

## **Low rates, northern lights and net zero: UK infrastructure in 2020**

*In the second of a two-part series, Darryl Murphy assesses the current state of the UK infrastructure market and the likely drivers of transaction activity in 2020.*

As we enter 2020, it is encouraging that deal activity in the UK infrastructure market has withstood the political uncertainty that characterised the second half of the last decade; from Brexit to the Labour Party's nationalisation policy. The fact that 2019 was a record year for infrastructure debt, with around £30 billion of transactions, highlights the resilience of the asset class, its growing appeal to institutional investors and the re-emergence of commercial bank lenders.

Nonetheless, it should be acknowledged 2019 was another year driven by refinancing; both of existing and newly acquired assets. The combination of low interest rates and reduced credit margins saw the all-in cost of funding hit new lows, with coupons on BBB-rated 30-year debt below three per cent.

Fears of a market correction proved unfounded as the heightened volatility experienced in public markets at the end of 2018 quickly dissipated in the first quarter of 2019 and remained stable thereafter, despite the political environment. Strong demand, particularly from commercial banks, compressed the illiquidity premium (relative to public markets) for institutional investors.

However, in the second half of the year several commercial banks seemed keen to sell down assets from their balance sheets and to explore new distribution models; a trend that looks set to continue in 2020. This could result in the development of hybrid structures that go beyond institutional investors and banks working alongside each other, which is now the norm, to banks underwriting larger transactions and distributing directly to institutions as part of broader partnership arrangements.

As far as other developments to watch out for in 2020, these can be broken down into two areas: big picture macro themes and sector-specific deal activity.

### **The B word and beyond**

*Infrastructure more vital than ever in a post-Brexit world*

After what seems like an eternity, the UK's likely course on Brexit has been set by the Johnson government. While its ultimate impact on the UK economy and industry remains uncertain, we do know that infrastructure investment remains a priority.

The government's commitment to increased public spending, especially in health and transport, may not directly lead to private investment opportunities in those areas. However, there will be much to play for elsewhere, where private investment into energy and digital remains critical.

The eagerly awaited National Infrastructure Strategy will be published in early 2020, which will provide greater clarity on how the government expects to deliver the investment required to 2050 and beyond. Among the possible announcements, the industry will look for any proposal for a government-backed financing body following the loss to the UK of the European Investment Bank post-Brexit. The National Infrastructure Commission floated such a possibility in its National Infrastructure Assessment, published in July 2018.<sup>1</sup>

The industry will, however, hope for more clarity from the government on the role of private infrastructure investors in helping it achieve its long-term ambitions.

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<sup>1</sup> [National Infrastructure Assessment 2018](#), National Infrastructure Commission

More immediately, market fundamentals remain robust, with only a few assets that could be affected by Brexit; a notable example being electricity interconnectors.

There are several such deals moving towards scheduled final investment decision and financial close, but these will require investor confidence in the operations of the UK energy market into Europe to get done. Similarly, the longer-term impact of Brexit on ports and airports will remain a concern for international investors and may reduce potential acquisition activity in these sectors.

#### *Northern star*

The general election redrew the UK political map, particularly in the north of England where several traditional labour strongholds turned conservative. Promises have been made about the region's importance and improving productivity, which will require increased public investment into local infrastructure – especially transport links. Although the infrastructure industry will keep a close eye on developments, there is little to suggest that private investment will play a key role.

#### *Independence Day*

Further north, the general election further strengthened the Scottish National Party's position and fuelled speculation about a second independence referendum. Such a possibility raises questions about the impact on infrastructure, especially on how the energy market may function given the wealth of onshore and offshore wind generation in Scotland. Future investment into Scottish energy projects will likely be hampered until the situation becomes clearer.

#### *The path to net zero*

The government's commitment to bring all greenhouse gas emissions to net zero by 2050<sup>2</sup> will have profound effects on UK infrastructure. It will soon need to provide an effective road map as to how this will be achieved, with investment into energy generation, heat and mobility critical.

The energy white paper expected in early 2020 should provide a starting point. However, much of the investment required relates to early-stage technology or sectors without a defined commercial funding model, including battery storage; carbon capture, utilisation and storage (CCUS); electric vehicle charging; hydrogen; district heating; energy efficiency; and nuclear energy (large and small scale). Private investment will likely be relatively minimal to begin with and limited to early-stage investors.

### **Transaction activity in 2020**

Outside of these long-term themes, infrastructure financing this year looks set to remain focused on private-to-private deals, with few involving public support. Here is our summary of potential transaction activity in the key sectors.

#### *Social infrastructure*

Greenfield activity in social infrastructure will probably remain concentrated on student accommodation and social housing, although the emerging residential healthcare sector may also offer opportunities to private investors. While the public-private-partnership (PPP) model may be gone in terms of new projects, refinancing activity is set to likely to continue. This will be driven by deals that closed early in the last decade, with equity funds who have consolidated large portfolios seeking to maximise returns through refinancing where it makes economic sense.

