National Infrastructure Commission Call for Evidence:

London Evidence

A Response by the Pensions Infrastructure Platform (PiP)

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Executive Summary

The issue of pension funds' investment in infrastructure cannot be looked at in isolation from the wider economy and, specifically, the role of defined benefit (DB) pension provision. Despite the gradual decline of DB pension provision in recent years, over a third of the UK's workforce is still accruing benefits in a DB scheme, with schemes themselves managing over £900bn of assets. It is therefore crucial that employers sponsoring DB schemes can meet their obligations to scheme members without facing undue impact on their ability to invest elsewhere in the economy.

In order to match their long term pension payment obligations, provide security for scheme members and reduce the risk of volatile cash contributions from scheme sponsors, pension schemes need investments that generate long term, consistent, low-risk, inflation-linked cash flow returns. Core infrastructure, including transportation system assets, can be a great source of these long term, low risk cash flows. Unlocking institutional investment into infrastructure on a large scale would also be highly beneficial to the economy.

However, achieving increased investment into infrastructure depends a great deal on the predictability of the returns that will be generated over the longer term. For transport assets, this predictability principally relates to the political and regulatory regimes the assets will be operating under, the level of any subsidies that may be paid and the usage revenues that will be obtainable.

Predictability in these areas is needed from start to finish – from the initial stages of project consideration – to make it worthwhile for pension schemes to incur the bidding and project development costs and to arrange long term funding – right through to operation.

Any reduction in long term predictability, whether real or perceived, increases the overall project risk for an investor, pushes up the level of returns required to reward the taking of that risk and therefore makes projects more expensive.

We believe that the definition of clear long term goals which form the basis for a coherent long term plan is the best way to provide confidence to pension scheme investors, developers and operators. Such a plan should also include transparent and predictable mechanisms for evolution to reflect changes in the external environment and to facilitate responses to unanticipated market or technological developments.

Overview of PiP Response

Introduction

1. The Pensions Infrastructure Platform ("PiP") is the UK infrastructure investment business set up "by pension funds for pension funds". Its objective is to facilitate investment into UK infrastructure projects by UK pension schemes, by developing investment vehicles which meet their needs in terms of structure, returns and cost.

2. PiP was established in 2012 following the signing of a Memorandum of Understanding by the National Association of Pension Funds ("NAPF"), the Pension Protection Fund ("PPF") and HM Treasury. The development was supported by 10 of the UK's largest defined benefit pension schemes.

3. PiP's first investment fund was launched in 2014. It is managed by Dalmore Capital and invests in PPP equity. The second fund invests in small scale (sub 5MW) rooftop solar PV installations. This was launched in February 2015 and is managed by Aviva Investors.

4. PiP has also worked with Dalmore on the successful consortium bid to construct and operate the new Thames Tideway Tunnel (TTT). PiP was instrumental in £370m of equity contribution to the project by UK pension schemes.

5. Since its establishment, PiP has helped secure over £1bn of committed investment into UK infrastructure projects.

6. PiP has recently received FCA authorisation. Future pension scheme investments into infrastructure will be delivered through a regulated investment fund, operated and managed by PiP.

7. Pip will not be commenting on the technical questions posed in the call for evidence. We are not urban planners, we are not transportation specialists nor are we electricity market academics. What we are is a specialist equity and debt financier, working on behalf of UK pension schemes to facilitate, source and manage effective investment by them into UK infrastructure projects. We do this because we believe the stable long term, inflation linked cash flows that can be generated by core UK infrastructure projects is a good match for the long term pension payment liabilities within such schemes. This makes decision making easy for PiP because there is one fundamental criteria above all else that determines whether pension schemes will invest into infrastructure; will the entry price, the risk taken on and the returns to be generated over the full project life improve the ability of pension schemes to pay their members pensions in full when they become due?

   If this criteria is not met, there will be no investment since it would breach the basic fiduciary duty of the Trustees who are responsible for the financial security of the schemes they manage. No amount of political expediency, publicity or perceived "national interest" will overcome this basic requirement to safeguard the retirement provision for UK pension scheme members.

Background

8. When pension schemes assess investment into long term, illiquid assets, such as transport infrastructure, which typically will be bought and held for at least 20-30 years, a key consideration is the stability of the operating regime and therefore the robustness of the long term financial forecasts which need to be made. Political, regulatory, legal and subsidy environments are core parts of this stability assessment.

