the market where the private sector is unable to take the risk. Unlike the Canada Infrastructure Bank, which has come under public and political scrutiny for running up considerable losses, the UKIB is not intended to be loss-making. It should only intervene where there is market failure. Equally, the UKIB should not finance projects that the private sector could finance alone, simply to secure a return. The Bank will need to balance carefully the higher risks associated with supporting new sectors and technologies where the potential for default is higher, while making sure it does not back a succession of loss-making projects.

The level of risk that the Bank will be able to take on when investing in projects is yet to be decided by Treasury. To be successful at crowding in capital, the Bank will have to take on risk that the private sector cannot. This presupposes its investments will have a higher risk profile, such as equity stakes in nascent technologies, guaranteeing construction risk or providing subordinated debt. But if the Bank is to perform commercially, it will need to manage its risk exposure. The Bank should though be flexible in how it evaluates risk. New technologies and major projects in particular are likely to present new risks which the market may not have previously priced. The Bank will need to have a deep understanding of the risk profile of the investments it makes in order to provide finance where private markets cannot, whilst remaining within the bounds of a commercially viable investment mandate.

Getting the balance of risk right will enable the Bank to grow sustainably over time and prevent it from artificially supporting projects and, more broadly, markets that are not viable long-term. This has been a cornerstone of the EIB's successful expansion over the years. Government will set a target for returns on the Bank's activity which should provide a check on its mandate to deliver policy and political objectives. Introducing a cap on the

UKIB’s total investment in projects could further help to reduce the risk that the Bank crowds out private markets. For instance, the EIB prior to the pandemic had a 50% cap on the finance it could provide to any project.

If the Bank is to invest capital early on to support the development of technologies and sectors, it will be particularly important to ensure there is a reasonable prospect of realising a return. It may prove difficult to provide development capital on a commercial basis without the Bank being perceived to be picking ‘winners’ or presupposing that further financial support would be forthcoming to get these projects off the ground. The Bank will need to carefully consider where it is appropriate to intervene in early stage development, versus where Government grants, coordinated with the relevant department, might be more suitable.

Treasury has also proposed that the Bank will be able to recycle its investments and retain any returns it makes. If the Bank is successful, this will enable it to expand its resources gradually over time. Capital recycling has been undertaken with some success in Australia, for example. With a deep understanding of how different types of capital operate in the infrastructure market, the Bank could bridge the gap between private equity investment in early stage technologies and infrastructure investors supporting more established asset classes to help roll out new technologies at scale.

A key question for the Bank will be over what period it provides support to projects based on when its interventions offer the greatest additionality. For example, financing could be structured such that UKIB support drops away after construction is complete. This would allow the Bank to reinvest capital elsewhere in the market and for private investors, often better placed to manage assets to increase their investments once the risk has been reduced. At the same time, the Bank will need strong asset management capabilities if it is to be seen as a worthwhile partner for private investors.

Structuring the Bank commercially has the added benefit of helping it to remain compliant with state aid rules. Under the UK’s new state aid regime, it is unclear whether the Bank will entirely avoid state aid in the same way as EIB lending. This will depend on the design of the UK state aid regime, the structure of the Bank and the terms on which it lends.

Treasury has already suggested that the Bank's pricing will reflect the level of risk to ensure the Bank is compliant with international obligations on subsidy control. But it remains to be seen how the Bank will take on risk that the private sector is unable to manage at potentially a lower cost of capital.

How should the Bank use the tools at its disposal most effectively?

Until it is put on a statutory footing, the Bank will operate under the powers set out in the Infrastructure Financial Assistance Act 2012, the Banking Act 2009 and the National Loans Act 1968. These give the Bank a range of tools to support private sector and local authority investment in infrastructure, including:

- Senior debt
- Hybrid products (e.g. first-loss and mezzanine debt)
- Equity – in the form of direct and co-investment funds
- Guarantees.

Treasury is also considering how the Bank might develop a Credit Enhancement Scheme similar to that operated by the EIB.

