IMPACT OF BREXIT
ON UK INFRASTRUCTURE

DLA PIPER

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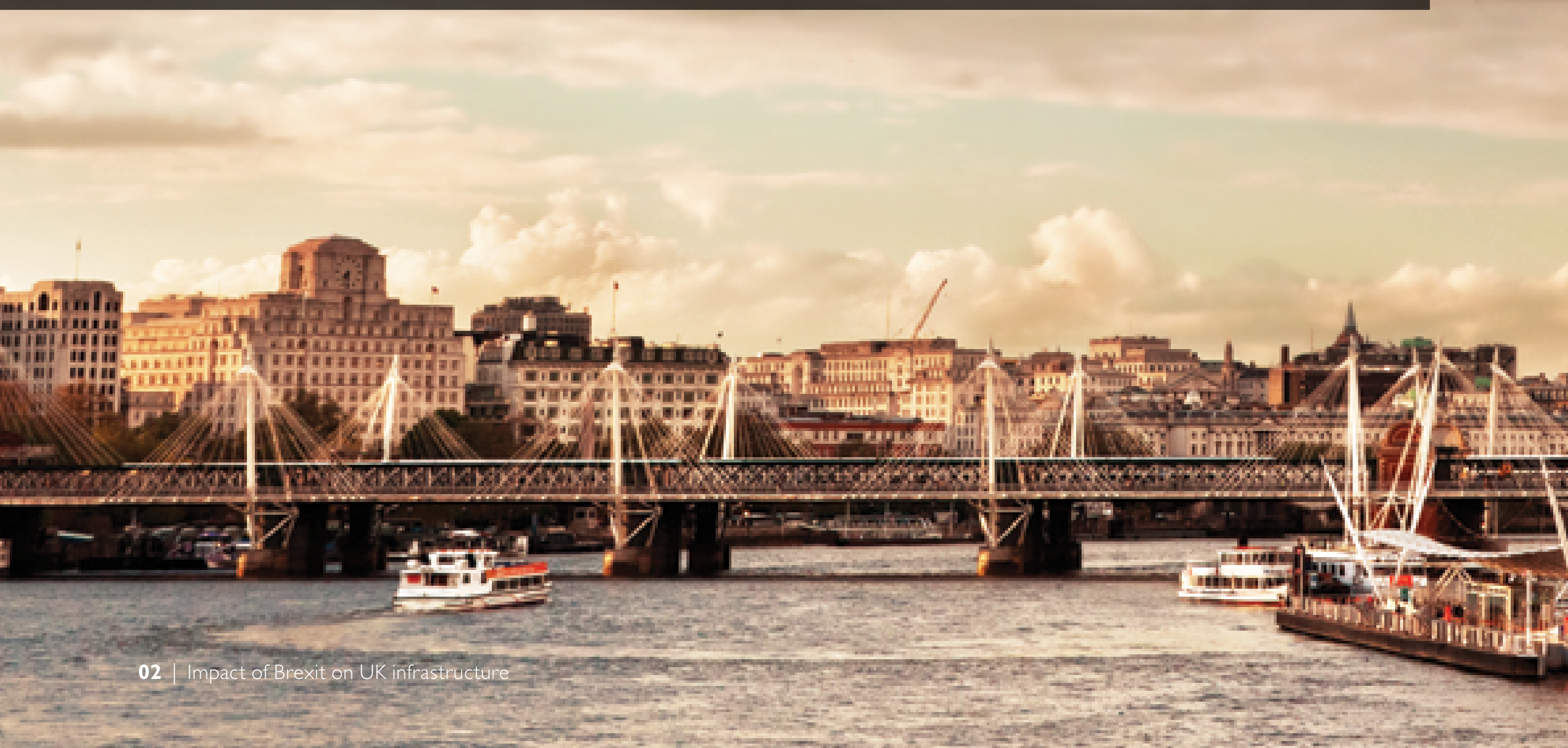
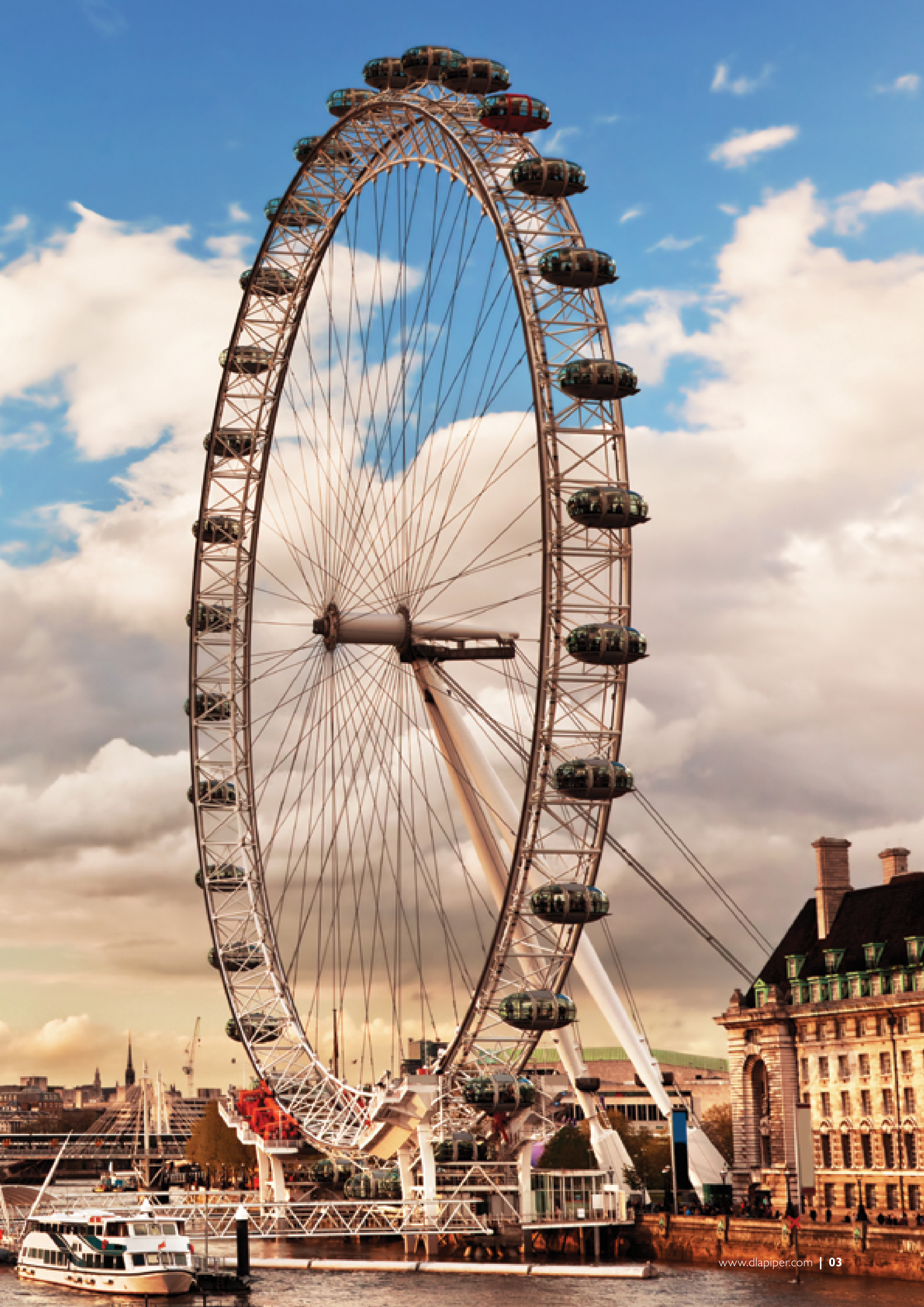




