

4.4 ENGAGING THE PRIVATE SECTOR

Headlines

- **The case for engaging the private sector in transport is well rehearsed and in the right circumstances can deliver:**
 - **reduced costs through greater efficiencies in construction and delivery of projects to time and budget; and**
 - **potential for increased benefits where efficiencies free up public funds for new investments.**
- **The Government is already using the private sector to deliver transport infrastructure and services in ways which secure value for money.**
- **Structural changes in the sector provide new and unique opportunities to engage the private sector where it represents value for money – most notably:**
 - **unprecedented global investor appetite actively looking for the potential stable and long-term returns offered by transport infrastructure projects; and**
 - **as markets mature, a narrowing of the gap between the costs of borrowing for the public and private sectors.**
- **As the sector evolves, Government must continue to learn the lessons of experience and help shape the future market:**
 - **offering certainty and transparency through a clear framework for private sector engagement, including managing a pipeline of potential projects; and**
 - **employing the right skills at all levels of Government to sustain this.**

INTRODUCTION

4.1 Globally, both developing and developed countries are recognising the importance of an efficient and effective transport system to support the economy. In the UK, both the public and private sectors play a key role in delivering transport projects. Public sector investment in transport infrastructure amounted to some £9 billion in 2005-06, securing benefits to the economy and wider society.¹

4.2 As Volume 3 highlighted, the Government can secure value for money on public spending through effective prioritisation. Much can be achieved through a combination of targeting, full appraisal and better use of existing resources.

4.3 The Government also needs to consider how to make the most of private sector engagement in transport: through the planning system (as Chapter 4.5, Volume 4 explores); through the procurement of projects; but also in terms of funding and financing of transport projects.

4.4 All projects must, of course, be funded from some stream of revenue. In the context of transport, there are two choices. Either the government pays through general taxation or the users of the transport infrastructure or service pay through some form of charging, i.e. fares or pricing. In practice, and as is often common for public transport and roads, there is a combination of the two, for example, the government subsidises bus provision but bus users also pay a fare (albeit lower than would be the case without the subsidy).

¹ *Public Expenditure Statistical Analyses*, HM Treasury, 2006. This figure includes capital spending by central government, local authorities and the devolved administrations.

4.5 Technological advances and greater acceptability of user charging continue to provide new opportunities for Government to review both the balance of public and user funding, and the allocation of risk between the public and private sectors. This chapter concentrates on those projects that are predominantly publicly funded but are delivered, where it represents value for money, through some form of private sector engagement.

Chapter context and structure

Transport has a long history of private sector engagement

4.6 The UK has a long history of private sector engagement in the transport sector. Railways in the nineteenth century were built through private sector entrepreneurship. Many of the major ports and airports in the UK operate through successful private ownership. And across all modes of transport, the private sector is already delivering through a range of models in which both the public and private sector play a part.

4.7 Of course in reality, all UK major transport projects and services are delivered through some level of co-ordination between the public and private sectors. Very little can be achieved by government without drawing to some extent on private sector skills, capacity and ability to manage risks. But the extent of such engagement varies significantly by project and in some cases private firms may only be involved as the supplier or sub-contractor.

4.8 Furthermore, boundaries between the respective role of public and private sectors are not fixed, and their potential involvement alters through time. Looking at recent experiences in the UK and elsewhere highlights that there is scope for the private sector to add value and secure value for money through effective engagement.

4.9 Structural changes in the financial and infrastructure markets present potential new opportunities, notably: unprecedented appetite for private sector investment in the transport sector; and, as markets mature, the narrowing of the gap between the costs of borrowing for the public and private sectors.

4.10 In addition, Government and the private sector now know more about what does and does not work, and can learn from past experiences. This is important to ensure the desired outcomes are achieved through the appropriate allocation of risk and obtaining value for money for public expenditure.

4.11 This chapter is split into three parts:

- the first discusses the balance between public and private sectors in the efficient delivery of transport projects based on the appropriate allocation of risks;
- the second discusses the structural changes in the financial and infrastructure markets and the potential opportunities they create for delivering transport through the private sector; and
- the third sets out conclusions and recommendations.

