

HOUSE OF COMMONS
ORAL EVIDENCE
TAKEN BEFORE THE
TREASURY COMMITTEE

PRIVATE FINANCE 2

TUESDAY 5 MARCH 2013

JOANNE SEGARS, ROBERT HINGLEY, GLENN FOX and PERRY NOBLE

RICHARD ABADIE and DAVID HEALD

Evidence heard in Public

Questions 1 - 108

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Oral Evidence

Taken before the Treasury Committee

on Tuesday 5 March 2013

Members present:

Mr Andrew Tyrie (Chair)
 Mark Garnier
 Stewart Hosie
 Mr Andrew Love
 Mr Pat McFadden
 Mr George Mudie
 Mr Brooks Newmark
 Jesse Norman
 Teresa Pearce
 John Thurso

Examination of Witnesses

Witnesses: **Joanne Segars** Chief Executive, National Association of Pension Funds, **Robert Hingley**, Director of Investment Affairs, Association of British Insurers, **Glenn Fox**, Chief Investment Officer, Hadrian's Wall Capital and **Perry Noble** Infrastructure Partner, Hermes GPE, gave evidence.

Q1 Chair: Thank you very much for coming to give evidence this morning. PFI has had a bumpy life so far, and it now appears to be in the process of being transmogrified; how much, is something that we want to explore. Thank you very much all of you, and I will go left to right or perhaps right to left. Why don't I go right to left for a change? I go left to right too often. Can I ask each of you whether you will invest in any of this stuff without a Government guarantee?

Robert Hingley: I am "right", am I?

Chair: Yes, Mr Hingley.

Robert Hingley: I represent the Association of British Insurers. There is essentially a strong interest among our members to invest in this asset class. There is a widespread understanding that the quality of revenue from these projects is high, it is uncorrelated to the corporate cycle. If problems do occur the recovery rates tend to be good, and the default rates tend to be pretty low. So, in principle, there is a strong interest in investing as an asset class. It also fits the liability structure, particularly, of annuities and some of the longer term life funds very well. Our members are looking for assets with a tenure of up to 30 years, so the asset class fits that very well. What they need for Solvency II—which is a particular problem for the life insurance industry—is essentially paper that is rated A minus or better.

To talk about PF2 specifically, one of the things that is helpful in that context, or the most helpful change, I think, is the increased equity proportion. So 10% to 20% will generally enhance credit quality. But the key thing—and this is where the Government guarantee may still be relevant—is if it becomes BBB, then the capital charge for holding that paper, particularly in an annuity fund, becomes greater. There are limits to the extent to which you can hold BBB paper. It has to be no more than 33% of the total if you were to qualify for the matching adjustment, which is an important issue.

Q2 Chair: You are saying that part of it has to be guaranteed or it has to be packaged in the form where the average risk value pushes it at least to AA minus, did you say?

Robert Hingley: To A minus, so one grade.

Chair: A minus.

Robert Hingley: It needs to be investment grade and one grade up. If that can be achieved without the Government guarantee, that should be fine, but at present I think the general expectation is that some form of Government guarantee is likely to be needed.

Q3 Chair: For part of it or for all of it? Clearly Government guarantee takes you way above one peg above investment grade.

Robert Hingley: Then it should be for part of it. Government guarantee is one means of credit enhancement, and monoline insurers used to provide guarantees in the past for part of it. I think that is the role that Government would still be expected to take on.

Q4 Chair: So the answer to my question was, “Yes”?

Robert Hingley: Yes, partially.

Q5 Chair: This is not a flier without risk transfer?

Robert Hingley: Sorry, I did not hear.

Chair: Without risk transfer to the Government?

Robert Hingley: Sorry, I still did not hear you.

Chair: With part of the risk being transferred to the Government?

Robert Hingley: Yes.

Q6 Chair: Appearing one way or another on the UK’s balance sheet somehow, which is an accounting issue?

Robert Hingley: Yes.

Q7 Chair: So a very helpful, if somewhat lengthy, introduction. I am going to carry on moving from my right to left. Mr Noble, who can tell us something about Hermes.

Perry Noble: Yes, Hermes. I am here with an infrastructure investor hat on. The Hermes Infrastructure Fund acts on behalf of various investors but, in particular, the long-term institutional investors that I think you are here to speak about. To answer the question perhaps a little less lengthily: yes, in principle, but the devil is in the detail. That is: yes, in principle, there is certainly an appetite to invest, and, yes, in principle, without a Government guarantee.

Q8 Chair: So it is a different answer from Mr Hingley.

Perry Noble: A different perspective.

Q9 Chair: You are happy to go ahead without a Government guarantee?

Perry Noble: In principle. But the devil is in the detail, which is all around the risk transfer and the way in which some of these proposals that are being discussed will be implemented.

Q10 Chair: Well, either the risk is transferred or it is not.

Perry Noble: It is the intelligent transfer of a risk.

Q11 Chair: At the point at which risk gets transferred, there is a guarantee.

Perry Noble: I don't think it is a "one size fits all" solution.

Q12 Chair: You cannot have these projects two-thirds built and then just sitting there, can you?

Perry Noble: I think it is correct to say that our biggest concern with the current construct will be in relation to the construction risk and how that risk is managed.

Q13 Chair: I am trying to get to the heart because I am trying to unpick the words "in principle". It seems to me you are saying there needs to be a Government guarantee to cover the construction risk.

Perry Noble: I am reluctant to say that.

Chair: Although you have come here, you are very reluctant to say it.

Perry Noble: I am reluctant to say that because I think there are other ways in which you could approach this in order to achieve an outcome without the Government guarantee. But I am looking at it very much from an investor perspective rather than from an institutional pension fund perspective, as an investment professional.

Q14 Chair: What are these other ways?

Perry Noble: It depends a lot on the role of the public sector equity, the extent to which sponsors are involved, the capital structure, the debt structure, the nature of the construction risk that you are talking about. We would look at this very much more in relation to counterparty risk, refinancing risk and external factors. Many of these things are driven by the extent to which this type of product is affected by macro and external factors. Yes, a Government guarantee is one way of approaching that but it is not necessarily the most efficient way of approaching it from the pure project perspective.

Q15 Chair: Joanne Segars?

Joanne Segars: Thank you. From a pension fund perspective, very much like the insurer's perspective, infrastructure should be a good match for pension funds. It should be able to deliver long-term, low-risk, inflation-linked returns, which is what pension funds want. In particular, what pension funds are after is lower leverage. That way, we can get the inflation linking—very high levels of leverage tend to squeeze out the inflation linking that my members need to match their inflation-linked liabilities. So we have certainly welcomed the drive in the PF2 initiative and in the Autumn Statement to have lower levels of leverage. We think that that will make this particular sector more attractive to pension funds as investors, and will enable us to get the inflation linkage that we are after much more in terms of return. So I think, in principle, yes, this is a sector that could be attractive to pension funds.

Q16 Chair: We are sure it is interesting. All of us are convinced it is interesting.

Joanne Segars: Interesting as an investment.

Q17 Chair: I know I am being fairly generous on time here for your answers, but what I want to know is, will the people you represent do these without risk transfer, without a guarantee?

Joanne Segars: As a Pensions Infrastructure Platform, we are currently looking at the specific investment criteria that we may invest in. We are creating the fund at the moment; the fund doesn't actually exist, unlike Perry's fund. But we think that, yes, in principle, this again could be interesting. We are certainly also talking to the Treasury about the construction guarantee.

Q18 Chair: You say “interesting”; I am trying to pin down what this means. This could be done without a guarantee?

Joanne Segars: We also want to look with the Government at the role that the guarantee scheme could play, yes.

Q19 Chair: So was that a “yes” or a “no” to my question?

Joanne Segars: It was a “We are likely to want to invest in this sector.” The presence of guarantees might make that more likely.

Q20 Chair: Well, we are slowly groping our way towards some sort of answer. Mr Fox.

Glenn Fox: Chairman, I can be more definitive. I represent an infrastructure debt fund, which has been set up specifically to provide credit enhancement to attract capital markets investors into PFI-type projects. Yes, absolutely, we are bidding to invest in projects today without the need for a Government guarantee. Our view is that for the vast majority of projects in the PFI sector—perhaps not in other sectors, but in the PFI sector—Government guarantees are not necessary in order for those projects to be financed.

Q21 Jesse Norman: Can I be perfectly clear as to what is happening? We have two sets of long-term pension investors. We have one infrastructure risk-taking investor and we have one monoline insurance provider, as was.

Glenn Fox: As was.

Jesse Norman: As was, thank you.

Perry Noble: Just to be clear, our clients are primarily long-term investors. We are not a short-term fund but we are an investor. We write cheques.

Q22 Jesse Norman: To crystallise this, for example, you guys would take construction risk?

Perry Noble: In principle, yes.

Q23 Jesse Norman: We are back to “in principle”. You would insure construction risk?

Glenn Fox: We don’t insure. Our new business model is about providing long-term credit debt.

Q24 Jesse Norman: So, you will provide credit debt?

Glenn Fox: We provide cash and we will take construction risk.

Q25 Jesse Norman: I am assuming that the NAPF and the ABI would not take construction risk.

Robert Hingley: The same sort of answer as Joanne gave—that we are looking at ways with our members of being able to take construction risk. Construction risk has historically been unattractive to insurance companies. A sixth of an inch between pensions is quite important, but it is something they have historically been unwilling to do; but we are looking at ways of trying to take that up.

