

Roundtable: Understanding risk in sustainable infrastructure investments

Event summary

EVENT DETAILS

Date: 20th October 2017

Venue: Staple Inn Council Chamber, High Holborn, London WC1V 7QJ

BACKGROUND

This joint roundtable was conducted by the Institute and Faculty of Actuaries (IFoA) and the Aldersgate Group. It brought together key stakeholders from the Aldersgate Group and IFoA membership alongside government representatives and civil society organisations for a high-level discussion on the importance of climate and other environmental factors for infrastructure investments, and to share ideas on how risks facing infrastructure investments can be identified. The roundtable focussed on the UK regulatory and investment environment.

Investing in sustainable infrastructure

The UK has a set a binding target to reduce greenhouse gas emissions by 80% against 1990 levels by 2050 under the Climate Change Act 2008. To meet this target and the interim carbon budgets, as well as the forthcoming 25 Year Plan for the Environment and our international commitments under the Paris Agreement and Sustainable Development Goals, an enormous amount of new and resilient infrastructure will be needed, requiring significant capital investment.

Sustainable infrastructure is infrastructure which does not detract from, or improves, the social, economic and ecological environment in which it exists, providing a positive contribution in the long-term and contributing to sustainable prosperity. Investing in sustainable infrastructure refers to building new, sustainable projects as well as redeveloping and enhancing existing projects to make them more sustainable. It implies investing in projects with high environmental and social standards, which are consistent with long-term societal trends and objectives. Infrastructure which mitigates or assists with adaptation to climate change events can provide portfolio diversification or a hedge against climate change-related events.

ROUNDTABLE DISCUSSION

The plenary discussion was wide-ranging. Some of the main points discussed are summarised below.

Infrastructure risk

Infrastructure risks vary depending on the investment type. Debt investment through bonds can carry risk associated with the bond issuer or with the revenue stream of the asset. Equity investment may carry construction risk – as such potential investors tend to shy away from investment at the construction stage. At the operational stage, risks are lower, although ongoing

risks still exist. Good risk management from the outset of a project and cost-effective steps to mitigate risk can make investments more resilient.

Infrastructure suffers from underinvestment in the UK

There is a larger market for infrastructure investment in Australia and Canada than in the UK, where investments tend to be in financial instruments. This can partly be attributed to a perception of policy risk. Greater UK policy stability in the form of the recently published Clean Growth Strategy with cross-Whitehall buy-in may help to some extent. The independence of UK regulators is also appealing as it lowers the risk of regulatory change in the short term – maintaining this will be important for ongoing investment. Whilst policy should be reasonably flexible, a policy trajectory with transparent decision-making processes and scenarios for resilient infrastructure can help to overcome policy risk.

‘Unsustainable’ infrastructure is not an attractive investment proposition. Indeed, infrastructure that is not sustainable arguably should not be defined as infrastructure. When determining investment risks, actuaries and investors should ask what the risk of *not* investing in infrastructure is, considering the knock-on impacts of a portfolio if vital social services are not delivered.

Infrastructure investment requires a level playing field

Investments in financial instruments like derivatives do not factor in the real costs and/or risks. The externalities of all investments should be incorporated into the risk assessment in order to level the playing field and bolster the fundamentally strong case for investment in infrastructure. This could be achieved by regulation on resource use, such as a carbon price. However, pricing in other factors like natural resource degradation is more challenging as we lack established metrics.

A longer-term view is needed across the investment landscape

It is logical for long-term investors in infrastructure to take a sustainable approach to promote the underlying health and longevity of an asset. This should significantly reduce the potential for investment in ‘unsustainable’ infrastructure projects, such as coal processing plants, as the business model carries greater risk over its lifetime.

A lifecycle approach should be taken to value the full environmental impact, cost and benefits of an infrastructure project, from raw materials, to embedded water and carbon, decommissioning costs (or technological redundancy) and end of life use.

