National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

UK Guarantees scheme for infrastructure

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Key facts

£40bn

maximum value of support provided under the UK Guarantees Scheme (excluding interest)

£1.7bn

total value of commitments entered into by HM Treasury as at 31 December 2014 (excluding interest)

£12.3m

HM Treasury's estimated annual fee income from the first 7 guarantees in 2014-15

7 guarantees (and 1 standby facility) signed or approved at 31 December 2014

44 years the longest life of the signed guarantees, requiring ongoing monitoring until 2058

39 projects remain pre-qualified by HM Treasury as eligible for guarantees

£24 billion potential maximum level of guarantees based on pre-qualified projects, including up to £17 billion for Hinkley Point C nuclear power plant

£173 billion reported value of contingent liabilities and guarantees across the public sector

Summary

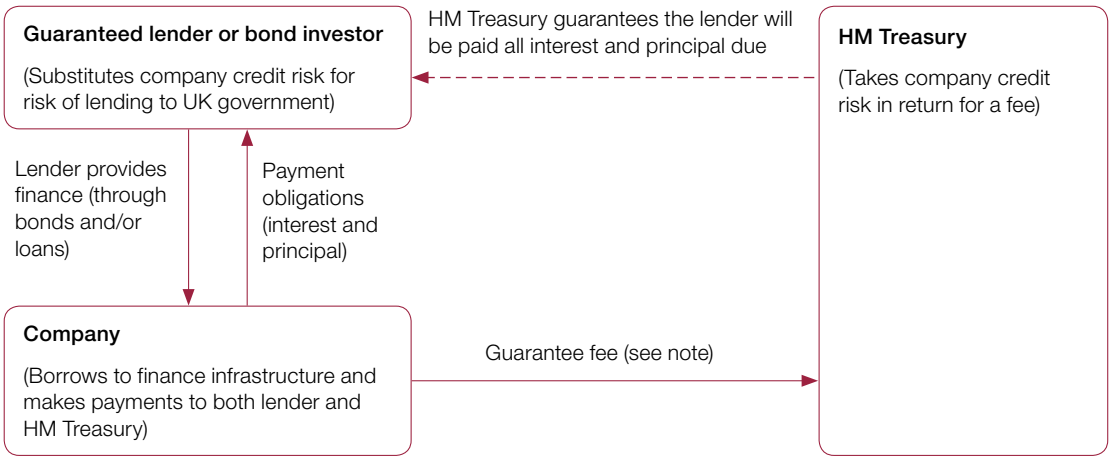
1 The value of lending to new UK infrastructure projects halved from £6 billion before the financial crisis to £3 billion in 2010. In October 2012 the Infrastructure (Financial Assistance) Act became law, allowing government to issue guarantees to projects meeting a broad definition of infrastructure, spanning energy, transport, health, education, courts, prisons and housing. The UK Guarantees scheme (the Scheme) is designed to avoid delays to investment in UK infrastructure projects that may have stalled because of adverse credit conditions and provides a sovereign-backed guarantee to help projects access finance. HM Treasury (the Treasury) also aims to attract new sources of finance into infrastructure projects, such as pension and institutional investors.

2 The Scheme is operated by a team of experienced commercial specialists within Infrastructure UK, a unit within the Treasury and is open to applications from infrastructure projects in the public and private sectors. The Scheme enables the Treasury to issue an unconditional and irrevocable guarantee to the lenders to infrastructure projects ensuring that scheduled interest and principal payments will be paid in full, irrespective of project performance. This transfers project risk to government, and ultimately taxpayers, in return for a fee (**Figure 1**, overleaf). The Scheme provides stronger protection to lenders than comparable European state schemes, which provide credit enhancement but not a full sovereign guarantee of principal and interest.

3 The first guarantee was issued in April 2013 and by December 2014 the Treasury had agreed guarantees with a value of £1.7 billion (excluding interest) to 7 projects (and 1 standby facility), with 39 more projects pre-qualified for a guarantee. The Scheme has a limit of £40 billion in guaranteed lending (excluding interest) and is currently due to close in December 2016.

4 To comply with European State Aid guidance on the issue of guarantees by member states, the Scheme is not intended to provide subsidised loans to infrastructure projects. To ensure this, the Treasury charges each infrastructure project company a market-oriented fee. The fee is determined by the Treasury's assessment of project risk and prevailing market prices for equivalent risks. At an overall Scheme level, the Treasury expects taxpayer risk to be minimised because fee income should exceed expected losses and the Scheme's running costs and the Treasury has standard rights of senior lenders to enable the recovery of monies in the event that there is a call on a guarantee.

