Better Government Series

Funding UK Infrastructure

Policy Insight

July 2016

Foreword

Infrastructure needs to be a central priority for policymakers given the increased economic uncertainty that has emerged following the decision of the British people to leave the EU.

This assertion may sound surprising, as encouraging infrastructure investment has apparently been a focus of successive governments since the end of the financial crisis. There have been numerous announcements and reforms over that time, all with the aim of facilitating more investment.

In reality though, these reforms have yet to show up in the numbers – investment in infrastructure in the UK is flat or declining, with pre-referendum forecasts reflecting a stalling in infrastructure investment until the end of the decade.

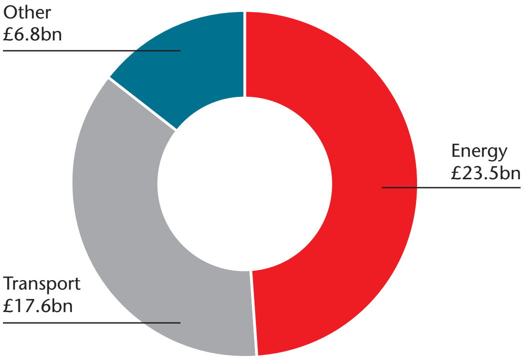
At the same time, efforts to encourage increased investment by the private sector have not been successful. Private finance initiative (PFI) contracts used over the last couple of decades to enable private investment in public infrastructure have ceased to be attractive, albeit perhaps for good reasons. And while generous market incentives did result in a boost to investment in renewable energy, policy changes have since made this area much less attractive for investors.

ICAEW believes that now is the time for new fiscal rules to turn the rhetoric on infrastructure investment into reality.

One major change in fiscal rules has already been made – the abandonment of the target of a balanced budget by the end of decade. There is now the potential to use borrowing to fund an immediate increase in infrastructure investment.

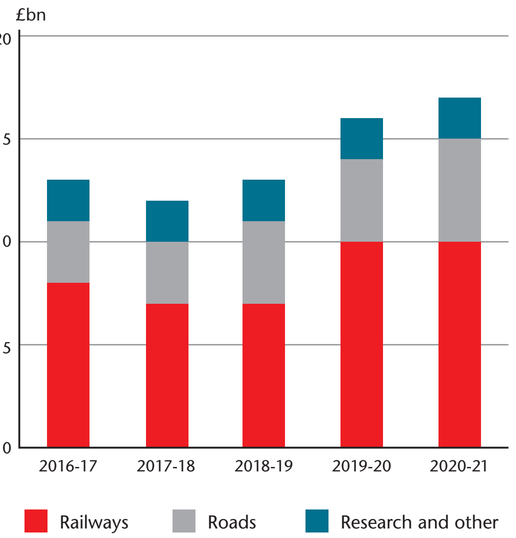
It is also time to look again at the way government measures financial performance and assesses investment decisions. In the medium term this means using Whole of Government Accounts, but in the short term PFI contracts need to be brought back on balance sheet so they can be evaluated solely on their merits and priority should be given to infrastructure investments that provide a positive return to the taxpayer and so pay for themselves.

