British Private Equity & Venture Capital Association

BVCA 2014 Budget Submission

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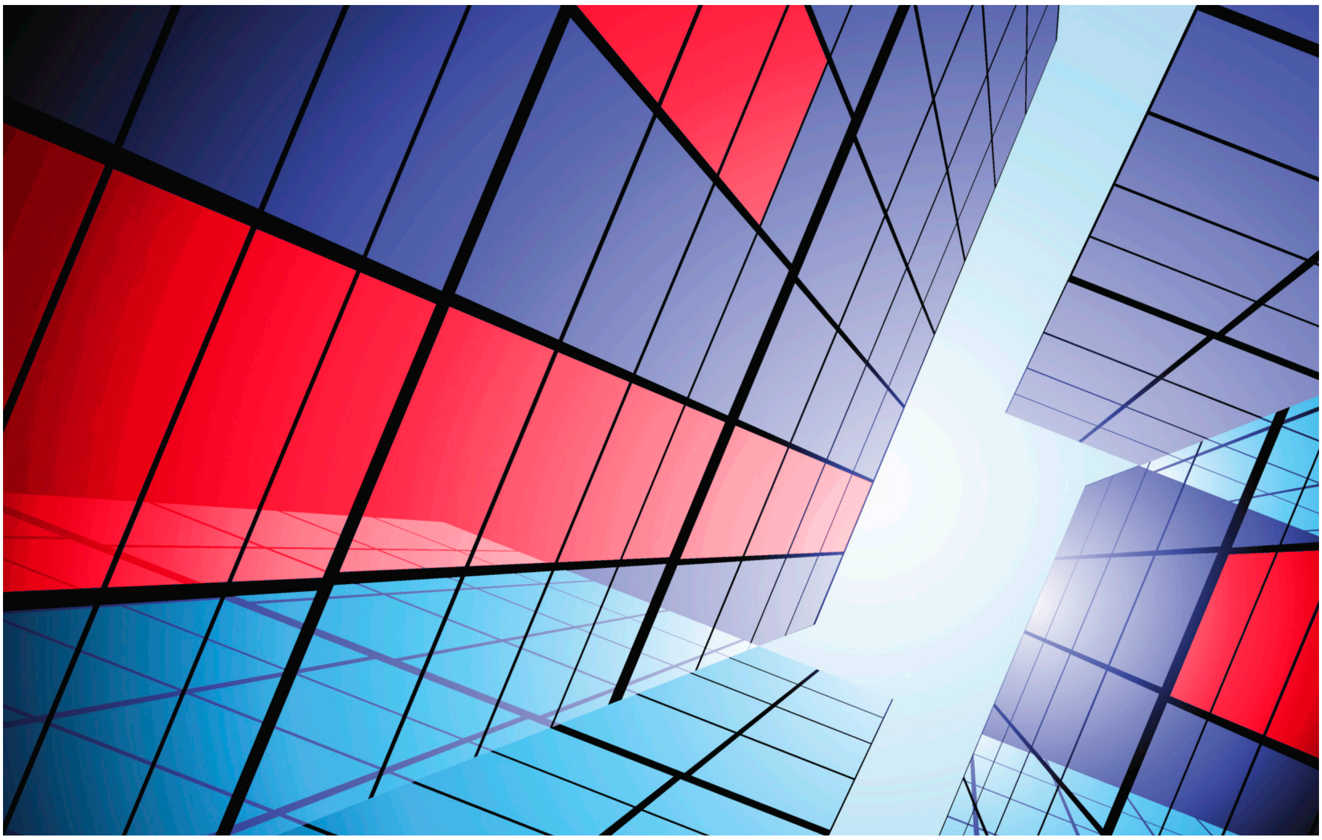
Introduction and Executive Summary

The UK economy is now growing again and this is very welcome news. But already it is time to start thinking about making that growth sustainable – based on innovation, higher productivity, exporting and business investment. But how should policymakers go about fostering these? The debate at present encourages us to choose between one aspect or another of our political economy – SMEs or large businesses, bank debt or equity finance, infrastructure investment or exporting. But actually we must look at all of these in the round. We want SMEs to become large businesses and we want large businesses to invest in small ones to foster innovation. A healthy mix of equity and debt is more important than prioritising one over the other.

