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Retirement and Investment | Public Sector

UK Infrastructure Announcement

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Introduction

This paper provides an overview of the Chancellor's recent announcement regarding infrastructure investment in the UK. It looks at the the UK infrastructure market and includes some considerations for the Local Government Pension Scheme (LGPS).

Overview

On 5 October 2015, the Chancellor of the Exchequer announced a major plan to catalyse infrastructure investment in the UK. There were several components to the plan; the most relevant to LGPS funds was further clarity regarding the Chancellor's view on pooling, specifically:

- The existing English and Welsh LGPS funds should be pooled into up to six British wealth funds. Each wealth fund will develop the expertise to invest into infrastructure projects with the aim of saving money on fees to external managers.

Other components of the plan included:

- The government will be endeavouring to raise around £5 billion from the sale of State assets, with the proceeds recycled to help fund new infrastructure projects.

- A new independent National Infrastructure Commission (“NIC”), chaired by Lord Adonis, has been created to offer unbiased analysis of the UK’s long-term infrastructure needs. The NIC will initially focus on high speed rail, London’s public transport infrastructure and national energy infrastructure. The NIC is expected to publish advice to the Government by the Budget in 2016.

The UK infrastructure market

We believe this announcement is a positive step for the UK infrastructure industry.

Particularly, we believe the creation of an independent commission to offer unbiased advice to the government on infrastructure needs is a key initiative. There can be political inertia in infrastructure delivery and while the commission is unproven, the establishment of the NIC is an important initial step. Similar commissions have been established in other parts of the world (eg Infrastructure Victoria in Australia).

The other key announcement is the pooling of money from LGPS funds. As well as reducing costs, the plan is also to change the way pension savings are invested. It is proposed that the British wealth funds will follow a similar approach as international schemes and invest more in infrastructure. Currently, LGPS infrastructure allocations are low, averaging around 1% (according to WM Q2 Quarterly Review) compared with, for example, the Australian and Canadian pension plans (some of which have allocations between 10-20%). These plans tend to have global infrastructure programmes, with a preference for OECD countries.

While the Chancellor's plans may mobilise more money to invest in UK infrastructure from UK institutions, we believe it is more important to address the supply of investible projects to create more deal flow for institutional investors, including LGPS funds who are typically seeking long term, stable, inflation-linked cash flows.

There is already a high amount of capital chasing deals in the UK, including capital from infrastructure funds, overseas pension funds and sovereign wealth funds. Coupled with a limited supply of projects, this has led to high prices for assets and a reduction in expected returns from new investments. An example is the social infrastructure sector, where uncertainty over PF2, the successor to PFI, has impacted the pipeline of primary projects. This has in turn affected the supply of operational projects, where there is typically a recycling of capital from construction firms to institutional investors. We hope that the establishment of the NIC will contribute to the development of new investible projects over the medium to long term. The £5 billion asset sale programme referred to above is small in the context of demand for UK infrastructure assets.

LGPS considerations

We are supportive of infrastructure investment across our client base, including LGPS funds. This is due to the potential for access to long term, uncorrelated, inflation-linked cash flows (typically with a cash yield in excess of 5% pa). A key reason to consider infrastructure in a portfolio is to diversify from other asset classes. An infrastructure allocation can also be used to seek growth or for liability matching purposes. We do not generally expect infrastructure to deliver private equity-like returns but to show uncorrelated, stable returns.

Unless there are specific limiting features, we are generally supportive of a 5-10% allocation to infrastructure for LGPS funds. We typically advise LGPS funds to seek diversified exposure to the asset class. This includes investing across different strategies, sectors, geographies and vintage years. Investors typically have a preference for brownfield infrastructure, for example Heathrow Airport in a UK context, to provide access to immediate yield in addition with brownfield assets generally being of a lower risk profile compared with new infrastructure developments. Greenfield investments, for example CrossRail in a UK context, have tended to feature in a minority of portfolios. However, there may be more interest from LGPS funds to invest in greenfield projects if mechanisms are in place to de-risk the construction period and to deliver yield at an early stage to investors. We have seen such a Government support package in the Thames Tideway Tunnel deal.

George Osborne's announcement envisages direct investment into infrastructure projects by the LGPS. Accessing infrastructure via direct investment has the advantages of control over investment decisions, capital structure and governance as well as saving fees paid to external managers. To date, this method to access infrastructure has not been available to many LGPS funds due to the scale, governance and in house skills required to source, assess, structure deals and then invest in assets and companies directly.

The creation of the British wealth funds could therefore mean a significant change in how LGPS funds access the infrastructure asset class. However, there a number of important considerations which require further discussion by the various stakeholders:

- There may be a variation in objectives between central Government and the LGPS. Central Government may wish the proposed wealth funds to invest in new infrastructure projects for the benefit of the UK economy. However, this may not be consistent with the objectives of the LGPS funds, which, as mentioned above, typically seek to diversify their investment portfolios across geographies and weight their portfolios into brownfield assets. We note that sovereign wealth funds tend to diversify their investments away from the home economy (eg diversifying away from the oil sector in the case of the Middle East SWFs).

- Given the wider pooling debate within the LGPS, there is still uncertainty about what level of decisions, for example the amount to allocate to infrastructure and where to invest, will be taken by each of the six proposed British Wealth Funds versus those that remain with the LGPS administering authority. Currently the administering authority of the individual LGPS fund has a fiduciary duty to employers and members.

- If the desire is for the wealth funds to invest directly, it is likely that skills will need to be hired in. These individuals will need to be appropriately incentivised to induce them to join the platforms.

- Finally, consideration should be given as to how the investment strategies will differ across the six proposed wealth funds and how these strategies overlap. It would be a suboptimal outcome if they are bidding against each other for projects. Another consideration will be how their strategies will overlap or otherwise with the Pensions Infrastructure Platform.

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