HERBERT SMITH FREEHILLS

BREXIT SECTOR VIEWPOINT
INFRASTRUCTURE

Following the UK's vote to leave the EU, the UK, Europe and now the United States have found themselves in a state of political and economic uncertainty. As voters around the world express frustrations at the ballot box, the previously stable infrastructure sector is not immune either from sharp market fluctuations or shifts in policy.

Although ministers in the UK have been quick to offer assurances about the UK remaining 'open for business', with green lights for the Hinkley Point C new nuclear project, the full HS2 high speed railway line and a third runway at Heathrow airport, other moves have raised political risk concerns which have not traditionally featured prominently for investors in the UK, such as the degree of international involvement in future foreign investment in critical national infrastructure.

OPPORTUNITIES OUTWEIGH RISKS

The Brexit vote in the UK - and the uncertainty it brought - had most immediate effect on the currency markets. Sterling fell against other major currencies and continues to react to developments in the Brexit process.

However, infrastructure investors remain mostly sanguine about the consequences of Brexit. The UK will remain an attractive foreign investment destination in regulated and other social and economic infrastructure classes for a number of reasons, unaffected by the current uncertainties:

- Demand for core infrastructure is unlikely to decline as a result of Brexit, being largely immune from exchange rate volatility and economic fluctuations.
- In addition, the UK Government has indicated its preparedness to increase greenfield infrastructure spending, particularly smaller scale projects, to bolster jobs and offset any wider downturn. It has also set a course for a permanently-higher share of GDP to be spent by government on strategic economic infrastructure eg transport.
- UK regulatory regimes remain robust, transparent and largely independent of political interference. Their statutory focus is on reliable service for users, fair prices for consumers and reasonable returns for investors. They are well understood and trusted by international investors and are often cited as a key attraction of UK infrastructure assets.
- The UK Government has announced it will bring forward a "Great Repeal Bill", which, despite its name, will seek to preserve most EU-derived rules currently applicable in the UK as UK law after Brexit, with change thereafter being gradual. Businesses will wish to consider where they would be better served if the UK maintained close alignment with EU rules, or diverged, and lobby accordingly.
- Money continues to be relatively cheap, making major infrastructure financing less costly with the potential for more-attractive returns. The countervailing threat to liquidity from Brexit risk in the banking sector, and from possible "Trumpflation" (a new global trend toward rising bond yields) (after declining for over three decades), may yet filter through depending on what Brexit and Trump (respectively) turn out to mean.
- The ability of the UK construction industry to support the UK's infrastructure pipeline could of course be impacted if immigration controls (on EU or other citizens) restrict businesses' ability to secure the necessary skills.
- One significant effect of the UK leaving the EU Single Market is that the strict EU state aid and public procurement rules would no longer apply to UK Government support for projects. The WTO anti-subsidy and procurement rules would however apply and the EU would be likely to monitor compliance closely as part of any settlement as agreed between the EU and the UK.

"Speaking with infrastructure investors globally, none is shaken to the core by Brexit. Money needs to find a home and UK infrastructure remains a stable asset class. They may go about their business slightly differently in the future and create separate sterling and euro funds, but given the tendency for wobbles in the Eurozone, they might have done that anyway"

**PATRICK MITCHELL,
HEAD OF INFRASTRUCTURE,
HERBERT SMITH FREEHILLS LLP**

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While the UK would have greater discretion in providing state support to projects on their social and strategic merits, it would risk retaliation in terms of higher tariffs where its support could distort the export market. In relation to public procurement, the UK currently has quite stringent rules which unilaterally supplement the EU regime requirements and so it is not obvious that the UK would seek to depart from the EU's minimum standards.

- Indeed, in these and other areas it is possible to imagine a scenario where the effect of Brexit is to weaken the EU's commitment to resisting anti-competitive practices with like-minded EU members no longer having the UK as a powerful voice on their side.
- Brexit risks removing the European Investment Bank (EIB) as a possible source of funding for UK infrastructure projects which do not contribute to the EU Single Market. However, this sort of funding would generally be compliant with WTO rules, to which the EU and all its Member States are subject, so similar funding on similar criteria directly from UK Government or a UK Government-owned infrastructure investment bank should not be problematic. Certain projects, eg electricity interconnectors between the UK and an EU member state may still qualify for EIB funding on the basis of single market contribution.

BUYER BEWARE

Although there is plainly uncertainty in what Brexit may bring, infrastructure investors are still able to manage risk through rigorous diligence and pricing.

In the immediate wake of the Brexit vote, the new UK Government heralded a return to a more active UK industrial strategy and announced an unexpected but ultimately-brief review of the new nuclear power project at Hinkley Point C, on national security grounds. A consultation is expected shortly on a new framework for assessing foreign investments in 'critical national infrastructure', although it is considered unlikely to mark a shift away from the UK's welcoming attitude to foreign investment. It also recently shelved its previous plans to make the National Infrastructure Commission statutorily independent. It had been hoped that such independence would reduce the impact of the electoral cycle on long term infrastructure development decisions.

Shifts in policy such as these, to take (or not to relinquish) political control, may become the norm in the short-to-medium term as politicians seek to interpret messages sent by voters.

PREPARE FOR THE UNKNOWN

The UK faces a number of unknowns that rest on future government decisions and negotiations with the EU. Despite the uncertainty, businesses can prepare for Brexit.

Owners of infrastructure assets and prospective investors can assess the potential consequence of Brexit, by asking, for example:

- How will investment processes and contractors' supply chains be affected?
- How should I structure my investment funds to anticipate currency volatility?
- How will Brexit impact the effect of existing long-term contracts and the issues to be addressed in new ones (eg risk allocation, territorial scope)?
- What are the key characteristics of my projects and where are they in their life cycle?
- How will Brexit impact my sources of funding for future projects (eg EIB)?

By assessing and quantifying these and asset-specific challenges, infrastructure investors can define and prioritise mitigation strategies. Investors may wish to lobby government and industry bodies with arguments to shape future policy. They should monitor developments as the political landscape continues to shift and be prepared to modify their investment models and policies in response to evolving certainties.

> "We are seeing ongoing demand for infrastructure assets in the UK and Europe more widely. The firm is advising on major current UK infrastructure deals, with investors from the EU, the US and Asia evaluating and addressing the potential impact of Brexit. The exchange rate is not driving activity"
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> **GAVIN WILLIAMS, PARTNER, INFRASTRUCTURE M&A, HERBERT SMITH FREEHILLS LLP**

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