Venture capital is well known for investing in high-tech start-ups just as private equity is well known for investing in large, prominent household brands. But while the BVCA represents owners and investors in businesses of all sizes and types, it is worth highlighting that 90% of businesses that private equity and venture capital invest in are SMEs. As with every single private equity investment our goal is the same, to help them grow. These SMEs are therefore the ones with high growth potential – the ones that can create the jobs the UK economy needs. Private equity and venture capital investments are also deployed across the whole country, looking to the regions outside London and the South-East. Likewise our investments concern a wide range of sectors, contributing to the rebalancing of the economy, and helping us compete in a globalised economy.



Policy Recommendations

Encouraging entrepreneurs to start here and help them grow their business

There are many different elements in encouraging entrepreneurs to start here in the UK, as well what will help make them successful – from finance to skills to infrastructure.

Adequate finance

It doesn't matter where a business ultimately gets its finance from, only that if it has growth potential we make sure there is responsible, patient capital available. Of paramount importance is to make sure that these companies keep growing so that they can become large. We need more venture capital to help fund high-risk, high-growth innovative companies that conventional lenders won't look at but that overseas buyers all too often will.

- Encourage more institutional investors like pension funds to invest in small growing companies through venture
- Big business is a key financier of small business. Encourage more corporate venturing by offering corporation tax relief and loss relief
- Ensure the take up of the social investment tax relief to encourage private investment in UK social enterprises
- Entrepreneurs Relief. We need to abolish the 5% threshold, the employment test and the £10m lifetime limit, to send a clear message to entrepreneurs that if they make a success of their business in the UK, they deserve to keep the proceeds for them and their team.

Skills

To encourage them to invest in the UK, businesses need to know they will have access to adequate skills

- Deliver an apprenticeship tax credit so employers can regain control over skills policy and make sure they get the people they need.
- LEPs should gain greater control over the skills budget so they can work with local businesses to deliver regional employment strategies that are fit for purpose
- Visa restrictions should be lifted for non-European graduates who have studied a STEM subject

Innovation

In order for Britain to remain home to world-leading technologies and products emerging from commercialisation of university research, continued investment in the research base is essential as well as the fostering a collaborative environment between universities and business leaders. The important role of venture capital in this domain should be recognised.

- Enhance Catapult Centres' support for early research phases to ensure that promising blue skies research moves closer to commercialisation
- Encourage university technology transfer offices by reintroducing the University Challenge Funds
- Look at the current tax treatment of research institution spin-out companies

Energy and Infrastructure

To make growth sustainable, we need the right infrastructure to underpin growth, so increased economic activity is properly supported.

- Political uncertainty is the biggest problem for generating infrastructure investment. Consideration should be given to replicating the success of the OBR, by having an Office for Infrastructure Delivery
- The exploitation of shale gas remains a key for the future of our energy needs. The Office of Unconventional Gas needs to deliver a clear strategy, including improved planning and streamlined regulation and resolution on local settlement issues
- A new approach to energy subsidies should be devised that covers fossil fuels as well as renewables. Renewable energy is becoming increasingly competitive whilst fossil fuels remain heavily subsidised – Govt support should be looked at in the round to deliver a level playing field.

Access to Capital – improving the investor base of venture capital to channel more finance into high-growth SMEs

Figures from the 2012 BVCA Investment Activity Report confirm the recent trend towards increased investment in venture capital (VC), with the amount of investment in both UK and overseas VC rising to £708m from £492m in 2011. In addition, the number of companies that received VC investment rose to 510, accounting for around half of all companies receiving funding in 2012.

However, more needs to be done to incentivise institutional investors to put their capital to work into VC, given the continuing presence of the "equity finance gap" and the limited availability of debt finance due to the still-fragile state of the domestic banking industry. Besides, over the last decade, the VC sector has become increasingly characterised by a reliance on public sector institutions such as Capital for Enterprise and the European Investment Fund. In 2007 Government agencies accounted for less than 10% of investment in European Venture Capital. State sponsored funds are now the biggest investors in UK and European venture capital at around 57%. Pension funds, insurance companies and banks fell from 35% of funds raised in 2007 to just 5% in the first half of 2011[1].

The investor base must be expanded and diversified if in the long-term the industry is to become self sustaining. We believe there is scope to encourage more corporate and institutional investors investing into venture capital – not only tapping into pension funds but into other sources such as corporate venture capital and social investments, in order to channel more finance into high growth businesses.