Figure 1 National Infrastructure Pipeline annual spend



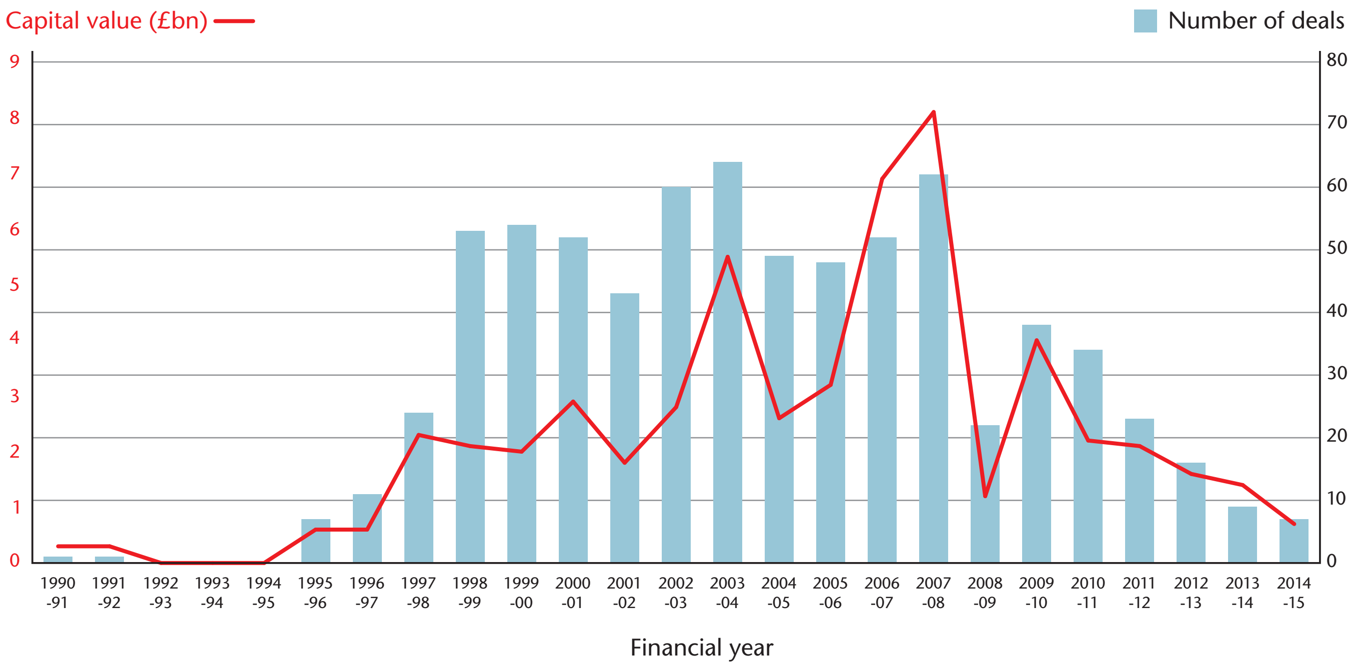
Source: National Infrastructure Pipeline, March 2016 – annual average of planned spending on economic infrastructure over five years from 2016-17 to 2020-21.

Figure 2 Public sector economic infrastructure spend



Source: HM Treasury, 2015 Spending Review – selected infrastructure spending (excludes social infrastructure).

Figure 3 Private finance initiative (PFI) projects



Source: HM Treasury, PFI summary data 2015 – projects reaching financial close.

> ‘To support the economic recovery, and to create jobs and more apprenticeships, legislation will be introduced to ensure Britain has the infrastructure that businesses need to grow.’

The Queen’s Speech, 18 May 2016

This ICAEW Better Government Policy Insight explores the situation faced by the UK Government in addressing the need to improve infrastructure in the UK.

How can it boost infrastructure investment while keeping a handle on the public finances, particularly given economic uncertainty following the decision of the British people to leave the EU?

From the roads that transport our goods to the broadband that keeps us connected, infrastructure provides the foundation for businesses to deliver jobs, growth and prosperity. Economic advice is that improving infrastructure in the right places should result in a healthier economy.

Many announcements …

Table 1 Announcements

Event or new body	When
Crossrail construction started	May 2009
Community Infrastructure Levy	Apr 2010
First National Infrastructure Plan	Oct 2010
Pensions Infrastructure Platform	Nov 2011
(National) Planning Inspectorate	Apr 2012
Airports Commission	Nov 2012
Broadband Delivery UK	Feb 2013
Infrastructure Act	Feb 2015
Road Investment Strategy to 2020	Mar 2015
New Highways bodies established	Apr 2015
Airports Commission report	Jul 2015
Proposal for a national roads fund	Jul 2015
National Infrastructure Commission	Nov 2015
Cities & Local Gov’t Devolution Act	Jan 2016
Infrastructure & Projects Authority	Jan 2016
National Infrastructure Delivery Plan	Mar 2016
HighSpeed 2 Commons approval	Mar 2016

From legislation to remove planning obstacles to new infrastructure projects, to increased powers for the highway authorities, to high profile projects such as Crossrail, HS2 and new nuclear power stations. Studies have been commissioned and quangos created. Successive governments have made their commitment to building new infrastructure clear.