Figure 1
How the Scheme works



Note

1 The company agrees to reimburse HM Treasury for any payments under the UK Guarantees Scheme. HM Treasury and the company document various bilateral rights.

Source: National Audit Office, based on *A brief overview of the standard documentation 2013,* Allen & Overy for HM Treasury

5 This report considers the risks to value for money associated with this Scheme that the Treasury must manage. This may inform the issuance of guarantees in future and may be applicable to other guarantees and contingent liabilities in government, which we plan to return to in future work. This report comes halfway through the life of the Scheme and reviews the Treasury's approach to the first 5 guarantees (but does not assess whether the underlying projects represent value for money). Background information on the first 5 guarantees is available in Appendix Four. Our approach and methods are described in Appendices Two and Three.

6 This report is structured as follows:

- Part One describes the rationale for the Scheme;
- Part Two reviews implementation including the Treasury's pre-qualification process, eligibility criteria and approach to value for money;
- Part Three examines the Treasury's approach to measuring and managing taxpayer risks at 3 levels: the projects, the Scheme, and government; and
- Part Four examines how the Treasury derives the price of guarantees and the role of financial market indicators.

Key findings

Rationale and implementation

7 When the Scheme was launched in 2012, private finance for infrastructure had been heavily constrained. Market conditions have since improved. By the time the first guarantee was issued in April 2013, lending to UK infrastructure projects had returned to 2006 levels, although bond issuance remained very limited and bank lending was concentrated in a few large projects. In 2013 the Treasury extended the Scheme deadline to December 2016 in part to accommodate renewable energy projects associated with the government's Electricity Market Reforms. By 2014, the Treasury identified greater availability and diversity in sources of infrastructure finance (including through this Scheme) and considered the infrastructure investment market would remain buoyant (paragraphs 1.3, 1.5 to 1.9, Figures 3 and 4).

8 The contribution of the Scheme to the National Infrastructure Plan has been modest to date but may increase substantially. The Treasury has received more than 200 enquiries, agreed 7 guarantees (and 1 standby facility) and pre-qualified 39 other projects. The pre-qualified projects have a total value of £34 billion, equivalent to 7% of the investment identified in the most recent National Infrastructure Plan (£466 billion) and could result in up to £24 billion in guarantees, including the Hinkley Point C nuclear power plant (up to £17 billion). Although the £1.7 billion of signed guarantees is relatively small in relation to the Scheme limit, the Treasury supported £827 million of UK project finance in 2014, making it the second most active lender to new infrastructure (paragraphs 1.1, 1.7, 2.2 to 2.3, 3.12, 3.13, Figure 2 and Figure 12).

9 Eligibility criteria are not strictly applied. The Treasury set 5 criteria to pre-qualify projects as potentially eligible for a guarantee but has not defined important aspects of 2 criteria, such as how to test whether projects need a guarantee and are of an acceptable credit quality (risk). The Treasury told us it chose to keep these criteria flexible as projects could find objective tests an onerous requirement. The Treasury does not document analysis against its criteria, for example evidence to demonstrate that projects make a positive contribution to economic growth. Three criteria were precisely defined: we found that 4 out of the 5 projects we examined met them, but the Treasury supported one £8.8 million project (SDCL EE) that cannot reasonably be described as meeting its 'nationally significant' test (paragraphs 2.4 to 2.8, Figure 7).

10 In relation to the Scheme, the Treasury does not consider the overall value for money of projects, but considers the guarantee to be value for money using a narrow test of whether the fee represents a market price for the risk. The Treasury's own guidance states that departments need to consider the impact of initiatives across the public sector. Our review of the first 5 signed guarantees identified involvement by various parts of the public sector. It is unclear how any individual Accounting Officer has an overall perspective. Infrastructure UK takes the value for money of projects as a given and focuses on getting projects delivered provided they are consistent with existing government policy. We have previously reported on the need for government to take a portfolio view of its activities (paragraphs 2.9 to 2.11, Figure 8).