INTRODUCTION

It's been almost eight months since the EU referendum in the UK resulted in the Government's decision to trigger Article 50 of the Treaty of the European Union commencing formalities to exit the EU. In a short space of time, the UK has faced an unprecedented change in its political landscape, including the replacement of infrastructure champion George Osborne at the helm of HM Treasury and a new Prime Minister in Theresa May.

At the same time, spending in UK infrastructure has fallen significantly since the EU referendum, as the construction and infrastructure industry faces uncertainty both in terms of the UK projects pipeline and the investment landscape. It is feared that significant projects which held favour with the previous Cabinet may experience delays in the face of such economic uncertainty. Recently, the Government's White Paper on the UK's exit from and new partnership with the European Union was published to allay concerns and provide some transparency on the UK Government's agenda for Brexit. In this note, we consider the actual and potential impact of Brexit on Infrastructure in the UK.

A. THE LEGAL FRAMEWORK **POST-BREXIT**

PROCUREMENT LAW AND PROCEDURES

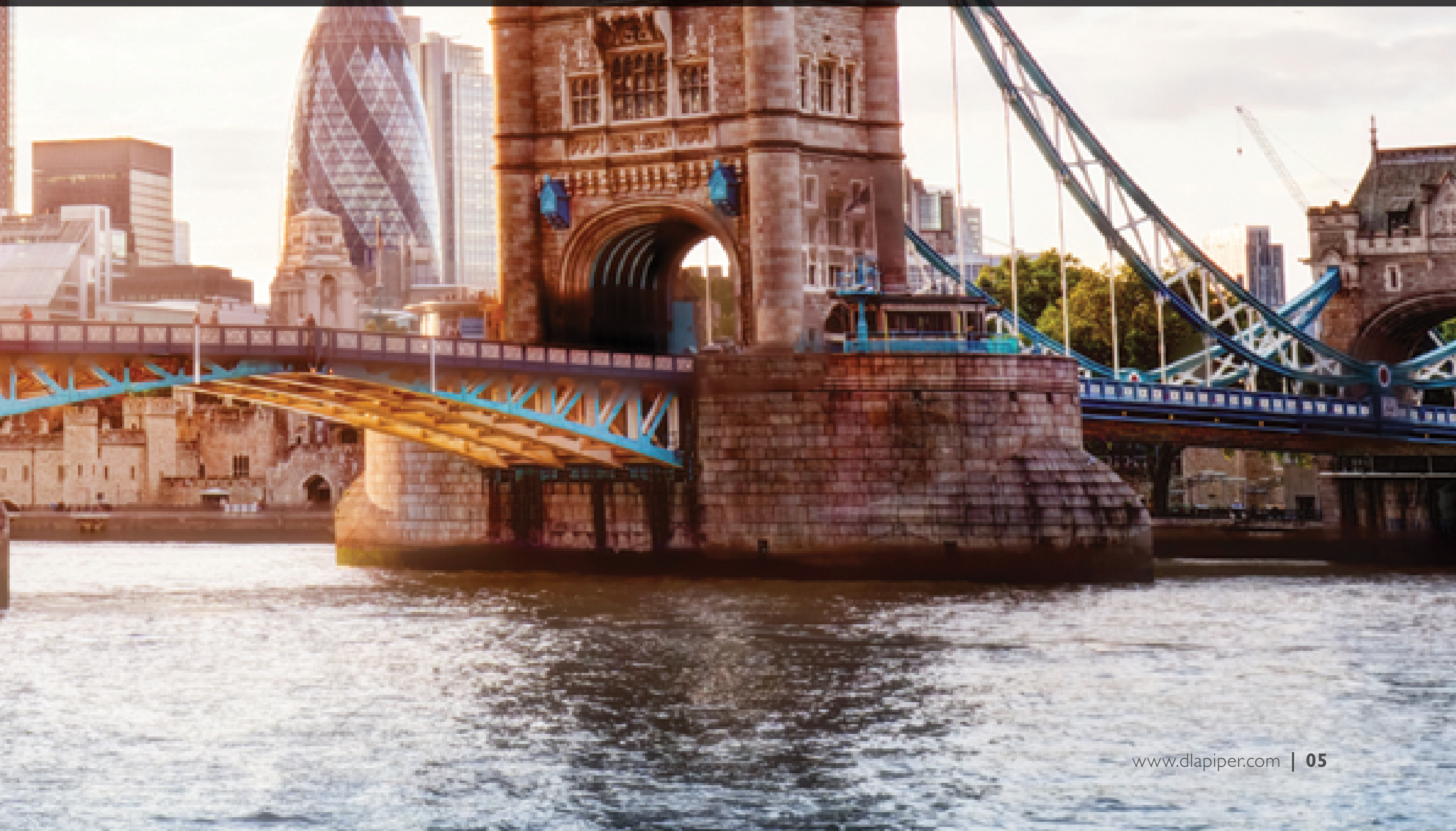
- It is likely that the potential implications for procurement law in the UK will be minimal in the near term. We anticipate that the UK will seek to have equivalent legislation in place post-Brexit, for reciprocity reasons and to avoid any risk of losing its legitimacy in international trade.
- Existing EU legislation has been ratified by the UK and would, therefore, have to be repealed and replaced, if the UK were to change this framework. Whilst a wholesale replacement of the existing framework is unlikely, the UK might like to loosen the regulatory bounds which would presumably seek to make the legal framework more user-friendly and attractive to the market.

STATE AID RULES

- EU rules currently prevent some forms of support and investment by the UK Government in UK business. The UK would have more scope to provide direct support for UK infrastructure post-Brexit (but would, conversely, lose the ability to challenge protectionism by other EU Member States).

CONSTRUCTION AND ENVIRONMENTAL RULES

- Currently, EU requirements to assess the possible impacts of developments on the environment and ecology under the Environmental Impacts Assessment Directive and the Habitats Directive apply – the UK may take a view that these should be amended to a UK environmental standard.
- The Energy Performance of Buildings Directive, aimed at improving the energy performance of all buildings, set target dates for nearly zero-energy buildings for December 2018 (new buildings occupied by public authorities) and December 2020 (other new buildings). These targets will no longer have to be met once the UK withdraws from the EU.



B. FUNDING AVAILABILITY AND **ACCOUNTING TREATMENT**

THE ROLE OF BANKS

- The full potential of Brexit on the financial services industry is yet unknown. Whilst banks have committed to maintain a significant presence in the City of London (notwithstanding the potential reorganisation due to the potential loss of passporting rights), it is sensible to imagine that there may be a smaller appetite for investment in long-term infrastructure projects in the short term, given the current political instability, macroeconomic uncertainty and currency volatility. UK infrastructure companies, however, continue to display highly stable operations making them good investment opportunities.
- It is yet to be seen whether risk premiums will be applied in the short-term to infrastructure lending, thereby increasing the financing costs. Nevertheless, this is unlikely to happen in respect of the regulated utilities which benefit from a more stable investment framework.

EU FUNDING

- A significant amount of funding for UK projects has historically been provided by EU institutions, including the EIB and the EBRD. Whether such funding continues to the same extent post-Brexit will be determined by the nature of the Brexit negotiations and the commitments the UK is willing to take (if any) in terms of contributions. Clearly, as the UK would need to relinquish its shareholding in the EIB post-Brexit, it will no longer be a key decision-maker in investment opportunities and will, therefore, have to rely on the remaining Member States for funding allocation.
- Similarly, the UK is seeking to obtain funding under the European Fund for Strategic Investments (EFSI or the "Juncker Plan") and it is yet to be seen whether future funding from this fund will be available to the UK post-Brexit.

