



# **KPMG's Response to the Inquiry into the Welsh Government's capital funding sources**

**May 2019**

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# 1 Foreword

KPMG is a professional services firm employing around 15000 people across the UK. Within Wales, KPMG employ around a 100 staff across many professional services disciplines.

KPMG has a leading role in developing infrastructure across the world. In the UK we have more than 150 staff wholly dedicated to infrastructure and capital projects, covering a broad range of sectors and offering expertise across the whole lifecycle of an infrastructure asset.

This includes infrastructure strategy, economic analysis, policy and regulation, developing business cases, procurement, financial/commercial structuring, transaction negotiation and due diligence, financial modelling, project management, cost monitoring, restructuring services, tax and accounting.

The comments below are drawn from conversations with a number of senior practitioners within the firm and reflect genuinely held views. Our team cares about building better infrastructure for everyone, enabling better delivery of public services through high quality built environment, protecting our environment and supporting innovation. We have no ideological or financial interest in any particular infrastructure finance model, preferring to select the best solution for a given project.

This document is the KPMG response to the inquiry into the Welsh Government's capital funding sources.

## 2 About the Author

This document represents the views of a number of senior practitioners at KPMG rather than the views of an individual. However, they have been pulled together by Gwyn Llewelyn, a Director in our Infrastructure Advisory Group who has spent the last 14 years advising on the delivery and financing of public infrastructure with a recent focus on healthcare, education and local government.

Gwyn has advised on financings using a wide variety of commercial structures, including Aberdeen City Council on the UK's largest municipal bond, the Scottish Non-Profit-Distributing model, concession models and several PFI contracts in England. He is part of an advisory group to the National Infrastructure Commission looking at the evidence base to support private finance into infrastructure.

Gwyn will be present to speak with you on 15th May.

## 3 Context for the Review

The backdrop to this review is the challenge posed in creating infrastructure fit for the 21st century that includes improving broadband speeds and mobile coverage, enabling housing development, improving our health and education infrastructure to improve social outcomes, decarbonising our energy networks, reducing journey times, investing in water networks, increasing our resilience to climate change and the impact of new technology.

This requires major investments from both the public and the private sectors, and in a changing landscape. The rapid development of new technologies will create new funding and financing challenges, and the UK's relationship with the European Investment Bank (EIB) will change as we leave the EU potentially further restricting access to low cost capital.

## 4 The Structure of Our Response

The response sets out thoughts on the areas identified for investigation by the review although does not cover them strictly sequentially as many of the issues discussed are interlinked and overlap. We instead provide general commentary on the use of public and private funding and cover the identified topics where relevant.

## 5 Commentary on UK infrastructure finance market

The UK has a large, well-established and technically expert finance market for investment in infrastructure. It has a global reputation in all aspects of finance and is the go-to market for overseas territories seeking best practice.

As a result the UK attracts talented individuals and global investors alike, further enhancing the diversity of expertise and innovation across all the financial markets and professional services.

This is supported by a consistent legal and regulatory environment enabling all parties to be confident of both fair and predictable treatment.

The UK regulators have a strong reputation as independent, clear and open institutions establishing further the trust between the private and public sectors.

The use of consistent trusted contractual structures and financing methodologies increases the understanding of the risk balance available in UK infrastructure.

The financial expertise is complemented by large UK based engineering firms with the technical skills to deliver complex projects helping to de-risk the provision of financing to UK infrastructure.

The UK's place as a leading OECD country within the G7 can also be viewed as a supporting pillar to the UK infrastructure finance market. The broader economic stability and prospects that this brings helps give the UK infrastructure finance a comparative advantage through association.

As a result of all the above there is plenty of money, debt and equity, ready to invest in UK infrastructure as long as projects have the right risk profile and investment characteristics. This availability of private capital to support projects is valuable where it can demonstrate advantages over the use of public capital, or it can supplement it.

## 6 What are the weaknesses in the infrastructure finance market?

The current uncertain political environment is a deterrent to investment.

There is political uncertainty regarding policy for private finance, with the abolishment of PFI and its replacement PF2 in England, the NPD model paused in Scotland and MIM model just beginning in Wales. The opportunity to help drive future policy is welcome, this consultation in itself signals further uncertainty to the market when MIM is trying to establish itself.

Historic Government focus on balance sheet treatment driving commercial solutions has weakened the industry's reputation, leading to some deals that are not necessarily right for a particular transaction but are financed that way to avoid the need for capital budget.

This is particularly an issue for the construction industry. MIM style project structures seek to pass significant risk to main contractors, few of whom in the UK have the financial standing to bear that risk, particularly when many smaller subcontractors in the supply chain refuse to have the risks passed on down to them.