THE BALANCE BETWEEN PUBLIC AND PRIVATE SECTORS IN THE EFFICIENT DELIVERY OF TRANSPORT PROJECTS

4.12 There is a broad spectrum of models across the transport sector, within which the public and private sectors are engaged to varying degrees in delivering transport projects. The appropriate model will be largely dependent on the risks involved and how they are allocated to the party best able to manage them:²

²It may also depend on the level of control the service provider requires over the asset.

- at one end of the spectrum is private ownership with little or no government involvement, for example, UK ports and the majority of airports;
- following on from this is a model whereby the private sector has responsibility for the transport asset but with oversight through an independent regulator, for example, a number of the large UK airports; in some cases such regulation is also accompanied by government support through subsidy, as with Network Rail;
- the largest range of models involving both public and private sectors come under the umbrella of Public Private Partnerships (PPPs). This includes Private Finance Initiatives (PFIs), where the private sector is involved in service delivery from the asset; and
- finally, at the other end of the spectrum is the public ownership model, for example, the local road network, where the private sector is usually only a contractor.

Private ownership 4.13 The public sector plays little or no role in the operation and enhancement of privately owned ports and airports.³ Due to the monopoly nature of some privately owned transport assets, a regulatory regime may be necessary in order to protect the interests of transport users.⁴

Regulatory regimes 4.14 The primary examples of regulated transport companies are: the provider of the air traffic control system, NATS En Route Ltd; and the four largest UK airports, Heathrow, Manchester, Gatwick and Stansted. Each sub-sector has its own independent regulator that has received its duties and powers through separate Acts of Parliament. Each of these regulatory frameworks has been designed to accommodate and incentivise investment through the pricing regime set by the regulator, to allow a suitable financial return to be made on investment. In some cases, the regulators will have processes for requiring specific investments from companies.

4.15 A variation of this model is that adopted by Network Rail (NR). NR is a private company that owns and operates the majority of rail infrastructure in Great Britain. This model differs from some other regulatory models because of its 'not-for-profit' status, with any profits earned going straight back into improving the railways. Furthermore, its debt is backed by Government guarantees and it receives subsidy from the Government. NR's financing requirements are principally met by debt raised from the capital markets.

Public Private Partnerships 4.16 Internationally, transport has absorbed a major share of the market for Public Private Partnership capital in the wider OECD, particularly in Europe. Over the four years to the end of 2008, Public Private Partnership projects under procurement will result in an estimated €55 billion of investment being committed, three quarters of which will be in the transport sector.⁵

³ Although some ports and airports are owned by local authorities, such as Manchester Airport and Portsmouth Port.

⁴ Such regulation would be required where there are market failures, such as monopoly power, or externalities, like congestion and environmental damage. These would not be accounted for in private behaviours or decision making and therefore under- or over-provision of transport capacity would result.

⁵ John Laing plc estimates quoted in *What Makes a PPP Effective For Government? A public sector perspective, Background Paper for 2005 PPP Transport Summit*, published DfT 2005, as part of UK Presidency of EU programme.

4.17 The range of PPP models includes variations of the design, build, finance and operate (DBFO),⁶ which the Highways Agency has adopted for some enhancements to the strategic road network; the build, own, operate (BOO),⁷ or the design, build, finance, transfer (DBFT) where the assets transfer to the client at the end of the construction period. In practice, in nearly all other models the assets are owned throughout, financed and operated by the public sector.

4.18 One particular form of PPP is the PFI, whereby the private sector is also involved in service delivery from the asset. In the UK, the transport sector has been a key recipient of PFI investment, with 41 projects with an aggregate value of £4.7 billion having reached financial close by 2006 and a further £4 billion scheduled to progress through procurement to financial close by 2010.⁸ These statistics do not capture the investment that has taken place under different PPP structures, which are significantly different from more standard PFI procurements.⁹

Public ownership **4.19** Finally, many transport assets are under public ownership. The private sector is still involved but it would only be contracted to act as the delivery agent, typically managing the risks around construction. This approach is used for the majority of local and strategic road enhancements, for example.