9. The perceived stability and predictability of the UK are real competitive advantages. Indeed, the reason why the UK has been so successful to date at attracting pension scheme investors into infrastructure projects is because it is viewed as having a very stable political, legal and regulatory environment. It is impossible to look forward to the potential for any future infrastructure investment projects without stating the essential precondition that the Government should NOT enact any retrospective legislation that would subsequently change legal contracts that have been freely entered into. Any such legislation would undermine the stability argument and severely damage long term investor confidence.

10. Where a system of subsidy payments forms a significant part of the operational economics of a project, it is equally important that these are predictable for the long term. This applies through the full project life from the earliest stages of investment appraisal, while funding sources are being secured and after project contracts have been signed.

11. Pension schemes have a fundamental obligation to pay accrued pension benefits to members, usually on a monthly basis. It is therefore vitally important that pension schemes have a reliable stream of income from their investment portfolios to enable them to fund their pension payments. This need for income imposes a finite limit to the proportion of every scheme's investment portfolio that can be invested into non-yielding assets, such as infrastructure projects which do not return any cash to investors during a construction period. In general, the longer the period of no income, the less attractive an asset is for pension schemes to invest in.

    The recent Thames Tideway Tunnel project provides a good example of how multi-year construction projects can be structured to make them attractive to pension scheme investors. Equity investors begin receiving returns on their investment as soon as cash is drawn down to fund construction. The project delivers a yield from day one. To balance risk between investors and users, there are also contractual risk sharing mechanisms to maintain the incentive on the construction team to deliver an operational asset on time and on budget.

12. We now turn to the specific questions posed by the consultation, focusing on those where we disagree with the current proposals.

Response to specific key questions

Question 4: What are the options for the funding, financing and delivery of large-scale transport infrastructure improvements in London, including Crossrail 2?

Funding:

It is important at the outset of any project for there to be clarity over how the new asset is to be funded, both through its construction and its full period of operation.

- Will construction and operation be funded in one single package, as is standard in PPP/PFI projects, or is there separate construction funding followed by distinct operational funding?
- Will the users pay directly, for example through a tolling mechanism, or indirectly via taxes which support government or local authority project funding?
- Will there be any form of ongoing government subsidy for operation of the asset? If so, what mechanism or legal structure will govern the subsidy regime over the full life of the asset?
- Through what mechanisms will returns be generated for investors in the project? How secure and predictable are these return streams?

Financial markets and investors have consistently proven their ability to develop new and innovative forms of funding. This will continue and can be promoted by early definition of key project parameters.

Financing:

UK pension schemes are keen to invest into UK infrastructure projects that can provide long term, low risk, inflation linked cash flow returns. These investments can be into project debt or equity depending on precise risk profiles and return streams.

The 2015 Annual Survey of UK pension schemes by the Pensions and Lifetime Savings Association reveals that, on average, UK defined benefit schemes are only allocating 2.1% of assets to infrastructure. This would rise to 5% or even 10% if UK schemes matched their peers in Canada and Australia. There is a potential investment pool of over £25bn from UK pension schemes for projects structured to meet their needs.

The keys to accessing this pool of potential financing are:

- A clear pipeline of future projects to provide the confidence for pension schemes to develop the internal capabilities and mechanisms to invest in infrastructure.
- Projects structured to reduce overall risk consistent with producing real returns in the 2-5% range.
- Projects structured to minimise any initial periods of zero yield.
- Inflation linked return streams for both debt and equity financing.
- Clarity over the long term regulatory and subsidy regimes within which the asset will have to operate.

Delivery:

Although this call for evidence specifically excludes any consideration of the third runway in the Southeast of England, there are lessons that can be learnt from it for future London transport infrastructure projects:

It is imperative that all potential project participants, can be confident that the critical political decisions will be taken to enable projects to progress. Where timetables are provided they MUST be stuck to.

Major transport projects in London will inevitably affect many individuals and businesses. Some will benefit, some will be disadvantaged. In the age of social media there will also inevitably be pressure groups opposing projects and supporting them.

It will always be easy to delay a decision to allow for more research or consultation. Major projects need courageous decision making to make them happen. If the Government is serious about wanting to attract UK pension fund investment into UK infrastructure (as the Chancellor said in his autumn statement in 2012 and more recently in relation to investment by local authority pension funds) it must be prepared to take bold decisions with a focus on the long term, not short term political expediency.

The funding, financing and construction skills are all available in the UK to deliver major projects. The critical constraint on delivery is political decision making – or the lack of it!

Further Information

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