

Driving forward

Niall Mills discusses the relationship between responsible investment and the inflation-linked income generated by infrastructure assets

ESG Infrastructure

At first sight, building or improving infrastructure may not fit in with a greater awareness of environmental, social and governance (ESG) and principles of responsible investment (PRI), but this would be a short-sighted view. PRI played a part in stock selection decisions of many pension funds and large institutional investors long before they became formalised. Now these key principles are central to investment decisions and a keen awareness of the ESG agenda is an important driver in successful infrastructure investment.

Responsibility counts

For many defined benefit (DB) pension funds, unlisted infrastructure is an attractive asset class. Not only does it produce a predictable stream of inflation-linked income but adding infrastructure to the investment mix can also diversify a portfolio and reduce reliance on equities and bonds. Certain infrastructure projects, such as utilities, power distribution and transportation have an attractive risk-reward profile for pension funds.

Complimenting this, PRI considerations have moved to the mainstream of pension fund thinking. Managers and consultants say new manager appointments now invariably take account of PRI. Pension fund investment committees are aware of the impact of environmental disasters on the value of investments. There has been an attitude change in society, which is visible from recycling household waste to the development of green vehicles.

Other indicators of the prevalence of ESG are the number of pension funds now becoming signatories to the United Nations Principles for Responsible Investment (UNPRI) and disclosures of how ESG principles are taken into account in a pension fund's statement of investment principles. Far from being lip service, it can be argued that pension fund trustees have a fiduciary duty to consider issues, including ESG criteria, when making long-term investment decisions. Poor ESG practices may indeed be a leading indicator of a badly run company.

Why are these trends compatible? It must be acknowledged that infrastructure projects may be perceived to have negative impacts in an ESG sense. Operating a toll road, or running a water and sewerage operation, needs to be managed from an environmental risk perspective. However, good infrastructure businesses do this successfully, striving to run sustainable businesses within the licensed and regulatory constraints without prompting. There are many examples of utility companies being part of the local community adding to its amenity and recreation diversity. This good practice, it helps attract and retain talented staff and improves morale.

It is also the case that many infrastructure investments are highly visible. If something goes



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wrong and environmental problems emerge, protestors and the general public will make their feelings known and the infrastructure operator and owners will face adverse media coverage and reputational risks. Infrastructure managers are aware that investors do not want to be embarrassed by the assets they hold.

Long term considerations

To demonstrate how PRI is taken seriously by infrastructure managers, we can look at cases where a project was developed with good environmental practices in mind. These are evidence of how such issues are taken seriously and incorporated into projects, with benefits for investors, managers and staff.

For example, an oil reclamation process carried out by Electricity North West, forms part of our portfolio of unlisted infrastructure assets.

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Electricity distribution involves miles of cabling and hundreds of local transformers, which step-down high-voltages to household usage levels. Within this process, oil is used extensively for liquid insulation purposes. Electricity North West's central oil-reclamation depot is used to reclaim 1.3 million litres of used insulation oil every year, this can be used 'as new', saving

the purchase of new insulation oil. The depot is properly certified operating to the ISO 9001 regime. Financially, it is better for the firm to run this itself, rather than outsourcing and it shows staff and the community that environmental issues are taken seriously. In the utility industry, this is an important consideration, as companies want to retain skilled employees and these employees want to feel proud of what they do for their communities.

Another example of PRI forming an integral part of infrastructure investment is the UK water industry. This industry was privatised in 1989. At that time an embarrassing share of Britain's rivers and waterways were categorised as having minimal or no fish life. These dead, industrial waterways have been transformed since privatisation, with change driven by European environmental legislation and the ability of privatised water companies to raise capital to fund improvements in catchment management and waste water treatment.

It is estimated that 99% of British rivers now support a huge number of species as nature had intended. Drinking water in the UK is around 99.8% compliant with European standards and leakage has halved. However, this does not mean the end to improvements as the water industry is expected to invest a further £10bn (€11.4bn) in the next five years, taking total investment in the period between 1989 and 2014 to over £100bn.

For example, Anglian Water, a UK water utility, in which we are a shareholder, has been investing to minimise environmental impact through the use of real-time pressure controls. These controls help to reduce waste and leakage and work by adjusting the pressure of water supplied over the course of a day in response to customer demand. On a local basis, Anglian Water calculated that the use of these pressure controls in one location cost £3,500 to install but then saved over £5,000 in the first year. So financially initiatives like this pay off quickly and are popular with employees, local councils and customers. There are many examples like this in the water sector.

Incentivised to care

It should be noted that recently regulation has moved from economic-based to more incentive-based, which has had a positive impact on environmental standards in utilities as they can earn rewards and funding for their higher levels of performance. Clearly the companies must balance their resources carefully, but the regulators are requiring them to listen to their customers. The use of incentives in areas such as customer satisfaction, mean that the top-performing utility operators can now earn rewards, which enhance their performance.

In conclusion, infrastructure investors should not ignore PRI or imagine they will not impact any assets they hold. There is now a clear link between striving for high standards of environmental good practice and financial performance. Good companies try to do the right thing without being forced to and, in today's climate, this brings rewards in terms of community reputation and staff morale, as well as better financial results. So infrastructure investment and PRI, two important trends for pension funds, can form a lasting partnership of mutual benefit.

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