The Bank will need to have the expertise and independence to deploy these tools appropriately to each technology and sector in a way that has the greatest impact. A one size fits all approach by the Bank will not unlock private investment at the speed and scale needed to the deliver on the Government's infrastructure ambitions. There are important lessons from previous cases, such as PFI, where finance structures applied at scale may not have always delivered value for money. The Bank will also face new challenges in financing projects, in particular on managing equity stakes where construction risk on major projects, such as nuclear, will be significant.

Some of the Bank's powers have been used previously by Treasury and the IPA to support infrastructure projects. However, the UKIB would benefit from carefully evaluating where these powers may not have previously been harnessed effectively to have the greatest impact on unlocking investment.

A prime example is the £40 billion UKGS for which the UKIB will take on full responsibility from the IPA. In the 8 years it has been operational, the Scheme has only issued £2 billion in guarantees. This in part has been due to the commercial implications of the guarantee for project developers, as well as the extensive due diligence process involved. Particularly for innovative and smaller companies at the forefront of new technologies, the UKIB will need to make the UKGS more accessible and cost effective for it to be an effective tool.

Similarly, the UK Government has somewhat limited experience in managing equity stakes in projects and companies. The Government rarely takes on equity stakes and when it does, it is often in extreme circumstances, for example in the case of Royal Bank of Scotland and OneWeb. UK Government Investments (UKGI) currently manages the Government's existing equity stakes and provides advice to Treasury and other parts of Government on commercial negotiations. Whilst the capability and commercial expertise of UKGI is strong, if the UKIB is to be more proactive in taking equity stakes and managing these to drive successful project delivery, it will need to expand this capability.

As nascent markets potentially expand rapidly, it will also be important for the Bank to update which tools it deploys and at what scale to have the greatest impact. Doing so will help to ensure the Bank does not crowd out private investment once the risk profile of new markets decreases. Maintaining good relationships with investors and developers post-financing will allow the Bank to gather valuable insight on its effectiveness and additionality. Likewise, it could be beneficial for the Bank to engage with early-stage technologies, for example nuclear SMRs and AMRs, to understand what kind of financing support may be needed in future. This will help to develop the project pipeline.

How will the Bank decide in which projects to invest?

The Bank's operations and investment decisions will be guided by six operational principles:

- Achieving policy objectives through sound banking
- Partnership
- Additionality
- Operational independence
- Impact and credibility
- Flexibility

As previously outlined, Treasury's forthcoming framework document will be a key next step in shaping the decision-making framework the Bank will use for assessing projects. A more granular decision-making framework will be crucial to ensuring the Bank's mandate is turned into supportive activities. The Labour Party has raised concerns that the Bank does not have a specific mandate for delivering net zero. This could though be assured through the Bank's decision-making framework by specifying net zero as a key priority.

How the Bank defines and identifies market failure will be central to whether it proves successful in expanding and accelerating the pipeline of projects. Treasury has indicated that the National Infrastructure Commission (NIC) will have a role in advising the UKIB which sectors and technologies – such as sustainable fuels, CCUS and heat efficiency – would benefit from support. This could give the NIC greater teeth than it has previously had to direct UKIB investment towards areas that support its recommendations.

In addition, the Bank will have an advisory function to bring together public and private sectors to structure deals. Offering financial support alone, no matter in what form, will not though be sufficient to bridge the financing gaps in new markets and technologies. The Bank could provide a leadership role in bringing the increasingly complex and interconnected web of stakeholders in infrastructure together to accelerate progress on the climate and regional growth agendas.

To do this effectively, it will be important for the Bank to make clear at what stage of development it wants to engage with projects. If the Bank is to be more front-footed in seeking out investment opportunities than Treasury and the IPA have been before, it will need to invite projects to come forward earlier in development. Early engagement with projects will also be crucial for the Bank to be meaningfully involved in discussions on structuring project finance to deploy its resources with the greatest additionality. Transparency on how projects engage with the Bank will be essential to avoid its investment decisions being perceived as politically driven.

