



HM Treasury

## **Government response to:**

A new approach to public private partnerships consultation on the terms of public sector equity participation in PF2 projects

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October 2013





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# 1

## Introduction

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**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*' published by HM Treasury in December 2012.<sup>1</sup> As part of its reforms to the Private Finance Initiative ('PFI'), the Government announced that it will look to act as a minority investor in future PF2 projects. The Government said at the time it would consult on the governance and the shareholder arrangements for this public sector equity.

**1.2** On 10 July 2013, the Treasury published the consultation document, '*A new approach to public private partnerships: consultation on the terms of public sector equity participation in PF2 projects*' ('consultation paper').<sup>2</sup> The consultation sought views on draft standard form equity documents ('Standard PF2 Equity Documents') comprising a Shareholders Agreement ('Shareholders Agreement' or 'SHA'), Articles of Association and Loan Note Instrument. Views were also sought on the public sector's approach to investment appraisal, due diligence and the initiatives to encourage third party equity investment.

**1.3** The consultation received a total of 30 written responses from businesses, industry representative groups, other interested parties and individuals. A list of respondents is provided in Annex A; their responses have been published on the Government's website: <https://www.gov.uk/government/consultations/a-new-approach-to-public-private-partnerships-consultation-on-the-terms-of-public-sector-equity-participation-in-pf2-projects>.

**1.4** The aim of this document is to summarise the responses received and to set out the Government's response. The Government is grateful to all those who contributed their views during the consultation process.

**1.5** The evidence gathered by this consultation has been considered in the structuring of the arrangements for PF2 public sector equity and finalisation of the Standard PF2 Equity Documents. These documents have now been published on the gov.uk website as finalised standard form documents for the public sector to use for their procurement of PF2 projects. The Standard PF2 Equity Documents (as amended for schools) are being issued to bidders by the Education Funding Agency for the privately financed element of the Priority Schools Building Programme.

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<sup>1</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/205112/pf2\\_infrastructure\\_new\\_approach\\_to\\_public\\_private\\_partnerships\\_051212.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205112/pf2_infrastructure_new_approach_to_public_private_partnerships_051212.pdf)

<sup>2</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211518/pf2\\_public\\_sector\\_equity\\_consultation.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211518/pf2_public_sector_equity_consultation.pdf)





# 2

## Policy developments since the consultation

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### (I) Introduction

**2.1** After reviewing the responses to its consultation the Government has now published the final Standard PF2 Equity Documents. These documents contain the commercial principles which the Government consider as appropriate having regard to Government policy, responses made during the consultation and earlier PFI transactions in which the public sector has been an equity investor.

### (II) Status of Standard PF2 Equity Documents

**2.2** The Treasury has produced the Standard PF2 Equity Documents with the intention of minimising the time and costs of dealing with standard commercial and legal issues. On any PF2 procurement this documentation will be customised by the Treasury PF2 equity unit, in conjunction with the procuring authority ('Authority'), prior to issue, to reflect project specific issues.

**2.3** Bidders will be asked if they accept the commercial terms of the Standard PF2 Equity Documents (as revised by the Authority in conjunction with the Treasury PF2 equity unit to reflect project specific issues). It is recognised that some equity investment arrangements may be bespoke to the particular project and in such circumstances amendments may be proposed to the Treasury PF2 equity unit at bid stage provided they are genuinely project-specific changes supported by a project-specific justification. The Government is willing to consider amendments to the commercial arrangements if a strong case can be made for doing something differently and the proposals remain compliant with the Government's policy. Amendments submitted as part of a bid will form part of the due diligence undertaken by the Treasury PF2 equity unit at that stage (see section 2(XII) below). As the Standard PF2 Equity Documents are not a 'prescribed' suite of documents, no formal derogations arrangements will apply. Interested parties can seek informal guidance from the Treasury PF2 equity unit at any time regarding proposed amendments.

**2.4** By way of example, the 'Developer' may comprise a consortium of entities who together submit a bid and share the development costs. They may wish to propose a board composition and voting arrangements which differ from those set out in the Standard PF2 Equity Documents. As a second example, all the equity funding might be made at the outset, by instalments matching senior funding in a given proportion or paid in part at the end of construction using an 'equity bridge facility'. On the above, and other points, the Standard PF2 Equity Documents contain footnotes to explain the position of the Government in further detail.

