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The future of infrastructure finance: what is the role of private investment? – ICE Presidential Roundtable Summary

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Background

Governments worldwide are grappling with similar challenges: growing and decarbonising their economies, adapting to climate change, and meeting the increasingly complex needs of communities.

Addressing these challenges requires sustainable, resilient infrastructure systems. Simply 'building more' isn't enough. Ecosystem loss destabilises society, the environment, and the economy, and demands a more nature-positive approach to infrastructure planning.

All this requires investment, much of which will come from private sources. Governments know this, and the global market is becoming increasingly competitive. Policy initiatives such as the US Inflation Reduction Act, the European Green Deal, and the UK Infrastructure Bank aim to crowd in private finance for new, green infrastructure.

This presidential roundtable explored the role private capital can play in delivering governments' infrastructure objectives. Infrastructure professionals from the UK and around the world discussed the scale of the challenge, the mechanisms and options that exist, and what it will take for the private sector to change its risk appetite.

Recap: The National Infrastructure Commission (NIC) projects that the UK will need to increase its infrastructure spending over the next decade from around £55 billion to between £70 and 80 billion per year. Globally, there's a projected $15 trillion gap in infrastructure investment.

In 2021, the Conservative government set up the UK Infrastructure Bank (UKIB) to replace the UK's membership of the European Investment Bank. The UKIB's purpose is to deploy public funds and crowd in private investment to help meet the government's net zero and levelling up objectives.

The new Labour government wants to make the UK "the green finance capital of the world". A new National Wealth Fund will, via the UKIB, invest £7.3 billion in key infrastructure and clean energy projects, with the aim of attracting an additional £21.9 billion in private funding.

Key discussion points

- The 'overwhelming demand' for new infrastructure in the UK, driven by its legally binding net zero target.
- The constraints on government investment and why it needs to be ruthless about prioritisation.
- Why the private sector sees UK infrastructure as a high-risk investment, and how to mitigate this.
- Alternative sources of private investment and lessons from around the world.
- Changing the narrative to one that is more confident, collaborative, and open to failure.

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The UK's infrastructure gap

In the UK, there is 'overwhelming demand' for new and better infrastructure in all sectors, including transport, water, and energy. The maintenance of existing assets has also been neglected for too long.

The government's investment capacity is constrained. This is due in part to external factors, such as inflation. But the previous and current governments' self-imposed fiscal rules further limit the UK's investment potential.

This places an even greater responsibility on the private sector. But there are self-imposed constraints here too. The private sector's risk appetite and return expectations are not currently flexible enough to accommodate the UK's needs.

The UK's low levels of investment are not connected to any single political party or government. Under-investment has been a long-term systemic challenge.

The net zero challenge

This investment shortfall will become more acute as the 2050 net zero target draws nearer. Net zero is becoming the main driver of infrastructure planning and investment in the UK. Unlike the government's other long-term objectives, the 2050 target is legally binding. Achieving it means the UK must do something it's never done before: build a low-carbon economy while decommissioning a high-carbon one.

Deploying new technologies at scale will carry a huge cost. Governments needed to get the ball rolling, and that has been the case in the UK. Various governments have designed the strategies, milestones, business models, and frameworks needed to deliver the transition.

To date, they have also borne most of the risk. While the private sector has done much of the financial heavy lifting, it hasn't taken on much of the risk. But the government's fiscal constraints mean its capacity for risk is finite.

Resolving this dilemma will require changes in mindset and approach.

Being ruthless about prioritisation

The UK's infrastructure needs are considerable. The government can be more efficient in delivering projects to maximise the benefits of investment. However, it can't deliver every proposed project, and will need to be ruthless in its prioritisation.

The ICE's Enabling Better Infrastructure programme has been helping governments strategically plan and prioritise infrastructure. It has worked with the New Zealand Infrastructure Commission (NZIC) to developing the framework for a new Infrastructure Priorities Programme: an independent review, led by the NZIC, to assess currently unfunded projects in New Zealand. It will prioritise those that are realistic, good value, and in line with the government's strategic objectives.

The new framework draws on insight from around the world. As the NZIC put it into practice, the UK and other governments will be able to learn from it.

Understanding the cause of risk aversion

There is a gulf between major infrastructure risk management and private sector risk appetite. Some UK projects, such as the Thames Tideway, have bridged that gap by using government guarantees to remove major risks from the equation.

But infrastructure delivery risk is much higher in the UK than in many comparable countries. Research suggests that, while the UK is not a uniquely poor performer, it is among the worst for delivering infrastructure efficiently. If it is too difficult to get projects done in UK, investors will inevitably go elsewhere.

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Risk aversion is also particularly high in the UK. This leads to ‘perverse risk aversion’, whereby the impact of all investors being risk averse is to increase, rather than reduce, the amount of risk (as well costs) in the system.

