**MEF Discussion Paper:**

# Funding Regional Infrastructure

**Prepared: March 2018**

## 1. Overview

The Midlands economy ranks amongst the more dynamic regions in the global economy, integrated at or close to the apex of a number of global value-added supply-chains. Indeed, in many aspects and sectors, this economy appears to be operating at close to full capacity and often above that, most noticeably in terms of global, national, regional and local transport connectivity.



In a period of continued fiscal restraint, and one in which a number of funding and delivery schemes have lost their previous allure, new approaches are required. In particular, given the current rate of sovereign debt accumulation, any new approach to funding infrastructure, in particular railways, must provide options that ultimately enable reduction of the stock of public sector debt. Improvement of tax revenue flows would also be an additional advantage as well as approaches that avoid the apparent pitfalls of past schema.

The current provision of existing transport and connectivity is very uneven, with considerable distortions in the allocation of public-sector funding streams to the devolved nations and regions. The distortion has become even more obvious with the recent announcement of the cancellation by Network Rail in its submission for works in Control Period 6 (CP6) of all works of major enhancement; the HS2 Project continues, without any reduction in its scope or funding, leaving the regions to fend for themselves. If the national transport infrastructure strategy is to achieve the desired rebalancing of the economy, structures and processes need to be created within it that address regional imbalances.

Furthermore, if new sources of domestic and international funds are to be articulated any new instruments adopted will need to be attractive to investors. Examining available funding programmes elsewhere internationally, with proven track records, the US system of tax credit bonds appears to offer a potential solution. However, importing these structures wholesale may not be an option given the different constitutional and financial histories and structures. Britain may need to create regional vehicles, perhaps along the lines of the Network Rail Infrastructure Finance (NRIF), (Glossary of terms at end?) to enable funds to be both raised and as significantly directed toward building regional infrastructure capacity. Nevertheless, whilst this asset class is designed to fund regional regeneration, fundamentally the

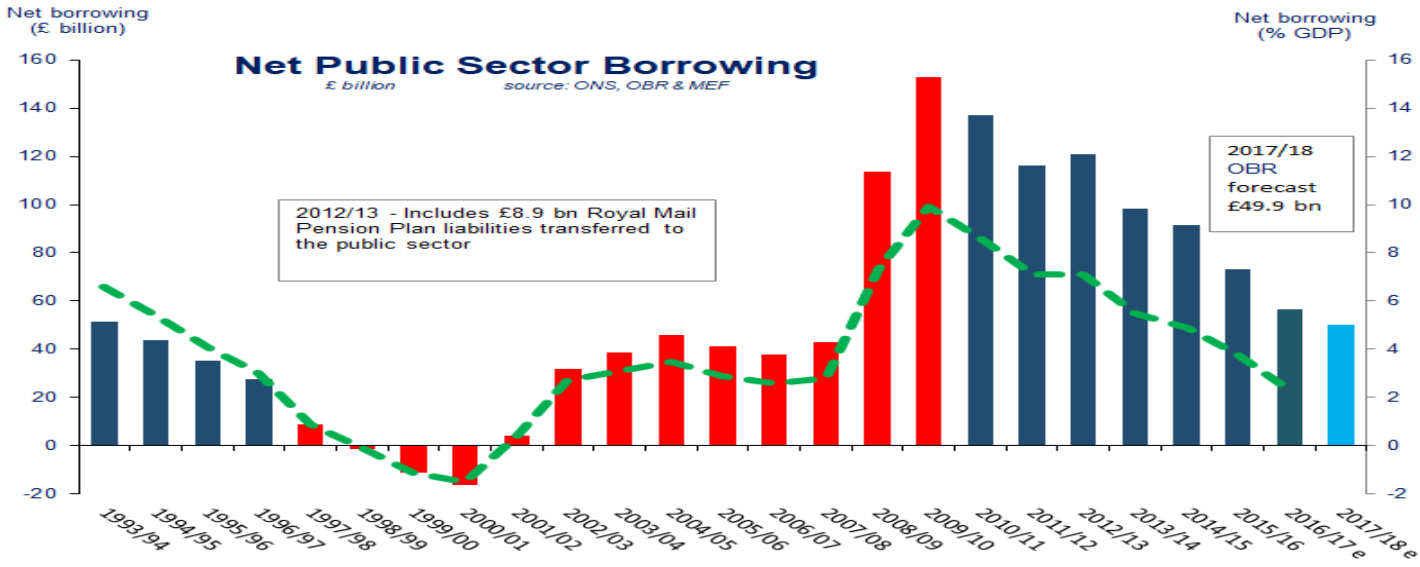
liability should be recognised as National, with responsibility as repayment guarantor being the Treasury, otherwise this debt accumulation could further intensify regional imbalances. In order to avoid further accumulation of the debt burden, British Tax Credit Bonds should not only offer relief on interest but also a component that enables the amortisation of some, if not the bulk of the principal.