Risk

11 The Treasury has assembled an experienced commercial team and internal governance arrangements to measure and manage risks to the taxpayer. Approval decisions rest with Ministers. Infrastructure UK has a team of 12 commercial specialists with backgrounds in project and infrastructure finance and commercial guarantees. The team apply recognised commercial practices (due diligence and techniques similar to project finance banks) to assess the risk of each project and negotiate terms to mitigate risks where possible. The Treasury has also put in place a governance process that subjects risk assessments and deal terms to challenge and scrutiny by an internal risk expert and internal risk committee prior to submission for ministerial approval (paragraphs 3.2 to 3.8).

12 The Treasury has underwritten some higher-risk projects and there is no limit on the probability of default over the life of a guarantee. However, the Treasury considers that guarantees with a very high risk rating (corresponding to a greater than 5% probability of default in any given year) would be incompatible with European State Aid guidelines. In practice, the Treasury considers many infrastructure projects with construction risk are likely to be 'non-investment grade' (the Treasury assessed 3 of the first 5 deals to be in this risk category), although recovery levels can be higher than for other assets. Historic data for non-investment grade credit suggest it has a higher than 5% probability of default over 5 years (paragraphs 3.2 to 3.3, Figure 9).

13 The Treasury has not issued guarantees where it considers projects do not stand up to commercial scrutiny or if is unable to identify price benchmarks. The Treasury identified 3 main reasons why few of the 200-plus enquiries resulted in guarantees: first, for many projects it was too early to finalise financing (for example, planning permission or revenue subsidies were not yet secured); second, where the Treasury's due diligence concluded projects were poorly structured and therefore not commercially viable; third, if there are no relevant price benchmarks (necessary for compliance with European State Aid guidance). A lack of price benchmarks for weaker non-investment grade risk over 10 years can limit the level and duration of risk exposure: none of the non-investment grade guarantees the Treasury has provided are for longer than 5 years (paragraphs 2.2, 3.2 and 3.4, Figures 6 and 7).

14 The Scheme has an overall limit of £40 billion of guaranteed lending but risks are not evenly distributed (and the Treasury never intended them to be). The £40 billion excludes interest, which is potentially significant for longer dated commitments. The Scheme has underwritten a diverse range of project risks across a range of industries and risk ratings, and support ranges in value from £8.8 million to £750 million and exposure lasts up to 44 years in the case of the University of Northampton guaranteed bond and loans. The Scheme is currently dominated by its largest commitment (currently the £750 million Northern Line Extension standby refinancing facility). The uneven distribution would become much more pronounced if the Hinkley Point C guarantee is issued, focusing a substantial proportion of the planned guarantee capacity on the risk of 1 project (paragraphs 3.12 to 3.14, Figure 12).

15 There have been no calls on the issued guarantees under this Scheme but this has happened unexpectedly to government on previous occasions. The Treasury has put in place ongoing monitoring to manage this risk. It is possible that none of the guaranteed debt will be called. The government has experienced previous calls on guarantees it provided to transport infrastructure (HS1 and Metronet). To manage such risks, the Treasury has negotiated standard senior lender rights in the event of default and put in place a small team to monitor projects for their lifespan. (paragraphs 3.9, 3.11, 3.18 to 3.19, Figure 11).

16 Government discloses limited information about guarantees and contingent liabilities. Beyond this Scheme, the Whole of Government Accounts identifies £173 billion in guarantees and contingent liabilities across the public sector (including Network Rail and export credit guarantees). Government financial statements provide details of total exposure where this can be quantified, but do not set out the probability of default, or the duration of exposure. The Treasury discloses the aggregate value of each of the guarantees it has signed, but it does not disclose the individual risk ratings or the amount of interest guaranteed (paragraphs 3.17 to 3.20, Figure 13).

Price

17 There are no directly comparable market benchmarks for the Treasury guarantee fee because the guarantee is superior to commercial alternatives. The Treasury charges each project a fee which seeks to ensure it pays a market-oriented cost for debt finance, to comply with European State Aid guidance. However the Treasury guarantees have unique characteristics that cannot be readily observed in market prices for commercial guarantees because no commercial products can provide the extensive protection provided by substituting the UK's credit rating for the risk of the project (paragraphs 1.17 to 1.19 and 4.3, 4.6 to 4.7, and 4.9).

