DLA Piper Response to HM Treasury's "A new approach to public partnerships: consultation on the terms of public sector equity participation in PF2"

21 August 2013

Introduction

This is a response on behalf of DLA Piper UK LLP in relation to HM Treasury's consultation process issued in July 2013 on ***"A new approach to public private partnerships: consultation on the terms of public sector equity participation in PF2"***.

We have a great deal of experience in advising each of the main stakeholder roles, namely procuring authorities, private sector sponsors and funders, on project finance and PFI/PPP transactions in the UK and abroad. Furthermore, we have a deep understanding of equity and subordinated financing issues and structures through our involvement in a wide variety of sectors and financial structurings on both primary and secondary transactions. Our response to this consultation process is based on our experience and our understanding of the market but does not represent the views or positions of a wider group or our clients. We note that many of the specific consultation questions are of a commercial, rather than legal, nature and in those instances we have tried to be helpful in providing general thoughts and analysis. However, we recognise that the most meaningful responses to those points will be from private sector investors including its general attitude towards the proposed equity participation by HMTCo and third party equity providers at financial close.

As a general observation, we note that the draft shareholders' agreement is largely based on the "LEP Shareholders' Agreement" from the BSF programme. Whilst this is helpful in that there is market precedent (particularly regarding BSFI equity participation) in relation to some of the issues, LEP arrangements applied to the general strategic direction of a BSF and were "one step removed" from individual project finance transactions. Consequently, bidders may have some concerns as to direct public sector equity participation at Project Co level, particularly with regard to any perceived conflict of interests. Furthermore, we understand that the PF2 documents will apply to all sectors (i.e. outside of the education sector) and, as such, some of the proposed arrangements will be unfamiliar to some prospective bidders who will have to view the applicability of the proposals on a sector-by-sector basis.

We have provided contact details at the end of this note and please do not hesitate to contact any of the listed individuals should you wish to discuss any of the contents discussed or raised.

Question	DLA Piper Response / Comments
General Considerations	
1. Please give your observations on the proposed investment appraisal and due diligence arrangements?	Bidders are likely to require further details on the exact mechanics and proportions of the equity arrangements at the outset of the bidding process including details of the respective proportions of equity that a procuring authority or HM Treasury determines should be provided by HMTCo and a third party equity provider. This will clearly affect pricing and market appetite for bidding for a particular project. Currently, we note that HMTCo is expected to hold 15% of the equity/sub-debt investment and that the Developer hold a majority stake but bidders will want clarity as to the exact proportions as soon as possible. Furthermore, bidders may wish to better understand how HM Treasury will resource and gear-up to manage the investment and deal close process. In terms of the proposed investment appraisal and due diligence process itself, we would expect that there will be lessons learnt from the BSFI experience and there are clearly efficiencies in asking for bid information at preferred bidder stage but there are some questions as to practicality and processes which will need to be addressed in due course e.g. • how is HM Treasury to be kept informed about post-preferred bidder changes? Hopefully these will be small in number but will it be for the PB or the procuring authority to keep HM Treasury involved and updated? • what is the extent of HMT's right to review the information? Will it have a veto/right to block changes and/or require amendments? Will this be at bid stage only or at any time? What comfort will the PB have that HMT will not materially change its position; • some thought will need to be given as to the content of the letters of reliance that are to be required from the ProjectCo's advisers. Visibility at the outset as to what advisers will be asked to commit to will be helpful, particularly in relation to the legal advisor's report as there is no recognised "standard". Unless carefully managed, it is possible that this process may lead to some delay in the overall procurement timetable to financial close and bidders/the procuring authority will no doubt be keen to be comforted that this will not be the case.

Question	DLA Piper Response / Comments
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.	Any guidance will be helpful and welcomed by the relevant parties, but in the absence of a clear steer as to how binding or persuasive such guidance is to be treated, it may well be of limited use. As much clarity as possible from the outset would be helpful to manage bidders' expectations in general but also specifically in relation to the way they may wish to propose equity and financing structures (which in turn could impact on pricing).
3. Do you have any objections to disclosure of the Transparency Information? Please give reasons for any objections.	We have seen some initial nervousness from the private sector around these provisions but, on the whole, we are finding that sponsors and funders are coming to terms with accepting them as drafted. In particular, when we have acted for procuring authorities recently, the private sector is accepting the general transparency principles set out in PF2 and the required drafting in project agreements and we note that many of the principles in the draft shareholders' agreement are a continuation of those in the PF2 project agreement. Bidders may, however, want to look at particular aspects of this on a project-specific basis in light of their proposed financing structure.
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)?	We expect that bidders will be more comfortable with scenario a) than scenario b). More specifically on each of the scenarios: a) On an initial analysis the administration for this seems potentially quite burdensome. A post-preferred bidder equity funding competition could be protracted and could delay what is otherwise a timely procurement process. There could also be concerns whether such a competition would mean the potential to re-open terms and positions settled at preferred bidder stage. Even if positions cannot be re-opened, presumably there would be a necessary amount of due diligence required which would have to be factored into the relevant timetable. This may also apply to other issues such as agreeing funding terms and also intercreditor issues. On the latter point, we expect intercreditor issues to become more complicated given the current restraints in the funding market and the desire to use more innovative funding solutions (including the use of structured debt and the capital markets). We note that it is proposed that the equity funding competition be run by the preferred bidder and that the selection of the successful candidate will also be made by the preferred bidder. However, further clarity will be needed as to any public sector requirements as to the identity of the Third Party Equity Provider. If the selection choice is entirely with the preferred bidder, this raises questions as to whether unrelated third party equity provider (i.e. entities who are not connected or associated with the rest of the bidding consortia) should simply form part of the bidding consortia for the main project.

Question	DLA Piper Response / Comments
	In any event, we would expect bidders to be able to require that commercial competitors and/or unsuitable third parties are excluded from the process. b) Sponsors may also be nervous as to any transfer by HMTCo to commercial competitors and/or unsuitable third parties and may seek protections to address this although it is noted that this risk may be mitigated by the application of pre-emption rights.
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.	Our experience suggests that, outside of BSF, working capital in project-finance tends to be provided by way of reserving, a separate facility from an external funder or increased sub-debt amounts. A facility provided by investors tends to be rare. On a large BSF scheme we advised on, a working capital facility to develop future schemes (at LEP level rather than at the Project Co level) was provided by each of the private sector partner, BSFI and the procuring authority in proportions which reflected their equity/sub-debt contributions. Bidding Developers may well expect similar arrangements to apply on future PF2 schemes as a working capital facility can be viewed, in this context, as a further tranche of sub-debt and in this way all equity investors would be sharing the risk pro rata to the rest of the investments. Bidding Developers may view any requirement to provide a working capital facility by itself as increased risk which may, in turn, affect pricing. As such, HM Treasury may find that there may be value-for-money benefits if it discusses the need for working capital on a project-specific basis. If HM Treasury maintains this requirement, bidding Developers are likely to require that Working Capital repayments rank higher than regular subordinated debt and equity payments and distributions to them through the "cash waterfall" arrangements under the senior financing documents, the intercreditor arrangements and, potentially, security arrangements. Furthermore, going forward, any future working capital/injection of equity should be at the discretion of the Developer, and they should not be compelled to provide it (as per the drafting in the draft Shareholders' Agreement).