The appropriate allocation of risk

Risks should be allocated to the party best able to manage them **4.20** In delivering transport projects, which by their nature have inherent risks (ranging from pre-construction, construction, to operational stages), the most appropriate model to adopt will largely be determined by how those risks are best allocated, i.e. by assessing which party would be best placed to manage them. This is a crucial component of the extent to which value for money of public expenditure can be achieved. The risks can be broadly characterised into different types, including:

- pre-construction;
- construction and operation;
- demand; and
- network and other external factors.

Pre construction risk **4.21** Pre-construction risks can be significant for some schemes and can impact both on the costs and timing of delivery, and in some cases on design. This might be the case, for example, for projects where planning permission is not straightforward. Depending on the stage of procurement, this risk tends to be managed by both the public and private sectors. Outline planning risk in the early stages is usually managed by the public sector but later in the process risk associated with detailed planning (post financial close) tends to be better managed by the private sector.

⁶ Here a Special Purpose Vehicle (SPV) is created by the private sector, which is responsible for raising finance, designing, constructing and operating the assets. The SPV is entitled to a payment stream, which may comprise of direct charging (e.g. real tolls/fares), availability payments or shadow tolls.

⁷ Here the private sector owns the asset outright and therefore bears all revenue risk in perpetuity. It has the right to design, build, own, operate and maintain the asset.

⁸ *PFI: strengthening long-term partnerships*, HMT, 2006.

⁹ *PFI: meeting the investment challenge*, HMT, July 2003.

Construction cost risk 4.22 Most often, construction cost risks are managed by the private sector, as they are priced into the cost of the project through the contract. This is an area where the private sector has substantial experience and the levers to manage design risk, and can deliver on time. Where costs come in higher than originally planned, it would generally therefore be the private sector that pays.

Operational cost risk 4.23 There is also substantial risk in the operational phase: risks associated with maintenance and operating costs can be substantial and can vary according to the level of demand for the infrastructure in question. Where whole-life cost risk is managed by the private sector, it is best placed to take a view on balancing design, construction methods and quality against the long-term operating costs and maintenance requirement.

Demand risk 4.24 Revenue streams from transport projects are often dependent on demand and risks around demand projections therefore matter. The inherent difficulties and uncertainties often associated in projecting demand can have significant implications for costs and in some cases the viability of the project.

Network and external risks 4.25 Policy changes on the network are also a risk that needs to be managed. For example, changes in policy that affect certain parts of the transport network, such as closures or new links, may impact on the demand for other pieces of infrastructure. This could potentially affect the costs, and in some cases the viability, of a particular project. Other external factors such as economic growth, and changes to prevailing laws such as environmental standards, also have the potential to affect the costs of delivery, operation and maintenance of the asset.

The potential efficiencies from effective private sector engagement

4.26 In securing the delivery of transport projects, the likelihood of achieving best use of public funds will be vastly increased if:

- the procurement process is efficient and programmes are implemented as planned;
- major cost overruns are avoided;
- completion is on time so services are not delayed;
- whole-life costs in operation are minimised; and
- assets are adequately maintained and serviced over long periods.

4.27 Under the right circumstances, the private sector can make a valuable contribution to achieving these goals.

Reduced costs through greater efficiencies 4.28 An important component of the assessment of major transport projects is the cost of construction. The true costs of implementing interventions can in some cases prove higher than were initially envisaged at the stage of the public investment decision. This may be due to poor cost estimation by the promoter, poor project management, or unexpected costs in delivery for which insufficient contingency has been allowed.

4.29 International experience suggests that governments have often struggled with the effective planning and delivery of major capital investments.¹⁰ This is an area where the private sector, given its experience in the design, construction and delivery of large capital-intensive¹¹ projects, on time and to budget has particular potential to add value, especially where the process of relying on project finance clearly incentivises performance.

4.30 After construction the asset needs to be maintained. The long life of many transport investments requires strong attention to the issue of minimising whole life costs and the private sector is often better placed to plan and manage spending efficiently over a 25-30 year contract, than a public sector body with a shorter planning horizon. This can potentially be a substantial source of efficiency savings. This potential is recognised under the PFI model in the UK in the context of maintenance of street lighting and highways infrastructure where a number of such contracts have been let.