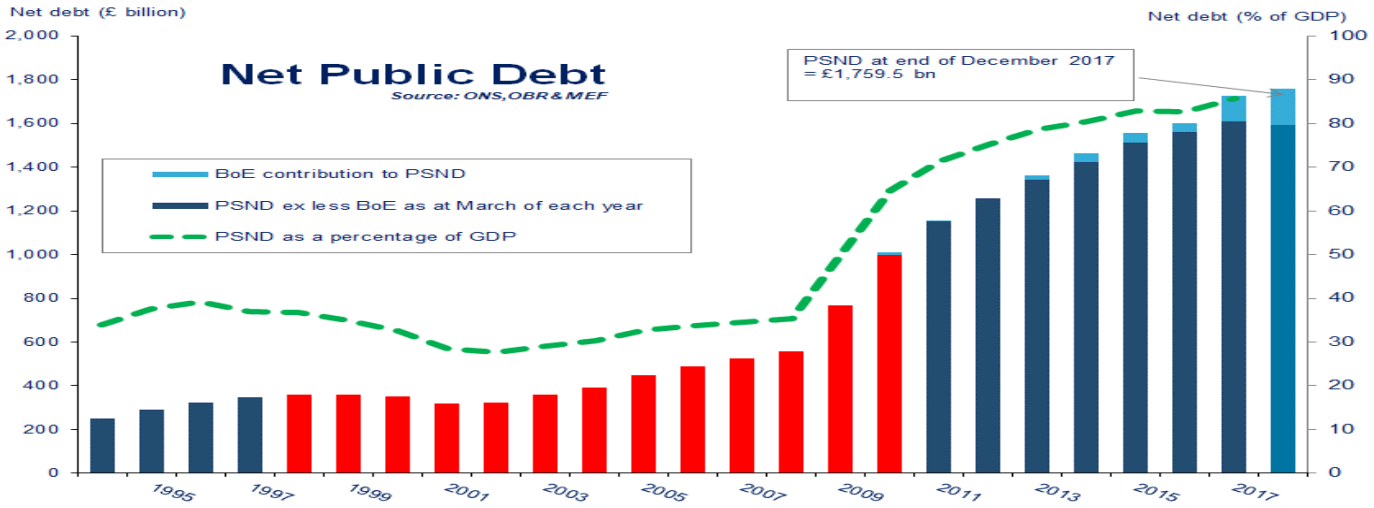
This paper attempts to address these issues and propose a potential solution in the form of Regional Infrastructure Bonds.

## 2. National Fiscal and Project Delivery Constraints

Since the financial crisis in 2007-09, and the level of subsequent government support, it is widely perceived that government fiscal resources have been under severe pressure from both weaker revenue inflows and increased expenditure demands, not least from debt servicing. The immediate impact of the financial crisis saw annual net public sector borrowing balloon to the equivalent of 9.9% of GDP in the fy 2009/10. The weakness of the subsequent post-crisis economic recovery, coupled with the rigidity of government expenditure programmes has ensured, that notwithstanding an extensive and extended austerity programme, attempts to reduce annual borrowing have proved problematic. By fy 2015/16 the level of annual borrowing was still in excess of the international benchmark Maastricht criteria at 3.8% of GDP, only in the last fiscal year (2016/17) did it ease below that level at 2.3% of GDP, with further improvement toward 2% of GDP anticipated in the current fiscal year.



The inability to rapidly reduce the imbalance between revenue and expenditure has contributed to an acceleration of the stock of public sector net debt. From levels that were internationally competitive and historically impressive in the late 1990s and early 2000s, in fy 2001/02 it fell to 27.7% of GDP, in the current fiscal year the level of public sector net debt is forecast to be close to 90% of GDP.




Whilst there is widespread debate over at what proportionate level of debt stock constitutes a drag on economic performance, and indeed there are widely varying international burdens, the current rate of accumulation by Britain does appear to be problematic. Moreover, the debt stock has yet to exhibit any evidence of stabilisation, let alone erosion.