Question	DLA Piper Response / Comments
Shareholders Agreement (SHA) and Articles of Association (Art) **Restriction on share transfers (SHA Clause 9 and Art 11 to 15)**	
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)?	We note that "stapling" is relatively common practice in the project finance market and that such a practice does tend to reflect the normal market practice of those acquiring equity/sub-debt interests in closed transactions in the secondary market. In principle, this appears to make things more straightforward but commercially sponsors may find that this restriction fetters their ability to do business. In particular, we note that different sponsors/consortia take different approaches/views on "stapling" partly driven through their tax structurings. As such, unless there is an overriding concern on the part of HM Treasury on this issue, it may be sensible to leave this as a point to be addressed by bidding sponsors as part of the bid process to reflect their project-specific equity financing solutions.
7. What are your views on the pre-emption provisions?	We note that these closely follow those contained in the BSF Shareholders' Agreement which were generally accepted in the market. We also note that the arrangements broadly reflect those entered into by consortia on non-BSF schemes. The new clause 9.6 is helpful although from a practical perspective it may prove administratively difficult as the number of shareholders increases (e.g. on sale by HMTCo of only part of its holding).
8. Do you agree with the event of default and deemed transfer provisions?	Subject to the below, the list of "Events of Default" are broadly consistent with that seen elsewhere in the project finance market as are the underlying principles of the deemed transfer provisions. One Event of Default which may cause investors some concern is the fact that the determination as to whether an investor's business has made it an "Unsuitable Third Party" is made by the HMTCo (albeit it in its reasonable opinion). This could lead to concerns about potential abuse of this provision. Normally, in shareholders' agreements this is tied into the concept of an "Unsuitable Third Party" at Project Agreement-level and it may be more appropriate (as we have seen on other schemes where the public sector is investing into a Project Co) for this provision to only apply where the procuring authority has deemed it to apply under the Project Agreement. Furthermore, potential investors may have concerns with some of the mechanics including: • Clause 9.5 - the provision deeming the market value of the Investment as "nil" and that the Defaulting Shareholder is only entitled to the par value of the shares and nothing for the sub-debt at par particularly given that an Associate of the Defaulting Shareholder is not entitled to bid for the acquisition. Investors may require further flexibility and safeguards in this regard. • Schedule 5 and the requirement of the Defaulting Shareholder to "ensure that the Investment has the widest possible market" is very broad and may benefit from further certainty. Furthermore, the Defaulting

Question	DLA Piper Response / Comments
	Shareholder, given the implications, may require more flexibility or control over the process.
9. Do you have any comments on the definition of 'Market Value' and the manner in which this will be determined?	We note that this is a question for commercial and financial consideration but by way of general comment, some more flexibility as to who is to carry out the valuation (e.g. someone other than the auditors provided the relevant parties agree) would be useful. Limb (a) of the definition of Market Value would also benefit from referring to fraud in the carve out, as well as manifest error. In terms of limb (c), having all shareholders in agreement before any directions can be given to the Valuers may prove stifling and ultimately restrictive in terms of how such process is to proceed. This could perhaps be limited to majority shareholders but given the gravity of the issues at large, it may be sensible for each of the shareholders to agree the mechanics prior to financial close to reflect the different concerns of the equity make-up of that particular project.
Board of directors (SHA Clause 5 and Art 3 to 8)	
10. What are your views on the proposed arrangements for nomination and composition of the Board of directors? If you disagree with the proposal, please suggest an alternative structure and give the reasons why you regard this as preferable.	This is a commercial issue but the arrangements seem much more practical and straightforward compared to those seen previously in the BSF shareholders agreement. This is likely to be welcomed. One observation to make on market precedent is that investors may view the cap on three directors as not being appropriate if, for example, an investor holds more than 60% of the shares. Although it is recognised that clause 5.1(e) reflects market precedent, there may well be a practical sponsor difficulty in the implementation of that clause, which effectively ensures that SPV and HoldCo have the same directors at all times. It is recognised that there is precedent for higher threshold to pass certain decisions (in this case board level voting) prior to the expiry of the Lock in Period (as set out in clause 5.5(a)(i)(A)), we expect bidders may have some concerns as to whether this will be appropriate on all projects across all sectors. In particular, to ensure that such a provision can work, the Developer will need to have confidence that each of HMTCo and the Third Party Equity Provider has appointed sufficiently qualified directors.

Question	DLA Piper Response / Comments
11. Do you agree with the provisions relating to the chairman?	These are helpful especially given that the chairman does not have to be an independent non-executive chairman. In practice, the need for an independent non-executive chairman who is effectively an "external" appointment is likely to be determined on the size, complexity and PR-needs of the project. In clause 5.4(b) it would be worth clarifying that the Chairman appointed pursuant to that clause shall not have a vote on either Board or Shareholder resolutions. Furthermore, from a practical perspective given the critical phase of activity following financial close, there may be some sense in allowing the Developer to appoint the initial Chairman rather than HMTCo or the Third Party Equity Provider.
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?	This will be a commercial issue but the principle of appointing an observer should be acceptable in principle particularly given the ability to exclude the observer under clause 5.6(e). However, there may well be some nervousness about who that observer is/where the observer comes from, particularly following any exit by HMTCo as a shareholder. Some comfort (e.g. that they won't be drawn from competitors) would perhaps be welcomed by the private sector.
Reserved matters (SHA Clause 6.2 and Schedule 8)	
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 and explanation for your views.	How appropriate the reserved matters items will be is primarily a commercial issue but some general comments are: • Please see item 18 below regarding potential points of concern regarding "public sector" conflicts of interest. • Some consortia may require that certain decisions are undertaken at shareholder level rather than board level and there may be issues that only "commercial" private sector investors are entitled to vote on - please see item 18 below. • On item D1, it may be useful to have a specified and quantified materiality threshold. • Reserving more administrative/day-to-day matters to the Board instead of the shareholders is preferable, especially given the potential for there to be a number of different shareholders.

Question	DLA Piper Response / Comments
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.	This is largely a commercial issue and although there is precedent for this approach, we note that certain consortia may a) have concerns over public sector conflicts and b) be keen to ensure that certain decisions are made at a pure-shareholder level (rather than as a director at the direction of its appointing shareholder to avoid a breach of directors' duties).
Dispute Resolution (SHA Clause 11)	
15. Please give your views on the proposed dispute resolution arrangements (SHA Clause 11).	The process, particularly given the nature of the joint venture and the investors, seems reasonable, allowing for escalation within each investor's organisation before turning to dispute resolution. It may be that certain investors would find it helpful for mediation to be expressly referred to. That said, experience has shown that there is no "right way" to provide for shareholder disputes. Some sponsors and consortia provide for dispute in a more direct manner and in a way which is more typical of private sector joint venture arrangements (which can result in a shareholder being forced to exit the joint venture) but we recognise such provisions are unlikely to be appropriate in this context.
Loan Stock Instrument	
16. Do you agree that shareholder loan stock should be unsecured?	Broadly, yes although there may be project-specific factors meaning a different conclusion might be appropriate. It is difficult to see the benefit in securing the subordinated debt interests and in general the market practice is to leave such loan stock unsecured. However, we do note that there is some precedent for securing loan stock albeit it was for the narrow instance of BSFI requiring security in relation to LEP loan stock so as to mitigate its exposure to non-PFI FM risk. However, it should be noted that this position (where one investor has security but the others do not) would be problematic for other investors and most likely would lead to delay and potentially re-pricing of risk.
17. The Bidder incurs costs and risk in bidding for a PF2 project which are not borne by equity investors who make their 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	We note that this is largely a financing/commercial question.