### (III) Quantum of the Government's proposed investment

**2.5** When an Authority launches its procurement for a PF2 project, it will advise prospective bidders if the Government wishes to make an investment and the quantum of that investment as a percentage of the total shareholder funding. The detailed procurement requirements will then reflect this intention. This means the Government has a firm intention to invest, subject to the transaction satisfying the Treasury PF2 equity unit's eligibility criteria ('Eligibility Criteria').<sup>1</sup>

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<sup>1</sup> The Eligibility Criteria will be published on [www.gov.uk](http://www.gov.uk), following their approval by the Investment Committee of the Treasury PF2 equity unit.

Bids will be assessed against the Eligibility Criteria by 'primary' due diligence following submission of final bids. The Treasury PF2 equity unit will also undertake 'final' due diligence prior to financial close. (This is addressed in further detail in section 2(XII) below).

**2.6** Bidders are required to submit bids which demonstrate that the equity will be fully funded if the public sector decides not to invest. When appointed, the preferred bidder will be informed if, as a result of its 'primary' due diligence, the Treasury PF2 equity unit has concluded it is reasonable to expect the Eligibility Criteria will be satisfied at financial close. Whilst there is no legal obligation to fund at this stage (as is the case for all equity investors), this confirms the Government's firm intention to invest and the transaction would then proceed on the basis that it included public sector equity.

**2.7** Prospective bidders would also be told when the procurement is launched if the Government wishes to take an equity stake which is sufficiently large to enable it to sell part of its holding after financial close to facilitate the introduction of new long term investors. In this case, details would also be given of the quantum the Government wishes to hold as a long term investor. (See section 2 (XIII) below).

## **(IV) Transparency**

**2.8** Transparency is a key policy objective of the Government. Other equity investors will be required to disclose the beneficial ownership of their shares in the entity ('ProjectCo') which enters the project agreement with the procuring authority ('Authority') and the entity ('HoldCo') which holds the shares of ProjectCo (together with ProjectCo, the 'Project Companies'). Drafting of the Shareholders Agreement is consistent with the requirements of the Money Laundering Regulations 2007. Accordingly, other equity investors are required to take steps to establish beneficial ownership which are consistent with their existing 'Know Your Customer' procedures. Going forward the Standard PF2 Equity Documents will be amended to take account of changes in law, regulations and Government policy. By way of example, the Department of Business, Innovation & Skills is currently undertaking a consultation regarding transparency of UK Company Ownership<sup>2</sup> which may result in regulatory changes which need to be reflected in the Standard PF2 Equity Documents.

**2.9** If a shareholder is in persistent breach of its obligation to disclose Transparency Information,<sup>3</sup> this will constitute an Event of Default<sup>4</sup> which may then trigger a deemed transfer notice giving the other shareholders the option to buy the shares in the Project Companies ('Shares') held by the defaulting shareholder.<sup>5</sup> (See paragraph 2.17.3 below).

## **(V) Tax compliance**

**2.10** The Cabinet Office Policy Note: *Measures to Promote Tax Compliance (Action Note 06/13 (25 July 2013))* ('Action Note') applies to the Project Companies and their shareholders. The Action Note requires each Authority to have the right to terminate the project agreement where a Project Company or any shareholder is found to have an Occasion of Tax Non-Compliance ('OONC')<sup>6</sup> if that Project Company or shareholder does not provide details of proposed mitigating factors which are acceptable to the Authority, in its reasonable opinion.

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<sup>2</sup> Department of Business, Innovation & Skills: Transparency and Trust: Enhancing the transparency of UK company ownership and increasing trust in UK Business: Discussion Paper (July 2013); [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/212079/bis-13-959-transparency-and-trust-enhancing-the-transparency-of-uk-company-ownership-and-increasing-trust-in-uk-business.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212079/bis-13-959-transparency-and-trust-enhancing-the-transparency-of-uk-company-ownership-and-increasing-trust-in-uk-business.pdf)