4.31 The evidence also suggests that the private sector is able to:

- bring a broad range of skills to project delivery, including project management, innovative design and risk management;¹² and
- increase the likelihood of projects being delivered to time, as well as managing the cost risks. The NAO found that of the schemes they looked at, over 70 per cent of PFI projects were delivered on time and budget as opposed to just 30 per cent for non-PFI projects.¹³

4.32 Efficient use of public resources can also be achieved through PFI models, as payments are only made against service delivery or asset availability. This will only be the appropriate model if:

- these payments are affordable over the longer term;
- the private sector is actually better placed to manage the risks;
- the benefits, including cost, time, and value for money are not outweighed by the flexibility requirements of future service provision or being locked into a long term contract; and
- the use of private finance offers the best balance of whole-life benefits and costs for the public sector.

Greater efficiency may allow public resources to be 'freed up'

4.33 By adopting the right model to allocate risks appropriately, efficiencies can be realised. This could allow public resources to be freed up and hence potentially more projects can be funded than would otherwise have been the case. The overall value for money of public funds could therefore be improved.

REALISING THE BENEFITS OF ENGAGING THE PRIVATE SECTOR

4.34 Although the evidence suggests that there is potential for efficiencies to be achieved through engaging the private sector in transport project delivery, the government needs to ensure that the context is right to allow such benefits to be realised.

¹⁰ *MegaProjects and risk*, Flyvbjerg, Bruzelius and Rothengatter, 2003.

¹¹ *PFI: meeting the investment challenge*, HMT, July 2003.

¹² *PFI: meeting the investment challenge*, HMT, July 2003.

¹³ *PFI: construction performance*, National Audit Office, February 2003.

4.35 In recent years, significant developments have been made in the ability to exploit efficiency gains through appropriate private sector engagement. But there is potential to push this even further. Recognising developments in the UK and overseas, the Government can play an important role in securing efficiency and helping shape the future market. The Government needs to continue to revisit these possibilities as the commercial environment evolves and as the track record of delivery under different models becomes more extensive.

Managing a pipeline of investments **4.36** In the global market place, the UK is competing to attract the investment capacity of private firms that are able to offer skills, capabilities and efficiencies in the delivery of major transport projects. The UK should continue to position itself as a key player in this regard by sending the right signals about future investment opportunities for the private sector. This could offer potential investors a greater opportunity to understand the UK market and to develop the specific expertise to offer efficiencies in delivering projects, both in the near term and in the future.

4.37 Private sector capacity and the weight of competition will naturally be attracted to those markets where the potential pipeline of investment opportunity is seen to be both significant and stable, as this offers greater scope for expertise to be acquired and a portfolio of investments to be developed. The UK market has been a frontrunner, by some margin, in this regard in recent decades and has traditionally been an attractive market, exhibiting both a depth of opportunity and few artificial barriers to entry.

4.38 By setting out a clear programme or pipeline of investment opportunity, the inherent risks for the private sector in bidding for projects can be diversified across the range of investment opportunities. A potential efficiency from such a programme is the ability to invest in a bid where lessons learned can be carried forward to the next bid and standardising documentation allows costs to be reduced. This effect was seen with the announcement of the Government's Building Schools for the Future programme (BSF), for example, where the number of bidders tripled in 2 years. The DfT is also using this approach for its street lighting PFI programme.

Certainty and transparency **4.39** Certainty and transparency in procurement exercises are also essential in attracting both domestic and international investors. Where a procurement process has been initiated but then affordability or other reasons lead to the project being aborted or delayed, there are likely to be significant implications for investor confidence in a particular market. Not only is considerable project development effort likely to be wasted, in terms of overcoming successive planning and approval hurdles, but there are potentially substantial financial and reputation costs for all parties involved, impacting both on investor returns and the value for money obtained by the public bodies.