Reducing risk and uncertainties

This level of risk and uncertainty, which creates the need for government guarantees to deliver projects, needs to fall.

Better infrastructure planning and delivery practices can help:

- First, by reducing risk as far as possible in the planning phase through proper scoping, design, optioneering, etc.
- Second, by recognising the underlying risks of the project (such as demand and usage risks throughout the life of the project) and pricing them appropriately.
- And third, by bundling projects as programmes or portfolios to spread and aggregate the risk.

In the UK, project owners often try to solve the funding issue before solving the design. This can see projects handed early on to special-purpose vehicles led by equity investors who aren’t equipped to develop well-defined projects. Thames Tideway turned that upside-down by considering engineering and sustainability aspects upfront. The project was initially estimated to cost £80 per London household; it is instead being delivered at £20 per household.

Other investment solutions

HM Treasury set up the UKIB with £22 billion in notional capacity, but it also has an economic risk budget that allows for up to £4.5 billion in losses. The Bank was not set up to compete with or crowd out the private sector. It does not create investable propositions. Instead, it looks for problems and risks others will not take on and is completely product-agnostic.

The insurance sector is similarly risk-averse to banks. Changing risk appetite in insurance firms could help unlock greater risk appetite in banks.

There is also little venture philanthropy in the UK to demonstrate and familiarise the market with ‘first-of-a-kind’ transactions, which get the ball rolling by derisking and changing the investment calculus for private capital.

Some countries have explored an Inverted Bid model. Through this, the government decides on the long-term equity ownership model it wants for a piece of infrastructure, determine the internal rate of return that a long-term investor is prepared to sign up to, scope out the project, and then work with the investor to procure and deliver it. This model could increase certainty for both the government and investors. It can cap a private investor’s return if the project’s scope remains fixed, but guarantee a minimum return if the scope grows significantly.

Banks aren’t the only sources of private capital. Pension capital is another potential source in the UK, with the Mansion House Reforms having created an opportunity to unlock investment.

The ICE’s 2018 State of the Nation report explored a range of options, including asset recycling and land value capture.

Changing the narrative

Participants discussed why the UK is more risk-averse than many other countries. In part, attitudes to risk stem from how the media and political environment tend to dwell on failure instead of celebrating successes.

This mindset needs to change. The government has announced plans for a new UK Industrial Strategy. It will inevitably back some failures, which opponents will hold against it for political gain. However, for new initiatives to have staying power, there needs to be room for failure.

Some participants were more optimistic about the risk involved in net zero. Much of the technology required has now been developed. Low-carbon products, such as electric vehicles, are increasingly cheaper than fossil fuel alternatives. And the

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power sector is progressively transitioning to renewable sources and grids that have well-established investment instruments (such as Contracts for Difference and Regulated Asset Bases) and guaranteed uptakes.

The UK also has a lot of advantages for investors, including its net zero law, strong laws and institutions, and global financial capital. But the government also needs to do more to build investor confidence through long-term, stable policy making, aligned with the public balance sheet and the National Wealth Fund.

A more confident, collaborative narrative can help shift banks' risk appetite. But banks need to be challenged more, too. They often base their assessments on inaccurate forward-looking scenarios. Leaders avoid green investment by citing the appetite of their shareholders, or arguing that it is their fiduciary duty to maximise returns. Challenging them to put climate investment resolutions to their shareholders to establish their appetite for risk would potentially give them a mandate for riskier green investments. The FCA requirement for banks to maintain market structural integrity is another long-term lever to unlock green investment.

The link between net zero and the loss of natural capital is also under-emphasised. Nature depletion poses a genuine financial risk. Giving it more attention could help increase the appetite for green investment. Research suggests that the current rate of natural capital depletion could lower GDP by 12% in the 2030s, far above the 5-6% hit during the 2008 global financial crisis and in line with the 11% impact of the Covid-19 pandemic.

Nature depletion is also far more local and tangible than carbon emissions, due, for example, to supply chain impacts that hurt investments. This makes investors far more likely to pay attention and act quickly.

Questions to take away

- How can the government, the industry, and investors work together to reduce the amount of risk and uncertainties in the system?
- What requirements or stipulations for programme management could the Treasury mandate to improve cost controls in delivery?
- What else can institutions such as the UKIB and the ICE do to change the paradigm around risk appetite?
- What alternative sources of private investment exist, and how can the UK best engage them?
- What lessons should the UK be learning from around the world?

Further reading

- ICE: 2018 State of the Nation
- Boston Consulting Group: Reshaping British Infrastructure: Global Lessons to Improve Project Delivery
- Institute for Government / Grant Thornton: Capital spending in public services
- New Zealand Infrastructure Commission: Is local government debt constrained?
- IPPR report on low UK investment: Rock bottom: Low investment in the UK economy

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