We have also long argued that there is a need for more, larger venture capital funds in order to properly support companies throughout their growth cycle - although the quest for scale must not be at the expense of regional diversity.

Catalysing corporate venture capital

We believe that the other untapped and potentially huge source of capital for small businesses is corporate venture capital (CVC). A recent briefing from the professional services firm, Deloitte, calculated that there was around £488bn in cash and equivalents sitting on the balance sheets of UK corporates[2].

Whilst policymakers have made great strides in recent years to understand and accommodate the needs of early stage investors like angels and venture capitalists, equally we need an appreciation for the role of CVC as a source of equity investment, which can also play a vital role. CVC's remarkable diversity of models and styles of investment behavior and structure may represent 'the missing piece'[3] the Government is seeking to improve and expand SME financing. This is all the more important as other countries are already exploring introducing provisions to incentivize corporate venture investment in small companies. Indeed under Japan's Industrial Competitive Advantage Law, expected to come into force from January 2014, 80% of corporate venture investment through funds would be deductible from taxable income; while in France, any company that invests cash for a minority shareholding either directly or indirectly should benefit from a five year, linear amortization of their investment (to be effectively offset against annual income).

[1] EVCA position paper: "Accelerating Innovation: Using Public Sector Capital to Attract Private Sector Investors to the European Venture Capital Industry"

[2] Deloitte Monday Briefing of 25/9/13 - http://www.mondaq.com/x/265072/Economic+Analysis/Deloitte+Monday+Briefing+Looking+For+An+Investment+Boom

[3] http://www.bvca.co.uk/Portals/0/library/documents/BVCA%20The%20Missing%20Piece.pdf

We are keen on catalyzing corporate venture capital investment and we recommend the introduction of strategic incentives for corporate venturing to invest more in UK small companies. One way could be the reintroduction of the Corporate Venturing Scheme (CVS), introduced by the Government in 2000 to encourage companies to invest through tax reliefs. The scheme had been abandoned in 2010 as it was deemed underused rather than abused. However the combination of a new generation of corporate investors and entirely different economic circumstances actually lead us to believe the reintroduction of the CVS would see a material quantum of additional capital being unlocked for UK small businesses.

The tax relief provided by CVS covered the following:

- Investment relief - relief against corporation tax of up to 20% of the amount subscribed for full-risk ordinary shares, provided that the shares are held throughout a qualification period;

- Loss relief - relief against income for capital losses arising on most disposals of shares on which investment relief has been obtained and not withdrawn in full, net of the investment relief remaining after the disposal.

Whilst there may be EU state aid implications for introducing such measures, we are much encouraged by the latest iteration of the EU Risk Finance Guidelines (released on 15 January 2014) which states that:

“Member States may find it appropriate to put in place measures applying similar incentives to corporate investors [compared to natural persons i.e. EIS / VCT]. Tax incentives to corporate investors may take the form of income tax reliefs and/or tax reliefs on capital gain and dividends, including tax credits and deferrals. In previous decisions, the Commission has generally considered compatible income tax reliefs that are designed in such a way so as to contain specific limits as to the maximum percentage of the invested amount that the investor can claim for the purposes of the tax relief, as well as a maximum tax break amount which can be deducted from the investor’s tax liabilities.”

The BVCA reading of this provision is that if an aid measure exceeds the remit of the new General Block Exemption Regulation (as aid to corporate investors would) it could yet be deemed acceptable to the European Commission, provided sufficient evidence of market failure was supplied by the UK Government (which the BVCA would readily provide)

Encouraging institutional investors investing into venture capital

The paucity of large funds and the fragmentation of venture capital hamper the growth of UK SMEs in need of follow-on funding. We recommend further encouraging institutional investors such as insurance companies and pension funds to invest in venture capital. Having institutional investors such as pension funds return to venture capital would greatly enlarge venture capital in the UK, creating broader and deeper portfolios and greater economies of scale. Ultimately we believe that a larger investor base for UK venture capital would allow our start-ups to grow further up the funding ladder and prevent premature trade sales to overseas buyers.

We welcome the recent creation of a new Regeneration Investment Organisation to be administered by UK Trade and Investment to target overseas funds for new inward investment. The BVCA hopes that the Venture Capital Unit which was formed in partnership between the BVCA and UKTI in 2012, will be able to contribute to this programme in order to encourage overseas institutional investors into venture funds.