Reputation and past experience in the market **4.40** This can also have an impact on the operation and effectiveness of subsequent projects. Where private financing is relied on to deliver a project, the financial institutions set the cost of borrowing. If there is a perceived higher risk attached to those funds due to previous project problems, a higher return will be demanded with implications for value for money for public expenditure.

Adequate competition **4.41** Achieving value for money and securing potential efficiencies also requires adequate competition in procurement among a variety of potential providers. These include not only sponsors and developers but construction contractors, and equipment and technical service providers, all of whom must have adequate capacity to undertake the delivery tasks required of them and the financial standing to underwrite their obligations.

Skills and capacity 4.42 The extent to which the procurement process is efficient and risks appropriately allocated will, in large part, be driven by the skills and capabilities in taking the procurement process forward. This was recognised in the Government's most recent stock take of PFI.¹⁴ Here the Government has recognised the importance of refining and improving the procurement process of the private financing of public infrastructure. Such skills should be backed by continuous, evidence-based evaluation of financing options and potential project structures.

CHANGES IN FINANCIAL AND INFRASTRUCTURE MARKETS CREATE NEW OPPORTUNITIES FOR ENGAGING THE PRIVATE SECTOR

4.43 As well as continuing to seek greater efficiencies through current engagement with the private sector, Government must also be forward looking and seek to respond effectively to structural changes in the finance and infrastructure markets globally.

4.44 Over recent years there have been some very substantial structural changes in financial markets. These changes potentially offer significant opportunities that could help secure efficiency gains through more effective private sector engagement, notably,

- there is unprecedented investor appetite for transport infrastructure, driving up the value of those assets; and
- growing private sector expertise and capacity to manage and price risk. Risk premia are therefore falling, allowing relatively lower private sector borrowing costs.

Unprecedented investor appetite

Infrastructure sector has been very active 4.45 Investment activity in the transport sector, especially in infrastructure, has been particularly active over the last 12 months or so. Major deals in the UK have included Ferrovial's acquisition of BAA and Goldman Sachs buying AB Ports. Overseas, Abertis intends to merge with Autostrade; the French government has sold its remaining stakes in 3 autoroute operators; and the City of Chicago has sold a 99 year concession on its Skyway toll road to Cintra-Macquarie.

4.46 Planned private investment in new infrastructure has also continued, for example, ports developments at Bathside Bay and Felixstowe South were recently approved.

4.47 Competition for deals has led to unprecedented multiples that the acquirer is prepared to pay. For example, BAA paid 30 times the annual business cash flow¹⁵ for Budapest Airport; the service provider Cintra and the Macquarie Infrastructure Group consortium paid 63 times the annual cash flow for a 99 year concession on the Chicago Skyway in the US. These high multiples are an indicator of the private sector's perception of future profitability and therefore the potential value of this type of asset.

The market is global, large and growing 4.48 Fast, growing demand for infrastructure assets saw almost \$100 billion raised globally to fund deals in the sector during the first half of 2006, a year-on-year increase of about 71 per cent.¹⁶ Although this covers a wide range of transactions, including sales of existing private assets, it does provide a useful indication of the current scale and dynamic nature of activity in this sector.

¹⁴ PFI: *strengthening long term partnerships*, HMT, 2006.

¹⁵ As measured by EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) as operating revenues less operating expenses, meaning it represents operating income before amortization expense, net benefit plans cost, and restructuring and other items.

¹⁶ \$100 billion raised as deals boom in infrastructure Financial Times (London), Jul 18, 2006.

Infrastructure as a distinct asset class **4.49** Ten years ago, activity in the sector was dominated by construction companies and new infrastructure deals financed through bank debt. The market has evolved considerably since then. Infrastructure is rapidly being treated as an asset class in its own right, that is, it is separately recognised by financial investors as offering an attractive diversification opportunity, as part of a wider portfolio of investments. This is being accompanied by the creation of infrastructure investment vehicles that are international in reach, considerable in scale and growing at pace. This is largely in response to pensions and savings markets exhibiting a heightened appetite for access to the stable, long-term cash flows that infrastructure assets can yield during the operational phase, see figure 4.1.