What role could the UKIB have in shaping infrastructure finance frameworks?

To be successful the Bank is likely to need to take on a broader role in shaping the infrastructure finance market. In particular, the current lack of clear financing framework in the UK will present a major barrier to investment for both the private sector and the UKIB. Save for a few exceptions, such as the Contracts for Difference support mechanism for some renewable technologies, most sectors do not yet have a viable public-private financing model. This has been compounded by the impact of COVID-19 which has upended revenue streams for demand-based investments, for example in the rail sector.

Without developing sustainable, long-term revenue streams and managing risk exposure, private capital would be unable to bring forward the significant investment required in infrastructure. Equally, the UKIB's own investments would struggle to realise a return. This could risk the Bank becoming a vehicle for Government handouts.

Despite its small initial scale, the UKIB could have an impact far beyond its size by supporting and coordinating work underway across Government to develop commercial models for new markets. This will be the first, essential step to structuring finance for projects and unlocking private capital.

As markets develop, the Bank could also have a valuable role to play in supporting the evolution of financing models to ensure they deliver value for money. To fulfil this role, the Bank would have to work closely with the Treasury its sponsor department, as well as other departments, for example BEIS and DCMS which are leading thinking on how to finance CCUS and full-fibre.

At present, Treasury has not made clear how the Bank's mandate to work with other Departments, Government bodies and organisations such as Homes England and the Scottish National Investment Bank will operate in practice. It is important that the

Framework Document does so to avoid the risk of the work of the UKIB and others across Government not being joined up. This is a critical issue to address before the Bank undertakes its first investments which are expected to be in crosscutting sectors such as CCUS, sustainable fuels and heat efficiency.

How could the Bank be governed to set it up for success?

The UKIB will be owned by the Government and ultimately operate as a separate institutional unit at arm's length and with a high degree of operational independence. Treasury will be the sponsoring department and so will retain oversight of the UKIB's activities, as it has done with the NIC and IPA. However, much of the detail on how the Bank will be governed is still being decided.

A key question that will shape the Bank's focus and activity will be the balance between commercial and policy staff, particularly at senior levels within the Bank. Treasury is recruiting the Bank's Chair and the senior executive are in the process of being appointed. It is not though clear how active a role Treasury will play in the Bank's operation, for example whether a representative would have a seat on the Board. The composition of the Board and senior leadership team are likely to be influential in determining the degree of independence the Bank has in reality and how it balances its commercial and policy priorities.

A robust Investment Committee will also be central to upholding confidence in the Bank's investment decisions and help to reduce the likelihood of decisions being politically motivated. The EIB is well regarded for having a strong Investment Committee which relies on extensive due diligence processes to inform its decisions. Not only does this result in an exceptionally low default rate on EIB lending – in 2019 the EIB had written off just 0.02% of all loans granted since its launch – but its due diligence process reassures private investors to crowd in capital. Establishing a transparent process for reaching Final Investment Decision would help the UKIB to maintain trust in its operations and mandate.

Equally, the Bank should take care not to over burden developers and investors through the due diligence process such that seeking support from the UKIB becomes commercially unattractive.

To guard against concerns that the UKIB will follow in the Green Investment Bank's footsteps, sold just 5 years after it was set up to the private sector, Government is clear that the Bank will remain permanently in the public sector. This goes a long way to bolstering industry confidence that the Bank will be available to provide support long-term. But such certainty must be carried through in how the Bank operates day-to-day. If the Bank's remit, scope or tools are subject to frequent change or external influence, this will undermine the Bank's ability to grow the pipeline and crowd in private capital. The Bank will need to be a stable presence in the market, whilst at the same time responding flexibly as markets evolve.