Q26 Jesse Norman: When are you going to have a view?

Robert Hingley: When are we going to have a view? Well, we are working with our members.

Q27 Jesse Norman: Does that mean this year, next year?

Robert Hingley: This year.

Q28 Jesse Norman: Good. Then potentially substantial amounts of member capital could flow?

Robert Hingley: Absolutely, yes.

Q29 Jesse Norman: What kind of numbers, do you think?

Robert Hingley: Some of the larger members have indicated that, potentially, this asset class could be attractive for up to 15% to 20% of relevant portfolios for annuities and life funds, and I cannot give you exactly what that proportion would be.

Q30 Jesse Norman: That is an enormous capital pool.

Robert Hingley: That is potentially an enormous capital pool, yes.

Q31 Jesse Norman: What likelihood do you think there would be of investment out of that capital pool?

Robert Hingley: I think high. There are sets of risks. There are technical risks—that I think both Perry and Joanne have alluded to—about the structuring of individual deals. To some extent, those will be more easily solved once there is a flow of projects to finance. Solving things in the abstract is harder than in the specific. As Perry said, the devil is in the detail. There is a particular issue that the insurance industry has to address, which is currently unique to the insurance industry, concerning the capital treatment under Solvency II.

Q32 Jesse Norman: Thanks. Joanne, a similar kind of answer?

Joanne Segars: Yes, a similar kind of answer. As you know, we are building this Pensions Infrastructure Platform that will be a £2 billion fund for pension funds by pension—

Jesse Norman: £2 billion?

Joanne Segars: £2 billion.

Q33 Jesse Norman: It is not enormous.

Joanne Segars: It is twice what pension funds are currently investing in infrastructure as an asset class. A £2 billion fund is a pretty large infrastructure fund in the scheme of things—an individual infrastructure fund.

Q34 Jesse Norman: This will take risk-bearing investment, like construction risk as well as long-term debt or equity involvement?

Joanne Segars: What we want to do is to get involved at the construction phase because that is where the pipeline is coming from.

Q35 Jesse Norman: The £2 billion will be focused on that kind of investment?

Joanne Segars: A proportion of it will. What we are looking at is to get inflation-linked returns, so RPI plus between 2% and 5%. That gives you a range of potential assets in which you might invest, somewhere towards the lower end of the risk spectrum, so in the sort of PF2 space. What we are interested in—sorry to use that word again—what we want to be able to do is to get involved in the construction phase but without taking on the construction risk, just like the insurers. That is not where our expertise lies. Partly through the Government guarantee scheme, partly through other channels, we think that some of that construction risk might be able to be managed, might be able to be wrapped by others. From our perspective, what we are after are those inflation-linked cash returns.

To pick up on the Solvency II issue, at the moment it is an issue for insurers. It could also be an issue for pension funds as well, with a review of the Pensions Funds Directive in the EU. Again, if that comes to pass, I think that will dissuade pension funds from investing in this sector.

Q36 Jesse Norman: That is helpful. Again, to the two long-term investors—if I may put it that way; or three, if you like—how much actual investment have you done alongside public authorities, or have your members done?

Joanne Segars: The PIP doesn't exist at the moment. Certainly individual pension funds—

Q37 Jesse Norman: So pension funds have done virtually no investment alongside?

Joanne Segars: No, that is not necessarily true. According to NAPF's most recent survey, about 1.2% of pension funds' assets in total are invested in infrastructure. At the moment it is a very small asset class but one that pension funds are keen to see grow. The problem that pension funds face at the moment is that the market isn't structured in their interests.

Q38 Jesse Norman: I want to ask a slightly different question, which is not just what your appetite for infrastructure investment is but what your experience of working alongside public equity investors is?

Joanne Segars: That will vary from pension fund to pension fund.

Jesse Norman: But I am guessing it is quite small.

Joanne Segars: It is relatively quite limited. Perry, you will have more to say.

Perry Noble: Yes, alongside public equity investors.

Q39 Jesse Norman: The truth of the matter then is that your members don't have much of a feel for what it will be like to be sitting alongside a relevant public investor, and the kinds of tensions that might arise within the investor groups.

Perry Noble: It would be a very unusual construct.

Q40 Jesse Norman: Yes, and presumably there could be significant differences of view about this.

Perry Noble: That is difficult. One of the big concerns we will have is how you achieve the alignment—which I think everybody is looking to achieve—particularly where, from what I have read, it looks more like that alignment is with the sponsor equity in the first phase. There is a view that in some way the public sector equity will be recycled. That alignment with us, when we are long-term hold investors, is a very difficult tension to manage and we would need to understand how that would be dealt with.

Q41 Jesse Norman: A final question then, which is: if you are looking at those kinds of parallel investments—and again, this is for the investors, if you don't mind, the current investors—how much experience do you have in terms of driving out returns as investors? Because often, as you know, in these PFI deals a lot of the fat is sitting in the construction contracts, and what you need is more upward pressure from the equity investors saying, essentially, "Where is my cash?" I take it you do not have much experience of doing that within a public sector-type deal, but you might have some within private sector infrastructure investments.

Robert Hingley: If I can answer for the insurance companies. First, to answer a question you asked a moment ago about the level of current investment in infrastructure, there

is some. I don't have exact figures but it is quite low, so your point about experience is correct. As a general proposition, the investors that we would represent would be interested in the debt securities rather than the equity part of it. They would be looking simply at the credit rating and the security of the returns, rather than an active involvement in driving the deal.

Q42 Jesse Norman: They will be opting out from extracting value from the deals once they have been started up?

Robert Hingley: I think that that is the role of the equity holder rather than the debt holders.

Q43 Jesse Norman: Obviously; and from your point of view?

Perry Noble: We are a long-term investor. We are there to hold.

Jesse Norman: Because Hermes is going to be in that game.

Perry Noble: We are there to hold our investment, so it is all about the integrity and the robustness of the project.

Q44 Jesse Norman: It is so striking how little corporate governance gets applied from within the equity holders on the current deals.

Perry Noble: We would have a very big focus on corporate governance.

Jesse Norman: Good. That is very helpful. Anything else you wanted to add?

Joanne Segars: No.

Jesse Norman: I am sorry not to have involved you. Thank you, Mr Chairman.

Q45 Teresa Pearce: Joanne, on the pension investment plans being developed by your organisation, not many pension schemes are large enough to invest in an infrastructure project, so you are going to have to have smaller pension funds pooling together. How do you see that being done? What would the Government need to do to make that possible?

Joanne Segars: You are right that even some of the very largest pension funds do not have the in-house expertise to get involved directly in investing in infrastructure, and that is what sits behind the development of the Pensions Infrastructure Platform: the recognition that infrastructure should be, if it can be correctly shaped, a good investment class for pension funds. It should be a buy and hold. It should be a long-term investment. By joining together as a group of pension funds to develop a fund—a Pensions Infrastructure Platform, for pension funds by pension funds—and putting pension funds in the driving seat to try and get the sort of characteristics from this asset class that pension funds want, we think that we will be able to ensure that there is a much more significant investment by pension funds in this asset class.

We currently have 10 founding investors. They are among the largest pension funds in the UK, some from the public sector, some of the local authority funds, and some corporate funds. We have raised—if we can structure the Pensions Infrastructure Platform properly—£1 billion of capital from them, and we will go out later this year to smaller pension funds to invite them to join the Pensions Infrastructure Platform.

In terms of what the Government can do, that is about some of the policy changes that will help shape and make infrastructure an attractive asset class to long-term investors, not just pension funds but insurers and others as well. That is about the focus on lower leverage. It is about getting some of the policy issues right around Solvency II and those sorts of things. It is about looking at the leverage that comes through from the regulated utilities to tackle some of those issues.

We have had a very good, constructive dialogue with Infrastructure UK, with the Treasury, as we have been working through and developing the PIP. It is independent from Government, and I think it is important that that point does not always come across. By

developing something that is for pension funds by pension funds, we can start to attract more pension funds into this asset class.

Q46 Teresa Pearce: Trustees are required to understand the risks of their investment, and this is a pretty new area for lots of, particularly smaller, pension funds. Given everything else that is happening in pensions at the moment—we have the Pensions Bill, we have auto-enrolment, we have so many changes—do you think they will be able to grasp this or do you think this will just be for big players?

Joanne Segars: I have talked to an awful lot of my members about infrastructure over the last 18 months. Some of them have said, “Our trustees aren’t quite at the point where they can come in as a founding investor to your fund, but we are having discussions right now with our trustees and we hope to join the PIP at a later stage”. There are others who recognise that they need the sort of characteristics that the PIP and the infrastructure will be able to give them, so I think those discussions are happening.

You will know from your work on the other Select Committee that obviously, as pension funds are looking to de-risk, and as pension funds are closing in increasing numbers—and there is that focus on de-risking, but also on getting inflation-linked returns to match inflation-linked liabilities—then this sort of family of asset class will become more attractive to other trustees. Also, as pension funds see other pension funds getting comfortable with the asset class, I think more pension funds will be getting comfortable with the idea.

Q47 Teresa Pearce: One last point. You have already mentioned that the target size of the PIP is £2 billion, yet the Government said they are looking for £20 billion. Is that the wrong decimal point or are they over-optimistic?