Question	DLA Piper Response / Comments
this be structured? In particular, do you think a higher interest rate on loan stock is an appropriate mechanism?	
Other Issues	
18. Please comment on any other matter which you regard as important in connection with equity investment in PF2 projects by the public sector.	• We suspect that a key point that the private sector may be concerned about is a perceived conflict of interests in the way that HMTCo may operate. In particular bidders may have queries as to whether HMT will act as a "commercial" equity investor or whether it might side with the procuring authority where it suits a more general public sector position e.g. if the other shareholders would like to call an "Authority Default" under the Project Agreement. We would, therefore, expect that the private sector investors would require another class of "Reserved Matters" to be incorporated (which could be termed "Commercial Reserved Matters") where the entities entitled to vote would be the private sector investors (i.e. excluding HMTCo). In this context private sector investors could include any private sector entity that HMTCo may transfer its share to. Clause 6.5 may also needed to be updated in this context. • The above would also help address a concern that certain consortia prefer that specified key matters be determined at shareholder level rather than director level. • Inclusion of approved/sanctioned drafting and guidance in relation to the ability by investors to transfer to their related investment funds during the Lock in Period would be helpful. We note that there are various formulations of drafting that HM Treasury (through PUK or IUK) have previously approved but it would be helpful to have a market-wide precedent for consistency. • Under clause 9.7(b), it would be helpful to include the usual market-accepted carve-outs to allow for transfers during the Lock in Period in relation to the Developer such as stock exchange movements, transfers to specified investment funds etc. • It is noted that under the terms of the Loan Note Instrument (Condition 4) repayment on default will be on an "Indebtedness" basis (i.e. principle plus accrued interest) but some consortia seek to link this amount to a more "Spens"-style formula which is pegged to gilt rates. It would be useful if this was a point that could be discussed on each procurement depending on the equity funding solution provided for by bidders.

Consultation on the terms of public sector equity participation in PF2 Projects

A response from Galliford Try Investments

About the respondent

Galliford Try Investments in conjunction with Galliford Try Construction and Galliford Try FM is an active and significant player in the PFI market; our first successful close was in 1999.

We have invested and closed 29 projects with a capital value of £2billion principally in education, health, accommodation, affordable housing and extra care, highways, waste and community facilities sectors. We have invested in all projects, built the majority of schemes via Galliford Try Construction, provided concession management directly through Galliford Try Investments and prefer to use Galliford Try FM during the services phase.

The response below follows the chronology of section 7 of the "Consultation on the terms of public sector equity participation in PF2 Projects" questionnaire.

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?

Answer 1: The investment appraisal process being undertaken independently of the project procurement and by the objective Treasury PF2 Equity Unit is positive. This approach should ensure a consistency across projects and provides clarity to the procuring Authority that the investment return available to the public sector should form no part of the bid evaluation criteria.

It is unclear from the consultation document if the prescribed information (‘PF2 Equity Bid Information’) provided by bidders as part of the due diligence process will be subject to the same procurement parameters as the project. We would wish to understand if the information will be treated in confidence or shared with other parties during the bidding stage.

We note that no participation of external advisors is required in the procurement process until the selection of a preferred bidder. It is our interpretation that this may cause some difficulties if a number of bidders choose to involve advisors whilst others do not. A bidder without external advice may later be forced to change a negotiated position upon taking relevant external advice and an early involvement of external advisors may eliminate such potential issues.

The due diligence requirements prior to the preferred bidder stage appear acceptable given the nature of the investment involved. At the preferred bidder stage it is noted the bidder will be required to

provide a Due Diligence Memorandum and the financial model with certain sensitivity scenarios to the base case. The requirement for additional deliverables such as a formal Due Diligence Memorandum will require additional time and cost from the bidder and their advisors. It would be our expectation that the cost of providing the Due Diligence Memorandum is recoverable from the project.

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.

Answer 2: Any information sharing between bidders and the Treasury PF2 Equity Unit would be considered positive; further it would be beneficial if a formal and standard information sharing or clarification process was established. It would be extremely beneficial to know at an early stage in the process the level of equity to be retained by HMTco and the level to be offered to the third party equity provider.

When structuring investment in projects of key focus is how the results of the project company are consolidated within our wider corporate group. The proportion of voting rights and the control of the company this gives is a key part of our consideration, due to the nature of our accounting policies. In order to manage this element of the process we feel it would be extremely beneficial if we could also offer a share of the Developer Equity for sale at the preferred bidder phase. This could be done as part of the Third Party Equity competition or outside this process but would allow the Developer to manage and structure the investment to best meet their specific investment criteria, no matter the final levels of equity to be retained by HMTco and the level to be offered to the third party equity provider.

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

Answer 3: We have no objections to disclosure of the Transparency Information.

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)?**

Answer 4:

- a) A funding competition held for third party equity at the preferred bidder stage of the project is something we would accept in principle. As previously detailed early knowledge of the amount of equity involved in such a competition and the ability to auction off an element of the remaining Developer equity as part of this process would be welcomed.

The rationale for such an approach is a key concern we would have over this arrangement in that the true cost of a bidder's equity will not be known until post the preferred bidder announcement. If one bidder was able to attract cheaper third party equity than a competing bidder, this competitive advantage would not form part of the evaluation process. If the winning bidder had an obligation to run, evaluate and document the third party equity competition it would be the expectation that the cost of administrating this process could be recovered from the project.

Our experience of third party equity providers is they are attracted to transactions where they have a controlling interest in the project company and the investment they can make is of significant nominal value. For these reasons holding a third party equity competition for a non controlling interest in a single project even at the preferred bidder stage may not achieve the most optimal competition. Demonstrating a significant pipeline of future projects would be vital to attract competition or considering undertaking a programme wide competition for the entire third party equity rights may offer more optimal results.

b) We are comfortable with the provisions for equity reduction in relation to HMTCo.

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.

Answer 5: Working capital generally should not be required apart from as identified in clause 4.5 of the SHA which notes a requirement under framework type contracts. In our experience Senior Funders rarely require a firm commitment for working capital. If a working capital commitment is required and subject to the project specific nature of such a requirement we consider the Developer should not necessarily be the sole source of this funding.

The reason we consider this to be the case is that it may put the shareholders unnecessarily into a conflict situation whereby the party who is not financially exposed naturally considers additional investment to be correct whereas the party with the sole financial liability considers an additional investment may not resolve the particular issue. In a shareholder arrangement we believe the risk profile should generally be the same for all who invest.

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)?

Answer 6: Yes we agree with the approach to stapling. We note from the consultation process that the subordinated loan notes will be provided directly from the Developer to the Projectco and not through the Holdco. This will result in the project senior lender taking a charge over the loan notes

provided directly by the Developer. Such a structure has the ability to cause, in our particular circumstance issues with our corporate lenders and may result in a further holdco, which is a wholly owned subsidiary of the Developer. This additional administration could be avoided if the loan notes were invested into the Holdco and then on lent back to back by the Holdco to the Projectco.

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

Answer 7: The pre-emption provisions included at Clause 9 of the Shareholders Agreement and clause 11 through to 15 of the Articles of Association appear standard for transactions of this nature. We note and accept that the transfer rights of the Treasury PF2 Equity Unit are extremely wide. As noted in our response to Question 2 and Question 4 we would welcome the ability to freely transfer an agreed proportion of Developer equity (without pre-emption) at the preferred bidder stage.

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

Answer 8: The event of default and deemed transfer provisions appear acceptable. We do have a concern that as a result of a corporate takeover there is a potential pitfall in that the Developer shareholder could become an Unsuitable Third Party. If this occurred during the Lock in Period the ability to sell in order to protect the value would not be available.