… but, little sign of increased investment in infrastructure

But what is actually happening in practice? The weaknesses in the public finances mean that the government is not putting up any new public money for this infrastructure drive – the current plan is for public investment to be flat or declining over the next three years.

Unfortunately, the UK Government does not publish forecasts for investment in infrastructure on a Whole of Government Accounts basis. However, based on the more limited National Accounts measures it appears that the government expects declining investment over the next three years, with spending expected to recover only after the end of the decade.

Table 2 Public investment

Public sector net investment	£bn	% GDP
2009-10	51.5	3.4%
2010-11	43.5	2.8%
2011-12	34.4	2.1%
2012-13	38.7	2.3%
2013-14	31.8	1.8%
2014-15	34.8	1.9%
2015-16	33.2	1.8%
2016-17	36.4	1.9%
2017-18	35.3	1.7%
2018-19	33.2	1.6%
2019-20	32.1	1.5%
2020-21	42.4	1.9%

Source: Office for Budget Responsibility, March 2016. Includes other capital spending in addition to investment in infrastructure, net of depreciation of existing assets.

PFI contracts have offered a way to get schools and hospitals built by bypassing fiscal targets. But tougher rules and a less favourable investment environment have led to a collapse in the number and scale of transactions.

Is it all over for PFI?

Over the past two decades the UK Government has used PFI contracts to facilitate private investment in both economic and social infrastructure projects.

PFI contracts are reported in a register, which indicates that annual spending under existing PFI contracts is now around £10bn a year, comprising approximately £4bn in capital repayments and interest and £6bn in service charges.

The introduction of tougher PF2 contracts was supposed to enable this route to remain open while providing better value for the taxpayer.

However, the official PFI register, summarised in Figure 3 on page 3, and in Table 3 opposite, demonstrates how PFI contracts have being drying up, with only £0.7bn of projects reaching financial closure during 2014-15.

This low level of new PFI deals is unlikely to change significantly in the near future, given that there are less than £1bn of future PFI projects currently in procurement.

Table 3 PFI register 31 March 2015

Number and capital value	No.	£bn
Health	125	12.4
Defence	41	9.5
Education	171	8.4
Scotland, Wales & NI	141	8.2
Transport	61	7.9
Environment & Rural Affairs	28	3.8
Other departments	155	7.5
2015 summary data	**722**	**57.7**
Operational	679	52.8
Under construction	43	4.9
2015 summary data	**722**	**57.7**
2014 summary data	728	56.6
Reaching financial close	7	0.7
Finished	(13)	(0.2)
Cancelled	(2)	(0.5)
Other changes	(2)	1.1
2015 summary data	**722**	**57.7**

Source: HM Treasury, Private Finance Initiative Projects: 2015 Summary Data, 5 March 2016.

There have been numerous infrastructure initiatives over the last few years.

There is a pipeline, but …

The government tracks investment in economic infrastructure through the National Infrastructure Pipeline. This captures 602 major private and public infrastructure programmes and projects planned across the UK.

The headline amount of infrastructure spending in the pipeline of £425.6bn sounds very large – and it is – but it covers around a decade or more of planned expenditure.

Averaging the total for the first five years of the pipeline of £239.6bn is equivalent to an annual spend of £47.9bn a year, as shown in Table 4.

There is naturally more visibility for the earlier years, so the actual spend each year is likely to be closer to the £53bn included in the pipeline for 2016-17, close to £70 per month for each person living in the UK.

Of the average spending of £47.9bn each year to 2020, £27.8bn is privately funded and £20.1bn is funded by public spending or through public-private arrangements.

Table 4 The Pipeline

Average spend per year to 2020	£bn
HighSpeed 2	2.7
Rail	6.5
Roads	4.9
Local transport and ports	3.5
Transport	**17.6**
Energy networks	7.5
Oil & gas (inc decommissioning)	6.8
Renewable electricity generation	3.8
Gas-fired and other generation	3.4
Hinkley Point C nuclear plant	1.1
Nuclear decommissioning & waste	0.9
Energy	**23.5**
Water, waste and flood defence	4.5
Communications (inc. broadband)	1.2
Research	1.1
Other	**6.8**
Total	**47.9**

Source: National Infrastructure Pipeline, March 2016.

