HM Treasury

A new approach to public private partnerships:

consultation on the terms of public sector equity participation in PF2 projects

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1 Introduction

1.1 The Government's policy to invest equity in PF2 projects was first set out in the policy statement 'A new approach to public private partnerships' ('PF2 Policy'), published by HM Treasury in December 2012. As part of its reforms to the Private Finance Initiative ('PFI'), the Government announced that it will look to act as a minority co-investor in future PF2 projects.

1.2 Public equity co-investment will enable:

- greater alignment of interests between the public and private sectors, and a more collaborative approach to improving project performance and managing risk;
- better partnership working, with the public sector having greater visibility of project information and more involvement in strategic decision making;
- more transparency, including in relation to the financial performance of the project company, through its project company board membership; and
- value for money to be improved as, subject to the appropriate management of project risk, the public sector will share in the ongoing investment returns, reducing the overall cost of projects to the public sector.

1.3 To ensure an effective role is played by the public sector as an equity investor and to minimise the potential for conflicts of interest between the public sector acting as both investor and procurer, the equity investment will be managed on a commercial basis by a separate unit within the Treasury (the 'Treasury PF2 Equity Unit'), separate from the procuring authority ('Authority'). The investment will be made on the same terms as those agreed by the private sector for a particular project.

1.4 Public sector co-investment provides greater project transparency and accountability for project delivery and operation. Through project company board membership at Director level, the public sector will be able to participate in project governance with the project company's other Directors who will be appointed by the equity providers. This is expected to result in better partnership working between the public and private sector as the public sector will have greater visibility of project information and will be involved in strategic decision making.

1.5 This approach will also help to address concerns around a lack of transparency of financial information related to project performance as the public sector will receive this information in order to make necessary decisions as a Director on the project company board.

1.6 In addition, observer status at board meetings of the project company will be given to the Authority or other local representative as appropriate. For example, a school where it is not also the Authority. The intention is to support better collaboration, sharing of information and perspectives and to improve transparency. The observer will help to ensure the project company board understands local issues and concerns, which will support the effective management of the project through better partnering.

2 Consultation process

2.1 The Government's policy to invest equity in PF2 projects was first out in the policy statement 'A new approach to public private partnerships' ('PF2 Policy'), published by the Treasury in December 2012. As part of its reforms to the Private Finance Initiative ('PFI'), the Government announced that it will look to act as a minority co-investor in future PF2 projects.

2.2 The Treasury set out its intention to consult on the terms on which the Government would invest public sector equity. This is now being implemented and a draft Shareholders Agreement ('SHA Consultation Draft') is available on gov.uk[1], including standard Articles of Association ('Articles Consultation Draft').

2.3 As equity in Public Private Partnership projects is frequently invested by way of share capital and loan stock, Treasury has also included a standard Loan Stock Instrument ('Loan Stock Consultation Draft'). The Consultation Drafts refer to other documentation (such as an Equity Subscription Agreement and Intercreditor Deed). These have not been prepared as they are bespoke to the specific project.

2.4 The evidence gathered by this consultation will be considered in the review and finalisation of these documents. They will then be published as finalised standard form documents ('Standard PF2 Equity Documents'). Thereafter they would be issued by the public sector bodies as part of their procurement documentation. The Treasury recognises that equity investor documentation is bespoke to each transaction and that these will need to be revised on a project to reflect project specific factors. This purpose of the Standard PF2 Equity Documents is addressed in further detail in Chapter 3 below.

2.5 This document invites all parties with an interest in the delivery and financing of public sector assets and services under the PF2 Policy to share their views with the Treasury. In particular, feedback is sought from industry participants with an interest in providing equity to PF2 projects as well as from other participants with an active role in the delivery, operation or financing of PF2 projects and the public sector, wider stakeholders and others.

Structure of this consultation

2.6 The remainder of this document is set out as follows:

Chapter 3 – Purpose of the standard equity documentation

Chapter 4 – Investment appraisal process

Chapter 5 – Shareholders Agreement summary

Chapter 6 – Encouraging third party equity investment

Chapter 7 – Consultation questions

[1] http://www.gov.uk/government/consultations/a-new-approach-to-public-private-partnerships-consultation-on-the-terms-of-public-sector-equity-participation-in-pf2-projects

How to respond

2.7 The Treasury invites responses on the specific questions raised and any other views respondents may have on this issue. The questions can be found in Chapter 7 of this document.