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

Answer 9: We have no comments on market value or the manner in which it is to 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.

Answer 10: The proposed composition of the board and the nomination process for the Board of Directors is a satisfactory proposal in our opinion.

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

Answer 11: The provisions in relation to the chairman are acceptable, in the event it is decided on a specific project to appoint an independent chair we would assume the job description, conditions of employment, duties and the selection of the chairman are to be agreed between the shareholders.

In relation to the cost we assume an independent chairman, if required, would be agreed in advance

of selection of preferred bidder so that all bidders allow for the cost. If a requirement is established during the execution of the project which had not been allowed for in the original financial model, this may have the potential to cause dispute between the parties, is it better for the position to be agreed at the outset.

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?

Answer 12: We have no objections with the proposed arrangement for an observer.

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.

Answer 13: We consider the reserved matters list to be generally acceptable and envisage minor changes in order to capture project specific matters.

We would also expect to see specific board policies for example health and safety to be agreed annually, this type of issue is probably better addressed in the Business Plan, which we would anticipate will contain the detail.

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.

Answer 14: Due to the specific nature of our business which is equity provider, contractor and facilities management provider we are concerned that in situations of conflict and more specifically a conflict of a construction or facilities management nature, the Developers directors and Material Shareholder will always be excluded from the decision. We appreciate this issue has been addressed in part by allowing the relevant director to declare a conflict and the non conflicted shareholders can approve the conflict and feel this has given a level of comfort.

Would the idea of pre authorised conflicts in this particular instance be considered? As we perceive we may be unnecessarily disadvantaged compared to an equity led bid due only to the nature of our business.

Dispute resolution (SHA Clause 11)

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

Answer 15: The dispute resolution process is similar to arrangements we are familiar with. We feel careful consideration should be given to business's in our particular situation as being an equity provider, contractor and FM provider it may be argued in the escalation process that the shareholder relevant MD/CEO are conflicted in the same way as the director which could automatically lead to a legal judgment this may not be in the best interest of any party.

Loan Stock Instrument

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

Answer 16: We would be comfortable investing if the loan stock is 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?

Answer 17: It is our belief that the greater risk that the Developer equity provider assumes by bidding the project should result in a differential return compared to a Third Party Equity provider introduced to the project at the preferred bidder stage. Structuring a differential return through different loan stock coupon rates would be acceptable to us as an investor if the interest compounded regularly and ranked pari pasu. This may be difficult to achieve if it resulted in intercreditor issues, uncertainty over ranking of payments and possibly doubt over the deductibility of the interest for tax purposes.

We would support the differential return being paid as an arrangement fee on financial close which was only paid to the Developer equity provider who has assumed the bidding risk of the project. This will be subject to the senior lenders approval.

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.

Answer 18: What we would welcome is any further initiative to keep bid costs to a minimum which we consider would also ensure a higher bidder participation in the market. Minimising bid costs and procurement times will also result in reducing the return differential between Developer and Third Party Equity returns. A visible future pipeline would also inspire confidence in the market sustaining current interest levels and attracting new entities into the sector.

Hermes GPE

Hermes GPE's responses to a new approach to public private partnerships:

Consultation on the terms of the public sector equity participation on PF2

21 August 2013

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?

1. The Treasury PF2 Equity Unit's proposed investment decision-making process creates a cost free option for the public sector without the discipline that follows from participating in a competitive process and underwriting bidding costs according to prospective equity shares.
2. Lack of certainty regarding the public sector's equity participation in the project will add to the moving parts which are inevitable in any competitive process. Lack of certainty discourages private sector participation and/or may increase the price of bids as potential bidders evaluate the project and the risks and rewards of entering into the competition.
3. Bidders will be obliged to fully fund bids and participate in the full competitive process with the additional risk that their equity participation may be scaled back at the option of the public sector. This runs the risk of reducing the ability of projects to attract private investment and perversely may increase the cost of equity as the private sector investor seek compensation for the additional bidding risk.
4. Will HMTCo be separately advised on the SHA and associated investment documentation? If so please clarify the relationship between these advisors and the bidding consortium's advisors generally. Bidders will wish to avoid duplicating legal advice on project documents and second guessing of advice generally.
5. How will information flows between the Treasury PF2 Unit and the Authority be regulated during the bidding process? Bidders will be concerned at the possibility that due diligence information passed to the Treasury for investment evaluation purposes may be passed to the Authority in connection with project evaluation. Will the Treasury PF2 Unit sign up to a market standard NDA? Consortium members will be concerned that their approaches to pricing, risk and bidding tactics on a project may be shared even inadvertently, with other Authorities on later projects.
6. Confirm that the intention of clause 13.7 of the SHA is to exclude any warranties in respect of due diligence information (specifically in respect of preliminary appraisal information) by consortium members in favour of HMTCo.
7. It would be helpful if the Treasury, in the relevant project information, indicated:
   - Whether it had an in-principle interest in making an investment (so as to help mitigate against fishing exercises) and the reasons
   - That it will communicate with bidders reasonably simultaneously and on the same terms and that any information given to one bidder will be shared with all others
   - That it will comply with the Authority's bidding timetable for decision making
   - That it will notify bidders immediately if it resolves not to take up any equity
8. Generally, the private sector will welcome the Treasury's views on how the logistics of its participation will be managed so as avoid inefficiencies during the bidding process.

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.

In general yes but see above comments in respect of added uncertainties and need for

commitment on confidentiality, timing of responses and decision making.

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

No objection in principle. The short hand language used in SHA Schedule 7 (Transparency Information and Commercially Sensitive Information) requires drafting refinement to ensure that such information is identified precisely.

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

a) Equity funding competition post appointment of preferred bidder?

As a prospective long term investor in PF2 projects we welcome developments designed to reduce costs of participating in projects at an early stage and to ensure a level playing field for financial investors to take up project equity. However, we are concerned, for the reasons described under 1. above that lack of certainty around the public sector's intention to participate in project equity may compromise the value of the equity competition. Generally, as indicated under 18. below, we are principally concerned with the inevitable conflicts of interest which arise as a result of the public sector acting as both procuring Authority and equity investor and will need reassurance regarding those conflicts before contemplating participating in such an equity funding competition. We also note that whilst a funding competition mitigates against the extended bidding risk it does not address construction risk.

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

We do not, as a matter of principle, agree that the public sector investor should be subject to a more relaxed sell-down regime than the private sector and query the need for the Lock In Period to be subject to public sector specific exceptions (save in the case of a funding competition where the public sector is effectively acting as a bridge equity funder).

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.

Our general position is that all funding should be sought as cost efficiently as practicable determined on a project specific basis and that the public sector should generally avoid being prescriptive in such commercial areas. There may be good reasons why the Developer may be best placed to provide working capital funding (for example if efficient working capital management will be assisted as a result) but other sources of working capital (including senior bank debt) may be attractive.

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)?

Agreed.

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

In principle agreeable. Our preference, as a long term investor, is for the grant of a right of

first refusal rather than a right of last refusal which may affect liquidity.

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

In principle agreeable.

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

None.

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.

Generally agreeable.

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

Yes. Our preference is for the appointment of an independent chairman particularly where the Project Company is owned by multiple investors with differing investing outlooks (developer, public and financial). However, we acknowledge that not all situations require or justify the additional cost of such an appointment and that the question should be addressed on a case by case basis.

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?