But, they have yet to feed through into the numbers – actual investment appears static or declining until at least 2020.

… the signs are not positive

Although the government announced that the total pipeline had increased from £411.0bn in 2015 to £425.6bn in this year's version, the near term profile of investment grew by less than the overall growth in the economy. This is demonstrated in Table 5, which shows only a small increase in overall spending per year after inflation.

Energy investment actually fell with fewer renewable energy projects, while the apparent increase in transport investment turns out to be driven by corrections to amounts recorded for existing programmes rather than from the initiation of new projects.

Table 5 Pipeline changes 2015 to 2016

	Energy £bn	Transport £bn	Other £bn	5 year average £bn
2015 version	24.1	15.9	6.7	46.7
Inflation	0.4	0.2	0.1	0.7
Net change	(1.0)	1.5	–	0.5
2016 version	**23.5**	**17.6**	**6.8**	**47.9**

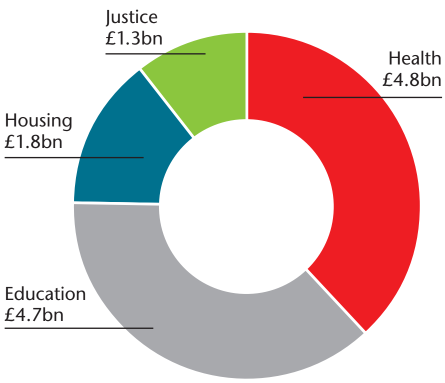
Social infrastructure investment slowing down too

In addition to economic infrastructure, investment into social infrastructure such as housing, schools and hospitals is also very important. According to the UK Government this amounts to some £11.5bn on average each year, as shown in Figure 4 below.

The average of £1.8bn for new housing is, in theory, an increase in public funding from previous periods, but this is before offsetting reductions in capital investment by housing associations expected over the same period, expected to fall from £7.9bn in 2015-16 to £5.1bn in 2019-20 before starting to increase again.

Other areas are also expected to be flat or declining over the period. For example, the average for education is based on a capital budget for the Department of Education that is expected to decline from £5.2bn in 2016-17 to £3.8bn in 2019-20, while the Department of Health's capital budget is frozen at £4.8bn a year until 2019-20, a decrease in real terms over that time.

Figure 4 Social infrastructure



Source: National Infrastructure Delivery Plan, March 2016 – annual average of planned spending on social infrastructure over five years to 2020-21.

Encouraging the private sector to fill the gap left by dwindling public sector investment has not proved successful. Brexit may make this task even harder.

What about private investment?

Approximately £40bn of spending on infrastructure each year is financed by the public purse, either directly or through public-private partnerships. This makes up around 5% of total government spending each year.

If this cannot be increased, then can the government encourage private investment to grow instead?

Experience to date is not hopeful

Private investment in infrastructure continues to be challenged by difficulties in obtaining funding. Following the financial crisis banks reduced lending as they sought to strengthen their balance sheets, while the absence of cover from monoline insurers reduced the ability of institutional investors to underwrite bond finance for infrastructure projects.

The notable exceptions have been for price-regulated energy and water utilities with assured revenues and strong balance sheets, and for renewable energy projects where (until recently) generous market incentives encouraged substantial investment.

The tendency of incoming governments to scrap or reform their predecessors' incentive schemes and a lack of long-term consistency presents a high degree of political risk for investors. For example, the changes to market incentives for renewable energy in 2015 have resulted in a reduction in investment in energy generation, with EY reporting that the UK has moved from the most attractive country in the world to invest in renewable energy in the early 2000s, to 8th place in 2015 and to 13th in 2016.

Try, try and try again

This is not to say that the UK Government has not been doing anything. It has been very active in trying to encourage more private sector investment over the last few years.

However, the government has discovered that it is much harder to encourage private investment than originally hoped, particularly at a time when public investment has been cut.

One potential source identified by the government has been UK pension funds, with an estimated £2 trillion under management. With their long-term investment horizons, they seem natural investors into infrastructure projects. After all, foreign pension funds are often major investors in infrastructure – the Ontario Teachers' Pension Plan alone has around £7bn invested into infrastructure projects.