Construction is a low margin business and whilst competition for new public sector work continues to be heavily price-led this will continue. But to paraphrase one CEO of an international contractor "3% margin businesses cannot take 50% risks". The criticism of PFI/PF2 in England leading to excess profits is rarely set against the collapse of Carillion, Interserve, Jarvis, Ballast Neill et al.

Press coverage of infrastructure tends to focus on the negatives. There is no consistent voice standing up for the positive transformation that infrastructure can bring. Proper informed debate is undermined by headline grabbing sound-bites.

Delivering projects in the UK is typically more expensive than in other jurisdictions. The reasons for this are complex (and not necessarily negative) but lengthy and costly bidding processes can act as a significant deterrent or barrier to entry.

## 7 Appraising the merits of different forms of finance

Too often, the debate around source of finance for a project focusses on a comparison to UK gilt rates. This is incorrect. All academic and corporate finance literature is clear that investment appraisal should be based on the risk level of the investment, not the party borrowing the money.

To explain the point, in an efficient market the expected return generated by an investment increases with its level of risk, with risk measured as volatility of return<sup>1</sup>.

An investment grade borrower (such as a public body) will have a low cost borrowing rate as they themselves are stable with limited volatility – they can be trusted to repay borrowing. A higher risk borrower with unstable income will have a higher cost of borrowing as there is less certainty on whether they can repay their borrowing.

The value of an investment is not different for the investment grade borrower than the higher risk borrower just because he has a lower underlying cost of funds. The value of an investment is driven by the risk of the investment (how likely is it to repay funds), not the party investing in it.

If the reverse was true, it would encourage borrowers with a low cost of capital (such as public bodies) to borrow heavily and invest in risky projects, as risky projects on average return a higher amount. Such a strategy would be widely discredited (although we can see it happening from time to time across English local authorities who are borrowing cheaply from the Public Works Loan Board and making speculative investments into real estate, unfortunately).

Why are we covering this? Because the government gilt rate represents the cost of borrowing for UK government, not the required return that should be sought from an investment into infrastructure given its risk level. In fact, the gilt rate becomes an irrelevance apart from the fact that it also underpins the market cost of borrowing. A capital project should be appraised using a project specific rate (usually as a discount rate for future cash flows), which unless there is a market failure, should be a market rate reflecting the risk of the investment. Comparing cost of finance with looking at risk allocation, whilst tempting, should be left to the tabloids.

## 8 Why can the government borrow cheaply?

Putting it another way, the only reason government can borrow so cheaply is its right to tax in the future. This is established through the credit rating methodologies used to rate sovereign

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<sup>1</sup> (this is a slight simplification to ignore adjustment for idiosyncratic risk, but the point holds and it is not the purpose of this paper to discuss the valuation of risk in depth)

credit risk.<sup>2</sup> The market rate for finance is typically driven by the equilibrium between supply and demand for capital, the largest moving parts of which are pension and insurance funds. Put simply, the market rate represents the rate we expect our pension fund managers to achieve on an investment with any given risk level with our retirement savings, given other available options. Just because government can borrow more cheaply to raise capital doesn't mean it should, as that capital is cheap because it is taking into account the right of government to tax future generations. In other words, it is taking bets with the taxable income of future generations for a lower return than we are happy to accept from our pension funds with our own income. That doesn't sit well.

## 9 Funding versus financing

Most infrastructure is funded in one of two ways – either through user charges or through tax payers. Private finance can be used for both as set out in the simplified diagram below.

Funding/ Financing	Public finance	Private finance
User Charges	Gilt borrowing, repaid through user charges	Private infrastructure, regulated assets, concession models
Tax payers	Gilt borrowing, repaid through tax income	DBFM structures, such as MIM

There are exceptions, where infrastructure can be paid for not by the user but by other beneficiaries, such as land value uplift or developer charges.

Ultimately, in our view, the biggest challenge for Welsh Government capital financing is one of funding not one of financing. Is the funding generated by user charges for infrastructure, or the increases to tax receipts it is likely to generate over time, sufficient to fund the capital cost plus appropriate borrowing costs. Can sufficient revenue be generated from assets to pay for them. If so, a myriad of options exist for raising the finance to deliver them whether public or private.