2.8 When responding it would be helpful if interested parties provide supporting evidence, research or reference project examples where possible. To assist us in reviewing responses it would also be helpful if respondents can explain their particular interest in the discussion and also make clear if their response is as an individual, on behalf of a group or a representative body.

2.9 All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

2.10 This consultation will run from Wednesday 10 July 2013 to Wednesday 21 August 2013.

Please send responses to:

PPP Policy Team
HM Treasury,
1 Horse Guards Road,
London
SW1A 2HQ

Email: PF2equity@hmtreasury.gsi.gov.uk

2.11 The Treasury will consider the evidence received and may, where appropriate, follow up through further engagement to obtain additional detail. Following the review of the evidence the Government will finalise the documents which form the basis of this consultation and these will be published on the Government's website.

2.12 To meet the Government's transparency commitments the Treasury intends to publish all responses received to this consultation including the names of companies, organisations and their named representatives submitting their evidence. However, we do not intend to publish the names of respondents who respond in an individual capacity. The contact details that are supplied will not be published and used only for the purpose of the evidence gathering exercise.

Confidentiality

2.13 If you want some of the information you provide in your response to be treated as confidential and not published please note that on your response and include the information in a separate annex. However, please be aware that, under the Freedom of Information Act 2000 (FOIA), there is a statutory Code of Practice with which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided to have the quality of 'in confidence'. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

2.14 HM Treasury will process your personal data in accordance with the Data Protection Act and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties, other than the publication of the names of representatives of organisations and companies as stated above.

Consultation Principles

2.15 This consultation is being run in accordance with the Government's Consultation Principles. The Consultation Principles are available on the government website: https://www.gov.uk/government/publications/consultation-principles-guidance.

2.16 The Government's Consultation Principles state that "timeframes for consultation should be proportionate and realistic". This consultation will run for six weeks, which should be sufficient time for stakeholders to consider and respond. A longer consultation is not considered necessary given the scope of the issues the Government is looking to explore with interested parties.

Statutory equality duties

2.17 The Government has considered the proposed reforms in relation to its public sector equality duties in the Equality Act 2010. It has concluded that no relevant issues arise. The policy measures considered are strategic in nature. All UK residents would be affected to a greater or lesser extent by the proposed policy measures dealt being considered in the consultation.

3 Purpose of Standard PF2 Equity Documentation

3.1 The Government will determine, on policy grounds, whether public sector equity should be invested when the Outline Business Case for the relevant project is approved. The inclusion of public sector equity will then be set out within the relevant procurement and the Standard PF2 Equity Documents will be included within the documentation issued by the Authority. In each case the public sector would have a right to invest equity up to the quantum specified in the procurement but it will have no obligation to invest. The equity investment must satisfy the overall PF2 policy and wider objectives of the public sector. This will be determined by the Investment Committee of the Treasury PF2 Equity Unit.

3.2 It follows that a bidder must submit bids which are fully funded on the basis that no investment is made by the public sector.

3.3 Bidders should continue to structure their funding as they deem most appropriate, including the respective amounts of senior debt and equity, the proportions of share capital and shareholder debt and choice of investment vehicle, subject to the bid document requirements regarding taxation and other matters. The bidder will be required to incorporate the investment vehicle and obtain any required consents, licences and approvals.

3.4 The Standard PF2 Equity Documents contains the arrangements which Government regards as appropriate for public sector equity participation. Bidders are expected to adopt these principles. Bidders will be able to request guidance from the Treasury PF2 Equity Unit on specific points as part of the procurement[1] of the project. This contact would be separate from the procurement dialogue with the Authority.

[1] Consultation question 2

4 Investment appraisal process

4.1 Public sector equity investment appraisal is undertaken independently of the procurement of the project. Decisions are taken by the Authority by reference to their evaluation criteria and they do not represent the interests of the Treasury PF2 Equity Unit. The procurement only facilitates the flow of information to Treasury PF2 Equity Unit and gives a right to invest public sector equity.

4.2 The Treasury PF2 Equity Unit wishes to carry out due diligence in an efficient manner without the need to carry out detailed due diligence on all project documentation.