Joanne Segars: That was a Treasury figure that was announced at the Budget in 2011. Treasury subsequently clarified that that was a long-term ambition; I think they were talking about something over 10 years, from a range of institutional investors and not just pension funds. We have never said that it will be £20 billion. As I said to Mr Norman, £2 billion would be about twice what pension funds are currently investing in infrastructure and, in and of itself, will make the PIP a rather large infrastructure fund.

Q48 Mr McFadden: To carry on on the same theme, to Joanne. Teresa Pearce mentioned the trustees’ responsibilities for assessing risk. This kind of thing ought to be attractive to Governments, because it means somebody else pays in the short term when they are worried about their public borrowing. It ought to be attractive to pension funds because of the long-term returns that you are talking about. Historically, what have been the other obstacles—apart from this question of assessing risk—that have stopped pension funds investing in this kind of area in the past?

Joanne Segars: There have been a number. It has partly been to do with the way in which the market has been structured. So pension funds have objected to the very high levels of leverage that they find in current deals and current funds. That does squeeze out the inflation linking that I have said that pension funds are really seeking. Pension funds have also objected to some of the high fees that are present in the infrastructure market, and what we are trying to do through the Pensions Infrastructure Platform is to develop something that has low leverage, a low fee base, and also gives us the inflation link; so it is those three things coming together. The absence of those three things are among the factors that have dissuaded pension funds from investing in this asset class.

The other is internal expertise within some of the funds. So I think by coming together, by developing something that is for pension funds by pension funds, with dedicated expertise and with a dedicated manager, we can start to overcome those barriers. It would

therefore become a much more attractive asset class to pension funds, and in a sense put pension funds much more in the driving seat to be able to demand what they want much more from the market.

Q49 Mr McFadden: So that has been the historic problem or the things that have been in the way. Looking at this current design and set-up, you have said there is about £1 billion at the moment. This new PIP has about £2 billion, and the Government is clearly ambitious for more for reasons I think we understand. In simple terms, you have been involved in a lot of discussions with the Treasury, and so on, trying to design a new system that will make this more attractive to pension funds. What are the current obstacles that are still standing in your way? In a sense, we provide an opportunity as a sort of message mechanism to the Treasury. If you could name, say, three things that you want changed to open the door to put this on a different scale, what would they be?

Joanne Segars: It is around the Solvency II implications that might come through the review of the Pensions Funds Directive, which will effectively rate infrastructure as a risky investment, whereas we are looking to put this in our de-risking asset class, so there is one policy issue. There are policy issues around the leverage attaching to regulated utilities, which tend to be rather high and which could dissuade pension funds from entering that particular asset class. That is about tackling the regulators and the regulated utilities. Also, we want to see a bit more about how the guarantee scheme could be made to work, so we might be able to use that to wrap some of the construction risks that I talked about earlier. There are some other more technical issues, which no doubt Perry knows more about, on the unbundling of electricity and power supply issues. As I say, they are the core issues. If we could tackle those—and we have made this quite clear to Government in our Budget submissions, and elsewhere—they would start to attract pension funds in. But I would say the real focus is on how we might tackle some of the high leverage that comes through some of the regulated utilities.

Q50 Mr McFadden: Finally, can I ask you about some of the other comment around this area? Paul Morrell, the Government's Chief Construction Adviser, told the *FT*, and I am quoting here, "There won't be a barrel-load of funding coming in from pension funds for Greenfield infrastructure". "The Construction Products Association, said Ministers had failed to produce a model 'with relatively safe payback' for private groups to invest". You seem a little bit more optimistic than those comments would indicate. Why do you think there is other commentary around that says this problem has not yet been cracked; that the changes announced have not been enough to unlock the greater scale of pension fund or other long-term investment the Government wants to see?

Joanne Segars: I am more optimistic, as you have rightly spotted. Perhaps it is a failure to recognise that, for pension funds to invest in this new asset class it is not just a snap of the fingers and it gets done; there are due processes. There is significant governance that sits around decisions—and rightly so—that pension fund trustees have to make. As Ms Pearce has said, to get very comfortable with the asset class they have to understand the risk and it is absolutely right that they do. Developing a new fund, which is a brand new initiative bringing together these different pension funds to work together to develop a very bespoke solution—is something that hasn't been done in the UK before specifically for pension funds; it has been done elsewhere, in Canada and Australia, but not in the UK—is a question of timing. So I would suggest to those perhaps more cynical people that they be a bit more patient.

Q51 Mr McFadden: Are some of the trustees saying to you, "Look, why should we bother with this? At the moment we basically choose between a range of investments. We can

choose to invest so much in equities, so much in bonds, so much in this. Now you are asking us to try and get our heads around environmental risk, construction risk, supply chain risk and all these other things. This isn't really our job". Do people say that?

Joanne Segars: No, they don't. If you look at the path of pension fund investment over the last 10 years, it is one of increasing diversification. The era of, "We invest in equities. We invest in bonds" is long past. So it is about increasing diversification. It is also about looking for where you can get return for that de-risking portion. Frankly, you cannot get that in the gilt market at the moment. So it is about looking at where else you can get those sorts of returns.

Infrastructure is one that is being increasingly recognised by trustees and, if you like, we are reflecting the needs of our members. We are reflecting what they are asking us to do. It is not the NAPF driving this. It is our members saying to us, "We want to get involved in this; let's work together to do it".

Mr McFadden: Thank you.

Chair: I am going to bring in Andy Love. While I am doing so, I am going to invite the others—who have not had such a good run as Joanne Segars on those quite important points—to reflect on whether they want to chip in. So, Andy Love, and then anybody except Joanne Segars.

Q52 Mr Love: I am sorry to disappoint, Chairman, but I am going to follow on with Joanne Segars. I do apologise. I want to come back to this point about building the expertise to invest in infrastructure. I wonder, first, how long you think that might take; the Government was talking about £20 billion over 10 years, and you are talking about £2 billion. Is that over a 10-year period? The other part is: is a fund of £2 billion sufficient to have the expertise within it that will be necessary to evaluate all of the different types of projects that you are likely to want to invest in?

Joanne Segars: Let me deal with each part of that question. On the £2 billion, we aim to launch the fund later this year. So that is £2 billion this year, invested clearly over a time frame. In terms of whether £2 billion is enough to have its own internal expertise, as I said, £2 billion would make this a rather large infrastructure and one of the larger infrastructure funds in the UK. So, compared to the Government's needs and wants on infrastructure, yes, it is relatively small, but compared to what is going on in the wider infrastructure market it is quite a large fund. Of course, we are investing in this to get the right returns for pension fund members, and that is what has to motivate us. Going back to the earlier questions, it has to motivate the trustees who are deciding to invest in this, not whether the National Infrastructure Plan gets bids. That is not the primary driver. The primary driver is clearly seeking returns for the trustees.

So, yes, I do think that with the right management—and we are currently working at the moment to develop the right manager proposition, and that is work that is live at this very moment—we will be able to have the right expertise. As I mentioned earlier, as more pension funds see more pension funds investing in this asset class, that will hopefully build success in this area.

Q53 Mr Love: Let me ask a slightly different question, and others might want to respond to this. Of course the amount of leverage the Government has suggested is 75:25. But this is driven by the marketplace. How confident are you with the Government suggesting that it will actually turn out to be that, because I assume that this is a critical issue for all of you?

Perry Noble: There is a long history of PFI, unfortunately, and—

Mr Love: Some have been good.

Perry Noble: Some of it has been interesting. In my experience of public sector procurement, it is very price driven and that leads you to lowest costs. If you look at the price components of a typical PFI project, there is a very significant element that is capital related, which drives you to a capital structure that maximises the cheapest source of capital, which historically has been senior debt. I am not quite sure how that fits, so that is the first thing. I think for all of us—certainly for us—the leverage in the capital structure is a very significant indication of the overall risk in the project. Without a doubt we have a big interest in seeing leverage being more prudently managed. But if you look at the tax break on debt, and if you look at the price necessities around public sector procurement and the way in which the public sector goes around procuring assets, there is a massive tension there between the two, so I personally cannot see yet how those two tensions will be managed.

Q54 Mr Love: That needs to happen for you to invest.

Perry Noble: It will be capital structure, counterparty risk, inflation risk. We talk about construction risk, but most of the construction risk is more about counterparty risk, both in terms of credit and in capability of the players around the table. Those three are the things that would be most focused on. In a world where longer term debt finance is less available than it once was—probably for good reason—refinancing risk is going to be an increasing issue for long-term investors, where there may be capital market solutions that will come into play.

Q55 Chair: Thank you. I am going to come to Mr Hingley and then Mr Fox.

Robert Hingley: Perhaps I can pick up both those questions. In terms of what investors want, I would echo virtually everything that Joanne has said but I think you can boil it down almost to two things. The first is regulatory certainty, and I have made the Solvency II point. The second is, as much as anything else, it is deal flow. What the insurers would like is a significant “plain vanilla asset class”, as they refer to it, so lots of comparability between instruments for different projects and the deal flow, I think—

Q56 Chair: An asset-backed security perhaps?

Robert Hingley: Possibly, yes.

Chair: Sorry to have broken the flow there.

Perry Noble: Good financiers.

Robert Hingley: But on the question of getting the requisite expertise and dealing with a lot of these technical issues, the market is good at solving that. It is a little bit like getting the bicycle pedalling properly—once there is a continuing flow of deals, I think investors and banks are good at solving those problems. I would boil down the request to those two things.