<sup>3</sup> SHA schedule 1

<sup>4</sup> SHA schedule 1

<sup>5</sup> SHA clause 9.2

<sup>6</sup> This is defined in the Action Note and SHA schedule 1

**2.11** In the Shareholders Agreement, each shareholder gives a warranty regarding tax compliance on the effective date of the Shareholders Agreement<sup>7</sup> and thereafter it must disclose any OONC and provide details of any mitigating factors (such as measures to ensure future tax compliance).<sup>8</sup> New shareholders give the same warranty when they become shareholders.<sup>9</sup>

**2.12** If a shareholder is in breach of this warranty or an OONC occurs at a later time then the shareholder must to provide details of proposed mitigating factors. The public sector shareholder ('HMTCo') then determines if, in its reasonable opinion, these factors are acceptable. If they are not, the shareholder will be given a period of 90 days in which to divest itself of its Shares<sup>10</sup> before an Event of Default occurs, triggering the compulsory share transfer arrangements.<sup>11</sup>

## **(VI) Bribery Act 2010**

**2.13** The Shareholders Agreement includes provisions regarding compliance with the Bribery Act 2010.<sup>12</sup> On execution of this agreement each shareholder warrants it is in compliance with the anti-bribery and corruption laws (together 'corruption laws') applicable to its business and operations.<sup>13</sup> If a shareholder commits an offence under a corruption law in the United Kingdom, this is an Event of Default.<sup>14</sup>

## **(VII) Number of directors and voting provisions**

**2.14** In view of the consultation feedback (see paragraph 3.13 below), it is now proposed that a shareholder with at least a 15 per cent shareholding ('Material Shareholder') can appoint a director for each 15 per cent shareholding<sup>15</sup> (with no maximum number). Each director can have up to three alternates at any time. Decisions are made on a simple majority basis, save in respect of Reserved Matters.<sup>16</sup> The voting arrangements also differ during the construction period and early operations. During this period, if the majority shareholder is associated with the construction sub-contractor, matters will also require the support of a director appointed by a different shareholder.<sup>17</sup>

## **(VIII) Conflicts of interest**

**2.15** The 'step-aside' provisions in the Shareholders Agreement<sup>18</sup> have been revised in the light of feedback during the consultation. Now a director ('Step-Aside Director') is required to 'step-aside' when the Material Shareholder responsible for his/her appointment has a firm intention to issue proceedings against a Project Company. Then the directors appointed by the other Material Shareholders ('Independent Directors') are entitled to defend the claim in the name of that Project Company. In the Consultation Paper these arrangements were triggered at an earlier stage, namely when a claim was asserted. The documentation now also provides that the Step-Aside Director will not receive any information from the Project Companies regarding those

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<sup>7</sup> SHA clause 10.4

<sup>8</sup> SHA clause 10.5

<sup>9</sup> SHA schedule 4

<sup>10</sup> SHA clause 10.6 and 10.7

<sup>11</sup> SHA clause 9.2

<sup>12</sup> SHA clause 6.1(f)

<sup>13</sup> SHA clause 10.2(g)

<sup>14</sup> SHA clause 9.2

<sup>15</sup> SHA clause 5.1

<sup>16</sup> SHA clause 6.2

<sup>17</sup> SHA clause 5.5 (a)

<sup>18</sup> SHA clause 6.5 (a)

proceedings. The 'step-aside' arrangements also apply where a Material Shareholder asserts that a Project Company has a claim against another Material Shareholder.<sup>19</sup>

**2.16** These provisions have been extended so that the director nominated by HMTCo must step aside if proceedings are issued between ProjectCo and the Authority.<sup>20</sup> Whilst there is no legal reason why the HMTCo director should not participate in these decisions, the Treasury has concluded, in the light of the consultation, that these revised arrangements are appropriate given the commercial context. In this case the observer (appointed by the Authority) will also be excluded from meetings and will not receive relevant information.<sup>21</sup>

**2.17** A shareholder may now make representations to HMTCo if the individual proposed as the observer is an employee of, or is associated with, a direct competitor of that shareholder.<sup>22</sup>

## **(IX) Events of Default**

**2.18** In the light of feedback during the consultation, material breach of an obligation will not trigger an Event of Default. Instead, a shareholder (and its nominated director(s)) will be disenfranchised from voting until that breach is remedied.<sup>23</sup> Breach of the following will remain as Events of Default:

- insolvency;
- material breach of warranty (save in respect of tax avoidance where the arrangements described in section 2(V) above apply);
- any attempt to dispose of any Shares, debt investments in a Project Company made by shareholders ('Shareholder Debt') or any interest therein, otherwise than in accordance with the Shareholders Agreement;
- breach of a payment obligation in respect of Shares or Shareholder Debt; and
- persistent breach of the obligation regarding disclosure of Transparency Information.