Figure 4.1: The evolution of the infrastructure market

Direct private sector appetite to build, operate and maintain transport assets is growing:

- **transport is highly capital intensive: private sector has a wealth of experience in the effective construction and delivery of large capital projects;**
- **long-life nature of transport assets: eases the financing of projects due to longer periods to service the debt; and**
- **predictable and stable cash flows: travel demand is relatively insensitive to economic cycles and so less vulnerable to many external factors.**

This is also supported by increased attraction by fund managers:

- **asset/liability matching is attractive to pension funds: utilities infrastructure funds, including transport, are seen as a new product, in-between equity and debt. Such funds act as a reasonable proxy for global GDP growth and are an alternative to index-linked bonds, for which yields are very low at present;**
- **earnings stability for private capital: earnings are relatively predictable over the longer term compared to other asset classes;**
- **often offer an established track record of cash flows;**
- **diversification: low correlation with more traditional asset classes allows a reduction in portfolio risk; and**
- **retail market is also starting to develop, e.g. for the Connect East project in Melbourne, some local people are buying a share in their road as this is seen as a social/community asset.**

4.50 The emergence of infrastructure as a more distinct asset class (and investment in transport projects and undertakings is an important subset of this asset class) has been furthered by:

- the track record established by a greater number of operational projects;
- capital recycling by original sponsors and equity investors seeking to deploy resources on new projects;
- the growth of intermediaries purchasing in the secondary market; and, importantly;
- changing asset allocation strategies adopted by pension funds, life companies and institutions seeking to match long-term liabilities with assets that are capable of generating long run predictable returns.

Supporting the pension fund sector 4.51 These trends have been particularly pronounced in markets where a high degree of workforce pension coverage has resulted in a steady and substantial flow of funds into industry, trade union and company pension schemes. This has, in turn, often been associated with the early development of the private financing of infrastructure. The Australian and Canadian markets are prime examples and it is noticeable that, more recently, an increasing number of institutions from these jurisdictions have, in the past two years, been among the most active participants in the growing number of infrastructure sector transactions globally.

Private sector appetite and ability to manage and price infrastructure risk is growing

4.52 In a further sign of the medium to long-term nature of this shift in allocation strategies, infrastructure fund managers and pension companies are exhibiting greater interest in acquiring development capacity, often at a premium to net asset value.¹⁷

Private sector capacity is increasing 4.53 Private sector capacity and expertise for managing all types of transport infrastructure risk is growing. Aspects include:

- construction and engineering groups extending their capacity to invest directly in long term concessions;
- the emergence of integrated infrastructure companies, where construction and engineering divisions are matched by considerable operational service business activities, plus facilities and system management capacities;
- the formation of consortia combining independent specialists to bid for PPP contracts in competition with these integrated groups;
- the growth of funds, specialist banking divisions and both listed and unlisted companies specialising in infrastructure equity investment;
- increased competition between different forms of financing from the banking and capital markets to support transport investment and increasing sophistication in financing; and
- growing sophistication in the commercial evaluation of project risks as part of the project financing, delivery and operation cycle.

4.54 In addition, the fact that the UK offers a stable system of financial regulation, low and stable inflation, and strong institutions is attractive to private investors because it creates a more favourable background in which to manage risks.

The maturing market for infrastructure has brought about reduction in the private sector risk premium for debt