Nevertheless, more positively, the average tenor of British debt instruments continues to be amongst the longest dated of comparable economies. By end-March 2016, the average maturity of the stock of all marketable debt was projected to rise to above 16 years. The average maturity of the stock of conventional gilts is projected to rise to 15 years, with index-linked gilts continuing to be above 22 years. The average maturity of the government's wholesale debt is consistently longer than the average across the G7 group of advanced economies. However, given the apparent debt management strategy of the current government, simple issuance of further debt to fund infrastructure seems remote. As a result, new asset classes would seem to be needed, both to fall within the parameters of the current austerity strategy as well as to provide a commercially and economically sustainable revenue stream.

The recent collapse of Carillion has thrown into focus many concerns regarding public-private finance initiatives, both in terms of debt servicing costs to the exchequer and the capacity of the private sector to manage and fulfil often complex and long-term contracts. There are, however, examples globally, as well as in Britain, of such initiatives which have proved successful in respect of easing debt burdens or delivering projects on time, and sometimes even both. However, in the aftermath of the Carillion debacle it is anticipated that the government may prefer new forms of debt instruments that have limited impact on the stock of public debt.



The impact of the Carillion collapse has yet to be fully felt or understood. Other major contractors have already expressed their reluctance to accept, without adjustments to existing contracts, the financial consequences of failed joint ventures with Carillion. The industry's reaction is that it does not want to be drawn into a situation akin to that previously faced by Lloyds Bank plc in the wake of the imminent failure of Bank of Scotland the Halifax plc.

Significantly, since September 2014, the ONS has reclassified Network Rail as a Central Government Body for national accounts and public-sector finance purposes, as a result of revised ESA10 guidance. Furthermore, difficulties encountered in delivery of a number rail franchises has raised concern over sources of future infrastructure funding; not least the delivery problems associated with the East Coast Mainline, and the seemingly random extension of existing franchises, without recourse to competitive tendering, such as the West Coast Mainline.

Until recently, the only vehicle for improvements and enhancements to the “classic railway” network was through Network Rail (NR), which, as a state-owned company, was confined by processes relating to project appraisal and limited access to funds. This made the forecast cost of new projects very much higher than is reasonable and difficult to finance due to the ever-increasing demands on the public purse.

Recognising these problems, in 2016, the Hansford Review was commissioned, reporting in June 2017. The report makes the case for third-party sponsorship and funding of projects and recommends that the current opaque procurement processes used by NR be simplified and far greater cost transparency be offered to would-be third-party investors. For these investors to consider entry to the rail market, NR acknowledged that a “common cost language” for construction works was needed

and beginning in 2011 began work to continue the development of methods of measurement, valuation and estimating in the industry along the lines of those established in the private sector and in widespread use by private investors; NR published the rail methodology in July 2014.

One great benefit of the NR work is to produce data that can be collected in an elemental cost database through the Rail Cost Information Service (RCIS), in similar manner to the long-established Building Cost Information Service (BCIS), providing investors with accurate, valid early state cost advice on which project appraisals can be made and project cost limits established. These improved valuation and analysis methodologies, allied to improved procurement strategies, suggested that savings of between 25% and 40% of the analysis provided, until recently, by NR. The publication of The Hansford Review and the NR initiative to develop a common cost language goes a long way towards meeting these needs, and is a direction the region should take advantage of. The recommendations of "The Hansford Review" and the new approach to measuring and valuing the cost of railway engineering projects offers an opportunity to create an infrastructure bond market for the Midlands, an area, which has a GDP greater than some of the states within the European Union.



### 3. New Asset Class Options - Tax Credit Bonds?

There are numerous conceivable potential asset class structures that could provide vehicles to fund infrastructure development. However, what is needed is a structure that would prove attractive to investors, both private and institutional, as well as provide facilities that can ultimately improve public sector debt ratios or indeed accelerate tax revenue inflows. Moreover, instruments need to be created that can achieve an interest rate not greater than that of the sovereign. To avoid large upfront development costs, that financial institutions may impose for new products, instrument classes that have proven track records would seem preferable.

US fiscal financing programmes provide a potential solution. Although the federal-state structure adds a complexity that is only marginally, and if at all patchily, evident in Britain, it can provide some insights.