**2.19** Further Events of Default have been added in respect of:

- bribery and corruption (see section 2(VI) above); and
- failure to dispose of shares following a notice from HMTCo to do so following an OONC (see section 2(V) above).

**2.20** The Event of Default relating to an Unsuitable Third Party is now limited to a change in business which results in the shareholder becoming an Unsuitable Third Party.<sup>24</sup>

## **(X) Taxation matters**

**2.21** As the proposed taxation arrangements may differ, bidders may propose bespoke drafting on a case by case basis, provided any such arrangements are compliant with the Action Note. If bidders wish to insert bespoke tax related arrangements in the Shareholders Agreement, they are required to summarise these when submitting their bids. Bidders can seek guidance from the Treasury PF2

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<sup>19</sup> SHA clause 6.5(b)

<sup>20</sup> SHA clause 6.5(d)

<sup>21</sup> SHA clause 6.5(d)

<sup>22</sup> SHA clause 5.6(b)

<sup>23</sup> SHA clause 5.5(g)

<sup>24</sup> SHA schedule 1

equity unit on the acceptability of these arrangements before bids are submitted. As a consequence the tax related provisions in the Standard PF2 Equity Documents have been simplified.<sup>25</sup>

## **(XI) Working capital**

**2.22** There is no specific provision relating to the provision of working capital. As consultation responses were varied (see paragraph 3.6 below) this will now be addressed on a case by case basis.

## **(XII) Investment appraisal**

**2.23** The Government has decided to retain the same approach to investment appraisal and due diligence that was described in the consultation paper. The Government has carefully considered the views of respondents and judges that this approach is the most efficient way for the public sector to appraise and conduct due diligence on its investments.

**2.24** The Treasury PF2 equity unit will carry out due diligence ('Primary Due Diligence') on the final bids submitted to an Authority. The information required at bid stage will be included within the Authority's requirements to avoid duplication. This will include information regarding risk allocation between ProjectCo and its supply chain, the creditworthiness of supply chain contractors and the other shareholders and details of the proposed funding arrangements, including term sheets. This will not require bidders to provide detailed drafting of project documentation or a marked up copy of the Standard PF2 Equity Documents but bidders must give an explanation of, and justification for, any proposed amendments to the commercial and financial terms of that documentation. The Treasury PF2 equity unit will use confidential information received during the bid process only in connection with the relevant bid.

**2.25** Following Primary Due Diligence, a report will be submitted to the Investment Committee of the Treasury PF2 equity unit which will determine if it is reasonable to conclude, in respect of the relevant bid, that it will satisfy the Eligibility Criteria at financial close.

**2.26** The entity appointed as preferred bidder will be informed of this determination and, assuming the Eligibility Criteria are satisfied, negotiations will then proceed on the basis that public sector equity is included.

**2.27** The Treasury PF2 equity unit will be guided by the preferred bidder and the Authority regarding the timing of its final due diligence ('Final Due Diligence'). This should be largely 'confirmatory' in respect of matters previously disclosed during Primary Due Diligence, assuming there has not been any material and adverse change in circumstances. The Treasury PF2 equity unit recognises that it may be appropriate to conduct Final Due Diligence when negotiations are at an advanced stage but before the project and finance documents have been finalised. The developer and its advisers would then remain in contact with the designated representative of the Treasury PF2 equity unit regarding the manner in which those remaining points are resolved.

**2.28** Following its appointment as preferred bidder, the relevant developer will receive a due diligence questionnaire to be completed and returned prior to the start of Final Due Diligence. This will be analogous to the form of document used by prospective purchasers in secondary market transactions. The Treasury PF2 equity unit will also require a copy of due diligence reports prepared by technical and insurance advisers. Where the developer has not retained its own advisers in these fields, the relevant reports prepared for senior funders would be used. The Government expects to rely on these materials prepared for other participants in the project as instructing its own advisers would increase the overall cost of the project to the public sector and may introduce delay. Letters of reliance, addressed to HMTCo are expected in respect of all reports it uses for due diligence.