Having sufficient autonomy from the temporal nature of political decision making and influence will be crucial to the success of the UKIB. Although the Treasury has made clear it will retain ownership of the UKIB, this need not extend to direct oversight of the Bank's day-to-day operations. The European Investment Bank has demonstrated that an institution with greater independence can make commercially sound investment decisions yet still support long-term strategic priorities, such as decarbonisation. The Bank of England (BoE) could also offer a possible model. It is owned by the UK Government but its operational independence is enshrined in law. Specifically, Government sets the BoE's strategic priorities whilst the BoE determines how it meets these and is accountable to the UK Parliament and public, most notably through the House of Commons Treasury Committee. The UKIB could follow a similar trajectory to ensure its increasing independence does not lead it astray from effectively delivering on its objectives.

Whilst guidance from Treasury will be necessary in the early stages of the Bank's operation, Treasury should aim to increase the independence of the UKIB gradually as it matures and expands. A combination of clear strategic principles guiding the Bank's decisions, coupled with effective accountability mechanisms both internally through its Investment Committee and externally to Parliament, will support the UKIB's effective operation as it obtains greater independence. Doing so will best prepare the UKIB for statutory independence when Treasury reviews its remit in Spring 2024.

At an institutional level, the creation of the UKIB will likely change the governance structures which shape UK infrastructure policy and delivery. Both the NIC and the IPA will be core partners to realising the UKIB's objectives. The NIC will help the Bank to identify what sectors and technologies could benefit from financial support. This could expand and strengthen the NIC's remit quite considerably beyond making policy recommendations to Government. Meanwhile, the IPA will continue to focus on the successful delivery of infrastructure projects, whilst the UKIB will likely take on greater responsibility for infrastructure financing, including the full UKGS.

Overall, Treasury's approach points to a triangulation of UK infrastructure policy development around the UKIB, NIC and IPA. It will aim to align the NIC's long-term view on the UK's infrastructure needs, the UKIB's financial support to unlock investment and the IPA's guidance to ensure successful project delivery. This is an extension of Government's work to strengthen the 'golden thread' that runs through policy making, public procurement and project delivery to realise its objectives to level up the UK and reach net zero by 2050. In this way, the UKIB, if designed well, could realise Government's infrastructure ambitions in a way that even the EIB could not. If public funds alone could have realised these objectives, the Bank would have been surplus to requirements.

What Government lacked was a way to overcome the risks of new technologies to unlock private investment in specific areas of the market.

Longer term, it will be important to consider how the influence of these institutions evolves over time, particularly given both the NIC and IPA are executive agencies of Treasury. As the UKIB is put on a statutory footing, this could significantly shift the dynamics between the three.

Finally, despite Government expecting regulated infrastructure to deliver a significant proportion of the investment required to meet net zero by 2050, detail on how the Bank will interact with regulators was notable by its omission from Treasury's document. Previously, the EIB helped to unlock private capital in major utility projects, such as the Thames Tideway Tunnel. If the UKIB is to fully realise its two core objectives – to support the climate agenda and regional and local growth – collaborating with economic regulators should be central to its operations.

Given the technological and demand uncertainties faced in regulated sectors, the Bank could take some of the risk that might otherwise be passed through to consumers. Particularly where there are clear market failures, taking some risk off the private sector could help to accelerate investment decisions and reduce the cost of capital.

Conclusion

The creation of the UKIB offers an unprecedented opportunity to unlock significant private capital for investment in infrastructure. The UK has long been a global leader on infrastructure investment. The Bank could be the next step in evolving the UK’s approach to financing infrastructure so that Government can successfully deliver on its ambitious targets on climate and regional growth. But for it to fulfil this role, Treasury will need to carefully calibrate the Bank’s design and resolve the tensions inherent to a Government-owned Bank operating commercially.

Resolving these questions would help to set the UKIB up for success. However, as the Bank interacts with the market, it will raise questions in itself which will determine whether it proves effective in the long term. The Bank will need to draw on the expertise and experience of industry, as well as public sector stakeholders such as local authorities, the NIC, IPA and economic regulators to help it answer these questions. A collaborative approach both to the design of the Bank and how it deploys its resources will stand the best chance of maximising its impact to support the UK infrastructure market in overcoming the vast challenges ahead.

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