UK FUNDING

- As highlighted above on state aid, the UK will be more able to support projects directly. The Prime Minister has expressly pointed to Treasury backed bonds being a possibility for raising funds for infrastructure.
- Clearly, any ability by the Government to provide funds for infrastructure will be heavily linked to the performance of the UK economy. With forecasts talking of a slow-down in the growth of GDP, investment in expensive infrastructure may not reach the top of Government's spending priorities. However, whatever investment the Government does make will need to be matched by the private sector and the Government may need to consider what fiscal incentives it puts in place to attract such private investment.

FOREIGN INVESTMENT

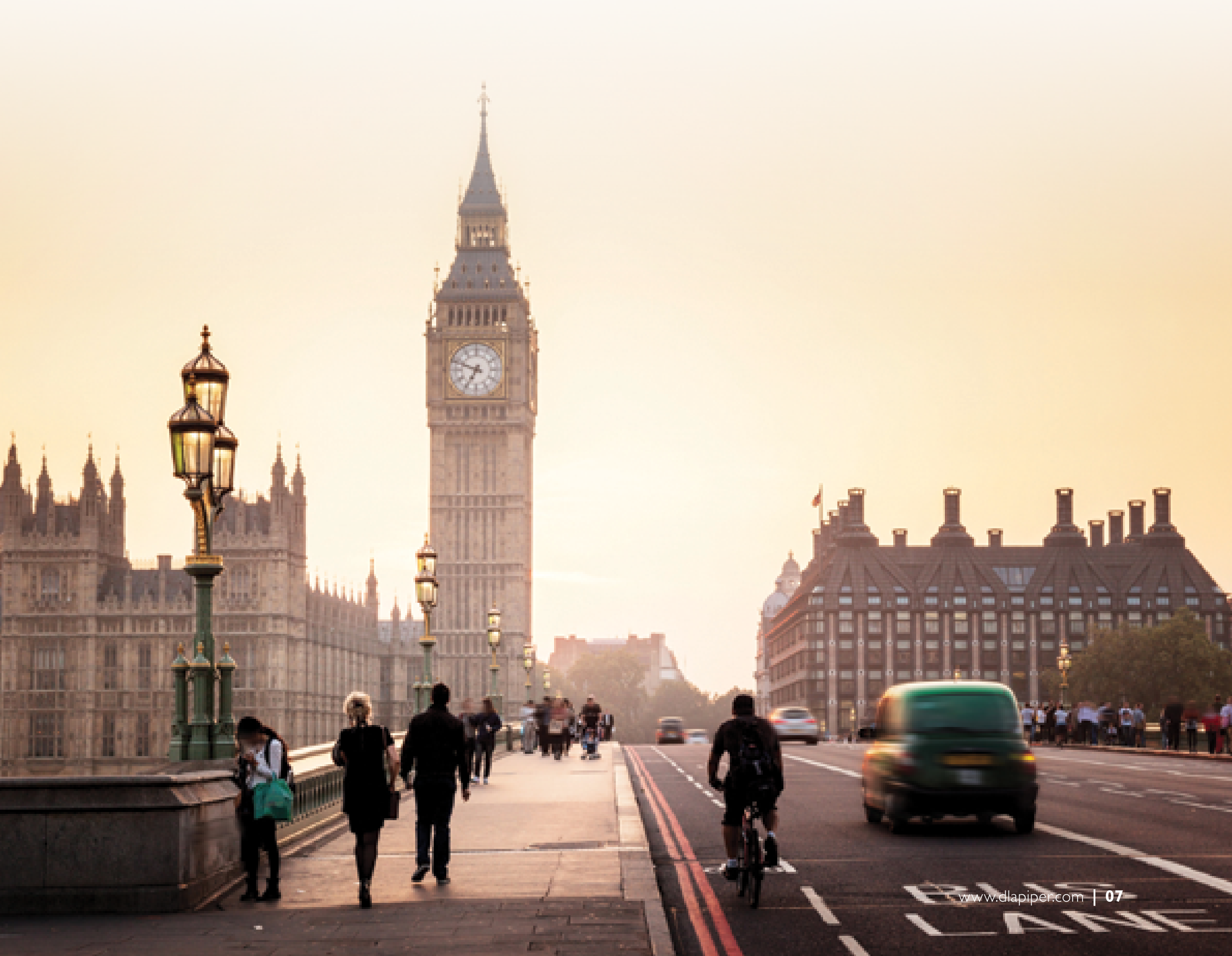
- In the long-term, foreign investors may find that their returns decrease (given the currency volatility) and that underlying project costs increase (particularly where the transaction relies on imported goods and services).
- Whilst this relatively short period of instability and uncertainty may deter foreign investors, the UK remains a stable and mature economy and therefore this period may also lead to opportunities for higher returns on investment for some investors. The currency volatility leads to a number of questions in respect of underlying project costs, but it also means that foreign investors get more for their money on a secondary market purchase, for example, when Sterling is on a decline.
- Whilst we have not seen a movement by the investors or funders to seek further assurances from the public sector around the ability of UK public bodies to meet their payment obligations or the political risk of Brexit (be it by way of Government guarantees or letters of comfort) one should not

discount the potential impact, albeit a low-risk short term impact, implementation of Brexit may have on the UK economy and potentially the assessment of the UK's credit rating.