<u>Encouraging pension funds investments into venture capital trusts</u>

The structure and governance that has been built up over the years with venture capital trusts (VCTs) should be used in such a way as to open up venture funds to institutional investors, and in particular long term investors such as pension funds and charitable foundations. Venture capital is an asset class that can deliver the long-term, stable returns pension funds seek.

We believe that the decline in investment by UK pension funds in venture capital could be addressed through a tax credit on a pension funds UK dividend income. In a manner similar to the current provisions for private investors, we would propose that institutional investors obtain tax relief of up to 30% of their investment in a venture capital trust (VCT). However, unlike private investors, the institutions gain this relief through a tax credit on their other UK dividend income. Thus, for every £1 that an institutional investor in a VCT receives in the form of dividends from UK quoted companies, 10 pence may be claimed back from HMRC, up to a total level in aggregate of 30% of their investment in a VCT.

<u>Introducing further Enterprise Investment Scheme changes</u>

Government schemes such as the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS) which encourage investment through tax breaks are highly praised by the venture capital community and we particularly welcome the positive changes made by Government to increase the amount that companies can raise under EIS from £2m to £5m. Creating the right investment environment is crucial if we want to see the next Twitter, Google or Facebook coming from the UK.

Finance to bridge the gap from early stage to late stage funding is the most hard to come by, so anything we can do to permit venture capitalists, angels and EIS investors to come together should be explored.

The BVCA has been successfully working with support from HMRC towards updating the standard term sheet particularly so that it is compatible with EIS investors in order to increase co-investment on EIS deals. As EIS and VC move closer together, we believe that this practical change will be highly beneficial to investment and growth. In particular, we believe that this will help boost co-operation between angel investors and venture capitalists and pave the way for angels to continue to back their winners alongside VC investors as they grow. Ultimately this will mean more funding for entrepreneurs and the fast growing companies they are building as well as generous tax reliefs for the investors willing to take the risk to back them.

In order to channel more finance in the VC eco-system and to boost investment for high growth companies, we recommend the introduction of the following changes to the rules surrounding the EIS:

- Allowing EIS investors to take preferential shares; a key issue for venture capitalists is to attract venture capital support at an early stage in order to build on the comparative advantage of the UK science and technology base. However under EIS and SEIS current rules, investors are not allowed to take preferential shares, which is actually exactly what venture capitalists need and therefore under current rules, can’t invest in EIS companies. Follow-on capital is not easy through EIS and building VC winners take several rounds. A broadening of the range of securities in which the EIS can invest would ensure that there is no conflict with instruments provided by other forms of VC finance. This would match the Government’s broad aim of encouraging more syndication to enable larger deal sizes, while also enable early stage EIS investors to “follow their money” by investing in later stage VC rounds.

- Making EIS suitable for managing venture funds as opposed to just incentivising individual investors. This would encourage investment in EIS from venture capital funds and therefore strongly boost overall investment.

- Allowing investors who commit funds to such schemes to receive tax relief immediately – the current rules provide that investors need to wait until an EIS vehicle has made all of its investments before they can claim income tax relief.

- Expanding the requirement for approved EIS funds from 12 months to invest 90% as now to 24 months to invest 70% for approved funds.

- Allowing for Convertible Loan Notes to be eligible for EIS/SEIS relief at the point the loan notes are converted from loans to equity, subject to the conditions required of equity in the current EIS/SEIS legislation. Convertible Loan Notes would benefit from such allowance, as under EIS and SEIS current rules the requirement for the investment to take the form of equity has a number of limitations and creates unnecessary friction – in particular the completion of legal documentation for an equity round takes longer, at a time when a startup most needs the funds.

Supporting social impact investment

The BVCA strongly welcomes the proposal by the Government to introduce a new tax relief for private investment in social enterprise from 2014 in order to encourage private investment in social enterprise. There is appetite amongst our members to support the social enterprise space and we look forward to the publication of the “roadmap for social investment”.

In the consultation response we submitted to the Treasury last summer, we highlighted the need to substantially increase the size of the investment limit in order for intermediaries and advisors to get involved, and recommend social investment opportunities to their clients. Indeed the size of permitted aggregate investment in a social enterprise as currently proposed is €200,000 – this figure derives from what is the present limit to avoid triggering European Commission State Aid permissions. We argue that this amount per social enterprise is so small as to make it both impractical and uneconomic for financial intermediaries to market to their clients, even on a pilot or trial basis. Creating a fully functioning market and ensuring its takeup requires attracting advisors and intermediaries which in turn requires scale in the investment limits. We recommend increasing the limit to £5m and argue that there is scope for such application to be granted under the Risk Finance Guidelines.