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<sup>25</sup> SHA clause 8.5

**2.29** The Treasury PF2 equity unit will undertake due diligence on the financial model. It will work directly with the financial adviser to the developer regarding this due diligence. The Treasury PF2 equity unit will require a finite number of sensitivities to the base case.

**2.30** The Treasury PF2 equity unit would participate directly in negotiations between the equity investors and senior funders regarding the terms of their commitments to the senior funders and the terms of the principal finance documents, including the intercreditor arrangements.

**2.31** Following completion of Final Due Diligence, a report will be submitted to the Investment Committee of the Treasury PF2 equity unit who will determine if the Eligibility Criteria have been satisfied. It will inform the Authority of its determination and, where the Eligibility Criteria are satisfied, it will request the Authority's approval for release of the funding required to make this public sector equity investment.

### **(XIII) Initiatives to encourage new long term equity investors**

**2.32** The consultation has raised a number of important issues regarding the Government's proposed initiatives which are to be explored in further detail. The Government will continue discussions with market participants on the arrangements for encouraging third party, long term equity investment and equity funding competitions. Further information will be made available before this initiative is implemented.

# 3

## Summary of responses

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### General considerations

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

**3.1** Many respondents thought the approach of requiring legal advisers to ProjectCo to produce a Due Diligence Memorandum for the PF2 equity unit was outside market practice and would likely lead to an increase in bid costs. Some respondents took the view that legal advisers to ProjectCo are not in the business of providing letters of reliance and this was an extension to the advisers duty of care, which will add further to bid costs. A few respondents offered the alternative that HMTCo should employ its own legal advisers to conduct due diligence.

**The Government's response:** The Government has decided to retain the approach to investment appraisal and due diligence set out in the consultation paper. It is of the view that this will be more cost effective (looking to the overall cost to the public sector for the relevant project) and more expedient than retaining its own advisers. Advisers who have participated in the preparation and negotiation of project and financing documentation are familiar with its terms and will be able to complete the due diligence questionnaire more easily and quickly than a new set of advisers. There are precedents for letters of reliance in the PFI market and other instances where advisers owe a duty of care to shareholders.

**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.**

**3.2** The majority of respondents thought that some public sector equity guidance during procurement would be useful. Some pointed out that this should not be a substitute for clear statements regarding the Government's intentions regarding investment. There was a comment that the same information should be available to all bidders.

**The Government's response:** Informal public sector equity guidance is intended to give market participants the ability to hold informal discussions with the Treasury PF2 equity unit regarding matters where they wish to receive an informal view during the bid period as to the acceptability of possible arrangements which differ from market norms. If, during any informal exchange, matters come up where the Treasury PF2 equity unit is of the view further information should be made available to all bidders, the relevant bidder will be informed of this. At this point the relevant bidder will then decide if it wishes to withdraw the question or agree to the issue being referred by the Treasury PF2 equity unit to the Authority to determine if wider disclosure is needed. The bidder will be informed of the Authority's determination and will be given a further opportunity to withdraw the question if the answer would be subject to disclosure. In addition market participants may at any time hold informal discussions (not related to any particular transaction) with the Treasury PF2 equity unit seeking informal guidance.

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



**3.3** None of the respondents expressed objections in principle to disclosure of Transparency Information, however a number of respondents were uncomfortable with the Treasury continuing to receive this information after it ceases to be a shareholder. A few respondents stated that in certain cases confidentially agreements in place between an infrastructure fund and its third party investors will impede the disclosure of beneficial ownership of shares listed in Schedule 7 of the Shareholders Agreement. One respondent pointed out the need for an exception for price sensitive information for publically quoted entities. Some commented on the need to define clearly the steps which need to be taken to establish beneficial ownership.

**The Government's response:** The scope of disclosure regarding beneficial ownership has been refined. As beneficial ownership is defined by reference to the Money Laundering Regulations 2007, investors will be required to take steps consistent with their existing 'Know Your Customer' procedures. Disclosure obligations bind ProjectCo for the whole life of the PF2 project (including disclosure of beneficial ownership of shareholders, as far as it is aware). Government has decided, on policy grounds, that the disclosure obligations should also continue to bind shareholders, even if HMTCo ceases to be a shareholder.