Given its constitutional settlement, states have always possessed the capacity to raise revenues, but local governments and sub-state authorities have been able to

raise bonds. Moreover; the bulk of these issues have been in the form of tax-exempt bonds. This tax-emption is achieved due to the fact that interest payments are excluded from the bond purchaser's federal taxable income. However, these are not classified as Tax Credit Bonds (TCBs). TCBs are instead forms of bonds in which the bond purchaser is offered a federal tax credit instead of interest payments.



The initial TCBs were introduced as part of the Taxpayer Relief Act of 1997, becoming first available in 1998. Subsequent TCBs were made available as part of specific targeted programmes, such as to deal with disaster relief or specific market failures. Indeed, there is now an extensive range of TCBs including:

- Qualified zone academy bonds,
- Clean renewable energy bonds,
- Gulf tax credit bonds,
- Qualified forestry conservation bonds,
- Qualified energy conservation bonds,
- Midwest Disaster Bonds.

There are also newer forms of bonds becoming increasingly available that utilise a tax credit provision whereby issuers have the option of receiving federal payments in place of tax exemptions. Additionally, there are a variety of mechanisms adopted to establish the interest rate regime, such as the rate being agreed to by the issuer or investor or the rate being set by the US Treasury with respect to prevailing market parameters. Three rates varying from the equivalent to 35% to 100% relief, according to the Federal Administration's initiating priorities. Another aspect is that TCBs have specific time limitations. Importantly, TCBs are designed to generate funds for a specified qualified or designated activities or projects, these can include:

- Public school construction and renovation,
- Clean renewable energy projects,
- Refinancing of outstanding government debt in regions affected by natural disasters,

- Conservation of forest land,
- Investment in energy conservation,
- And for economic development purposes.



Whilst the applicability of US-style TCBs is apparent in terms of providing sources of funding, the scale and tenor of rail projects would seem to necessitate more longer-term instruments. However, simply providing new revenue streams for the national exchequer, or indeed to National Communities Investment Fund, would both mitigate against the underlying strengths of TCBs and limit the potential impact to deliver specifically targeted funding projects. Moreover, TCBs in their current format would reduce interest payments over the life-time of any bonds, but still add to and extend the current debt stock as a bond redemption would still be required at the maturity of the bond.

There are also specific British, if not English, factors which need to be brought under control. Not only are there concerns regarding the performance of NR, but also there are significant regional imbalances in terms of both actual capacity and expenditure allocations.

A British TCB could be developed to address these issues.

Firstly, a more dynamic application or the tax credit mechanism could have a greater beneficial impact on the sovereign debt burden. By including a graduated amortisation component, in addition to the interest rate relief, over the lifetime of the bond the bond issuer would be left with a zero balance and not contribute to further accumulation of the debt stock. In addition, the actual initial purchase of the bond has the impact of bringing tax revenues forward.

Secondly, by providing an attractive financial instrument it would incentivise tax payers, both corporate and private, to advance payments to the exchequer.

Thirdly, a British TCB system could be structured to start addressing some of the regional infrastructure imbalances, especially in the English Regions (outside London), by designating specific projects or group of projects or services to fund. This would be tax neutral in that it would not require new taxation measures,

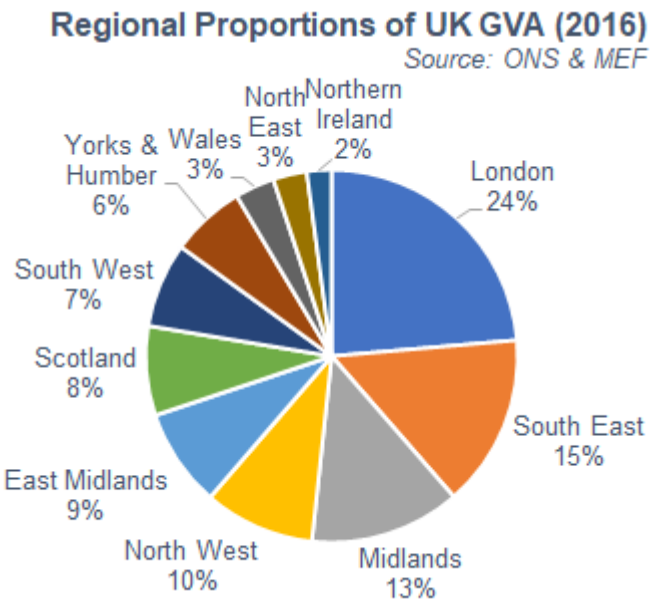
although it would require an adjustment to medium-term expenditure plans, although treating it on an accrual basis could mollify the impact.