The Chancellor confirmed in the 2013 Autumn Statement the intention for the relief to be available for equity and certain debt investments in charities, community interest companies and community benefit societies. We welcome that debt instruments are now fully included in the scope of the scheme as we suggested in our submission[4]. Considering that the majority of investments into social enterprises are made through loans or quasi-equity, we concluded that the structure of social enterprises lends itself far better to debt and that social enterprises are not suited to equity financing, as it is not in their nature (nor in their policy objective) that they should ultimately seek an exit.

We also emphasise that using an evergreen vehicle rather than a limited life EIS structure would be the best method of achieving the policy objectives of a social investment tax relief, as the only investment structure that really suits social enterprises are longer term loans, amortising over not less than 5-10 years. Besides an evergreen vehicle similar to VCTs can not only accommodate this time profile but would also recycle the loan repayments into new enterprises.

[4] http://www.bvca.co.uk/Portals/0/library/Social%20investment%20tax%20consultation%20response%206%20September%202013.pdf

Supporting Entrepreneurs and Innovation

Expanding the Entrepreneurs' Relief to support entrepreneurship

The BVCA has long been advocating for an expansion of Entrepreneurs Relief, as this equity incentive is key in providing a major boost to the entrepreneurial culture in the UK but it could also help foster a savings culture, by allowing more of those involved in the outset of a company to pay a lower rate of capital gains tax. The Government's moves in this area have been significant and welcome. But we need to foster a deeper and wider culture of entrepreneurship, so as to encourage not just founders, but investors, advisors, academics and graduates to participate in starting and building new businesses. To complete this direction of travel, we propose three amendments pertaining to the scheme:

- We recommend removing or significantly lowering the 5% equity stake holding requirement, to allow smaller employee shareholders to qualify and therefore encourage broader participation in company share schemes.
- We also recommend removing the employment requirement so that Entrepreneurs Relief serves as an incentive to High Net Worth Individuals and business angels to provide young companies with capital but also vital expertise and mentoring services.
- Lastly we believe that increasing the cap beyond £10m in a lifetime would encourage greater aspiration by entrepreneurs for making more investments creating a culture of serial entrepreneurship akin to our US compatriots.

Encouraging further the commercialisation of university research

In order to sustain the UK's position as a world-leading research nation, continued investment in the research base is essential and the important role of venture capital in this domain should be praised. We believe that this objective also requires the fostering of a collaborative environment between universities and business leaders, likely to offer attractive career prospects to the UK's most promising entrepreneurial academics.

The UK is already home to a number of successful firms that have been spun out of universities, commercialising their research and creating world-leading technologies and products. Graphene, the revolutionary material, constitutes such example, being pioneered at a facility out of the University of Manchester Intellectual Property (UMIP), which since 2004 has overseen £225m of venture capital investments. As the BVCA report Tech Country[5] highlights, existing clusters such as the ICT cluster in Cambridge and the material science cluster in Manchester, bringing together leading researchers, industrial and supply chain partners, provide a strong foundation for developing potentially high growth technologies and bolstering regional growth.

[5] Tech Country, BVCA report, March 2013 http://www.bvca.co.uk/ResearchPublications/ResearchReports/TechCountry.aspx

A number of Government-led schemes exist to encourage this partnership. We particularly welcome the Research Partnership Investment Fund - set up in 2012 to run for three years until 2015 - which has raised over £1.1bn from the private and charitable sectors after an initial Government investment of £300m. The fund has led to twenty collaborative projects including the National Automotive Innovation Campus, bringing together Jaguar Land Rover, Tata Motors and the University of Warwick, and the Material Innovations Factory, a collaboration between the University of Liverpool and Unilever. We also welcome the announcement made by the Chancellor of the Exchequer in the 2013 Autumn Statement that the Government will create a £75m a year fund to improve the research and innovation capacity of Emerging Powers and build valuable research and innovation partnerships for the UK.