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<sup>2</sup> <https://www.gov.uk/government/news/uk-becomes-first-major-economy-to-pass-net-zero-emissions-law>

In the last two years, we have seen the evolution of leveraging PPP equity portfolio holdings and this should continue in the short term. PPP refinancings can also offer large financial gains to the public sector which should fuel further activity, although 2020 may prove to be the final year of such opportunities.

Despite the demise of PPP in central government, the Welsh government will continue to develop its mutual investment model. This will see the A465 road reach financial close in 2020, following on from the successful £1.2 billion financing of Silvertown Tunnel in 2019, which was among the 40 largest deals of the decade. However, successful progress on the Velindre Health PPP and the schools PPP will provide an opportunity for the private sector to show the public it has learnt from the perceived failings of the past.

### *Transport*

Rail franchise competitions are now at the end of the recent cycle. The industry will soon be engaged with the findings of the Williams Review, which in early 2020 will report on the most appropriate commercial and organisational frameworks to support the government's vision for the railways.<sup>3</sup>

However, two of the largest PPP financings of the past ten years will be looking to refinance, namely Thameslink and IEP 2. These refinancing structures will look to tap into the experience of institutional investors in being comfortable with the long-term risk of rolling stock, beyond Section 54 support from the government.

Opportunities in ports and airports will likely come in the form of optimising existing financial structures and capitalising on the continued low cost of capital in the debt markets.

Mobility will get a lot more attention in terms of EV charging, but financing opportunities are likely to be limited to early-stage corporate developers in large cities. The sector remains one to keep an eye on for the future.

### *Digital*

The government has stated its support for fibre-to-the-home broadband, but physical delivery at a local level remains challenging. Roll out will continue from the major players to local community broadband providers. The sector remains in the sub-investment grade class, but this should change over time as operations stabilise post roll-out. That is more likely a scenario for 2021-22 unless the government intervenes to accelerate the investment required.

Like EV charging, data centres are a hot topic, but financing opportunities are rare. This may change in 2020, with potential data centre construction projects coming to market along with the potential consolidation of existing facilities through the involvement of infrastructure equity funds.

### *Energy*

Power and utilities look set to be the main sector in terms of activity for 2020. Offshore wind promises to grow from strength to strength, as projects successful in the third Contracts for Difference (CfD) auction round will all be in the market. This includes the financing of the Dogger Bank schemes with a strike price of £39.65 for delivery in 2023. These schemes will need to optimise every aspect of the financing structure, including longer-term views on power prices beyond the CfD term of 15 years.

The continued development of zero-subsidy onshore wind and solar renewable projects is also set to continue. There are multiple examples of these projects across Europe but few in the UK, with little evidence of investors taking a view on merchant power price risk. Financiers will need to wean

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<sup>3</sup> <https://www.raildeliverygroup.com/about-us/priorities/williams-rail-review.html>

themselves off subsidy-based regimes to remain active in these sectors, as well as have more confidence in long-term power forecasts. The natural place for many new schemes will be Scotland although, as mentioned earlier, the independence debate creates uncertainty. Given the net zero commitment, we may see the government begin to lift restrictions on new onshore wind schemes.

This year should also see the outcome of the consultation on the use of the regulated asset base model for new nuclear projects. The forthcoming energy white paper will need to set the pathway to net zero; including the role of technologies such as nuclear and CCUS and how these will be supported to be investable at the scale required.

The UK offshore transmission market remains the only true pipeline of projects in procurement. This year should see the close of the Galloper and Walney as well as Beatrice and Hornsey, which will be the largest OFTO asset to be financed. These latter two deals will need to break recent experience in progressing from preferred bidder to financial close. The severe delays of Galloper and Walney in relation to the original tender process and the requirement for committed financing continues to raise serious questions around the efficiency of the financing process, both for Ofgem and the financing market.

Interconnectors such as Neuconnect to Germany and Greenlink to Ireland should progress after another round of consultation from Ofgem. The proposed changes to the cap and floor regime are promising and suggest Ofgem is keen to develop private financeable schemes. As noted above, the market will be keen to understand the impact that the implementation of Brexit will have on the European energy market.

Another nascent market in the form of direct procurement for customers in the water sector should continue to get greater exposure. The initial aqueduct scheme for United Utilities will act as an interesting test as to whether a “PPP-like” model can be created without the need for a new licence holder, as used on Tideway.

Finally, energy-from-waste/biomass could be the most talked about sector in 2020. After a few years of failed projects due to corporate and technology failures, we should see the emergence of a new fleet of plants supported by feedstock supply contracts of various lengths. Investors showed strong interest in the Cory Riverside transaction in 2018: 2020 is likely to see a competitive process in relation to the sale of Wheelabrator and possibly Viridor, along with individual plant refinancings and sales. Existing and future development looks set far for the next few years, which could offer immediate investment opportunities.