It also follows that, once you have a real record of deals out in the market, then you will start to see very clearly what levels of leverage are sustainable and, in particular, what levels of leverage are potentially sustainable, or that credit ratings can be sustainable without the Government guarantee. You might expect that once there is a longer track record, then the need—this is where we started—for the Government guarantee to support these transactions partially may start to diminish.

Glenn Fox: In terms of general institution investor demand, the market has reached a tipping point. I spent three and a half years of my life trying to raise an infrastructure debt fund. It took two and a half years to raise that money, and realistically it has taken another nine months to get to the point where we can see real opportunities to invest capital. We are now at a point in the market where there are a wide variety of fund managers out there actively raising infrastructure debt funds, and it has almost become the flavour of the moment, given the limited alternative opportunities there are to invest in relatively safe assets that offer

a reasonable yield above gilts. From that point of view I am very confident that the Treasury will see long-term institutional demand for projects, provided there is a sufficient pipeline, of course, which is another matter.

In terms of the price of debt and whether a more leveraged or less leveraged structure is going to be the cheapest alternative, well, that is very much in the hands of institutional investors themselves to determine whether or not they are offering an efficient price for a more highly rated piece of debt. The evidence we see in bidding for projects today is that, if we structure a project to the right kind of credit rating, investors will give us a price that provides a potentially compelling proposition against other financial structures.

Q57 Mr Newmark: I will start off with Perry because he has been quiet for a while. I want to talk about the UK Guarantees Programme. Has the programme enabled institutional investors such as you to invest in infrastructure projects?

Perry Noble: Not as at today. We have not seen projects coming to us with that Government wrapper yet but, in principle, as we have heard already, we would be open to investing.

Q58 Mr Newmark: Is the issue for you, though, the guarantee or is it the availability of equity?

Perry Noble: No. I am afraid it is the detail in the individual project. We have to look at this. For all of the desire to standardise everything, which I understand—and I have been here before in terms of standardisation of PFI contracts—when you are writing a cheque for someone else's money, and someone else's pension, we look at it very much on a deal by deal, project by project-specific basis. So it will depend on the nature of the project. There has not been real visibility yet, at least from my institution's perspective, on specific projects with a guarantee structure in place which we could analyse and get our mind around. So, it is deal flow.

Q59 Mr Newmark: So, it is deal flow or is it the fact that you will ultimately have some sort of protection from the Government which is going to enable you to make that decision? Obviously you have the devil in the detail in the various issues that you have raised, but as a backstop, what is lowering your risk, or whatever: the fact that the Government is there and the cost of risk is being pushed down the order?

Perry Noble: We would invest in a Government guaranteed scheme, without any question whatsoever, if the scheme otherwise meets our investment options.

Chair: That is a slam dunk, isn't it?

Q60 Mr Newmark: What you are saying is that if ultimately—Mr Chairman, if I can just finish—the real risk is shifted to the Government, in other words the taxpayer, it is a slam dunk. You get what Glenn was talking about: people starting to crowd into the market with their tongues hanging out because it is a no brainer.

Perry Noble: It will have a market consequence, clearly, and it will also potentially—

Q61 Mr Newmark: So you are doing it—I was in private equity before—because the equity is there and we make a decision that the risk reward ratio is there. The risk reward ratio is being tilted in your favour because there is the backstop of the taxpayer if things go wrong.

Perry Noble: As I say, it depends on the integrity of the project. We are not a private equity fund. We are a long-term investor, and we have a different risk profile and a different return expectation to a private equity fund. It depends on the nature of the project, it really does. It is a project by project analysis.

Robert Hingley: And the nature of the guarantee.

Perry Noble: And what is being guaranteed.

Q62 Mr Newmark: Sorry, Robert, you wanted to say something.

Robert Hingley: I was simply saying that it is question of the nature of the guarantee. Your question seemed to predicate a total guarantee. I am not sure that is expected, but it is about looking at forms of credit enhancement, which is perhaps most easily provided by the Government, to make sure that the capital structure stacks up with the right credit ratings.

Perry Noble: Historically, the obsession with risk transfer, the theology around risk transfer, has led to risk being transferred for disproportionately the wrong price, which has created opportunities for secondary trading and so on. The fact that there is a recognition of that, and a more balanced approach to risk transfer, I believe should ultimately lead into a much better, stronger value for money proposition for Government.

Q63 Mr Newmark: I want to understand Glenn's comment a little bit more. Is my analysis correct: that this is leading to lots of people raising funds with their tongues hanging out because, ultimately, people out there who are willing to put money to work see this quasi-backstop—which I view as a real backstop—of the Government and the taxpayer as encouraging people to come into the market?

Glenn Fox: I would point to three different things. One, which is outside the scope of PF2, is quantitative easing. Quantitative easing has driven down the investor returns to the point—

Mr Newmark: Are you trying to press my heart button here?

Glenn Fox: It has driven down returns in the market, to an extent that investors are very keen to look at any alternative source of yield. That is a big part of the backdrop to institutional investors being keen to invest in the sector. Then there are two separate roles of Government, which can potentially make projects more or less attractive to private sector investors. The first is that all privately financed projects of the sort we are talking about ultimately have a public sector counterparty. It is that public sector counterparty that is going to be paying the cheques, provided the project is delivered to the specification that underlines the base credit quality of these projects and makes them attractive to investors in principle. Then there are other members of the panel who have rightly said that it is the nature of the Treasury guarantee that may make a project more or less attractive.

If the Treasury were in the business of guaranteeing all of the debt of a project from beginning to end, then you would find that none of the people at this table would be selling that as an attractive proposition to their investors because that would mean a much lower yield on the investment, and we are all looking for yield.

Q64 Mr Newmark: I understand that. What I am also looking for is making sure we don't have roads and bridges going nowhere, and we have sensible infrastructure projects. So, number one, obviously it is good to get infrastructure projects going because that creates jobs, but there has to be the return on capital employed—the return on investment aspect. People dipping their hands in their pocket, as I view it, and putting some equity on the table provides a sanity check in that regard. What you are saying, and what I am hearing out there is that discipline of me dipping my hand in my pocket, putting real money on the table, which provides that sanity check, is slightly being obviated because the Government guarantee is there, and is therefore making it easy for you to make a decision to actually put money to work.

Glenn Fox: That would be a strong criticism if the Treasury were offering to guarantee the debt of a project in full throughout its life. I don't think that is what the

Treasury is aiming to do. The Treasury is aiming to create a market for infrastructure debt at better pricing than it has been seeing in the bank debt market, and it considers that, in some cases, Treasury guarantees of a limited part of the debt may be necessary to get the best price.

Q65 Mr Newmark: It is helping the decision making then because it is reducing the overall cost of capital, and because there is the overall reduction in the cost of capital, because debt is cheaper than it would otherwise be, more investors are likely to come in then. That is really what you are saying.

Glenn Fox: In general, I would say that, for the vast majority of PFI-type projects, there will not be Government guarantees because there will be no need for them in order to raise competitive funding. There will be projects that have more complex construction requirements or a very large size, where a Treasury guarantee can help to reduce the overall cost of financing to a level that the Treasury considers value for money.

Mr Newmark: Thank you.

Q66 Chair: That is very, very helpful, thank you. Let's take that one step further and go to the PF2 launch document, which I am sure you have all read carefully. You do not have enough detail, do you, to know, because the devil is in the detail, whether enough risk is being transferred to reduce the cost of capital overall to make this worth while? Is that a correct summary?

Perry Noble: Correct, based on that document, yes.

Chair: If it is not, please say so. Mr Fox.

Mr Love: Just nod.

Glenn Fox: Yes, it is a general policy document, so of course.

Q67 Chair: Yes. It has some phrases that are seeking to give us comfort, but they are not doing much more than that.

Glenn Fox: No, I think there are some very positive initiatives contained within that document that will help institutional investors invest with more enthusiasm in the asset category.

Q68 Mark Garnier: I would like to follow up on a couple of those points that have already been picked up on, so if I might just jump around a few points. Mr Fox, you talked about quantitative easing driving down your yield, so you have to scratch around elsewhere to get yield. Also it is having the effect of pushing down your risk-free rate. Do you think that, because of quantitative easing, we are getting a situation where people are taking on risk for too cheap a price because of having to scratch around to find that yield? Is risk properly being valued as a result of QE? Anybody else can jump in.

Glenn Fox: As investors, we all have to justify the investments we are making to the people who have given us the money. We can only ever look at the price of risk on a relative basis, and therefore—

Q69 Mark Garnier: You can look at it on a relative historic basis as well as a current relative basis. If you go back over the last 20 years, you were getting paid a lot more for risk in the past than you are now.

Glenn Fox: Yes.

Q70 Mark Garnier: Do you think that now the price of risk or the risk-free rate is too cheap and, therefore, what you are getting back for your risk is not enough?

Glenn Fox: All I can say is that the risk that we are able to offer to investors in our fund is regarded by the investors in our fund as an adequate return for the risk they are taking.

Q71 Mark Garnier: Mr Noble, would you come in? You can come in on to our side of the fence.