4.3 Due diligence will be carried out before the appointment of preferred bidder by reference to prescribed information ('PF2 Equity Bid Information') which will be required as part of the bid. This information is provided by the bidders and no participation by external advisers is required. It will include information regarding the allocation of risk between the project company and its supply chain and risks to be borne by insurances. Whilst detailed project documentation may not have been prepared at this stage, risk allocation should have been determined and priced (subject to senior debt due diligence post preferred bidder). Bidders will also be required to provide a description of any material proposed changes to the Standard PF2 Equity Documents, such as the definition of Material Shareholder (see below) and voting arrangements.

4.4 Prior to financial close the Treasury PF2 Equity Unit will undertake final due diligence which would include the detailed terms of the equity documentation (including documentation between senior funders ('Senior Funders') and equity investors) and restrictions placed on payments to equity investors. The bidder will be required to provide the financial model and certain sensitivity scenarios to the base case.

4.5 In addition the Treasury PF2 Equity Unit would require a detailed memorandum (the 'Due Diligence Memorandum')[1] describing risk allocation from the legal advisers to the project company. The bid documentation will set out the matters to be addressed in the Due Diligence Memorandum. If the preferred bid includes arrangements which differ from those typically used in the market, the Due Diligence Memorandum would also need to address these. The Due Diligence Memorandum would be provided together with an advanced draft of the project and finance documents.

4.6 At financial close, advisers to the project company and the model auditor will be required to give letters of reliance to the equity investors (including any third party equity investors introduced following an equity funding competition).

4.7 In cases where the project company has not retained its own technical and insurance advisors, the Treasury PF2 Equity Unit will also require a copy of the reports prepared for the Senior Funders by their technical adviser and insurance adviser (including letters of reliance addressed to the equity investors).

[1] Consultation Question 1

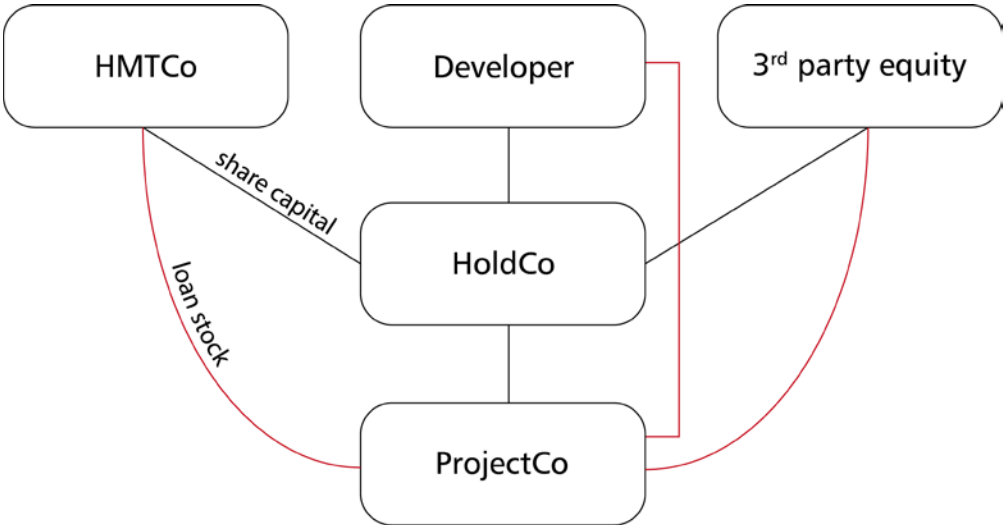
5 Shareholders' agreement summary

(I) Parties

5.1 The SHA Consultation Draft has been prepared on the following basis:

- there are three shareholders ('Shareholders'), comprising a company within the same group as the bidder ('Developer'), a third party equity provider ('Third Party Equity Provider') and a company which is wholly owned by the Treasury ('HMTCo');
- HMTCo has a minority shareholding;
- the Shareholders subscribe for shares in a holding company special purpose company ('HoldCo') which owns 100 per cent of the share capital in a second special purpose company ('ProjectCo');
- the Shareholders subscribe for unsecured loan stock in ProjectCo; and
- ProjectCo enters into the Project Agreement with the Authority and raises secured debt from Senior Funders.