Whilst in principle we have no objection to the appointment of an HMTCo Observer the consultation does not always clearly differentiate between the role of the Authority Observer and the HMTCo Observer. As we are of the view that most (if not all) of the public sector's information requirements could be legislated for under the Concession Agreement (or equivalent) and exercised by the Authority (with Treasury assistance where required) we do not agree that the HMTCo Observer should continue in place post HMTCo equity exit.

Where an independent chair is appointed we would prefer for the chair to manage the participation of Observers and believe that the chair's discretion in relation to the Observer's disclosure, conflicts and commenting only where invited to do so by the chair, should override the SHA.

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.

We are generally agreeable to the proposed regulation of Reserve Matters and Reserved Matters Board Approval provided that clause 6.2 of the SHA (which is predicated on the approval of Material Shareholders and Directors appointed by Material Shareholders) is correct and that the reference to unanimity as described indicated in paragraph 5.9 of the consultation is not intended. Please note that the definition of "Shareholder" should be limited to Shareholders for the time being and not necessarily include the parties to the Agreement

(who may subsequently cease to be Shareholders) in all circumstances.

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.

Subject to providing for an emergency situation requiring an urgent decision in the interests of the Company (possibly determined by the independent chairman where one is appointed) then we do believe that the proposed arrangements will be practicably workable.

Dispute resolution (SHA Clause 11)

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

None at this stage.

Loan Stock Instrument

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

Agreed.

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?

We expect bid costs to be funded through the Financial Model and therefore financed out of initial capital and loan stock subscriptions. An appropriate share of such costs will therefore be reflected in the price of equity and loan stock subscribed by the equity investor. The pertinent issue is risk (of aborted third party advisor costs, the cost of internal resources and consortium member opportunity costs) which we believe that the original bidding consortium should reasonably be compensated for. We do not believe a differentiating return necessarily achieves the optimal outcome as:

- it is subject to project performance where the risk has been taken upfront (including under senior debt lock-up ratios);
- it creates additional complexity; and
- breaches the principle of equality of treatment for all investors which is our preferred approach (and which is consistent with the approach taken elsewhere in the consultation).

Our preferred approach is for the later equity investor to pay a premium for the purchased equity and loan stock (if acquired) from the original investors and/ or by way of opportunity fee, in each case calculated as percentage of bid costs as an approximate albeit imprecise proxy for bidding risk.

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.

Why does the public sector investing alongside the private sector create closer alignment between the two where, with the objective of managing conflicts, public sector equity will be managed entirely separately from the Authority? Realistically, how will the alignment of interest between the public and private equity investors affect the alignment (or lack of alignment) of interest between the project company and the Authority? The implication that greater alignment between public and private sector interests generally will be achieved as an inevitable consequence of the public sector investing is, we believe, an over-simplification of the case.

Whilst it is of course reasonable for the public sector investor to expect to earn a return on its investment commensurate to the return earned by the private sector, including on exit, the consultation statement (paragraph 1.2) that public sector value for money will necessarily be enhanced as a result is an over simplification which ignores the wider potentially negative value for money implications of the public sector investing (such as the extent to which forecast exit values have previously subsidised project equity IRRs in bidding scenarios and the potential value destructive consequences of the resultant conflicts of interest).

Profits realised as a result of the arbitrage available in the secondary market for PFI projects have had little to do with operational outperformance or the favourable mispricing of risk. The exit “value” of a PF2 project is primarily a relative one determined by reference to “risk free” returns. If this is correct then the critical issue is not the availability of asymmetric information concerning project financial performance but the public sector’s lack of market intelligence regarding the relative value of project cash-flows in the secondary market. Whilst the public sector investing alongside the private sector will ensure that the public sector will benefit from the arbitrage in the same way as any other investor it does not necessarily address the issues that the consultation purports to address.

Our principal concern remains the management of public sector conflicts of interest. It is challenging for us to reconcile how a Treasury investor can reconcile maximising value for its shareholding (and an appointed Director acting in the best interests of the Company) with the interests of the procuring Authority. The lack of clarity over information flows between the Treasury investor and the Authority and the broadly defined Transparency and Commercially Sensitive Information accentuate this issue. As indicated in the response above we do have any objection in principle to full transparency but we are concerned about the information will be used in practice and to what extent the actions of the Treasury investor will be compromised by the wider public sector interest. Our fiduciary obligation to act in the best interests of our investors is clear.

HOCHTIEF

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20/08/2013

Consultation Questions

Q1	**Please give your observations on the proposed investment appraisal and due diligence arrangements?**
	The proposals for due diligence prior to appointment of PB seem sensible and pragmatic although much will depend at the level of detail required by the "PF2 Equity Bid Information" which is yet to be published and may vary from project to project. Following selection of PB and in the run up to financial close it would appear that the focus of DD is restricted to the equity and other finance documents with reliance being placed on the "Due Diligence Memorandum" for the remaining elements of the project. Whilst every effort should of course be made to ensure that any DDM is as comprehensive as possible there should be no expectation that the warranty to that effect will be sought from the Developer or other shareholders (the only warranties between shareholders being those set out in clause 10 of the draft SHA). All the shareholders must invest on an equal footing, with all parties doing so with an equal knowledge (or deemed knowledge) of the projects' risks and rewards. With regards to the methodology for investment appraisal; whilst it is right that this should be undertaken independent of the Procuring Authority, it is important that decisions are made as early as possible in the bid process. Bidders/ developers need to understand what proportion of equity is available to them to allow them to undertake their own investment appraisal prior to committing or incurring considerable bid costs.
Q2	**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.**
	We expect any such guidance will be helpful, however until it becomes available in practice we cannot comment further.
Q3	**Do you have any objections to disclosure of the Transparency Information? Please give reasons for any objections.**

	We have no objections in principle to the disclosure of Transparency Information as currently defined and set out in the draft SHA.
Q4	**What are your views on the following arrangements to promote new equity investors?**
	a) Equity funding competition post appointment of preferred bidder?
	Before deciding to bid any PPP project bidders must consider the "at risk" cost of bidding (commonly between £500k and £1000k) relative to the potential returns they might expect if successful. Where an equity funding competition is proposed, it will be very difficult for bidders to accurately complete this assessment as their potential share of the investment and the rate of return they can expect on the investment will be affected by the outcome of the funding competition. It seems inevitable that bidders will be forced to accept the equity funder with the lowest return expectations and that the public sector will expect the bidder to match those returns. This will have the effect (over time) of an irrepressible downward pressure on the returns for bidders and developers towards levels currently associated with secondary market transactions. Unlike the secondary market situation, where the principle project risks have expired, bidders will still retain the full project risk liability and significant bid cost risk, at a greatly reduced return. Whilst this will undoubtedly achieve the government's goal of reducing the level of investor returns, it will either force an element of the current bidding fraternity to gain their return expectations elsewhere in the project, or to look outside the UK for more attractive opportunities. We believe that this proposal is a significant disincentive to bidders.
	b) Reduction in HMTCo equity post financial close (either during the Lock in Period or thereafter)?
	We have no objection to HMTCo selling its shares post financial close. They invest on the same basis as other shareholders and should be entitled to dispose of or transfer that investment just as freely.
Q5	**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**
	Unlike previous BSF projects wherein there was a requirement for the LEP to be funded through Working Capital Loans from its shareholders, there is generally no requirement for any Working Capital loans within either the SPV or HoldCo. Project Co's Working Capital requirements are managed within the cashflows of the financial model. This is met in the construction period from equity (including shareholders loans) and senior financing loans and during the operational period from the unitary charge etc. The circumstances under which shareholders would be called upon to inject further capital to ProjectCo are extremely limited and would only be likely to occur at times of project distress. In the unlikely event of this being necessary all shareholders should be treated equally
Q6	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)?