Perry Noble: It is a truism, of course, to say that it is a relative assessment, which of course it is. It would be fair to say that the current environment creates the possibility that risk is being mispriced. That is clearly the case, but, having lived through this now for 20-odd years, there is always something in the current environment that seems to encourage risk to be mispriced for one reason or another. The idea of lending to the UK Government at the current rates, from a personal risk assessment perspective, is quite a stretch. You cannot ignore the importance of that, because everything is driven off what the price of a gilt is and yield of gilts, and particularly around inflation protection and counterparty risk. The extent to which that is distorting or has the potential to distort the market I would not underestimate.

Q72 Mark Garnier: Do you think that is making it that much more difficult for you to go into these? I know I am slightly coming back over old ground, but what I am trying to do is bring all this together.

Perry Noble: It is always complex, and investment decisions when you are looking at investing for 20 years plus, in what will be a changing world over that period, are clearly very complex decisions to make. On the current environment, I cannot recall macroeconomic conditions of the nature that we are facing, which have such a big effect on what we are doing. It is an incredibly important part of all of our analysis at the moment, and I am sure has influenced Joanne's and Robert's discussions. It is a very difficult environment to look through and see where we are going to get to, and that may be the biggest challenge we all have currently.

Q73 Mark Garnier: To slightly summarise that, on the one hand you are saying we have to get a return. You have assets under management. You have to invest in something. You are trying to find a return.

Perry Noble: Yes, rather than a negative return, yes.

Q74 Mark Garnier: Exactly, you have 190 basis point yields—

Perry Noble: Negative real return.

Mark Garnier: Yes, exactly, so 190 basis points on 10-year gilts and inflation at about 3%, yes. So you are already 1.2% the wrong way. Equally, the other side of this, with your knowledge—all of you seem to have been around for 20 years or so, and perhaps I am guessing how old everyone is, but you have been in this business for a long time—you will have seen much better returns. Actually, no matter how hard you look at it, if you were looking at it on a long-term basis, now is not the time to be taking on too much risk, given the fact that you are not getting the return for the risk because you are taking a 20 or 30-year view on this stuff, aren't you?

Perry Noble: Yes.

Q75 Mark Garnier: To a certain extent, if I was going to try to come to some sort of summary on this, you are almost looking for a time when quantitative easing has disappeared, the economy is back into some sort of growth but, importantly, interest rates are back up to a more—

Perry Noble: Long-term normal.

Mark Garnier: Yes. Therefore, it would be a lot easier for you to go in. We have a slight catch-22 situation where it is just too difficult, with these incredibly low gilt yields and, therefore, the very, very low value pricing of risk, to be able to get involved in it.

Perry Noble: I think the reality is we need to put money to work and, for all the reasons that Joanne and Robert described, there is an appetite to put money to work in this sector. It is our job to find ways to manage the risks that you have identified. As I mentioned, the inflation risk and the leverage risk, if that leads to refinancing, plays exactly to the issues you have identified. I would hesitate to say that would mean that we are not capable of doing it. I think we are all gearing up in order to do it.

Q76 Mark Garnier: But an equity investment, therefore, gives you that much more excitement. On the subject of equity investment, clearly it is treated differently for taxation purposes. Is that something that is also a stumbling block? If there was a change in taxation—rather like the Mirrlees report on the equity dividends—would that be one of the things that could help this infrastructure investment on its way?

Perry Noble: Tax treatment of debt I think has a big impact on the way in which we approach this type of capital structure.

Mark Garnier: Skewing you towards debt.

Perry Noble: It leads into the leverage, the whole issue of what risk are you building into the project by the nature and the extent of leverage. There is an inbuilt incentive to leverage up, and that is it.

Q77 Mark Garnier: If that incentive to leverage up was reduced by having a different tax treatment on equity dividends—rather like Mirrlees—then actually you would start moving towards having a greater return on your investments, which is what you are really after, and a better valuation for risk.

Perry Noble: I think we would regard it as more of a prudent capital structure consistent with such a long-term investment. It is all about risk rather than return.

Robert Hingley: I would agree with that, too. Can I just pick up one point, which is on the yields? I think that everybody has indicated—and I would certainly share that view—that the yields across all areas of fixed-term income have become highly compressed. Quantitative easing has compressed yields in the gilt market and there has been a knock-on effect into corporate debt. As Glenn said earlier, there is a search for yield.

In terms of are people willing to invest in current circumstances, then certainly from an insurer's point of view if you look at the liabilities that you are matching, people write annuities. They need assets to match those annuities, and the fact that yields are very low means that by historical standards annuity rates are quite low. But it does not mean, on the basis that you are fixing a liability against a certain rate, if the asset is matching that rate and you are going to hold that asset to maturity, that can work. It is a slightly longer version of saying you need to put money to work.

Q78 Mark Garnier: I expect half of you don't have the internal expertise but do have the cash, and the other half of you do have the internal expertise but don't have the cash. Mr Fox and Mr Noble, you have investors who come to you because you have that expertise and, Joanne Segars and Mr Hingley, you have the money but not the expertise. Surely the obvious answer—dare I say this?—is for you to get together and for two of you to give your money to the other two, obviously for a—

Perry Noble: If you take a commission on the low price, yes.

Mark Garnier: I would be delighted to take a brokerage fee. But there is an important point, isn't there? Given the fact that you don't within the pension fund and the insurance

industry have that expertise, surely it makes it worth while coming to the investors with the expertise and giving them the money, rather than necessarily having to try to develop that yourself.

Joanne Segars: We are developing that ourselves so we will have the money and we will have the expertise.

Robert Hingley: Same answer.

Chair: Thank you very much indeed for coming this morning. It has been relatively brief but extremely thought-provoking, and an enjoyable canter around an old subject. Thank you very much indeed.

Examination of Witnesses

Witnesses: **David Heald**, Professor of Accountancy, University of Aberdeen Business School, and **Richard Abadie**, Global Head of Infrastructure, PricewaterhouseCoopers, gave evidence.

Q79 Chair: Thank you very much for coming in. As is usual on this Committee, we are pressed for time. We are always trying to do too much in too short a time, but that is the way of things. Can I begin with you, Professor Heald? The original intention of PFI was that it would bring better value for money in projects, construction and management, and that there would be a very high level of risk transfer. A PFI panel was created to police that transfer. That later transmogrified into quite a different type of PFI in which, by implication, we now know there was a lot of risk transfer. We are now going round the same circuit, amplified by a macroeconomic incentive and an opportunity to do this because of the downturn in activity and the slack in the construction sector, and an opportunity because of yield compression at the long end of the market. How can the Government better protect itself this time from being taken to the cleaners, as it was in the last PFI?

Professor Heald: That was a complicated question but I will try to answer it. I think that we are at a rather dangerous moment, which reminds me of 1992 when there was equally a great desire to get spending on infrastructure facilities, partly because the infrastructure was needed and partly because of macroeconomic reasons. The reason why I say it is a dangerous moment is, listening to the previous discussion of guarantees, it strikes me that guarantees might be the next big problem. One of the driving motives for PFI became the accounting treatment—getting things off balance sheet. So one of the things that Parliament has to watch very carefully—and it needs to ask the Treasury questions very soon—is to avoid the Government just issuing guarantees about very long-lived projects, which don't score in public finances at the present time but will actually have long-term consequences.

Going back to your point about the PFI in the past, my view about PFI is quite nuanced. I think the accounting treatment issues have been quite outrageous. It has taken about 20 years to sort the accounting treatment issues out, and we still haven't fully done it because the last spending review and, I suspect, the new spending review will still be on national accounts basis for PFI and not an IFRS basis.

On the value for money side, I think the picture is much more mixed than the impression one often gets—the idea that the taxpayer is being ripped off by PFI. If you look at Parliament, if you look at the difference of tone in some PAC reports and the Treasury Committee report in 2011, in comparison with the House of Lords Economic Affairs Committee, you will see between the lines quite a lot of difference. In the PF2 document, the Treasury seems to be quite ambiguous about whether it really did get the construction risk transfer and really did get better performance, in terms of time and construction costs. I think there has been an unhealthy interest in the excess returns on particular projects. If certain

projects had very high excess returns but at the same time the thing got delivered on time and to cost, I don't think the very high returns or very narrow equity base necessarily contradict the fact the public sector got good value for money.

On the accounting, I think this is one of the areas where the Committee has to pay attention to make sure it does not take 20 years again to sort things out. On the value for money side, the picture is more nuanced. The proposals in PF2 very clearly involve less risk transfer than in conventional PFI. That will have implications not for the financial reporting accounting, not for the Government accounts or the whole of Government accounts, but it might well have implications for national accounts treatments. One of the things in the PF2 document is that 90% of PFI projects are on balance sheet for financial reporting purposes, but only 15% for national accounts purposes.

Q80 Chair: I want to clarify one point. Prior to the late 1990s there was very little risk transfer. When you said compared to early PFI, you were presumably referring to middle period PFI?

Professor Heald: Middle period, yes.

Q81 Chair: Mr Abadie, is there anything you want to add to what has been said before I pass on to other colleagues?

Richard Abadie: No, Mr Chairman.

Q82 John Thurso: Professor, can I follow up on the accounting issues? Because I rather agree with you that they are the heart of a great deal of what we need to get right. One of the key observations in our past report was the fact that PFI was possibly quite often being decided upon, not as the best way of undertaking a particular project but precisely because the accounting treatment meant that it minimised the short-term current account spending, and the actual expenditure itself was off balance sheet. You make the very good point that following adoption of IFRS, 90% of that was shown to be on balance sheet, but for the purposes of how national accounts are dealt with only 15% would appear. To what extent is PF2 open to similar flaws, in the sense that the motivation will be not for procurement and funding but to get things done so that it doesn't appear on the budget that the particular Department is dealing with?