The decision of public or private finance then boils down to a number of factors, the most pertinent of which are:

- The risk to the public balance sheet and whether the public sector is well placed to take and manage that risk
- The incentives the finance creates on the delivery and operation of that infrastructure. Private investment being at risk can be a powerful incentive to meet contractual obligations.
- Tying in private sector expertise in delivering and operating complex infrastructure
- The level of control, influence and flexibility demanded by the public sector over an assets

<sup>2</sup> The right to tax is of primary importance. When we advised Aberdeen City Council on their £400m+ municipal bond, the ratings agencies took the view that a local authority does not have sufficient right to tax and so only qualifies as sub-sovereign, meaning the cost of finance was some 100bps+ higher than gilts.

- Whether there is any market failure in the private financing market that justifies government intervention.

The latter two points are worthy of further exploration below.

## 10 Control, influence and flexibility

A frequently levied criticism of private finance is that it leaves the public sector with complex and inflexible contracts. In many instances this is justified.

PFI contracts in particular are complex, often negotiated by specialist advisors not the people who will ultimately be left to manage them. Steps have been taken with MIM to address this, but it is likely they will still be more complex than public capital.

Change within such a contract can be costly, with consent needed from lenders and investors for change.

As a result of the complexity of contract, we have found many instances where projects are managed on the basis of custom and practice rather than contractual obligation, so the contracts are not followed. In some of these instances it results in the public sector not getting what they are paying for.

The industry (public and private) can take some criticism for treating contracts for a road the same as a hospital or schools. Simplifying the argument slightly, but a road is a strip of tarmac whose performance lies in being kept open and safe. A hospital is a building of complex public service delivery with changing needs and models of healthcare. It necessarily needs more flexibility and active contract management – on both sides of the table. Unfortunately, standard form contract and management practice have not always delivered such active management and true partnership. There are good exceptions to that criticism.

## 11 Market Failure

Whilst it is frequently noted that there is a 'wall of private capital' available to well-structured projects, typically this is capital seeking investment grade projects (ie long term and low risk). As technology develops, it is hard to match that to the risk of the types of infrastructure being developed. Easy examples are emerging technologies in battery storage, electric vehicle charging points, drones, heat networks, tidal lagoons, 5G networks. These are investments that are higher risk than traditional building projects, with shorter life spans. More and more the lifespan of infrastructure is not governed by its physical life but how long before technological obsolescence. Can we really appraise the building of car parks over 40 years when market commentators are suggesting autonomous vehicles and low rates of vehicle ownership in 25 years? As such, there is a clear financing market failure for new and novel assets.

There is also a market failure for financing of very large assets, such as nuclear power stations, where co-ordinating private finance is challenging without government intervention.



Taking that to its logical conclusion would suggest that government should be reserving its limited capital to areas of market failure which are typically larger and higher risk projects, leaving private capital to finance infrastructure where there is a proven market rate for capital and better understood risk – such as schools, hospitals. That can be counter-intuitive and contrary to the general adverse media that accuses the use of private capital for such assets as profiteering or having limited risk transfer.

## 12 What models of finance are appropriate for the future

Generally, moving away from making financing sourcing decisions on the basis of balance sheet treatment and more on the basis of value for money and addressing market failure has to be a good thing. That is not to say we don't appreciate the budgetary constraints facing government, rather that they shouldn't be the overriding factor.

This will allow more appropriate sharing of risk between parties – ESA2010 government accounting treatment has a checklist of more than 80 commercial considerations and often contracts are designed to tick the ESA2010 box rather than what is commercially sensible.

Once balance sheet treatment is removed as a decision making factor, it allows better partnership between the public and private sector. Examples would include:

- Joint funding, with some public and some private capital. This could be through public sector capital contributions alongside private finance, something we have experience of with an example being the Royal Papworth Hospital PFI in Cambridge that opened earlier this year, which combines 40% public capital with 60% private capital. Of the private capital, 50% of the senior debt was provided by EIB and the all-in cost of finance was less than 4%, but still transferred all construction and operational performance risk to the private sector. Such models seem worthy of further exploration.
- Mixed funding. Increasingly infrastructure is not delivered as a single asset for a single owners (a hospital delivered for a health trust, for example), but infrastructure systems of multiple assets delivered to make an area work, i.e. a life sciences park may need NHS involvement, university involvement, local authority involvement, pharmaceutical and industry involvement etc. They may need new transport links, key worker housing, commercial buildings and laboratory infrastructure. The deals needs are complex and bespoke, and need to be worked through on the basis of what is the best form of government intervention to make the project happen. Sometimes but not always that intervention will be the public sector providing all the capita.
- Targeted risk taking. Often there is a market failure in private investment because of specific risks. This tends to be in areas where high impact low probably events can severely impact lenders downside cases. In these cases government intervention by underwriting certain specific risks (maybe only in an extreme downside event) can be all that's needed through some form of financing guarantee.

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