Chart 5.A: Structure of the project company



Source: HM Treasury

(II) Shares and share transfers

5.2 The shareholders invest on the same terms[1] and there is only one class of ordinary shares. The shares can be sold to third parties, subject to pre-emption rights in favour of the other shareholders which is a straightforward 'right of first refusal'.[2] Transfers are also subject to

[1] This is part of PF2 Policy
[2] Consultation question 7

covenants in favour of Senior Funders and the Authority for an initial period ('Lock in Period') which are typical in this type of transaction. As part of PF2 Policy, the Government will promote investment opportunities for new long term investors. As Government may wish, in some cases, to achieve this by reducing its investment after financial close, the Lock in Period provisions have been varied to facilitate this.[3]

5.3 The SHA Consultation Draft also includes provisions which trigger an obligation to transfer shares to other shareholders if certain events occur, such as insolvency of a shareholder. These are customary in joint venture arrangements of this type.[4]

(III) Board of Directors

5.4 The draft proposes that each shareholder with a 15 per cent shareholding ('Material Shareholder') may nominate a director for each 15 per cent shareholding. The minimum HMTCo investment is expected to be 15 per cent. This percentage has been proposed to seek a balance between (a) the right of each shareholder to designate directors proportionate to its holding and (b) a board which is of a manageable size.[5] This percentage may vary on a case by case basis and bidders may propose a different board structure (provided HMTCo has the right to nominate a director with this percentage holding).

5.5 The Board decides whether it wishes to appoint a non-executive independent Chairman. This is not an HMTCo requirement. If there is no independent chairman the position would rotate among the directors appointed by the Material Shareholders. The chairman does not have a casting vote.[6]

5.6 HMTCo is entitled to nominate an observer to the Board to support better collaboration, as set out in PF2 Policy. The observer has no vote and can be excluded for the discussion of specific matters if so required by a majority vote of directors, recognising that this may be appropriate for certain matters. The right to appoint an observer continues after HMTCo ceases to be a shareholder.[7] This has been proposed to promote a better working partnership between the private sector and the Authority.

(IV) Decision making

5.7 Board meetings require one director appointed by each Material Shareholder. Standard provisions apply to vary the quorum where a director fails to attend and to permit video/telephone conference participation. Each director can also have an alternate.

5.8 The Board of Directors votes on a majority basis except (a) for Reserved Matters and (b) on all matters during the Lock in Period where directors appointed by two Material Shareholders must vote in favour. This additional control during the Lock in Period in not uncommon and is considered as appropriate during the period when the risk being borne by ProjectCo and its supply chain are higher. The use of a simple majority reflects PF2 Policy whereby the public sector would invest on the same basis as the other investors.

5.9 The list of Reserved Matters is divided into two tiers, matters requiring a unanimous director approval (Reserved Matter Board Approval) and those which also require unanimous shareholder

[3] Consultation question 4b
[4] Consultation question 8
[5] Consultation question 10
[6] Consultation question 11
[7] Consultation question 12

approval (Reserved Matters). Important matters which arise on a recurring basis only require unanimous Board Approval.[8]

5.10 Where a director reasonably considers that a matter gives rise to a conflict of interest between his duties to his employer and his duties as a director of the relevant company, that matter can be referred for shareholder approval.[9]

(V) Transparency

5.11 Transparency is at the centre of PF2 arrangements. As part of PF2 Policy, the Treasury will publish an annual report on the public sector's investments, including the actual and forecast equity returns of individual projects and of the portfolio.

5.12 Investing public sector equity in future PF2 projects will facilitate the achievement of greater transparency and accountability of project delivery and operation as the public sector will receive financial information related to project performance through its participation in the Board.

5.13 The SHA Consultation Draft sets out the categories of information (Transparency Information) which HMTCo requires for the preparation of the Treasury's annual report on transparency. This information is not subject to any obligation of confidentiality. Disclosure of Transparency Information is required even if HMTCo ceases to be a shareholder.[10]

5.14 In addition, HMTCo will report on a regular basis to the relevant Authority regarding the performance of the relevant investment.

[8] Consultation question 13
[9] Consultation question 14
[10] Consultation question 3

6 Encouraging third party equity investment

6.1 The Government is keen to see more investors with long-term investment horizons investing in projects at an early stage. It wishes to achieve this by the introduction of equity funding competitions or by reducing its investment post financial close.