Professor Heald: That goes back to the point I made about the ambivalence of the Treasury PF2 document. If the spending reviews are conducted on national accounts basis, and the off balance sheet PFI is not included in the budgetary numbers, there very clearly is a budgetary incentive to adopt that route. In fact, I think the public image of PFI was damaged by that accounting arbitrage, because there has been a lot of justified criticism of the accounting arbitrage but I think that has actually created a bad impression about PFI as a whole. My understanding is that what the Treasury intends to have is a control total of PFI liabilities, which is a different matter, which is not treating it on balance sheet but is actually showing what the future obligations are going to be. One of the benefits of getting whole of Government accounts is that we do know the scale of the regular reporting and the total of PFI liabilities. That is a matter for the Treasury. If the Treasury doesn't want the bias, the Treasury can actually remove the bias.

Q83 John Thurso: What we really need from the Treasury, or from any contract that any Government Department or local government body is wishing to enter into, is a clear statement of purpose setting out each of the different aspects in balance sheet terms, current account spending terms and cash flow terms, and where the risk lies, so that the value for money calculation, which is as much about transferring some of the risk as it is about the

cost—and, indeed, the two are obviously linked—is clearly understood by all the participants at the beginning and does not come as a shock five or 10 years down the track.

Professor Heald: One of the things about PFI that has always surprised me is that, compared with any other topic in my academic life, I have found that people tell me different things in private than they say in public. That is one of the significant difficulties. One of the things that one wants in the new round of PF2 is that people tell the same story in public as in private. My concern at the moment is not particularly about PF2 because, as I say, it is not going to alter the IFRS treatment; 90% off balance sheet is not going to affect control. I am certainly interested in what actually happens with, for example, taking out soft services, larger capital contributions, Government equity contributions. I suspect that in national accounts terms that is more likely to bring future projects on balance sheet. But my major concern is about guarantees—guarantees, for example, for power station output or high-speed rail projects. For example, if the Government guarantees the price of future nuclear output, how is it going to account for that? There are technical issues about whether that falls, as a financial guarantee contract, within international accounting standard IAS 39 or not, or some other kind of financial instrument. The question about how the Government is going to account for it is important, but I would also add how the private sector counterparty is going to account for it. Because there is no requirement under IFRS for symmetry in accounting, but one of the things I have learnt over time is when you get asymmetry that is a clue that you ought to investigate more. For national accounts purposes, there obviously has to be a symmetry.

Q84 John Thurso: If I have understood correctly what you are saying—particularly where there is that asymmetry you are referring to—the danger is that the desire to achieve a policy objective, such as building nuclear reactors and getting them up and running, and a similar but unconnected desire to have a certain series of numbers in the books, means that you take a decision on the former, which is not necessarily based on the best financial decision but it is one that allows you to achieve the objective on the latter.

Professor Heald: I agree with that explanation.

Q85 John Thurso: I am glad I understood it. Can I come to you, please, Mr Abadie, because I think you have advised the Treasury? Taking a specific example, supposing, say, the Department for Education decided to reject PF2 for its schools programme, on the basis of value for money, are there actually any practical alternatives available for funding the programme, or does that then mean that that programme doesn't go ahead?

Richard Abadie: I think that is a key question. I would emphasise I am not an accounting specialist, so David can answer all those questions. But the reality, as David has said, is in the past projects have taken place because there has been this accounting arbitrage. The new building schools programme is about £2 billion. It will be off the national accounts for all intents and purposes as far as I understand. If it were on the national accounts, the Department for Education would have to find a £2 billion capital budget to replace it. So there is a risk. I don't think that warrants all of the projects being treated as off balance sheet or off budget. I think there should be accounting symmetry. I don't know whether control totals get you there, but the bottom line is we do need to find a way of investing in the UK's infrastructure, that is key. What we cannot afford—and we have already had it over the last couple of years—is infrastructure investment drying up. The £2 billion schools programme, frankly, is relatively small in the bigger scheme of things. We need to be investing a lot more than that, and it would be tragic if we see investment further slow down because of some of the accounting issues. That having been said, exactly like David, I wish that just weren't an issue—

Q86 John Thurso: What I am trying to get my head round is, when I used to run businesses and I looked at the three legs of what I was trying to do, which was cash flow, available cash, P&L and balance sheet, there were circumstances where I did not have the cash flow to buy a big asset, which over time would generate more profit to invest in whatever it was. Therefore, there was a very sensible argument to be made for buying that asset on other finance terms, which would be more expensive but, ultimately, I would be making profit and improving the overall balance sheet. On the other hand, if I happened to be in a company that was flush with cash, the best decision would be to buy the asset with my cash. But if I don't have the cash I cannot do that, so a good decision is still to buy the asset slightly more expensively through whatever finance vehicle. To what extent does PF2 allow Government to basically say, "The best would be if we had lots of cash in the kitty, we would just go and buy it and do it, but we haven't so this enables us to do it"? How much is it just that and how much is it about other things, i.e. smart procurement, transferring risk from the public to the private sector? I have not quite got my head round what is actually the objective.

Richard Abadie: PF2 looks exactly like PFI from our point of view. The decision as to how we pay for the infrastructure that we need is a key decision. We either use PFI or PF2—whatever we want to call it—or we use Government borrowings. There is no way round it; we have to pay for this stuff, and if we want to repay it over a longer period of time, i.e. not out of taxes, we have to find some method of raising money. The trade-off is relatively simple. It is either through private finance sources—forget what the acronym is that we attach to it—or through public finances through the DMO's gilt programme. Either way, there is a price tag associated with it.

Coming back to what PF2 does, as I say, it is exactly like PFI from our point of view. What PF2 seems to seek to do is to improve efficiency and transparency. That appears to be its primary thrust. You look at disclosure requirements, and you look at some minor changes in risk allocation. That is an efficiency play. The other big element from what I can see in PF2 is that, as you had in the last panel, there is a long discussion around alternative sources of capital into the institutional markets, pension funds, life houses, insurance companies—alternative sources of finance. The reality, though, is that doesn't change the underlying point, which is that these assets need to be paid for in some shape or form.

Q87 John Thurso: My final question is, on the accounting treatment, then, what is absolutely fundamental is that both sides account transparently and openly so that the decisions that have been taken to fulfil the need are actually exposed clearly and openly in the accounting process. The question is: is what the Treasury proposes as its controls in PF2 going to achieve that? Either of you, or both?

Richard Abadie: Perhaps David after me, but I would agree with you in terms of the objective. I don't think PF2 achieves that outcome as laid out by David.

Professor Heald: Can I come back to John Thurso's point that the Treasury doesn't say that PFI is worse than conventional procurement. Basically, the Green Book procedures get corrupted to get the answer that is actually required.

The other point I want to make is that one needs a sense of proportion. It is very difficult. Governments tend to defend a particular fiscal mandate when they have actually determined it, particularly if you think about the present fiscal mandate and about the earlier fiscal rules. One should have a sense of proportion about PFI. Roughly, PFI if all on balance sheet would add about 2.5% to the public debt. In January 2013—

Q88 John Thurso: You think it is what, about £35 billion?

Professor Heald: It is 2.5%. In January 2013 public net debt, as a percentage of GDP, was 73.8%, in the way that the Treasury publishes the numbers. But if you go to the public

sector *Statistical Bulletin* published by ONS and the Treasury, it shows you that if they had not excluded the impact of financial interventions it would be 138.9%. The financial crisis had a huge effect both in increasing the net debt and also in creating the vast margin between the two measures of the net debt— the one we used to use and the one we use now. The amount of energy that goes towards getting the things off balance sheet is disproportionate to the actual numbers involved.

John Thurso: That is the point that I understood very clearly. The only other area where this Committee has seen that is with banks and SIVs, things of that nature.

Chair: Brooks Newmark has a few quick questions and then Mark Garnier.

Q89 Mr Newmark: I want to talk about Government taking minority stakes in businesses. The Government states that it will look to act as a minority equity co-investor in future projects. Under PF2 it argues that this will improve value for money as the public sector, i.e. the taxpayer, will share in the ongoing investment returns, reducing the overall cost of the project to the public sector. Do you agree that the Government taking minority equity stakes will improve value for money for taxpayers, Richard?

Richard Abadie: Not particularly. Let me explain why I say that. If you looked at it on a standalone basis—i.e. you were in the world of 10% equity and 90% debt; so where we used to be before PF2—Government taking, say, half of that equity would do something that I think adds value and that should make the deals cheaper. Whether cheaper is better value for money is a separate discussion. Why I say it would make it cheaper is if Government took half the equity and the return was paid back effectively to the taxpayer, you would argue that the net cost of PFI, being the payment that goes to private sector less the dividends that come back to Government, would ultimately make the deal cheaper. If your point, which is not how it is made out, is, let's get the cheapest potential source of capital—on average the lowest weighted average cost of capital—it achieves that outcome, and you tick a particular box or objective or policy initiative.

When it comes to value for money, you heard today there is substantial appetite in the private sector to take equity. Ironically, some of the previous panel were talking as if equity is a problem in today's market. It is not. There is so much equity flowing into infrastructure on a global basis that we do not have a shortage of equity. The latest estimate is about US\$150 billion. My question around that is: what is Government's policy intervention around equity? If it is to reduce the overall cost, as I say, that is not a problem at all. That is an understood and logical policy objective.