Q15	
	We have projects where shares and loan stock are stapled and we have projects where they are not. Both approaches have their respective advantages and disadvantages. We have no strong views for either approach and therefore no objection to the proposed stapling.
Q7	**What are your views on the pre-emption provisions?**
	The pre-emption provisions in the draft SHA appear to conform to market norms and as such we have no comment.
Q8	Do you agree with the event of default and deemed transfer provisions?
	The default and Deemed Transfer provisions in the draft SHA appear to conform to market norms and as such we have no comment.
Q9	Do you have any comments on the definition of 'Market Value' and the manner in which this will be determined?
	We have no comments on the definition of Market Value.
Q10	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.
	The proposals for the nomination of directors and composition of boards seem sensible and pragmatic and the footnote 9 allows sufficient flexibility to deal with projects' specific circumstances.
Q11	Do you agree with the provisions relating to the chairman?
	In our experience the requirement for an independent Chairman is impractical it also adds costs and offers limited benefits. We feel that the board is best chaired by a director on a rotating basis as per clause. 5.4 (c) of the draft SHA.
Q12	Regarding the appointment of an observer, do you have any objections regarding the proposed arrangements (a) when HMTCo is a shareholder and (b) thereafter?
	We are used to having public sector observers at our BSF board meetings (even if they do occasionally have to be reminded of their status at that meeting) and so have no objections to the proposed arrangements.
Q13	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.
	We have no comment on the draft list of reserved matters.
Q14	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.
	We have no comment on the provisions of Clause 6.3 of the draft SHA, however we consider that the provisions of clause 6.5 need to be extended to provide for the analogous situation in the event of the SPV having a claim against the Authority or other body within the HMTCo Group (or vice versa), wherein the HMTCo Director and any observer should be similarly required to "step aside".
Q15	Please give your views on the proposed dispute resolution arrangements (SHA Clause 11).

	We are content with the dispute resolution provisions in clause 11 of the draft SHA, except in relation to the final sentence of clause 11.4 regarding deemed consent. We believe this provision should only be applicable where parties have agreed in advance that the expert's decision will be binding.
Q16	Do you agree that shareholder loan stock should be unsecured?
	We agree it is normal market practice for shareholder loan stock to be unsecured.
Q17	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
	As per our response to Question 4 (a) above we believe that bidders cost and risk of bidding PF2 projects need to be properly reflected in the returns they can expect to make if successful. We have not yet considered how this would be achieved, nor if a differential rate of return would be practical. We look forward to exploring these considerations with procuring Authorities and HMTCo in due course.
Q18	Please comment on any other matter which you regard as important in connection with equity investment in PF2 projects by the public sector.
	No further comments

21 August 2013

Our ref: ICAEW Rep 110/13

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Dear sirs

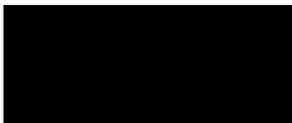
A new approach to public private partnerships: consultation on the terms of public sector equity participation in PF2 projects

ICAEW is pleased to respond to your request for comments on *Consultation on the terms of public sector equity participation in PF2 projects*.

ICAEW has a keen interest in the range of skills that are required to deliver successful public private partnership programmes. We would be delighted to provide assistance to HM Treasury to ensure that the public sector can access the right mix and balance of skills that are required from the start, ie at feasibility stage, and throughout the lifetime of a project.

Please contact me should you wish to discuss any of the points raised in this response.

Yours faithfully



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ICAEW REPRESENTATION

A NEW APPROACH TO PUBLIC PRIVATE PARTNERSHIPS: CONSULTATION ON THE TERMS OF PUBLIC SECTOR EQUITY PARTICIPATION IN PF2 PROJECTS

Memorandum of comment submitted in August 2013 by ICAEW, in response to HM Treasury's consultation paper, *A new approach to public private partnerships: consultation on the terms of public sector equity participation in PF2 projects*, published in July 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Consultation on the terms of public sector equity participation in PF2 projects* published by HM Treasury on 10 July 2013, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Corporate Finance Faculty is the voice of corporate finance within ICAEW. The faculty is responsible for submissions to regulators on behalf of ICAEW. It provides a range of services to its members including a monthly magazine *Corporate Financier*. Members of the faculty, a network of some 6,000 corporate finance professionals, have contributed to this response.

5. ICAEW's international capacity building work involves close working with counterpart bodies, financial regulators and governments in developing countries to strengthen the institutional capacity and the capacity of the accounting profession. We now have undertaken more than 20 projects in Asia, Africa and Europe. Recently the UK Foreign and Commonwealth Office approved the funding of a joint ICAEW-Myanmar Institute of Certified Public Accountants project. This project will involve the development of a strategic plan for strengthening the accountancy profession in Myanmar and delivery of training and workshops on international standards, audit quality assurance and professional ethics.

MAJOR POINTS

Support for the initiative

6. We are supportive of the government's policy to invest equity in PF2 projects. As set out in our response to the recent European Commission green paper on long-term financing of the European economy, we believe there is a role for greater involvement by institutional investors in the provision of long-term capital goods such as capital projects and public sector equity participation can help attract institutional interest. We would be interested to understand who HM Treasury considers is a potential third party equity investor, how it has assessed such investors' ability to appraise and evaluate participation in this asset class and what the implication of this will be on the required return. If, after public sector participation, the size of the stake in PF2 projects is likely to be small this may not be attractive to many long-term investors and, to address concerns such as this, it would be important for that assessment to be disclosed.

7. The primary objective of public sector equity stakes could be more explicit: is it to reduce the cost of equity or to widen the pool of equity investors who will invest in PF2 projects?

8. Other aspects of the government's policy also remain uncertain, such as the type of projects the public sector might take an equity stake in or on the grounds for not participating. The basis for the government deciding to reduce or sell its investment is also not clear (see our response to Question 1). Clarity on the objective of the observer role would also be welcome;

for example, is it to protect the public interest at a local, or a national level (see our response to Question 12)?

9. We believe that the process for encouraging third party equity investment could be simplified so that one process is in place for the public sector and other third parties to bid (see our response to Question 4).

10. We question whether the public sector can be considered to have equal shareholder status if it cannot be called upon for additional working capital or shareholder capital (see our response to Question 5).

RESPONSES TO SPECIFIC QUESTIONS

General considerations

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

11. The proposed investment appraisal arrangements lack the high-level criteria or reference to policies that we would have expected to see. The consultation paper does not elaborate on the type of projects the public sector might take an equity stake in or on any grounds for not participating. There is no indication of how the level of public sector equity participation will be determined or of the basis for a reduction in or sale of the public sector's stake. Prospective bidders would reasonably expect to understand such details in the investment appraisal.

12. Regarding the proposed due diligence arrangements, we believe that if the Treasury PF2 Equity Unit communicates its needs upfront it might generally rely on the primary equity providers to incorporate those needs in the scope of their due diligence. This would be preferable to the Treasury PF2 Equity Unit repeating work that has already been undertaken. We would be happy to discuss how we recently supported a government department and third party due diligence providers with determining the scope of due diligence.

13. We also find certain elements of the proposed diligence arrangements unhelpfully vague. For example, bidders will be interested to know the minimum documents that the Treasury PF2 Equity Unit will expect to see during due diligence. Moreover, once the documents are available, what timetable will the Treasury PF2 Equity Unit commit to for providing an decision on whether it will invest or not? The pace of this decision may be a factor influencing the provision of third party equity investment.