6.2 At the start of the project procurement bidders will be advised if an equity funding competition is to take place. This will be a one-stage process run by the preferred bidder without a prior and separate pre-qualification stage. Third party equity providers are approached for the competition by the preferred bidder. It is anticipated that prospective third party equity investors would receive the same due diligence information as that provided to the PF2 Equity Unit. The selection of the winning candidate for the equity funding competitions will be a decision for the preferred bidder based upon the outcome of a well documented and thorough bid evaluation process. The public sector, both as the Authority and equity investor will not be part of the selection process but will require open-book sharing of the results of the review process, the evaluation criteria and selection of the winning bid as part of the government's transparency agenda for PF2 policy. At financial close, the third party investors would receive letters of reliance from advisers to the project company and the model auditor.

6.3 It is expected that the preferred bidder would retain the majority shareholding and the public sector equity provider would always be a minority holder. The size of the public sector minority shareholding would be set by the Treasury in discussion with the Authority. The overall capital structure of equity funding and debt would be set by the preferred bidder.

6.4 If Treasury PF2 Equity Unit is contemplating reducing its holding post financial close, the procurement documentation will state a maximum holding and a minimum holding until the end of the Lock in Period.

7 Consultation questions

7.1 This document invites all parties with an interest in the delivery and financing of public sector assets and services under the PF2 Policy to share their views with the Treasury. In particular, responses are invited on the questions set out below.

General considerations

Question 1: Please give your observations on the proposed investment appraisal and due diligence arrangements?

Question 2: Do you think the informal public sector equity guidance arrangements during procurement will be of benefit to bidders? This would be carried out separately from dialogue with the Authority.

Question 3: Do you have any objections to disclosure of the Transparency Information? Please give reasons for any objections.

Question 4: What are your views on the following arrangements to promote new equity investors?

a) Equity funding competition post appointment of preferred bidder?

b) Reduction in HMTCo equity post financial close (either during the Lock in Period or thereafter)?

Question 5: Where there is a reasonable expectation that ProjectCo will require working capital (or Senior Funders otherwise require a firm commitment for working capital), do you agree that this should be provided by the Developer? If not, please explain your position.

Shareholders Agreement (SHA) and Articles of Association (Art)

Restriction on share transfers (SHA Clause 9 and Art 11 to 15)

Question 6: Do you agree that shares and loan stock should be stapled so that they cannot be sold separately (except with the consent of all other shareholders)?

Question 7: What are your views on the pre-emption provisions?

Question 8: Do you agree with the event of default and deemed transfer provisions?

Question 9: Do you have any comments on the definition of 'Market Value' and the manner in which this will be determined?

Board of directors (SHA Clause 5 and Art 3 to 8)

Question 10: What are your views on the proposed arrangements for nomination and composition of the Board of directors? If you disagree with this proposal, please suggest an alternative structure and give the reasons why you regard this as preferable.

Question 11: Do you agree with the provisions relating to the chairman?

Question 12: Regarding the appointment of an observer, do you have any objections regarding the proposed arrangements (a) when HMTCo is a shareholder and (b) thereafter?

Reserved matters (SHA Clause 6.2 and schedule 8)

Question 13: Please give your views on the proposed provisions identifying any changes you consider appropriate to the Reserved Matters and Reserved Matters Board Approval, in each case giving your reasons an explanation for your views.

Question 14: Do you think the proposed arrangements regarding a Director's conflict of interest (SHA Clause 6.3) are practicable? If you prefer a different arrangement, please propose this and give your reasons for this preference.

Dispute resolution (SHA Clause 11)

Question 15: Please give your views on the proposed dispute resolution arrangements (SHA Clause 11).

Loan Stock Instrument

Question 16: Do you agree that shareholder loan stock should be unsecured?

Question 17: The Bidder incurs costs and risk in bidding for a PF2 project which are not borne by equity investors who make their financial commitments at financial close. Please give your views as to whether this should be reflected in differential rates of return. If you support a differential rate of return, how should this be structured? In particular, do you think a higher interest rate on loan stock is an appropriate mechanism?

Other issues

Question 18: Please comment on any other matter which you regard as important in connection with equity investment in PF2 projects by the public sector.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

E-mail: public.enquiries@hm-treasury.gov.uk

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