Bonds are one of the two principal ways of investing in infrastructure. Credit Rating Agencies (CRAs) tend to take a three to seven-year view in their credit analysis for bonds. However, this is at odds with the long lifetimes of infrastructure. CRAs should therefore be encouraged to take a longer-term view. The EU’s High-Level Expert Group on Sustainable Finance is looking at how to put a requirement on CRAs to incorporate ESG factors into bond evaluations. CRAs are ultimately service agencies and should be influenced by client demand.

There is a role for regulatory bodies like the Financial Conduct Authority and the UK Listings Authority to set standards requiring advisors to look at strategic and ESG issues, ensuring risks and

opportunities are incorporated into the valuation and structure of bond issuances and reflected in prospectuses. Currently there is significant variation in how issuances deal with strategic issues.

Policy should regulate for resilience

Operational infrastructure risk such as flooding can be managed, but it may raise CAPEX significantly. As the cost imperative is key, sustainability and resilience elements of an infrastructure project, such as green roofs or solar panels, may be discarded under cost pressures. Investors and project sponsors must decide what their acceptable risk to cost level is, but regulation can help to embed resilience measures and manage risk in the design stage of an infrastructure project.

It is not the role of the private sector to determine the level of acceptable risk on a societal level however. Government must make decisions on acceptable levels of risk and required resilience. This helps to set a framework for investment.

Infrastructure investment will still require government funding

Government innovation funding remains key to incentivising early stage investment in newer technologies, such as battery storage, that accrue benefits across industry and for the UK as a whole. It may be helpful to map infrastructure projects that would happen without government support, those that could happen with certain policy interventions and those that wouldn't get off the ground without government stepping in to ensure efficient allocation of funding. There may be a role for a government Infrastructure Resilience Fund to mitigate climate-related risks associated with existing infrastructure.

Existing data should be used more strategically

Disclosure of climate-related information is helpful in reaching a level of better collective understanding of scenarios and risks, and has the advantage of being possible without regulatory intervention. However, the complexity and duplication of different reporting regimes for specific audiences (regulatory, financial, management) can create a significant burden for disclosing companies, adding operational costs that don't contribute to service delivery. It was suggested that users of the data should take on greater responsibility to find the information, which is often publicly available but not collected in one place.

From the investor side however, many investment analysts equally don't have the resources to search for information. There was agreement that the proliferation of different reporting platforms also makes it very difficult for actuaries and other investment professionals to aggregate risk information at a portfolio level to determine exposure to climate change and other environmental impacts.

One issue is that we are still on a learning curve: actuaries remain unable to truly chart investment exposure with available information. The Financial Stability Board's Task Force on Climate Related Financial Disclosure may help with this by measuring adaptation alongside mitigation measures. Dependencies and risks should be more clearly drawn out and communicated in a way that is useful to investors. Any reporting regime should also be sensitive to information that is not captured by numbers, such as competing investment priorities and risk tolerance, as well as the

many environmental impacts not measured by greenhouse gas reporting methodologies, such as climate adaptation risks. There is a case to rethink the reporting system holistically to make better use of existing data for all the different parties, without increasing the burden upon companies.

Communication is key

When talking about infrastructure risk and valuation, it is important to connect the investment to real stories of the service the infrastructure delivers. This is an effective way of increasing engagement and ultimately getting potential investors interested. Anecdotally, greater exposure to information about sustainable investment results in more engagement and a change in thinking across an investor's portfolio.

Current language around risk fails to communicate real-world impacts. For example, flood risk terminology of a '1 in 200-year event' is misleading, as non-specialists interpret this as a highly unlikely event. Furthermore, the likelihood is very difficult to assess, so the figure implies a higher degree of accuracy than is warranted. A more common-sense measure is needed to better communicate the risks to infrastructure. Rather than only reporting on risk, measures taken to increase resilience should also be communicated.

NEXT STEPS

The findings of this roundtable will be further investigated and may inform policy recommendations to be included in policy briefings and future reports and publications. The discussion will feed into the work of the BEIS Green Finance Taskforce.