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

- 1 Equity funding competition post appointment of preferred bidder?**
- 2 Reduction in HMTCo equity post financial close (either during the Lock in Period or thereafter)?**

**3.4** Respondents were uncertain about the requirements for the equity funding competition and asked for more clarity. A common concern was that a post preferred bidder equity funding competition would be likely to reduce third party participation at the initial bid stage, potentially negating any cost savings from holding an equity competition post preferred bidder. A few respondents stated that they did not believe a post preferred bidder competition for the typical PF2 project would attract institutional investors new to investing prior to financial close.

**3.5** Most respondents were comfortable with HMTCo selling down part of its equity stake after financial close. Some respondents agreed in principle but expected the ability to sell down an equity stake during the lock-in period to apply to all shareholders not just HMTCo. A respondent asked if existing shareholders' pre-emption rights apply to the sale of public sector equity during the lock-in period.

**The Government's response:** The consultation has raised a number of important issues which are to be explored in further detail. The Government will continue discussions with market participants on the arrangements for encouraging third party, long term equity investment and equity funding competitions. Further information will be made available before this initiative is implemented.

**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.**

**3.6** There was a broad consensus among respondents that in most cases the requirement for working capital should be considered a project cost and therefore should be provided by all shareholders scaled by the percentage shareholding. Some respondents suggest leaving this open to be determined based on the transaction.

**The Government's response:** The suggested provision in the Shareholders Agreement has been deleted. The Government agrees that the treatment of working capital should be addressed on a case by case basis.



## 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)?**

**3.7** There was general agreement among respondents that shares and loan stock should be stapled and this was in line with normal market practice. A few respondents made the point that stapling should not restrict intra-group reorganisation of the financial instruments if efficiencies can be found.

**The Government's response:** Consultation established that the proposed provisions are in accordance with market practice. The terms of the Shareholders Agreement acknowledge that Shareholder Debt may be held by a different entity within the same group as the shareholder.

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

**3.8** The majority of respondents agreed with the pre-emption provisions. Several respondents stated that potential investors would be concerned over the lack of certainty over the definition of an "Unsuitable Third Party" in the event that shares are unintentionally transferred to an entity that is judged by the Treasury (acting reasonably) as an Unsuitable Third Party.

**3.9** A few respondents were not in favour of any pre-emption provisions and some suggested alternative pre-emption mechanisms.

**3.10** A common concern raised by respondents was that the definition of HMTCo Group was too wide, giving HMTCo broad rights to transfer without triggering the pre-emption provisions. Respondents were of the view the definition extended beyond normal market practice and gave HMTCo disproportionate freedom, compared to private sector shareholders, to transfer its shares outside of the pre-emption arrangements.

**The Government's response:** The concept of parties being unsuitable as investors in PFI projects is well established policy in Project Agreements (between the Authority and ProjectCo). Some of these grounds are definitive; others include determinations being made by a public sector body (acting reasonably) as to a party being 'unsuitable' by reference to a specified criteria, such as national security. The Government has concluded that the proposed definition has sufficient certainty.

Pre-emption arrangements are very common between shareholders in PFI/PPP projects and following consideration of the alternative pre-emption mechanisms proposed, Government has decided to retain the arrangements set out in the consultation draft as these were supported by many respondents.

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

**3.11** Many respondents had no specific comments on these provisions but a significant body were of the view that material breach of an obligation should not be an event of default and that instead a shareholder in breach, and his nominated director(s), should be disenfranchised from voting. Some also commented on the occurrence of an Event of Default when a shareholder becomes an Unsuitable Third Party.

**The Government's response:** Following a detailed review of each shareholder's obligations, the Events of Default have been modified. Only a breach of a limited number of obligations now leads to default and the Government has adopted the disenfranchisement proposal for the balance. The scope of the default relating to Unsuitable Third Party has been reduced. Further information is given in section 2(IX) above.

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

3.12 Most respondents had no specific comments to make on the definition of 'Market Value' and its determination and many thought it in line with market practice.