18 We do not have full confidence in the reliability or completeness of market benchmarks used to measure actual risks to taxpayers. To set market-oriented prices, the Treasury uses a broad variety of publicly available market prices, and has constructed a database including some 800 corporate bonds and credit default swaps. The database has not been subject to third-party review to validate the reliability of the data. On detailed inspection the database contains relatively few financial instruments with similar characteristics to individual projects under review, for example, it did not include the INEOS group (and using this information could have resulted in higher fees). The prices of non-investment grade credit are particularly volatile (paragraphs 4.11 to 4.23, Appendix One).

19 The Treasury sets the fee for the whole life of the guarantee using the prevailing price at the date the guarantee is issued, even though credit markets can be volatile and project risk might change. Market prices and underlying project risks may vary independently of each other, therefore market price does not necessarily reflect the financial risk from guarantees. Guarantee fees are determined with reference to market prices, but once the Treasury has issued a guarantee it cannot withdraw it or change the price if project risk or market prices change. This removes price volatility for projects, as is common in project finance deals. If a project could obtain cheaper sources of finance and repaid the guaranteed debt, the guarantee would cease along with the liability to the government (paragraphs 4.2, 4.24 to 4.26, Figures 16 and 17).

20 Investors in government guaranteed debt may receive a return higher than that on government gilts even though the credit risk is equivalent but this can be reduced through financing competitions (eg auctions). Investors in guaranteed debt may seek a higher return reflecting that it is less easily tradable than gilts, reducing its attractiveness to some investors. The Treasury assumes a typical return of 0.5% above gilts, but has achieved better results in competitive pricing. Based on the use of the Scheme to date and the expected take up until it closes, the illustrative annual extra cost through using guarantees as opposed to direct lending could be between £35 million and £120 million, with and without Hinkley Point C. As the Treasury issues more guarantees, market familiarity with this product and transparency, open competition and best execution in the issue of guaranteed debt, gives the greatest potential to minimise the premium over gilts for investors. (4.27 to 4.31 and Figure 18).

Conclusion

21 The Treasury introduced the UK Guarantees scheme as a response to challenging financial market conditions for infrastructure finance. Although market conditions have improved considerably, the Scheme continues to support lending for new infrastructure projects. We recognise that the Scheme can play a role in enabling progress in some nationally significant infrastructure.

22 The lessons from the Scheme have wider relevance for the extensive range of guarantees across government. The Treasury deliberately designed the Scheme to be flexible, with few formal restrictions and no upper limit on risk. It takes a narrow view that guarantees are value for money if the fee covers the risk. It is good that the Treasury has a formal governance process and commercial specialists to help evaluate, manage and set a price for risks to the taxpayer. However, we question whether this approach, on its own, can measure long-term risks to taxpayers reliably. As market conditions improve, the Treasury should ensure that it is rigorous and objective in ensuring that guarantees for projects are genuinely needed and that the projects supported bring significant public value.

Recommendations

a **As market conditions improve, the Treasury should ensure that its eligibility criteria for this Scheme include a rigorous and objective assessment that guarantees are needed.** The Treasury should reassess the eligibility of prequalified projects, reviewing this annually to understand changes in circumstances. Across government, we expect to see objective criteria for issuing any government guarantees.

b **The Treasury needs to report to Parliament on the level of risk associated with guarantees.** Guarantees transfer risk to the public sector. The Treasury should report to Parliament annually, and as new guarantees are issued, on the level of risk associated with the portfolio of guarantees. The Treasury should also provide information on individual guarantees that are material to the portfolio (specifically for large, non-investment grade projects) and summary information on the measures in place to mitigate risks**.**

c **The Treasury should develop an additional pricing methodology based on an appropriate capital charge** to reflect the use of the national balance sheet and other costs associated with the Scheme. Charging for guarantees provides compensation for financial risk and it is important that fees fully cover risks, especially when market prices are low.

d **The Treasury should ensure that the expertise within Infrastructure UK is complemented by expert challenge from outside Infrastructure UK and that its pricing database and techniques are reviewed** in line with the recommendations of the Treasury's 2013 *Review of quality assurance of government models*. We also expect the commercial disciplines and practices applied in the UK Guarantees scheme (commercial charging, risk assessment, due diligence and securing senior lender rights) to be evident in all guarantees across government.

e **The Treasury should consider how it can maximise competition and transparency in the allocation of all government-guaranteed debt, to minimise the premium over government issued debt.** The Treasury should then use its position at the centre of government to promote best practice across other public bodies.