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.

14. We refer to our answer to Question 1 which sets out areas that should be addressed in any guidance.

15. Arrangements for giving informal guidance during procurement may be of some benefit to bidders. Such arrangements should not, however, provide a basis for potential procurement challenges which could be the case when such guidance is separate from the dialogue with the Authority.

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

16. We agree that transparency of information is a key principle for successful joint ventures and for enhancing the parties' understanding. However we would be concerned if transparency in this case could mean making commercially sensitive information available to the public, including to competitors. For instance, we don't think that the equity backers of losing consortia should be entitled to full details of the winning bid.

17. On a related matter it is important to ensure that appropriate skills exist within HMTCo to be able to analyse the Transparency Information and assess the performance of the investment. In its contribution to the call for evidence on reforming the Private Finance Initiative, ICAEW commented on the need to learn lessons from the absence of capability and skills in PFI projects such as the Highway Agency's project to widen the M25 and the Ministry of Defence's Future Strategic Tanker Aircraft project. The project management skills and financial capabilities required for successful set-up and delivery of public private partnerships, such as future PF2 projects, need to be in place from the feasibility stage and throughout the lifetime of the project.

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)?

18. We wonder whether HM Treasury has considered the option of all interested investors, including the public sector, being invited to bid simultaneously for their desired level of equity as an alternative to the proposed process whereby a third party equity investment competition would follow the public sector stake. We would like to understand the perceived advantages of the proposal, in particular as the first option would be quicker and would avoid the risk of delays and late variations to the terms which would have an impact on the timeframe.

19. Regarding a), we believe that the intention to provide the same due diligence information as that provided to the Treasury's PF2 Equity Unit, while appearing cost efficient, will not avoid altogether extra costs from running a competition and may not be acceptable to bidders, eg if other PF2 competitors are approached.

20. Regarding b), we believe that the basis for HMTCo deciding to reduce or sell its investment should be made clear and consideration made of the resulting governance implications (observers having to deal with changing directors). Clarity on the primary objective for public sector equity participation in PF2 projects, as we suggest in paragraph 7, would be helpful on this point.

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.

21. The proposed terms provide that the public sector would not be required to provide additional funding such as shareholder loans and working capital for the ProjectCo. We are not persuaded that equity investors or Senior Funders should not provide working capital. As a co-investor in a project on the same terms as the private sector, the public sector should be prepared to have exposure to the downside if a project gets into difficulties and this risk will influence the investment appraisal. In this context we disagree with SHA Clause 4.2(a).

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)?

22. We agree.

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

23. We agree with the provisions.

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

24. We agree with the provisions.

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

25. We have no comments.

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?

26. We broadly agree with the proposed arrangements for nomination and composition of the Board of directors although we observe that a 15% shareholding is a low limit to warrant the right to nominate a director. A odd number of directors is likely to be necessary as the chairman has no casting vote and there are situations where a majority of votes are required for a decision (SHA 5.5(a)(i)(B) and SHA 5.6(d) and (e)).

27. We would be pleased to discuss how ICAEW might help the public sector to promote understanding of the responsibilities and duties of directors of special purpose vehicles (SPVs) to ensure effective governance.

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

28. We agree.

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?

29. We support the principle of appointing an observer which will help the sharing of good practices across projects. Subject to further clarity on the objective of the observer role (see paragraph 8) we consider that, in recognition of the procuring Authority's continuing interest in the lifetime of the deal, it would be preferable for the Authority to have the right to nominate the observer, in consultation with HMTCo.

30. Regarding the proposed exclusion of the observer where conflicts of interest arise we recommend that appropriate safeguards are implemented to prevent the risk of arbitrary exclusions, such as circumstances where an observer might be most needed. The terms could, for example, indicate the circumstances in which the Board might exclude an observer so that this can be taken into account when nominations are being considered for the post.

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.

31. We believe that the proposed provisions should be consistent with best practice as set out in guidance issued in March 2010 by HM Treasury for public sector bodies forming joint ventures with the private sector.

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.

32. We have no additional comments.

Dispute resolution (SHA Clause 11)

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

33. We believe the proposed arrangements are reasonable.

Loan Stock Instrument

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

34. We wonder whether HM Treasury has considered securing shareholder loan stock behind the Senior Funders.

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?

35. It would be reasonable to expect equity investors to contribute towards the bidding costs and other risks borne by the Developer. However we have reservations about achieving this via differential rates of return to loan stock of the same class. Less complicated ways of compensating the Developer for bid risk would include a contribution on market entry by investors to the bid costs and the Developer invoicing the SPV. It could also be left to the parties to negotiate how to compensate the Developer.

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.

36. We note that the proposals for investment appraisal by the Treasury PF2 Equity Unit and decision-making by HMTCo's Board participation will potentially result in the concentration of skills and knowledge within Treasury. It will be important to ensure that the aims of public sector equity co-investment, such as visibility of project information, improvements to partnership working and greater involvement in strategy, will not be benefits that accrue solely to the Treasury but can be shared across the public sector.

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HM Treasury consultation on the terms of public sector equity participation in PF2 Projects
A response from The Infrastructure Forum

1. THE INFRASTRUCTURE FORUM

1.1 The Infrastructure Forum (the "Forum") was established by European Policy Forum to provide a centre for research, study and dissemination of materials on the cross-sectoral issues which arise in the development of the UK's national infrastructure.

1.2 The Forum works in parallel with the public and private sector members, and seeks to establish a powerful reputation as a source of high level research, policy proposals and networking on issues concerning Britain's economic regulators and competition authorities.

1.3 Click here to view website www.infrastructure.cc

1.4 This response has been co-ordinated on behalf of the Forum's Social Infrastructure Working Group by Andrew Briggs, a Partner of Hogan Lovells Infrastructure Project and Public Finance Practice.

2. THE NATURE OF OUR CONSULTATION RESPONSE

2.1 We note and have considered the detailed issues and consultation questions set out in HM Treasury's document: "A new approach to public private partnerships: a consultation on the terms of public sector equity participation on PF2 projects" (the "consultation document").

2.2 Many of the detailed issues raised by the consultation document are matters of commercial preference, particularly for the private sector members of the Forum. The nature of the Forum's membership means that we do cannot present a common consensus on all those matters of detail.

2.3 In general, our membership is strongly supportive of closer and more effective partnering between public and private sectors, in all procurement tools employed by the UK Government to enhance the UK's national infrastructure. PF2 is no exception. But in striking the right balance, the policy aims of the public sector need to be measured against legitimate commercial interests of private sector investors.

2.4 Against this background, there are a number of common themes, relevant to both public and private sector participants, that can be drawn from our members views and we set those out below.

3. OUR RESPONSE

3.1 Early stage third party equity

(a) We do not think it helpful to discourage "third party equity" from being part of bidding consortia during the early stage development of a PF2 project. We say this for two reasons:

(i) Experience tells us that third party equity brings a level of rigour to project risk analysis and a degree of sophistication to the financial engineering of a PF2 bid that is not always achieved by an industrial contractor/sponsor alone. It would be unfortunate to lose the benefit of this input during the critical early shaping of PF2 solutions; and

(ii) It will be difficult for contractors to provide the required 100% equity coverage alone – even if the risk of there being no third party equity interest is low.