Fourthly, these new forms of bonds operating though a Treasury approved operational system could be applied to existing and emerging local government structures, by utilising the NRIF model to create regional NRIFs to issue these bonds. These could then also be utilised to fund entities such as a Transport for Midlands.

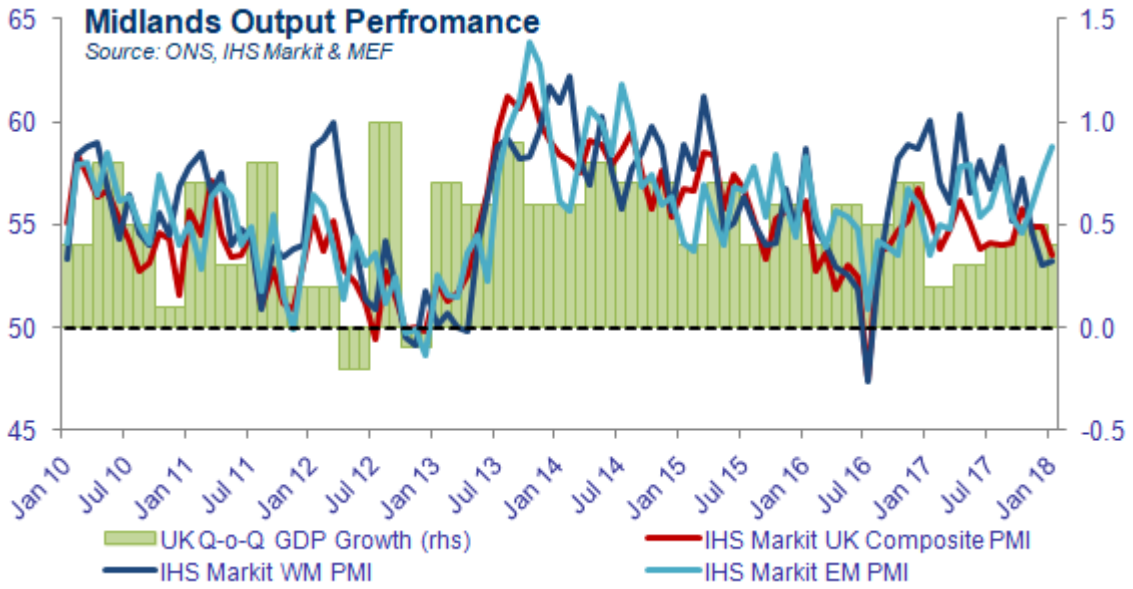


## 4. Midlands Economic Overview

The Midlands economy is the third largest economic area in the UK, after London and the South East, according to the latest official data, producing some 13% of the UK's economic output in 2016 and 15.2% of the UK's jobs in June 2017.