However, the Pensions Infrastructure Platform, founded with the hope of encouraging up to £2bn a year in investment by UK pension funds, has instead only raised £1bn over six years.

Similarly, plans to found a sovereign wealth fund with the capacity to invest in major infrastructure projects by pooling local authority pension fund investments are still being worked on, almost half a decade after first being identified as a route to sourcing funds for investment. When this will be launched, and how quickly it can start to make finance available for major infrastructure projects, is still uncertain.

Another route pursued by the government has been the UK Guarantees scheme, providing financial assurance to private investors in infrastructure projects. But this issued just £1.7bn in guarantees in its first two years of operation, out of a total initial capacity of £40bn.

The question remains – is it really possible to encourage more private investment in infrastructure at the same time as constraining public investment?

The accounting framework that underpins decision-making has a significant influence on the decisions that are made. Getting it right could have a major influence on future economic growth and tax revenues.

Accounting is important

The way financial performance is measured affects behaviour. At the same time the nature and quality of the financial information used for decision-making can have a significant impact on the quality of the decisions made.

The current principal system of government accounting, based on the National Accounts, does not provide the right signals around investment in assets that support the economy, in particular infrastructure.

For example, the National Accounts treat investment in public infrastructure as a current cost, rather than as a positive addition to the public sector balance sheet.

One particular issue with the National Accounts is that it prioritises most PFI contracts by allowing them to bypass fiscal rules. It also makes negotiating public-private partnerships more difficult given that complying with the complex technical criteria to obtain off-balance sheet treatment in the National Accounts often conflicts with the objective of obtaining value for the taxpayer.

This contrasts with the Whole of Government Accounts, which are based on international generally accepted accounting practice.

Infrastructure assets, including those acquired through PFI contracts, are recorded on the balance sheet and associated borrowing recorded as a liability.

The introduction of Whole of Government Accounts gives the government an opportunity to reform the way it accounts for and manages investment in infrastructure. This includes adopting commercial best practice in evaluating the financial returns available to the taxpayers from infrastructure projects.

First, sort out the rules

The current fiscal rules have failed to deliver the right outcomes for the UK economy. Changing them to benefit from best practice from the business world would have a positive impact.

In the medium term this means switching to Whole of Government Accounts to support better decision making within government and more comprehensive reporting of public sector financial performance.

More immediately two changes to current fiscal rules could have a significant positive impact.

Firstly, PFI financial obligations should be brought onto the National Accounts balance sheet. This would enable infrastructure investments to be evaluated based on the value for money they provide to taxpayers rather than whether they can be used to bypass fiscal limits.

Secondly, fiscal targets should be amended to permit additional borrowing for public infrastructure projects that pay for themselves through increased income (whether tax revenue, user charges, rents or sales proceeds) or through reduced costs.

This should prioritise much needed transport improvements and social housing construction that currently have to compete for scarce financial resources, even though they could actually improve the government's overall financial position. It should also enable capital investments that will benefit the taxpayer by reducing running costs to be moved closer to the top of the queue.

With economic and political uncertainty potentially reducing the appetite for investment in the UK economy following the referendum, this may be the ideal time to start a major works programme to help return the UK to stronger growth.

Then invest for growth

It is clear that the government needs to repair the public finances and improve its bottom line. Tackling the accounting deficit in the Whole of Government Accounts, which is substantially higher than the fiscal deficit in the National Accounts, will involve much more than just addressing the immediate issue of negative operational cash flows.

But, there is only so much that can be done through reducing costs. Ultimately it is necessary to generate top line revenue growth if long-term viability is to be assured.

As the government has discovered, encouraging the private sector to invest more in infrastructure at the same time as constraining public investment is more difficult than it appears. With Brexit, this may prove to be even more difficult.

With annual borrowing now around 3% of GDP and ultra low interest rates, there is capacity that we didn't have before.

It is therefore time to think about increasing public investment into economic and social infrastructure. Currently running at around £40bn a year, the addition of just £4bn in annual investment would represent a 10% boost.

And, if targeted effectively, additional investment could provide a positive return to taxpayers as well as supporting the wider economy.

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