- There may also be fewer opportunities for foreign investment due to a potential policy to encourage domestic growth by limiting participation in certain infrastructure projects to domestic investors.
- If foreign investment were to decrease, the domestic institutional investors may need to step up to bridge the gap.

ACCOUNTING RULES (ESA10)

- The emergence of the European System of Accounts (ESA10) heralded a shift away from the established principles of risk and reward in the assessment of balance sheet treatment, towards an increased focus on rewards and control – something that has been at odds with modern infrastructure PPP models and has caused many important infrastructure projects across the UK to stall.
- It is unclear whether the UK would wish to move away from the application of ESA10 to projects in the UK, post-Brexit. However, Brexit does provide the UK with an opportunity to grasp the nettle at a local level and adopt a different approach to its EU neighbours – one which is clear in its parameters, offers an opportunity for additionality of investment in times where capital budgets are constrained and one which is not at odds with modern structures that promote value for money, transparency and stakeholder involvement in the procurement of public assets.



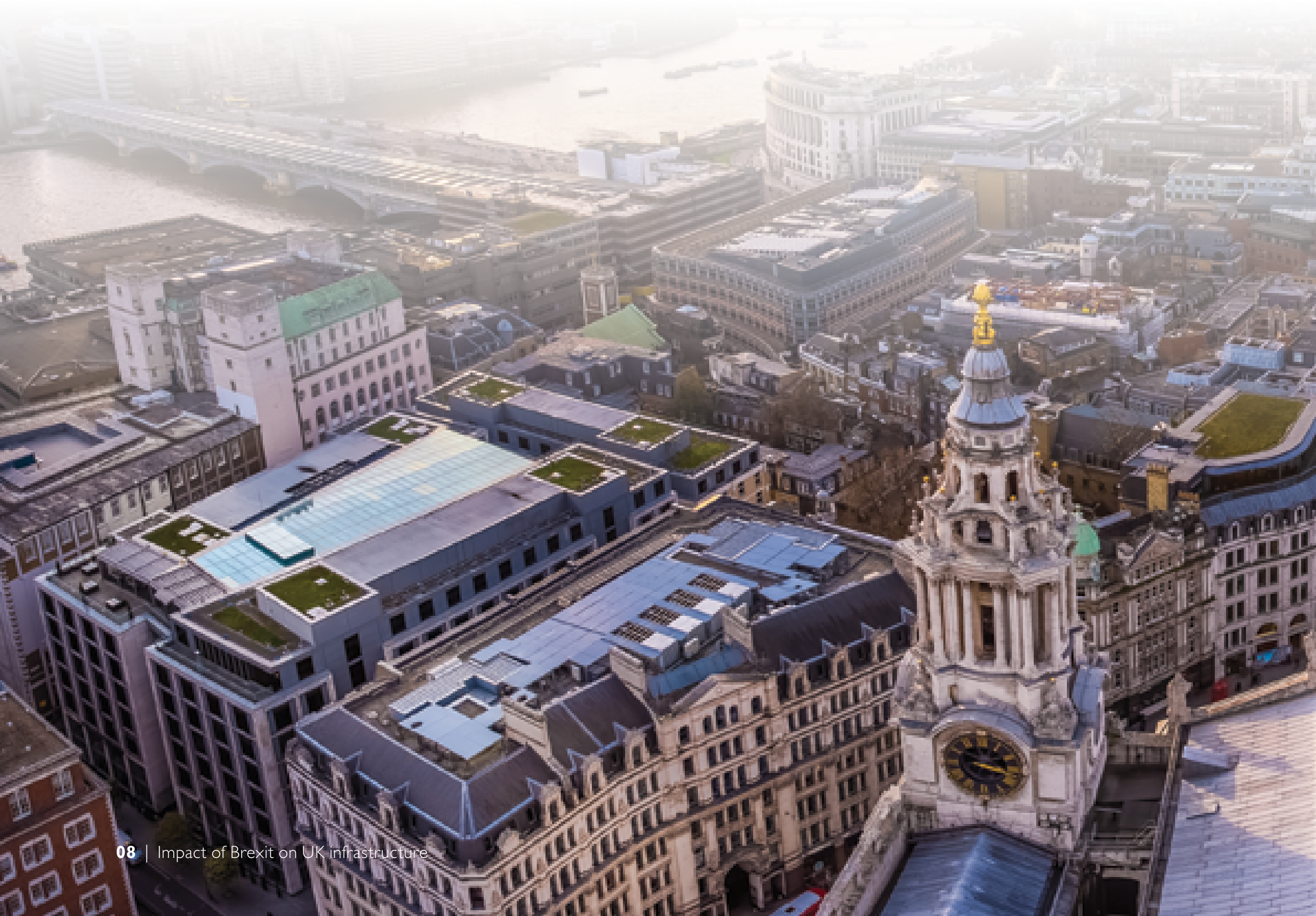
C. AVAILABILITY OF LABOUR **AND MATERIALS**