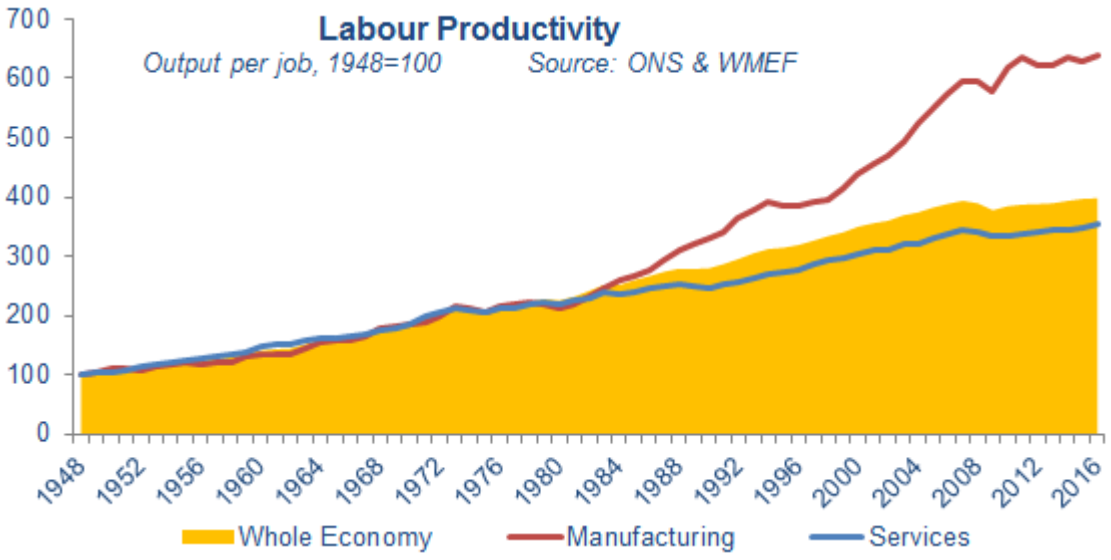



Regional PMI data suggests that the Midlands is one of the most dynamic regions in the UK, with regional PMIs frequently outperforming UK PMIs, as can be seen below. This, in part, is due to the strength of the Manufacturing sector in the region, with Manufacturing making up 16% of GVA in 2016, and the Midlands producing 20.5% of all UK manufacturing output.



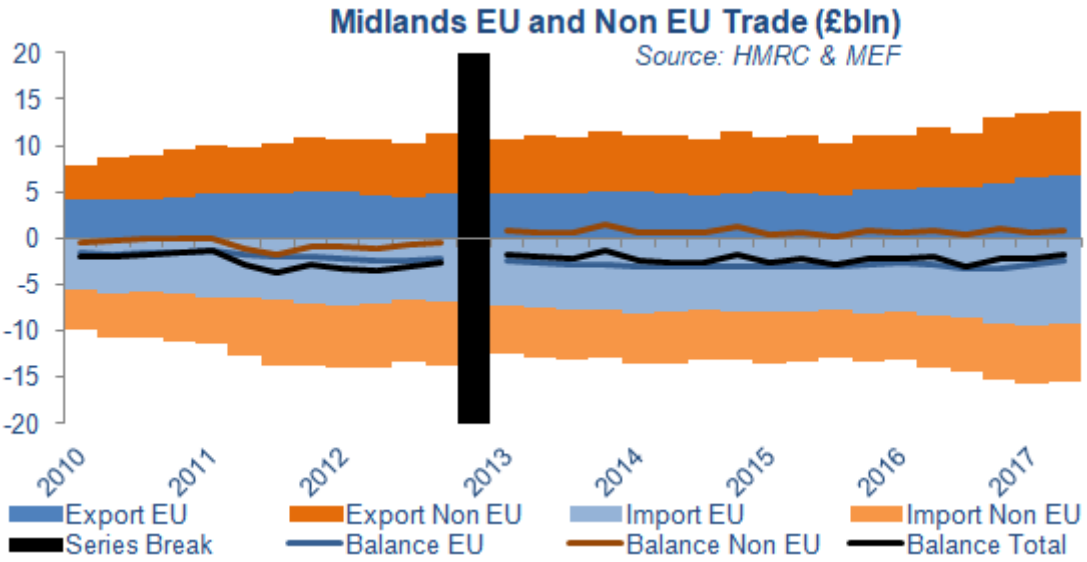



After the recession of 2008-9, the manufacturing sector in the Midlands has transformed from a labour intensive industry to a more capital intensive industry, with developments in advanced manufacturing and the internet of things meaning that manufacturing productivity has grown faster than that in the rest of the economy – despite the capacity constraints local businesses face in regional infrastructure. Moreover, given the low base from which regional infrastructure spending is starting at, investment in local infrastructure is likely to provide a larger boost to productivity than would be seen elsewhere in the country.




Businesses in the region are at the apex of global value-added supply chains, evident in the region's strong exporting track record. The Midlands is less reliant on trade with the EU than other regions in the UK, and actually runs a small trade

surplus with Non-EU trade partners, with Northern Ireland the only other region in the UK to do so in 2016. Key non-EU export markets include the USA and PRC.