The Technology Strategy Board's 'Catapult Centres', which bring together British businesses, scientists and engineers to transform ideas into new products and services, are also playing a crucial role in supporting SMEs to commercialise innovation. Currently, however, the centres are thinly spread across geographies and require more concentrated investment if they are to help create critical mass within pioneering clusters. Similarly, whilst existing arrangements target late-stage research development, we believe that by enhancing their support for early research phases, Catapult Centres would be better positioned to ensure that promising blue skies research moves closer to commercialisation in order to bridge the so-called "valley of death". We also suggest that the Technology Strategy Board should provide scientific research teams grants with no intellectual property attachment, in order to encourage technology transfers and to help bring the research project to the following stages of development - in particular the venture capital investment stage.

<u>Reintroducing the University Challenge Funds</u>

In order to encourage further university technology transfer offices, we recommend the reintroduction of University Challenge Funds. This scheme, established in 1999 to assist the successful transformation of research into business, has been unfortunately discontinued while it proved of huge value with a total of £40m raised from University Challenge Funds by 15 universities in the first round of 2000, invested in 835 lab projects that led to the creation of 378 spin out companies. The scheme offered universities the chance to win a Seed Fund of up to £6m providing they were prepared to put in 25%. It focused on taking projects to the proof of concept stage, which is by far the hardest to fund. We strongly recommend re-launching this scheme with a more significant funding of £100m which could take the form of loans rather than grants. We believe the interest rate should be lower than that of 4.5% for ECFs, should be undated or cover a long period such as 20 years, and take its first return on capital (with a lower share of the upside than ECFs though). One additional angle should be the option for applicant universities to partner with a venture capital firm, to fuel further university-business collaboration and to ensure that the VC discipline, networks and expertise are brought into the university's bid.

Safeguarding the Research and Development tax regime

Aside from funding programmes, it is important to recognise the impact of demand-side policies on the development of spinout firms. Recent changes in Research and Development tax credit, in particular changes to expenditure-related deductions, have proven very helpful. The BVCA emphasizes the continuing importance of R&D tax credits to SMEs as a source of critical funding as well as encouraging innovation. We believe that tax credits should continue to be targeted at appropriate projects, however improvements to the policy could be made, specifically allowing more regular claims to further enhance cash flows for emerging businesses.

Similarly we welcome the December 2012 announcement from HMRC to look at the current tax treatment of research institution spin-out companies, which we believe is a more significant issue for consideration than the availability of Enterprise Management Incentive scheme for academic employees. We would welcome an exemption on capital gains tax on the whole cycle of emerging innovative start-ups from the transfer of intellectual property, even if the development is successful. Currently tax exemptions exist only for research academics in relation to income tax. Extending relief to promising companies directly, however, would provide a better incentive to researchers thinking about spinning out their concept, with the firm more likely to survive its first years of business with a reduced tax burden.

Addressing the skills shortage

Encouraging science, technology, maths and engineering studies

Whilst more young people are entering university than ever before, businesses across the country continue to voice concerns that those seeking work lack their required skill sets. British universities are of course continuing to cultivate well educated individuals, however too few of them specialise in science, technology, maths and engineering (STEM subjects). Sectors that involve these fields of study are becoming increasingly important to the UK economy as we continue to shift towards knowledge-intensive and high tech industries. This skills shortage constitutes a major issue for VC and for technology firms across the country.

Therefore it is essential that our education system provides high-quality graduate and post-graduate recruits to fill the job vacancies they create. As such we welcome the announcement made by the Chancellor in the 2013 Autumn Statement that the Treasury will provide an extra £50m to universities to enable a greater number of students to study STEM subjects.

The BVCA has long been advocating for a renewed strategic partnership between education and business. Indeed by engaging more with schools and universities, businesses can help design and tailor curriculum to their needs, as well as provide mentorship and inspiration to the future workforce. Nonetheless we believe that businesses themselves are best placed to assess the skill sets they require and we support the shift of control of skills policy and budgets towards local employers as much as possible. This is achievable through Local Enterprise Partnerships (LEPs), which are more able to take account of local economic nuances. The Government has stated that skills should be a core priority for LEPs and that it is willing to transfer a nominal amount of the skills budget to the partnerships, although this would be placed in a single local growth fund and not be ring-fenced. If LEPs are to have real impact, greater commitments are required to enable educational institutions in regional cities to be better geared towards contributing to the local and national economy.