**The Government's response:** No changes are needed to the proposed provisions.

**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.**

3.13 There was a broad consensus that 15 per cent is a sensible size shareholding for a director appointment. However, respondents would prefer flexibility to vary the size depending on the nature of the project. Several respondents noted that it was unusual for director voting to be linked to the number of directors and a more typical and flexible system was for director's voting weight to be linked pro-rata to the shareholdings of their respective shareholders.

**The Government's response:** The proposed arrangements remain unchanged in the Standard PF2 Equity Documents. However, the Treasury PF2 equity unit is willing to consider alternative arrangements (provided the unanimity required for Reserved Matters remains the same and HMTCo may appoint a director) and a footnote has been included advising that bidders may propose alternative voting mechanics explaining their rationale, by reference to their proposed percentage equity interests (including the percentage of public sector equity stipulated at the start of the procurement).

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

3.14 There was no strong collective view on the provisions relating to the appointment of an independent chairman. A few respondents saw instances where an independent chairman could add value particularly for projects with a number of different shareholders with different motivations. A couple of respondents wanted the decision to appoint a chairman and the terms of the role to be agreed by the shareholders upfront prior to submitting its bid with the cost added to the project.

**The Government's response:** In view of the feedback and the flexibility included in the consultation draft, no changes are being made.<sup>1</sup>

**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?**

3.15 There was a mix of views from respondents with some reporting positive experiences with observers from past private finance projects. Several respondents thought it was important for the terms of the observer's participation to be agreed upfront, otherwise there was potential for disagreements which could have an adverse impact on the operation of the Board of directors. A few respondents suggested pre-announcing a list of potential candidates for the observer or replacing the role of observer by a liaison committee separate from board meetings to facilitate the dialogue with local representatives. There was some concern regarding the possible appointment of an individual who was associated with a competitor of a private sector equity investor.

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<sup>1</sup> SHA clause 5.4

**3.16** A small number of respondents did not believe it was appropriate for the observer to remain after HMTCo ceases to be a shareholder. A couple of respondents proposed delinking the observer role from the HMT Shareholding and including it in the PF2 project agreement instead.

**The Government's response:** As previously proposed, the observer can be excluded from discussions (and he/she would not receive any information) if the Board decides it is reasonable in all the circumstances. This is decided by a simple majority of the directors.<sup>2</sup> A new provision has been added so that the observer will not be party to any discussions, or receive any documentation, where the 'step aside' arrangements have been activated due to a dispute between ProjectCo and the Authority.<sup>3</sup> As the appointment of an observer is part of Government policy, the observer will remain in place even if HMTCo ceases to be a shareholder.

## **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.**

**3.17** The majority of respondents accepted the list of Reserved Matters. A number of respondents suggested additions or retractions from the list. On certain matters a few respondents questioned whether the level of approval should sit with the Board of directors or with the shareholders.

**The Government's response:** The Government has reviewed the submissions with care and some modifications have been made to the list of Reserved Matters in respect of issues which are analogous to those previously proposed as Reserved Matters.<sup>4</sup> Following further consideration, the level of approval required for certain Reserved Matters (Board of directors or shareholders) has been revised.

**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.**

**3.18** Overall respondents were content with the provisions regarding a Director's conflict of interest. There was broad consensus of agreement about the arrangements for directors to declare a conflict of interest and then abstaining from voting. A few respondents were unhappy in principle with the 'step-aside' provisions.

**3.19** Several respondents asked for the 'step aside' provisions in the Consultation Draft Shareholders Agreement to be extended to include the situation where ProjectCo has a claim against the Authority or any other body within the HMTCo Group or where any of those public sector entities brings a claim against ProjectCo. In this situation the HMT director and the observer would be required to 'step-aside', and lose the right to make decisions or otherwise participate in the conduct of that claim on behalf of ProjectCo.