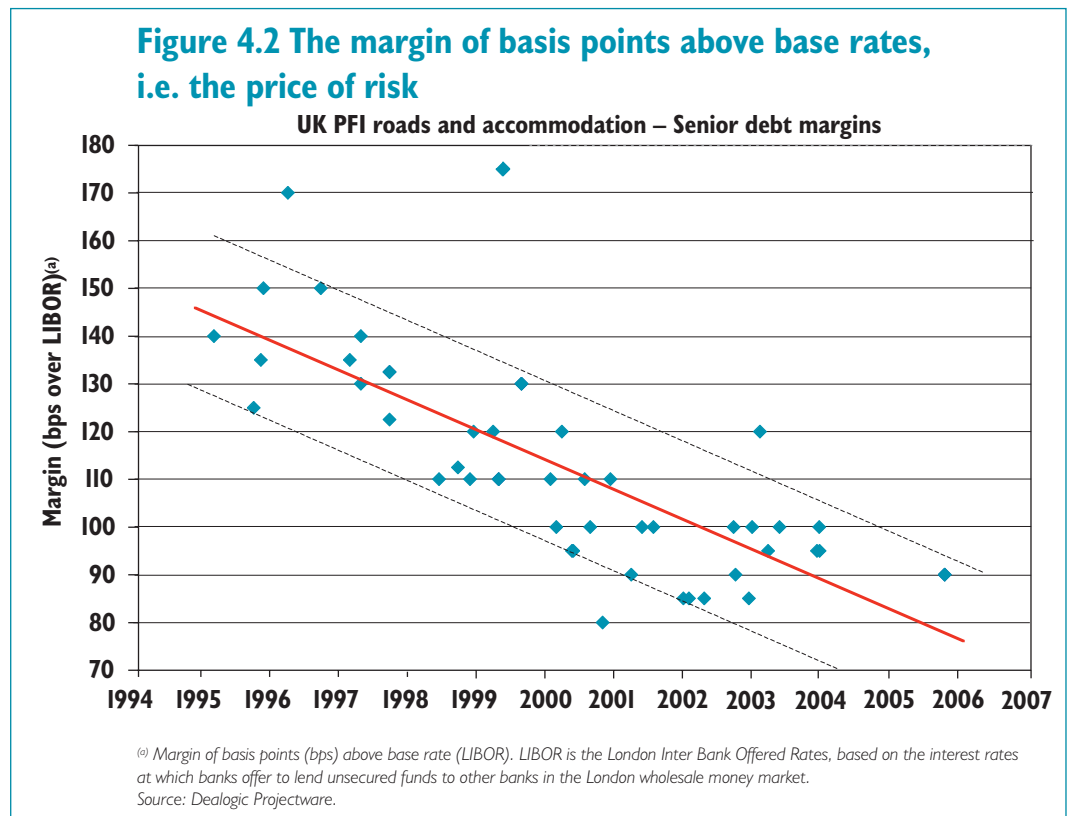
4.55 In assessing the overall value for money likely to be delivered by different procurement options, Government needs to take into account the relative borrowing costs of the public and private sectors, and whether any differential in favour of the public sector is fully offset by the value to the taxpayer of risks transferred and implementation efficiencies gained. Equally, the overall cost of capital employed in private finance solutions will be

¹⁷For example, the competition between Henderson and Allianz to acquire John Laing plc, a listed PFI/PPP developer.

influenced by the return demanded by equity investors for taking on the delivery and operational risks, and the mixture of different classes of equity and debt required to deliver a viable, project-financing strategy (the gearing level).

4.56 In this light, the fact that long-term borrowing rates are presently at an historic low is relevant, but not the most important factor. Low real interest rates impact on borrowing terms for both government and its authorities, as well as major operating companies investing in facilities or project companies set up to deliver and service specific infrastructure. What is central to the debate about borrowing costs and the broader cost of finance is, first, the margin over and above government borrowing charged by private financiers for different categories of risk, and, second, the equity return required by investors. In both these dimensions there is evidence that the evolution of the PFI/PPP market has been supported by a lowering of the risk premia applied by debt providers and equity investors to projects with a similar risk profile.

4.57 Figure 4.2 shows the evolution of the costs of borrowing for the private sector for a portfolio of PFI schemes.



UK is attractive because of macro economic stability

4.58 Figure 4.2 shows the margin at which lenders have provided debt, shown as basis points (bps) above the base rate (LIBOR), for a particular portfolio of road and hospital PFI projects,¹⁸ i.e. projects for which the risk profile has not materially changed. The downward trend in margins over time reflects an increase in competitiveness between lenders and a reduction in their perception of risk.¹⁹

¹⁸ Half are road projects, half hospital projects.

¹⁹ This chart is intended to illustrate the trend in margins for a given portfolio of projects for which the risk profile has remained relatively stable over time. For other projects, which involve a greater level of demand risk, for example, the margins would be likely to be higher.