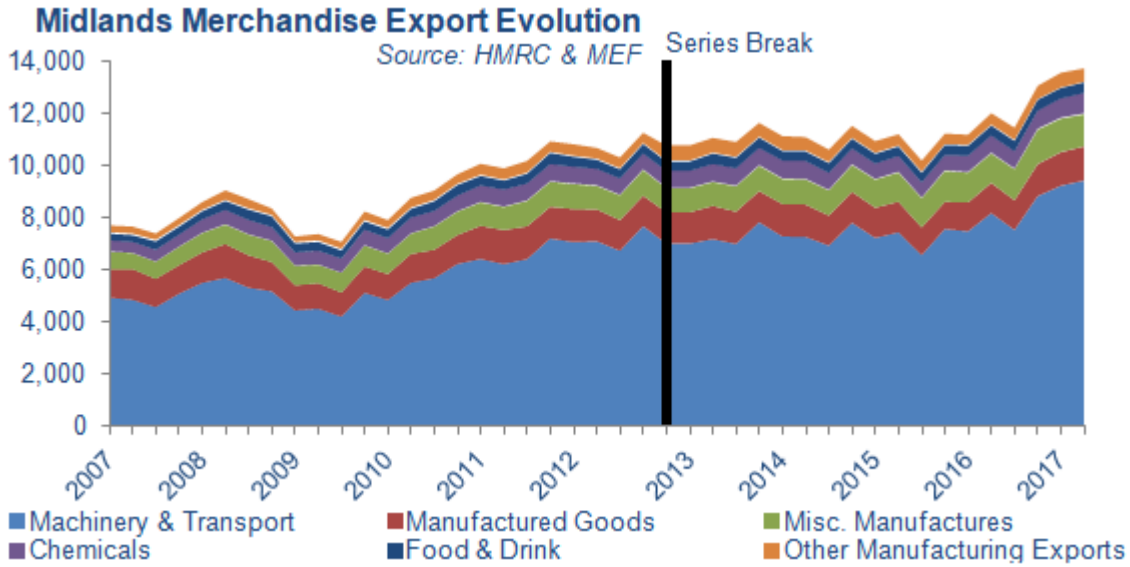




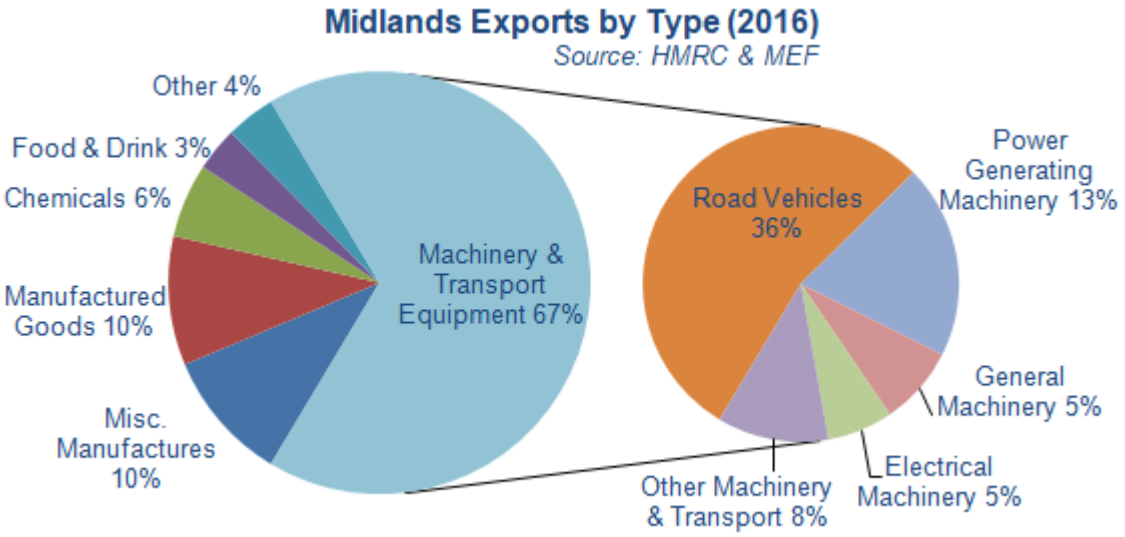

Nevertheless, 46% of exports from the Midlands went to the EU in 2016, with Germany being the destination for 11.3% of all Midlands exports that year, so the EU remains a significant market for the region.

Much of the Midlands exports are generated by its strong manufacturing sector, in particular the exports of machinery and transport equipment, which made up .67.4% of all Midlands merchandise exports in 2016.