Q90 Mr Newmark: There is a bigger thing. Again, from a private equity standpoint, we sometimes got management to put money into businesses with us because it actually also aligns interests. Would you agree with the statement that it is going to help align the interests of effectively the project manager and the institutional investor and the taxpayer? I only say this because historically there is this sense, and the evidence is there, that Government and taxpayers got ripped off by the charges as you stretched out time, and so on. It is almost like a form of schmuck insurance—that you want to reduce being thought of as an idiot for giving you guys this deal, and then three, four, five, 10 years down the line all these extra costs come in, and it is protecting a little bit of that, too.

Richard Abadie: It is an indictment on the model that we have deployed that we have not been able to—as the public sector and through procurement—achieve that outcome through the actual contract. That would be the preference, rather than participating in the risk of capital.

Q91 Mr Newmark: That is because the guys negotiating the deals are much smarter than the people on the Government side. That is why that happens. What has happened is that people have run circles around these people because they are not business people. They are not sharp people. They are smart people but they are not business people. As a result, the various loopholes in the contracts have enabled these add-on costs. Trying to align those interests, I am thinking that having them as co-investor might help that. Professor Heald, you have not commented.

Professor Heald: I don't know whether it would actually align interests. There is a danger of rolling out a very standardised model—for example, the discussion about what kind of maintenance would be part of the contract and soft services being necessarily outside. Your point is that there is a centralising tone to the PF2 document, pulling things back to Whitehall, and one can see conflicts within the public sector, between the local public sector client and central Government.

Q92 Chair: But the question for both of you is exactly as Brooks put it. He did not quite put it this way but it is what he was driving at. How are we going to stop the Government being taken to the cleaners by these very clever people when it comes to writing the detailed contracts?

Professor Heald: You hire very clever people yourself but that runs into the—

Q93 Chair: They are very clever people. We have very clever people, as Brooks pointed out, but they did not have the right technical expertise.

Professor Heald: Well, the people with the right skills. But that runs against the argument that nobody in the public sector should earn more than the Prime Minister, and also it exposes the Government to the revolving door, whereby one of the problems is the people who write the rules at the Treasury and other Government Departments then actually move back into the private sector. One of the worrying social economic things is the way that people arbitrage rules. Having been responsible on secondment to the Treasury for writing the rules, one then moves back to the private sector, and knows exactly how to arbitrage those rules. The answer to your question is the Government has to hire the skills itself and pay the market rate for those skills. If it is not prepared to do that, it is going to hit trouble. If it is not prepared to do that, it also has to go for simpler contractual forms.

Q94 Chair: Before long, we are going to be into European Parliament reports on PFI bonus and salaries, aren't we?

Professor Heald: If Governments want complicated forms of procurement, you have to make sure you have sufficient skills that belong to you, long term, that enable you to run those contracts. Things are becoming much more complicated. Thirty years ago, if the Government wanted nuclear power stations built, it would have told the Central Electricity Generating Board to build nuclear power stations or British Rail to build a new railway line. We are in a much more complicated world. If you are in a much more complicated world and if you are not willing to hire the skills and pay the market rate for the skills, you are obviously going to get into trouble.

Q95 Mark Garnier: I must finish up on this one particular point, but actually this is the key to the problem—it is asymmetry between the skills of the negotiators and the negotiatees.

Chair: And the moral hazard in that.

Mark Garnier: And the moral hazard, absolutely. If you are a provider of PFI, it is in your DNA that you know about return on equity and risk, and all this kind of stuff. Even if

you are the highest paid, most skilled individual that is available to humanity, employed by the Government on the procurement side, you don't have that tension when you wake up at three o'clock in the morning thinking, "Am I going to lose my job as a result of this?" because you have different dynamics. Is this just a problem we are never going to resolve in terms of the asymmetry? That was a question, sorry. Feel free to answer.

Richard Abadie: Yes, it is an issue. I was in the Treasury—so I am perhaps one of these people that cycled in and cycled out; I'm happy to have that as a separate debate—and the reality is the civil service prides itself on generalists, people who rotate in and out of roles on a regular basis, rather than having a cadre of specialists. In that policy document there is talk of doing that. As David was saying, it does run up against a contrarian view that you should devolve responsibility and authority rather than consolidate it. That is something that Government needs to work its way through. Procurement generally is complicated, and to get best execution you need specialists in that field. PFI is at one of the extreme ends of complexity.

Q96 Mark Garnier: Moving on, because that is a subject you can go on for ever, I think you were here for the last session and you might have noticed I was digging into the risk-free rate and what effect QE has had on the whole of the risk-free rate returns that you can get. PF2 now suggests that potentially, there will be a greater deal of equity in investment decisions. What is the solution with all of this? Do you see that the equity side of this is going to be the answer to investors getting a better return compared with what the risk-free rates are, and do you think in the future we will look back on this period as being a disastrous period for investment because the returns are going to be so low starting from where we are? Professor Heald, why don't you try to address that?

Professor Heald: I think that is a question more for Richard than for me, but we are in a very, very strange period. It is not clear whether the proposal for more equity is based upon principle or whether it is a pragmatic response to the lack of debt finance because the banks have moved out of the business.

Q97 Mark Garnier: Yes, but there is plenty of money around that will lend money on debt. We have pension funds that are desperately looking for risk-free investments or very low risk-free investments, but their risk-free rate is 1.9% based on 10-year gilts. That is simply not enough to be able to meet the expectations that they have in the future. How are they going to achieve it and is PF2 going to give the answer to that through equity?

Richard Abadie: If we separate out debt and equity, my earlier point was—and I am not criticising the panel—the concept of debt and equity got muddled very, very quickly. Answers were being given around financing generally, rather than separately. On the equity side, we do not have a problem with equity. There is a lot of discussion around it. You even heard some resistance from some of the panel saying, "We don't want to take construction risk". How we are going to increase economic growth, deliver jobs, is through investing in infrastructure that has to be built. All of us want no risk and to earn a return in every single one of our individual lives. Equity is not a problem in the current market. The key issue we face on any form of leverage—whether it is mortgages, whether it is any form of debt instrument, including in infrastructure, not just PFI and social infrastructure but our wider infrastructure market—is access to long-term debt. Currently, we have a situation where the banks are retracting. There is a handful of them, and no more than that, offering them long-term debt and the institutional market is where that policy document is headed to try to get institutions to lend long term. But it is not clear to me that that is going to be as big and as liquid as we all wish. One of the panellists mentioned that he had spent three years trying to

raise debt for his fund. It is not easy. It is not clear to me that we are going to get the level of debt coming in.

In terms of return, the other point the panel made—which I think is absolutely true and it is actually a concern—is that investors, both equity and debt, are chasing yield at the moment. They are getting no yield if they invest in Government gilts, or very little, so they are chasing absolute yield. As long as infrastructure gives them that yield, they will invest. I don't think it is particularly scientific. I think it is literally the highest return they can get in the current market to meet their long-term liabilities that they are going to seek. Why I say it could be a bit of a concern is if the market changes, and liquidity comes back more generally and rates improve, you may find the reverse happening, whereby people say, "Infrastructure is not that attractive. I am going to put my money somewhere else". That is a real concern. Whatever we create has to be sustainable in the long term. The last thing we want—and this policy document may or may not achieve that—is some short-term fix for a problem that unwinds itself at some future date.

Q98 Mark Garnier: I have seen in the past where a completed infrastructure project has been sold off in the equity market as an IPO. I am thinking particularly of the gas distribution network in Malaysia. You have one customer, which is the Government or the gas supplier, who rents the space in the pipeline. The equity market investors then own that investment, and there is a very, very simple return on that and it is a very low-risk equity investment. Ultimately, I would suspect there is an implicit guarantee behind that because clearly you want to get your gas distributed. There are things like that in the UK; for example, the railway network and the motorway network. Is there a possibility that that type of asset could be sold off to the equity market and then rented back by the Government?

Richard Abadie: The accounting issues aside, because it is worth understanding how that may happen, that does happen all over the world. You get not necessarily sale and lease back per se, but you get assets. We have a long history in the UK of energy and water assets being developed by Government, at the taxpayers' risk over time, and then being privatised. The key difference between—

Mark Garnier: A slightly different thing, though, isn't it?

Richard Abadie: I would hypothesise it is pretty much the same because when you talk about cost of capital, they are all regulated. Whether you are in the gas networks, the energy networks—not generation but distribution and transmission—whether you are in the water networks, there is a concept of regulating the cost of capital on a periodic basis, say, five years, which is the current convention. The difference with some of the PF2/PFI methodologies is that you are looking to transfer a fixed price on the cost of capital for 30 years. I know there was a debate somewhere in that document around whether we should move closer to a model that resets the cost of capital on a periodic basis, like a regulator would. Perhaps in this uncertain time when rates are uncertain, the future direction of finance costs are uncertain, we may be better off setting an environment where rates are reset—debt rates, equity rates, whatever the case may be. The weighted average cost of capital is reset on a periodic basis because—

Q99 Mark Garnier: It is quite a big ask, though, isn't it? Because if you are somebody who wants to buy a hospital, then there has never been a better time to do it than now because of the very, very low rates. Whereas if you are the provider of the PFI financing, you will want it changed every year for the next 25 years in order to keep up with the changes.