We are also keen to underline the importance of a high-value migration focused on the STEM skills. This could be promoted by increasing the take-up of the Tier 1 Exceptional Visa route and by granting a one-year visa for non-European students having graduated in a STEM subject. We welcome the recent changes introduced in April 2013 allowing students who have successfully completed a PhD in a University in the UK, to apply to stay in the country for one year to find skilled work or set up as an entrepreneur.

Introducing an apprenticeships tax credit

During the summer of 2012 through early 2013, members of the BVCA executive interviewed roughly 50 CEOs of a host of private equity and venture capital backed businesses from across the economy. The end-goal was a set of recommendations to Government, directly from the country's wealth creators on how the UK could generate economic growth in the short to medium-term; "The Growth Initiative"[6].

Throughout the course of meeting interviewees a recurrent theme that emerged from discussions was the need to incentivise businesses to take on more apprentices. This chimed well with one of the recommendations of the November 2012 "Richard Review of Apprenticeships", which suggested that increased apprenticeship funding via the tax system should be a policy implemented by Government.

The Richard Review was however primarily an explorative text, and offered little detail as to how such a policy would operate in practice. Given the level of enthusiasm the initiative had generated amongst business leaders interviewed, the BVCA policy team put together a more extensive schematic of how an apprenticeship tax credit could function, drawing heavily on a system already in place in Ontario, Canada.

The key points of the proposal as put forward by the BVCA last year were as follows:

- A refundable tax credit (this is the case in Ontario);
- Limited to a maximum of 10 apprentices per employer
- Subject to the following rates – the lesser of:
  - 25 per cent (35 per cent for SMEs) of eligible expenditure; or
  - £3,500 (£5,000 for SMEs) per apprentice.

We will continue to liaise further with both our members and their portfolio companies in light of procedural developments in this area. In particular we will be looking to understand to a greater level how such a policy might operate most efficiently in practice, and how we can gain widespread "buy-in" from the business community for the proposal.

[6] http://www.bvca.co.uk/Portals/0/library/documents/BVCA%20Growth%20Initiative.pdf

Supporting Growth Sectors

Infrastructure

The Government has announced a range of measures to support infrastructure. The Chancellor unveiled his aim to boost infrastructure spending by £3bn a year from 2015/2016, meaning £18bn of additional investment by the end of the next Parliament. Our top 40 priority infrastructure investments have been identified as part of the National Infrastructure Plan 2011.

But a large proportion of the priority investments required to resolve the UK's numerous infrastructure issues are expected to be met through private finance. With this in mind, the Government has helped to shape capital market solutions to enable private investors to step in such as the UK Guarantee Scheme, the Pensions Infrastructure Platform and Private Finance 2. These schemes are of paramount importance to catalyse private investments into infrastructure. In particular the BVCA is keen to explore longer-term private sector solutions through infrastructure funds and better connectivity to institutional investors. We welcome the announcement by the insurance industry that they will invest £25 billion in infrastructure as government published the National Infrastructure Plan delivery last December, though this looks to be primarily a debt driven program.

Ensuring that any outcome of the ongoing EU pensions reform (IORP Directive II) is not copied from Solvency II and does not lead to a significant reduction in the private equity investor base in Europe should also be a priority. While there will be no capital requirements under IORP II as currently drafted, we remain particularly vigilant towards the risk posed by the introduction of an "Own Risk Solvency Assessment" (ORSA) for IORPs. This provision is currently included in Solvency II under Pillar 2 relating to governance requirements but it is heavily entwined with Pillar 1 on solvency capital requirements. There is a concern among the pension fund industry that the Commission might use a reworked ORSA as a vehicle to introduce capital requirements 'by the back door'. We strongly argue against such feature in the European Commission proposal for IORP II.

Overarching these specific issues is a more general requirement for the government to provide long-term certainty and consistency for investors in infrastructure through programmes designed to underwrite and guarantee projects across parliaments and over long horizons. This would lower risk and reduce the cost of capital, and thus the cost for investors to partake in infrastructure projects.

Strong consideration should be given, to increase certainty to investors by creating a new Office for Infrastructure Delivery (or reform/rebrand Infrastructure UK) to make key recommendations on projects, including planning, finance and delivery. This would help avoid the economic uncertainty currently prevailing over airport capacity and High Speed Two. Similarly the creation of a Ministry of Infrastructure, whose Secretary of State for this Department should be a technocratic peer serving for whole parliamentary term, would help streamline Government policy and address the clash between long-term and short-term Government policies. Lord Deighton has already begun this work and we welcome that his role is shielded from the demands of democratic politics.