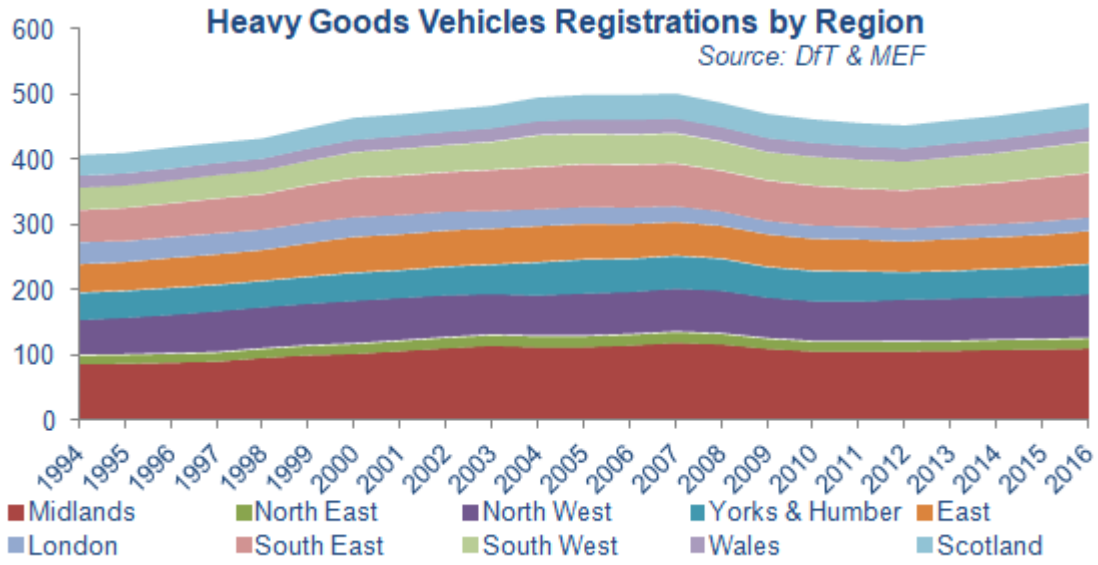
Critical to the successful export of such goods is the connectivity between all parts of the UK and its export markets, especially given the long supply chains and just in time manufacturing processes which can exist within key Midlands industries such as the automotive and aerospace sectors.




The bulk of machinery and transport equipment exports come from the automotive sector, with road vehicles making up 36% of all Midlands merchandise exports in 2016.




Linked to the strong regional presence of Manufacturing is the larger distribution sector. The Distribution sector in the Midlands is a significant part of output, providing around 24.4% of GVA in 2016.






22.5% of HGVs in Great Britain were registered in the Midlands in 2016, reflecting the strong presence of logistics in the region. Productivity in the logistics industry will also be boosted by investment in local infrastructure, as there will be fewer delays associated with moving goods since investment in passenger rail services could also free up capacity for road freight.

## 5. The Midlands Engine: boosting the regional economy via rail investment

The construction of HS2 promises to provide a boost for the regional economies of both the East and West Midlands, most notably and immediately adjacent to the new HS2 stations. To deepen and widen the economic impact, heavy and local light rail network connectivity will in some cases need to established and in others improved. Failure to create effective local and regional connectivity to HS2 will critically undermine the expected economic benefits.

Some of schemes suggested in the Midlands are: -

- The Bordesley Chords and the Benson Road curve providing better access to Birmingham City Centre and making better use of Moor Street and Snow Hill Stations
- The Sutton Park line – reinstatement of passenger services between Walsall and Birmingham City Centre, providing additional rail services from Sutton Coldfield and new services from Aldridge and Warmley

- Stourbridge – Walsall – Lichfield – reinstatement of passenger services to allow access via Walsall and the Sutton Park line to the NEC and the HS2 Interchange Station
- Extending regional rail services to Burton-on-Trent and providing a turn back facility at Burton for trains from the West Midlands
- "The Whitacre Link" – reinstating the long-disused line from Whitacre Junction to Hampton-in-Arden, with west facing junctions at each end to allow direct running to the NEC and the HS2 Interchange Station from all parts of the West and East Midlands, with(out?) the needs to travel via Birmingham New Street
- New west to east chord at Nuneaton to allow direct running between Coventry, Leicester and Nottingham with the need to reverse at Nuneaton
- Birmingham–Tamworth-Burton-Derby-Nottingham - major route upgrades to increase capacity and reduced journey times between the West and East Midlands
- Enhancing heavy rail connection to Telford and to Shrewsbury to address the connectivity concerns of these centres of population
- Increasing line capacity between the Midlands and the South East and South West by doubling the line between Coventry and Leamington Spa including providing new signalling
- Reinstatement of passenger services over the Sheet Stores-Stenson freight route (with the opportunity to add a passenger facility at East Midlands Airport to the freight scheme currently being developed), thus providing faster journey times on the Birmingham-Nottingham corridor, a new link to an international Airport, and a realistic alternative to M42/A42
- East Midlands Gateway rail freight hub

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