Richard Abadie: I remember that same argument in the late 1990s. People said rates surely cannot go any lower, and they did. We may argue that through the 2000s it was

artificial. I struggle to know where rates are going to go. They do feel exceptionally low at the moment, but I guess my point is: what is the risk that we are trying to transfer? If we are trying to get the private sector, through PF2, to commit to a fixed cost of capital for 30 years, we have to accept that, in a market that is uncertain and liquid, people are not going to take on that risk themselves. The taxpayer will pay whatever is the market clearing prices in a very liquid market. There is an argument that says the taxpayer may be more willing to pay based on what the current conventions are at a given point in time, rather than a fixed price for 30 years. Most of us cannot even think forward five years, let alone 30 years. That is where the regulated utilities come from, or the regulators come from. It is much more difficult where you have a substantial construction risk, I do accept that. The gas network is a lot simpler because the asset has been built and you have some contracted off-take as well.

Q100 Mark Garnier: Is there an argument for issuing—this is my last question, Chairman—specifically infrastructure bonds? There is a lot of talk about the Government borrowing at a very low rate at the moment. Rather than having a general gilt, which would then obviously increase as a general asset, specifying an infrastructure bond that is dedicated to this thorny problem?

Richard Abadie: Infrastructure bonds do occur in other markets. For me, it is more a debate about hypothecation of revenues and hypothecation of fundraising, and whether or not we are willing to do that as a country. On that theme, if we want retail investors—people around this table—to invest in infrastructure directly, right now you are dealing through a pension scheme, or not, as the case may be, listening to the absurdly low levels of infrastructure investment in UK pension funds. But if you want to do it directly yourself, you don't have access to the retail investment side. If you move to markets like the US, you have tax exempt municipal bonds. In other words, there is a scheme whereby you can buy directly into infrastructure, either through your pension fund or as an individual, but there is a tax arbitrage opportunity in that. There is a question for me, if we are keen to attract retail investors into the debt products we have in our market, as to whether we shouldn't be looking at something similar. Just to be crystal clear and for the avoidance of doubt, what that is effectively is tax flowing from the Treasury, i.e. from the centre, down to the project. That is a tax benefit that flows down through the structure. Again, that is another allocation of scarce resources. I would expect the Treasury to say they are not prepared to do that, although I know they are looking at tax incremental finance, which has some of those elements. But if we are looking at retail products to try to get individuals to invest in that infrastructure, bond or municipal bond as it is constituted in the US may be some way to do it. But I think what you have to then do is provide some incentive to buy it. Tax incentives would be the way.

Q101 Mark Garnier: That argument presumably applies exactly the same to the different tax treatment for equity dividends, does it?

Richard Abadie: Correct.

Q102 Mr McFadden: Mr Abadie, you said in the past, "I'm supportive of an infrastructure bank as well as these things". Going to David Heald's point about precautionary measures and all the effort put into creating these fancy vehicles, which can often be expensive—and given Mark Garnier's point about the Government's ability to borrow 10-year money at less than 2% at the moment—is all this stuff about trying to attract other investors worth it? Why shouldn't the Government use its historically low interest rates, whatever the reason for them, to finance the infrastructure investment it needs for growth?

Richard Abadie: I will come back to the infrastructure point, because your wider question is: why not just fund it ourselves? There is an argument for that, absolutely. As a

country, we can still borrow relatively cheaply, notwithstanding the Moody's downgrade. Let us say we were to go out to the market today and say—I think David was saying it is £35 billion and it could be slightly more, in terms of debt—well, actually, no, let us put it another way. We have announced an infrastructure programme of £250 billion, a good proportion of which is coming from Government but not the majority. If we were to go to the market today and say we are going to launch Government gilts to fund our infrastructure valued at—I need to make up a number—£100 billion, the market may take a fairly dim view of it. If we are using Government gilt programmes and we are going to shock the market with that level of borrowing, I don't know how the financial market will react. It is certainly not going to be positive. It may be negative; it may be neutral. At best it is neutral.

I had this discussion with somebody in the Treasury once where the Treasury said, "We should just fund this all ourselves", and I said, "Nobody is stopping you". This is the honest answer. Nobody in the private sector has said, "We are not prepared for you to do that". It is not within our gift in the private sector. Government is fully entitled to go out there and borrow the hundreds of billions of pounds it needs. I assume the reason they are not doing it is the potential consequence to our cost of borrowing and our credit rating. Therefore, you look at these alternative structures. The problem specifically with an infrastructure bank, and it is used in other markets, is that is an extension of Government borrowing. It is normally Government guaranteed. It is owned by the Government.

So, back to your point, while I may have said that it is an interesting idea, I don't think I would have advocated it, per se, because I think if you are going to set up an infrastructure bank you may as well have Government do the borrowing yourself.

Q103 Mr McFadden: You might have been misquoted. The quote we have been given is, "I'm supportive of an infrastructure bank".

Richard Abadie: Well, I probably said "Not".

Q104 Mr McFadden: Rather than pin you on this, what I want to get my head around is how this would work. We have these things in other countries. We have KFW in Germany and various other things. Given your experience around the world, how might such a public sector body work in the UK?

Richard Abadie: I have an interesting example. Just on KFW, if I can reflect on that. KFW is an interesting organisation, very successful, very active. Its accounting treatment is grandfathered to just after World War II, so that a lot of its borrowing is actually off balance sheet. It is a unique financial institution that we could not replicate in today's environment. The example I did want to give you that is of interest to me, but it requires some mandation of our pension fund industry, is in Brazil, about 80% of their substantial infrastructure programme is financed through a state-owned development bank called BNDES in Portuguese—basically, the National Development Bank. Most of the debt in that market, and a substantial chunk of the equity for the infrastructure programme, comes from the state-owned bank. The question is: where does the state-owned bank access its capital from? It is from the pension fund industry. What happens is there is a mandatory allocation from pension savers in auto-enrolment environments to this infrastructure bank, or development bank if you want to call it that, and that money in turn finds its way into infrastructure. When I, as a pension saver, say—and I cannot remember exact numbers—5% of my pension savings go to infrastructure, inevitably it is actually going into the Brazilian National Development Bank, which is stated owned, to in turn allocate into infrastructure. If we are looking at deploying capital out of the institutions, it is on a voluntary basis. You have heard some of the resistance to some of the investment that is taking place due to of the risks. There is a question as to whether you have a mandation environment where you actually mandate a minimum

allocation to infrastructure and you put an intermediate vehicle in place—quite possibly Government owned, entirely up to us as a nation—but you have a means of allocating that capital back into infrastructure. Your question is: are there alternatives? There are, but they do require some pretty significant shifts in how we regulate pension funds or insurance companies, the allocation that we need, and whether Government has the appetite to own and manage something that looks like an infrastructure or development bank.

Q105 Mr McFadden: Professor, I want to give you the last word on this. You have had a long, long involvement in all of this over decades, and you have seen what you describe as a disproportionate effort to keep this kind of investment off the balance sheet. Looking at the terrain of state-owned vehicles in different countries, the announcement here about the Green Investment Bank and so on, what is your view of something in this space that would be perhaps more straightforward and perhaps trying to use the current low levels of public borrowing that the Government can access?

Professor Heald: I am instinctively very suspicious of things that are off balance sheet. Accounting tries to portray economic reality. However, one of the problems one has is that sometimes the accounting can actually distort what becomes economic reality. The key question is whether the Government will borrow more through conventional means, conventional borrowing, to actually fund more public investment, or whether it regards the way it has formed its fiscal mandate—be it fiscal rules of the previous Government or the precise fiscal mandate under this Government—as actually justifying distorting economic choices. At the margin, I would finance more public investment out of conventional borrowing. I worry about the discussion earlier at this meeting whereby if the Government cannot get the skills to match the people facing it across the table, that suggests that the contractual means that are being used are actually too complicated.

Mr McFadden: Whether the borrowed money is borrowed through the PFI type thing or whether the Government borrows it, it is still a private sector construction company that builds the school, the hospital, the power station and so on. Anyway, I think I will leave it there for today.

Q106 Chair: Can I just end, Mr Abadie, with a question to you? Previous witnesses have told us that the move towards more equity finance will increase financing costs for PFI compared to PFI1. Do you agree?

Richard Abadie: Yes, I do.

Q107 Chair: How much? Obviously, you cannot say, but give us a feel.

Richard Abadie: I estimate that the overall cost could go up by up to 10%. Only for the sake of argument, if the weighted average cost of capital is 8%, it could go up to 9% or 8.8%. I would caveat that, though. If the pension funds and life insurance companies that we saw at the table earlier today are able to invest their debt at a lower price than banks are currently lending at, that difference would come down. It is quite an easy calculation, but my estimate is that the pension funds and insurance companies putting debt into projects, as opposed to equity, would have to have their debt in the projects 20% cheaper than the current banks to break even. It is an approximation, so effectively they would have to come in with much cheaper capital on the debt side than the current banking model.

Q108 Chair: Would it be a lot of work to set out that calculation on a scrap of paper and send it to us?

Richard Abadie: It is already on a scrap of paper. I can send it to you. It is not a problem.

Chair: Thank you very much indeed. Is there anything either of you want to add at this stage? No. We are very grateful to both of you for coming along—two serious experts on a complicated and serious subject. Thank you very much indeed.