MOVEMENT OF PEOPLE

- It is widely believed that one of the most significant reasons for the Brexit vote was the concern around one of the principal tenets on which the EU was formed: the free movement of people. The UK Government has been very clear that it will not accept freedom of movement for EU nationals into the UK.
- At its worst, this will result in an immediate reduction in the number of skilled labourers that have traditionally come to the UK from the EU and a consequent increase in the cost of domestic skilled labour. Given the short-term pipeline of projects requiring such labour, including Thames Tideway Tunnel, Crossrail, Hinkley Point C and the Heathrow Airport expansion, this may cause a strain on construction companies and raise questions around the ability of the construction industry to deliver the pipeline projects.

COST OF MATERIALS

- The UK Government will seek to continue to benefit from the advantages afforded by the Customs Union within the EU. This will clearly be a point for negotiation with the EU which, if this benefit doesn't materialise, will have the effect of making imported and exported goods and materials more expensive.
- In addition, given the exchange rate fluctuations, whilst UK entities are more competitive as exporters of goods and services, imported materials are currently more expensive.
- It is yet to be seen whether VAT (which found its origins in the EU) continues to be charged in the UK in the same way post-Brexit.



D. WHAT DOES IT MEAN FOR EXISTING **INFRASTRUCTURE CONTRACTS**

CHANGE IN LAW

- In practice, the UK's legal environment may not alter dramatically immediately on Brexit. However, the potential for change means that change in law clauses in contracts will be increasingly called upon. It will be interesting to see whether Brexit, whatever precise changes in law it leads to, is deemed to be a foreseeable change in law from the date that the referendum was called.

FOREX RISK ADJUSTMENT

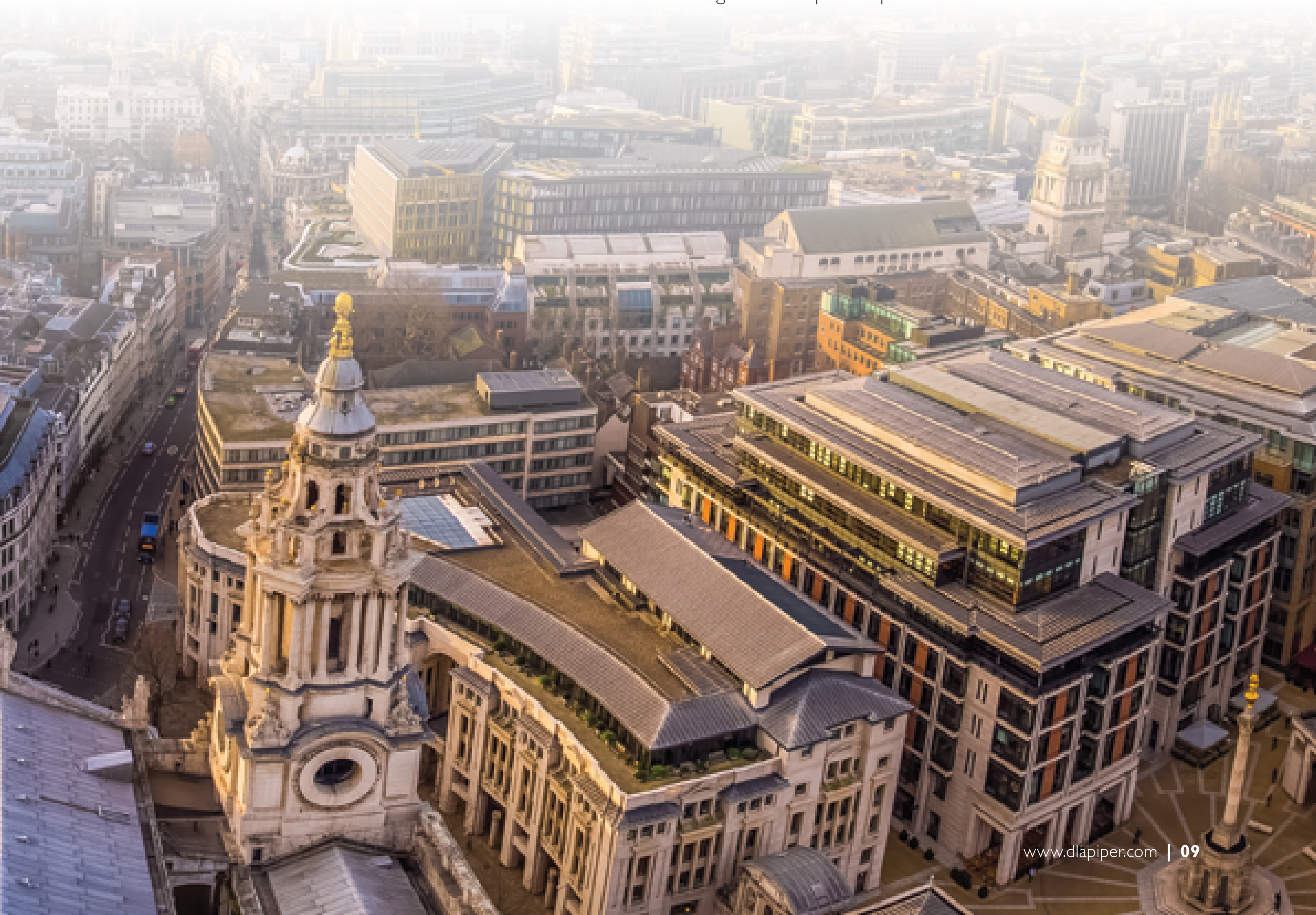
- Some complex infrastructure contracts with large exposure to foreign currency exchange movements may contain forex risk clauses which provide for an adjustment to payments due to the contractor determined by the movement in forex risk. Once again, these may already start to be called upon given the current forex market.