This should be accompanied by a meaningful local settlement, that will include markedly low energy costs, lower council tax or free travel, for those impacted by projects in their area. The rate of compensation needn't be punitively high from a government perspective, as behavioral economic analysis suggests that whilst people expect redress for new projects in their area, there is also a 'civic duty' aspect that explains their response[7].

Similarly we support the reintroduction of capital allowances for key infrastructure assets, particularly the Industrial Buildings Allowance. Bearing in mind that it is approximately 20% more expensive to invest in a structure or building that does not qualify for capital allowances, we recommend extending the list of eligible infrastructure assets. As outlined by the CBI[8], we believe that such relief should only apply to future spending to minimise cost to the Exchequer and ensure that the proposal incentivises new private infrastructure spending. The allowance would likely help to unlock new infrastructure investment by reducing the effective cost of investment for the relevant assets.

Also, drawing on the Credit Enhancement Mechanism programme that the European Investment Bank is undertaking as part of their Europe 2020 Infrastructure Bond Initiative, we support the proposal that the UK government should invest in a large number of projects at the same time rather than fully funding just one. This would increase the credit rating of all the projects and encourage institutional investors to partake in the development.

Energy

<u>Shale Gas</u>

We welcome the new tax incentives for companies developing shale gas, bringing them into line or even lower than tax rates on profits in the US, the current leader in unconventional gas exploitation. However it does not seem to be the tax structure that remains the main obstacle to new investors, but planning regulations and local settlement issues. We welcome the recent offer announced by the Government that local councils can keep 100% of business rates they collect from shale gas sites – double the current 50% figure. We also welcome the Prime Minister's recent comments to the House of Commons Liaison Committee that he would support cash payments to residents affected. While we appreciate the importance for the package of community benefits to be significant enough to overcome local resistance, since in practice local planners' consent will be of paramount importance for the industry, we call for a better appreciation of the high cost structure for onshore gas extraction in the UK before committing to large payments. The shale industry in the UK being in its infancy and having a cumbersome process compared with the US, we warn against any premature announcements to commit 10% of revenues when the cost structure is so high. A more balanced approach between the necessity to incentivise communities and the uncertainty for the industry revolving around costs and profitability should be reached.

[7] See 'Motivation, Agency and Public Policy', Julian Le Grand 2003

[8] CBI report, An offer they shouldn't refuse, May 2012

Office of Unconventional Gas

Whilst the Office of Unconventional Gas has now officially been set up, its meaningful work has yet to begin. Given that unconventional gas, and particularly shale, is a nascent industry in the UK, there is a lot of strategic work to be done, particularly on streamlining the regulatory process and interacting with local communities (see above) to create an efficient system of incentives for businesses, compensation for affected people, and the investor certain that would follow. The OUG is well placed to deliver this but its work must begin in earnest as lengthy planning and permitting is holding back the industry.

Renewables

The Government's strategy on off-shore wind was a welcome addition to the debate but further work is required in the following areas.

- Financial support in the form of debt facilities for UK SME supply – bank lending is still constrained
- Urgent progress to make operational the recently announced Offshore Wind Investment Organisation
- A reassessment of EU procurement rules regarding UK content.

Of all of these, the last is perhaps the most important. If we are to maintain public support for reducing our carbon footprint and combating climate change, a key plank will be more growth and more jobs from the renewables sector. To date other countries in the EU, notably France and Portugal have taken a more nationally competitive approach to interpreting state-aid restrictions on securing content provision for domestic SMEs, particularly in the supply chain. The UK's approach should take a similar approach.

Subsidy Regime

The renewables and clean-tech industry can be characterized as driven by subsidies with all the public expense, political wrangling and investor uncertainty that that entails. But what is perhaps under-appreciated is the amount to which fossil fuels are themselves subsidized, sometimes significantly, by the public purse. Significantly, some renewable technologies are moving more rapidly towards competitiveness in their own right than their non-renewable counterparts. The Government should reflect this in its communication of public policy. A new roadmap should therefore be drawn up that documents public subsidy, for the whole of the energy landscape, giving a clear path to a level playing field in support, but also a path to weaning energy of subsidies all together, including renewables.