C Reduction in the Cost of Capital

C1 Regulatory Asset Base Model

Description and Overview

The finance cost for infrastructure depends upon the cost of capital (the cost of debt and debt premium and the cost of equity) and that in turn depends upon the allocation of equity risk. Therefore financing cost depends a great deal upon whether the regulatory system and the role of government are designed to hold down the cost of capital. In the regulated utilities this is achieved through the Regulated Asset Base (RAB).

The RAB is a number which represents past investments, comprising what investors paid when the assets were originally privatised plus subsequent capital expenditure adjusted for depreciation. Once assets are in the RAB there is nothing that management can do to change their value. The RAB is an accounting number, protected by the duty which is placed upon regulators to finance the business, including the RAB.

This duty gives rise to an effective guarantee that the regulated company’s investment will be recovered over time from consumers. This guarantee contributes towards making investments in regulated utility companies relatively low risk. The equity risk in the RAB for the regulated company is zero as the risk has been transferred to consumers who are obliged to pay for the RAB.

If the RAB is guaranteed then it can be financed by debt and the debt is effectively guaranteed by the regulator’s financing duty. Therefore the cost of financing the RAB should be close to that for financing government borrowing.

Can the RAB concept be generalised? Particular RABs can be thought of as guarantees that the sunk costs of particular projects can be recovered. It can be seen as a commitment by future consumers to cover current investment. Seen this way the RAB model could be extended to pay for the carbon reduction obligation and potentially also roads instead of current users covering the cost on a “pay as you go” basis.

Extending the RAB model to assets and/or sectors which are not currently regulated may create a similarly low risk structure and a lower cost of capital. Waste is one other potential area where regulation and a charging mechanism for consumers could be introduced. The waste assets could be contained within RAB with a duty on the regulator to ensure funding from consumers.

However, a possible disadvantage of the RAB model is affordability issues arising from passing the risk of sunk costs to consumers and particular impacts upon specific groups of consumers. Social housing has some similarities to the RAB model. However the HCA as regulator does not have a duty to ensure that the RAB (housing) is financed. This is achieved instead by the contractual landlord and tenant relationship. Rents are regulated and affordability issues may make the application of RAB difficult.

There may be losses of competition. The application to social infrastructure may be difficult as consumers of the service generally don’t pay for the service. A transfer of the guarantee to the taxpayer will have inevitable balance sheet implications.

Equity is not removed as a consequence of RAB. It is important that undertaking capital expenditure remains sufficiently incentivised. The capital project itself will be financed by equity and project finance in advance of being sold into the RAB.
C1Comments

- RAB enables reduction in cost of capital.
- Potential for generalisation to economic infrastructure.
- Social infrastructure more difficult.
- Potential impacts on markets with competition.
- Possible consumer affordability issues.
- Equity still has role.
C2 Government Direct Lending

Description and Overview

HM Treasury established the Infrastructure Finance Unit (TIFU) in March 2009. The purpose of TIFU was to lend where there was a lack of available finance from the private market. TIFU lending would be on commercial terms, with the lending temporary and reversible. HM Treasury intended TIFU to increase the pool of finance available to projects but did not wish to interfere with market pricing of bank finance. One £120m loan was provided to the Greater Manchester Waste PFI project and other projects were subsequently able to secure funds from Banks. The 2010 Spending Review confirmed there is no separate funding provision for TIFU interventions and TIFU therefore no longer has capacity to make new loans.

A significant public lender is the Public Works Loan Board (PWLB). The PWLB is an independent and unpaid statutory body which has existed since 1793 and since 2002 has operated as part of the UK Debt Management Office (an agency of HMT). Its customers are local authorities and other prescribed bodies (although nearly all its customers are local authorities) requiring loans for capital purposes. Although not restricted to infrastructure lending much of its lending is for that purpose (probably more social than economic).

The role of PWLB therefore is to on lend central government’s own borrowing to local authorities to deliver capital investment. The PWLB interest rates are determined by HM Treasury and are relatively cheap although the Spending Review increased those rates by 1%. Local Authorities have express powers to borrow for the purposes of their functions provided such borrowing is within statutory self imposed and any nationally imposed limits. All PWLB loans are charged indifferently on the local authority’s revenues as there is a prohibition on mortgaging specific assets.

Local authorities can therefore borrow from the PWLB to finance capital works or infrastructure. However, as with any borrowing such needs to be affordable. Affordability can arise from a number of sources such as assets, efficiency savings, project income and reserves. The source of the affordability may determine the procurement route for example whether a design and build or long term contract including operation. In the case of the latter there will be complications around payment and performance due to an absence of a capital element in the payment and a lack of external funder incentives.

The Government has also announced the establishment of a Green Investment Bank which will support economic growth through investment in the green economy. The new institution will take on risks which the market will not currently finance. £1bn capitalisation will come from the sale of Government owned assets. Design work will be completed by Spring 2011.

Credit Guarantee Finance (CGF) was identified by HM Treasury in its PFI policy document ‘Meeting the Investment Challenge’ in July 2003 as an opportunity to reduce the cost of PFI debt financing. It recognised two elements of debt pricing: a risk premium and a funding premium. The idea behind CGF was that the Treasury retained the funding premium because it had a much cheaper cost of funding than any other debt provider. The risk premium was paid to monoline insurers. But even before the monoline business model died, so had CGF because no incentives were offered to PFI sponsoring authorities to share any of the funding benefits – the Treasury captured all of the funding premium.
C2 Comments

- Borrowing from the PWLB can be a relatively cheap source of finance.
- Borrowing by local authorities needs to be within their statutory self imposed and any national borrowing limit.
- Local authorities cannot mortgage or charge specific assets.
- Borrowing must be affordable i.e. capable of being repaid.
- Affordability may determine procurement route.
- PWLB monies may be invested or on loaned for capital purposes but subject to compliance with State Aid rules.
C3 Government Approaches to Risk

Description and Overview

Many different approaches have been taken to risk to reduce the cost of financing. At its most obvious it involves transferring only those risks which are best managed by the private sector. However, some approaches involve positive "risk slicing" of the project.

Underpinning is where the government in some form guarantees or uses its credit support to make financing possible at a reduced cost. Examples include the 95% underpinning on the Tube PPPs.

Other approaches have involved de risking elements of PFI projects. One model which has been used in the concession for the DLR Woolwich Extension is to reduce the risk to contractors by underwriting some of the financial risk during the operational phase. The greatest risks in the project are during the construction phase and it was during this phase that the benefits of risk transfer were at their optimum. As a consequence it was agreed to guarantee 75% of the unitary payment after the infrastructure had been completed and in satisfactory operation for two years. With public sector agencies having good credit ratings this enabled a substantial reduction in financing costs.

De-risking is likely to be benefit where:-

- operational risks are minor in proportion to construction risks;
- operational risks can be managed and/or the extra cost can be met;
- the project would ordinarily be on balance sheet.

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