INDEXATION CLAUSES

- Similarly, most long-term contracts will have complex indexation provisions, which protect the contractor from sharp inflation in the event that indexation is linked to the correct index. The impact of the limitation on free movement of people on labour costs and therefore the adequacy of indexation as a tool to mitigate increases in labour costs will need to be considered.

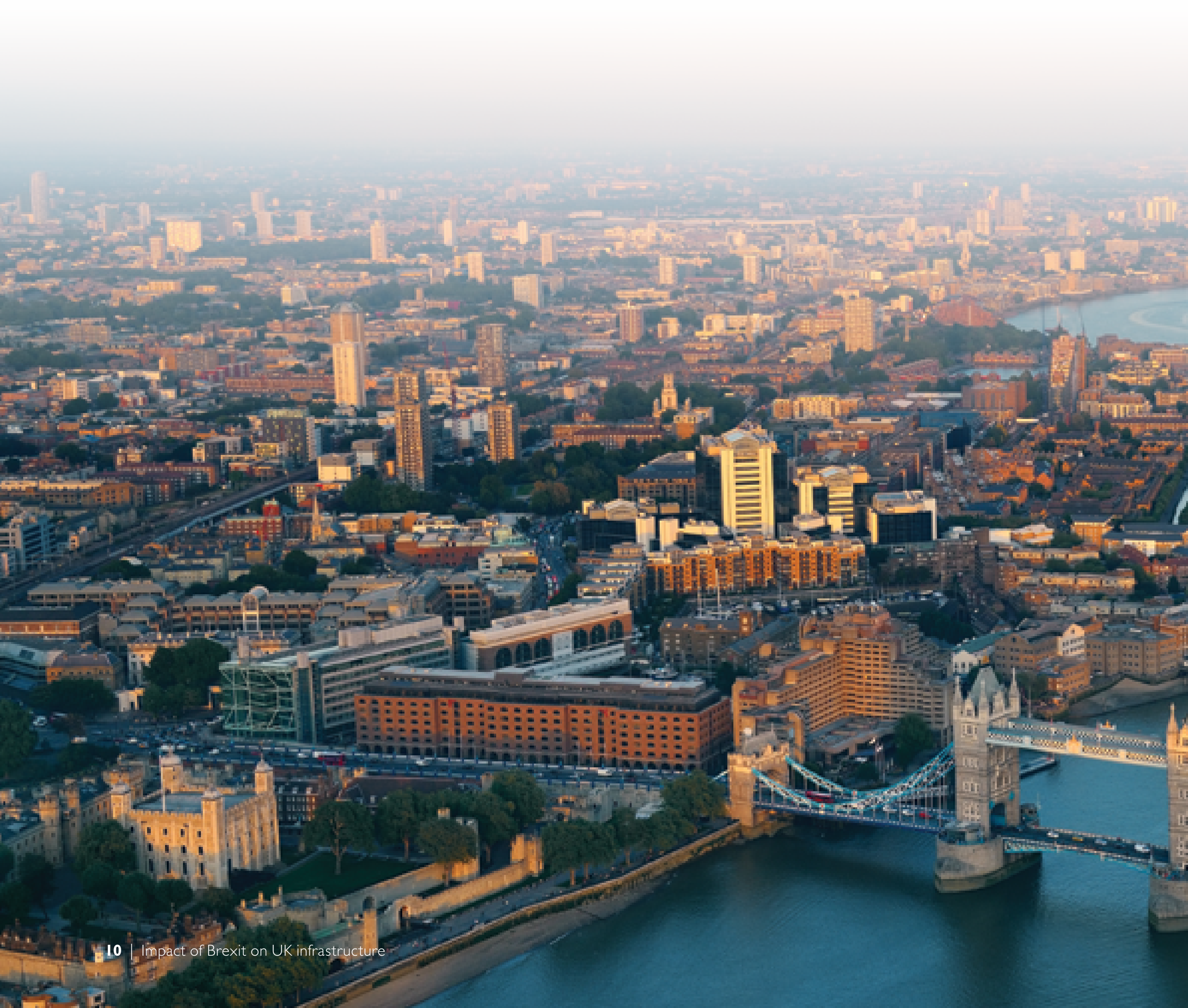
CHANGE IN CONTROL/DOMICILE

- Some contracts (particularly defence contracts where security of supply is a specific concern) will contain restrictions on transfer of ownership of the contractor (and in exceptional cases, the key subcontractors), and change of domicile. These clauses will need to be considered in the event of corporate reorganisations carried out to mitigate the effects of Brexit by ensuring a greater corporate presence in the EU.