**The Government's response:** The documentation continues to include 'step aside' provisions. Whilst there is no legal reason why HMTCo should not participate in decisions regarding claims between ProjectCo and the Authority, the Government has concluded that 'step aside' arrangements are appropriate if other shareholders wish it to do so, given the commercial context and the feedback during consultation. Further information is given in Section 2 (VIII) above.<sup>5</sup>

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<sup>2</sup> SHA clause 5.6 (e)

<sup>3</sup> SHA clause 5.6 (f)

<sup>4</sup> SHA Schedule 8

<sup>5</sup> SHA clause 6.5

## Dispute resolution (SHA Clause 11)

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

**3.20** The majority of respondents were content with the dispute resolution arrangements.

**The Government's response:** The dispute resolution arrangements will remain the same. The drafting has been clarified so it is clear that an issue requiring approval as a Reserved Matter will not constitute a dispute.<sup>6</sup>

## Loan Stock Instrument

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

**3.21** There was a broad consensus among respondents that in most cases shareholder loan stock should be unsecured. A few respondents argued for flexibility believing there was no need to be prescriptive.

**The Government's response:** The Standard PF2 Equity Documents assumes Shareholder Debt is unsecured. If a bidder's proposed funding structure requires that this is secured, it may propose this, setting out its rationale for this.

**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?**

**3.22** Respondents were in agreement that the bidder should be compensated for the costs and risks taken in bidding for a PF2 project. Several respondents proposed that, where those not taking development risk were to receive a lower equity rate of return, this be structured by payment of a premium at financial close. This was in line with views expressed by a majority of respondents who felt it was important that shareholders' interests remain aligned and accordingly differential rates of interest on the loan stock was not an appropriate mechanism to compensate for development risk. Many felt differential rates of interest would result in increased complexity.

**The Government's response:** The Government agrees that shareholders' interests should remain aligned and that payment of a premium at financial close is a good mechanism to achieve this. This premium would be paid to the Authority except where payment to the developer was agreed to compensate it for taking development risk. As HMTCo would not take development risk, it would look to invest on the same terms as other equity investors who do not take this risk. Appropriate changes would be made to the documentation when a project is structured in this manner. No drafting has been proposed in the Standard PF2 Equity Documents.

## 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.**

**3.23** Respondents submitted a number of general comments on the overall approach to PF2 equity alongside more specific drafting comments on the Standard PF2 Equity Documents.

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<sup>6</sup> SHA clause 11

**3.24** A common theme among the response was the need to avoid conflicts of interest inherent with the public sector director representing HMTCo and the Authority. A few respondents stressed the importance of the Treasury PF2 equity unit operating commercially, seeking to maximise the value of its shareholding, and not being influenced by other public sector interests.

**3.25** Several respondents made a wider point that the impact on the private sector's incentives to invest should be carefully considered when taking any decision regarding the terms of public sector equity investment. The size of the public sector's stake should not crowd out the ability of the private sector to take stakes that appropriately compensate them for bid costs and risks. Also the quantum of equity available to the bidder should be sufficiently high to enable construction companies to share development costs, risks and investment returns with others willing to share those risks.

**3.26** Many respondents stressed that public sector equity involvement should not add unreasonable additional costs and complexity to the procurement process.

**The Government's response:** The arrangements regarding conflicts of interest have been revised in the light of market feedback (see section 2(VIII) above). As it is in Government's interests to structure procurements in a manner which will attract a considerable number of interested parties who are willing to bid competitively for PF2 projects, it follows that the comments made regarding the quantum of Government's equity share will be a consideration when it makes this determination. This will also form part of Government's ongoing discussions with market participants on the arrangements for encouraging third party equity investment and equity funding competitions. The Government is of the view that its proposed arrangements for investment appraisal will minimise any additional complexity and costs.



# A

## List of respondents

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Allen and Overy  
Andrew Kershaw  
Ashursts  
Astrium Services  
Balfour Beatty  
Barclays Infrastructure Funds  
Carillion  
CMS Cameron McKenna  
DLA Piper  
Galliford Try  
Hermes GPE  
Hochtief PPP Solutions  
ICAEW  
Infrastructure Forum  
Innisfree  
Intergenerational Foundation  
Interserve Developments  
Local Partnerships  
Meridiam  
Miller Construction  
Morgan Sindall  
Nabarro  
Norton Rose Fulbright  
PPP Forum  
Sandwell and West Birmingham Hospitals Trust and Pinsent Masons  
Simmons and Simmons  
Skanska  
University of Ulster Real Estate Initiative  
Vinci Concessions  
Wates Investments Solutions





## **HM Treasury contacts**

This document can be downloaded from  
[www.gov.uk](http://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](mailto:public.enquiries@hm-treasury.gov.uk)

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