4.59 In the UK PFI/PPP arena, debt markets appear to have responded over time in the face of the lengthening track record of projects passing through the construction phase and into successful operation with a very low default rate. This, and the competition between different forms of senior debt financing, together with a closer understanding of the risks involved in delivering projects (now more frequently covered by standard terms and contractual conditions) have led to a significant narrowing of the differential between public and private sector borrowing costs.

4.60 Although extensive data series are not available, competitive processes and more established markets have also led to a lowering of the minimum equity returns required by sponsors and developers of projects, including third-party specialist investors in the sector. Whereas it was once common for bids to incorporate base-case equity returns in the high to mid teens (in percentage terms) for availability based projects this is now rarely the case.²⁰ Downward pressure on these returns is being furthered by the evolution of the secondary market where investors are prepared to pay high prices for equity interests in operational projects.

The maturing of financial markets and the infrastructure sector

4.61 The challenge for Government going forward is to continue to review the respective role of the public and private sector across the transport sector. The status quo is continuously shifting and much can be learned from experiences in the UK and internationally about what does and does not work. Strategy and procurement policy must continue to evolve and respond effectively to new opportunities that arise for private sector engagement in the transport sector, through appropriate allocation of risk from new advances and innovations in the market.

UK Government needs to compete for global investment

4.62 Within the environment of broader changes in the financial markets, transport as a sector has to compete for private funds that can often be deployed across a range of infrastructure opportunities globally. Attracting the private sector to invest is increasingly dependent therefore, on the transport infrastructure market being positioned favourably by government in a growing globalised market. This is particularly relevant given that the key players are international in focus and highly mobile, with portfolios sufficiently large in scale to take on big transport investments through better management of risks.

4.63 The UK has the opportunity to make the most of this unprecedented investor appetite, by ensuring that it continues to attract such investment where it is value for money. However, it cannot be complacent: where opportunities are not realisable private funds will go elsewhere.

Reflecting value of portfolio diversification

4.64 It is also important that government continues to scrutinise value for money assessment in all areas of private sector engagement (and more broadly, of course, across all public sector spending) to ensure sensible trade-offs are being made as part of the decision-making process. Developments in this process are already emerging. For example, portfolio diversification is valued by the private sector and therefore feeds through into investment decisions; the differentiated nature of returns on infrastructure investment may allow investors to accept a lower rate of return than would be required on other assets of similar riskiness.

²⁰ Those on which the SPV is paid where the asset is available (e.g. the road is available for use) as opposed to being paid for the use of that asset (eg real or shadow tolls).

CONCLUSIONS AND RECOMMENDATIONS

4.65 There are strong reasons why current circumstances suggest there is merit in the public sector continuing to secure efficiency gains through private sector engagement in the provision of transport projects. The key is finding the right balance between the public and the private sector to deliver projects, by allocating risks to the party best able to manage them.

4.66 If carried out effectively, private sector engagement has the potential to deliver significant efficiencies. Actions for the Government that would be likely to increase the efficiency of project delivery through the private sector are:

- offering certainty and transparency through a commitment to a programme of potential transport projects; and
- employing the right skills at all levels of government to secure efficiency savings.

4.67 It has also been shown that there are major structural changes in the finance and infrastructure markets, which open up new and unprecedented opportunities in the context of achieving value for money in the delivery of transport projects. This includes:

- unprecedented appetite for transport investment given a neat match between the long term and stable returns, and the requirements of pension fund investments; and
- the ability of the private sector to better manage the risks of such investment, which is allowing a narrowing of the gap between the costs of borrowing for public and private sectors.

Recommendation 5(c)

Continue to look for efficiency gains and secure value for money in the delivery of transport projects through the private sector by:

- (i) Securing transparency and increased certainty for the private sector by using the opportunities provided by the development of 10-20 year strategies and 5-10 year statement of commitments to identify a pipeline of transport projects and programmes to be completed in partnership with the private sector.**
- (ii) Continuing to build adequate capacity and skills within government for efficient procurement and delivery of projects.**
- (iii) Recognising and responding to changes in financial and infrastructure markets to make the most of new opportunities for efficiencies through private sector delivery.**