E. THE OUTLOOK FOR **UK INFRASTRUCTURE**

- It appears that infrastructure investors are playing it safe in the short-term, postponing investments until the UK and the EU finalise Brexit negotiations. Although growing uncertainty around the political and economic landscape in the UK, as well as in the EU, may lead businesses to search for opportunities elsewhere, in the meantime, the UK remains a largely attractive target for international investment.
- Such uncertainty could lead to a squeeze in available funds, which conversely could lead to higher returns for investment. However, the short-term outlook appears to indicate that funding for UK infrastructure is at risk as a result of Brexit.
- This uncertainty will also play a part in the development of the mid to long-term infrastructure project pipeline which will be vulnerable to not only the economic but also the political risk inherent in the next two years of Brexit.



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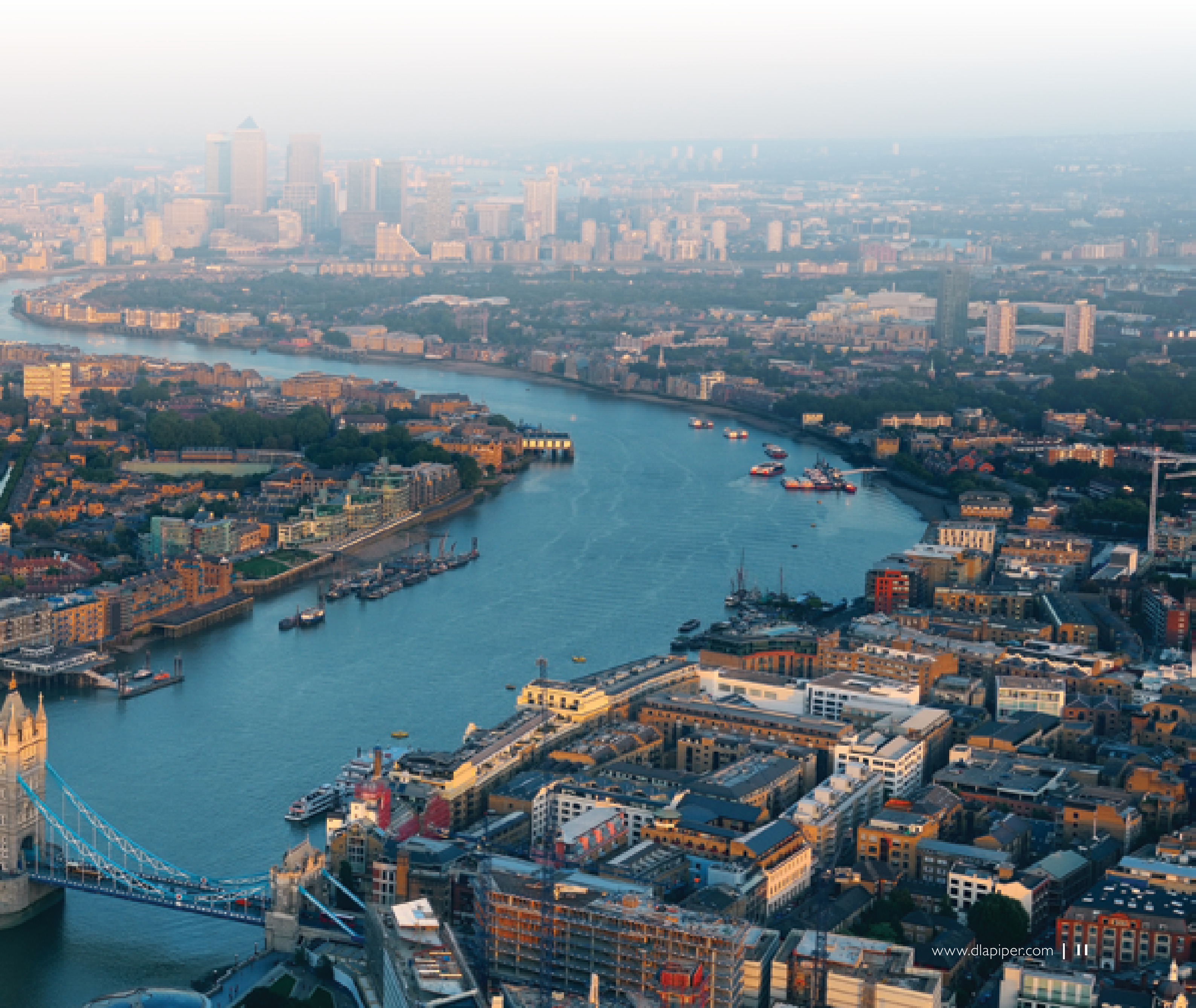

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