(b) The risk-reward assessment between bid-cost management and the quantum of available equity investment is finely balanced. If the potential for final investment is reduced, we are told that fewer third party equity investors will be inclined to participate in the early stage project development.

(c) We have concerns that the process to compete third party equity will not bring new players to the market – but rather will shift the participation of those investors currently active in the PF2 market from early stage to the equity competition phase. The level of resource required for direct investment and the size of the current visible PF2 programme will most likely mean that those financial institutions that currently invest through intermediaries (typically infrastructure funds) will continue to do so – whether as part of a pre-agreed consortium or through a project specific funding competition.

3.2 **Process evaluation and due diligence requirements**

(a) Greater clarity could be provided as to the basis on which the Treasury PF2 Equity Unit ("HMTCo") will assess proposals and make its investment decisions and run the equity funding competition. If third party equity is discouraged from early participation, this lack of clarity later in the process exacerbates the funding risk borne by contractor sponsors and risks delay and cost in the process.

(b) The manner and extent of the HMTCo's proposed due diligence requirements are inconsistent with current market norms. They will add to the bid-cost burden on bidders. We do not agree that the benefit to the Unit of their proposed approach outweighs the likely additional use of resource.

(c) We understand that a standardised approach to shareholder documentation will facilitate a third party equity funding competition (because each bidder will be familiar with its position if successful). But on balance we consider it unnecessarily restrictive for HMT, as a minority shareholder, to impose the full extent of the governance regime on its majority shareholder private sector partners. Each private sector partner will have its own preferred approach to matters of share ownership, which should be respected.

3.3 **Transparency information**

(a) We support an approach that encourages greater transparency between public and private sectors. Equally, we acknowledge the extensive level of reporting that is currently available in the standard from PF2 project agreement.

(b) Care will need to be taken that information that is genuinely commercially sensitive made available to HMTCo in its role as shareholder does not become publically known, whether through the application of the Freedom of Information Act or through more general dissemination by the Unit to wider government.

(c) HMTCo's right to receive the Transparency Information should cease if HMTCo ceases to be a shareholder, so that it is no better position than other investors.

(d) Certain private sector participants will have practical difficulty in complying with the requirement to provide full disclosure on beneficial ownership: in many instances this information will not be known to them, or be subject to pre-existing confidentiality requirements. We would propose awaiting the outcome of HMT's consultation: Transparency and Trust: enhancing the transparency of UK company ownership and enhancing trust in UK business (July 2013) before reaching a final view on this issue.

3.4 **The requirements of a PF2 financial model**

(a) Initial bidders will be required to support 100% of the required equity interest in a financial model, the return on which will be modelled to derive financial covenants for third party debt providers.

(b) If a lower rate of return is sought by third party equity providers, this will reduce the project's free cash available to support these covenants. Whatever method is used to document the potential for different rates of return required by different investors, the need not to undermine the project model will need to be considered.

3.5 **The detailed documentation**

(a) We have been supplied with various comments on the detailed provisions of the proposed documentation, but the Forum's view is that generally this detail is a matter for individual investors and not a matter of wider policy.

(b) That said, there is a small number of detailed matters that do raise policy issues:

(i) It is not clear to us that is consistent with the general principles of the consultation document that HMTCo should seek preferential treatment in several areas (for example, retained rights to information flow and greater freedoms to dispose of its interest). It seems to us that these rights should be the same across all shareholders.

(ii) The detailed structure should not place unnecessary barriers to early stage participation of third party equity investors in bidding consortia: so that the document should contemplate more than its current three-shareholder structure in certain cases.

(iii) The detailed structure should not discriminate against shareholders that are not based solely in the UK (for example, the requirement for a director to be in the UK to receive notices seems unnecessary).

(iv) In the view of many of our members certain provisions dealing with equity transfers and default are off-market. Clearly, this will be a matter for negotiation at the time, but from a policy perspective our concern would be the risk to the process if HMTCo looks to achieve a position that has historically not been acceptable to the majority of private sector participants.

(v) We would be happy to discuss the detail of the comments we have received if that would be helpful to you.

The Infrastructure Forum
August 2013

14 August 2013

Innisfree PF2 Memorandum

Innisfree Response to Consultation on Terms of Public Sector Equity Participation in PF2 Projects

The PFI procurement mechanism has been used by the UK government for over 20 years now and has been proven to deliver public, and particularly social, infrastructure on time, on budget and provide value for money.

PFI is not always the most appropriate methodology for procuring new social infrastructure and there are occasions where procurement funded directly by the public sector will offer better value for money. However, where risks which are defined and quantified clearly may be transferred from the public to the private sector, the introduction of private sector skills and incentives in the management of those risks has been proven to offer great scope for efficiency and innovation. This knowledge has been fed into new bids improving value for money for new projects. The widespread and growing adoption of PFI or PPP procurement methodologies around the world demonstrates the success of this model. This is based on a contract between the public and private sector which has evolved continuously and significantly since its outset in 1993.

Innisfree is a leading manager of investments in PFI projects and is one of the principal channels for institutional investment in PFI. Over the past 18 years Innisfree has raised 7 dedicated PFI investment funds with total commitments of £2.3 billion, mostly from public and private sector pension funds and life insurance companies. At present Innisfree manages equity investments in 58 PFI, P3 and PPP projects, with an overall capital cost of £18.9 billion. 20 of Innisfree's projects have been operating and delivering public services for more than ten years now.

Innisfree believes that HMT's proposal to invest equity in PF2 projects will in the future undermine the flow of institutional risk equity into this sector and significantly reduce the incentives for long term private sector participation in the delivery role.

These concerns are explained below.

Conflicts of Interest

It is difficult to imagine a circumstance where the public sector shareholder in a project company would act in a manner that overrides its interest as the sole customer. This creates a fundamental conflict of interest and serious governance issues which the public sector should be keen to avoid, and not try to manage (as has been proposed by HMT).

These governance issues are fundamental to both the private sector investors who need to see the project company managed in the best interests of its shareholders and to the public sector shareholder representatives on the board of the project company who are likely to feel their conflicting duties of care to be untenable.

We are aware of the argument that this conflict of interest is mitigated by having a dedicated HMT investment team separate from the procuring body of each project. Unfortunately we do not believe that this solution will be effective over the long life span of a PF2 project. The political pressures to which the government is subject vary constantly and there can be no doubt that were the weight of public and media opinion strong enough then it would become expedient to align the positions of HMT and the procuring authorities. Just recently HMT led the attempt to find weaknesses in PFI contracts that could be exploited to generate savings for the procuring authorities.

Non-Alignment of Objectives as Shareholders

The difference in long term economic objectives between public and private sector shareholders means their interests as shareholders are unlikely to be aligned. The aim of a private sector shareholder is to maximise sustainable returns on their investment. The public sector, whether HMT or the procuring authority, seeks to accommodate a whole range of policy objectives which are likely to change many times during the life span of a PF2 project. At best many of these policy objectives will not be relevant to a private sector shareholder's overriding objective of maximising long term returns on invested capital. Recent experience has demonstrated this, as evidenced both in the political and media positions on PFI and by the very nature of these proposals which are aimed at limiting private sector returns and controlling the delivery side of the concessions.

This non-alignment of interests goes to the heart of the private sector investment dynamic which is to create efficiencies and above average returns for investors. It is this dynamic which has enabled PFI over a long period to deliver some £60 billion of projects on time and on cost and to maintain investor interest. To restrict this would place this dynamic at risk and lead to a return to the dynamic of traditional procurement where the public sector maintains control of the delivery side. It is difficult to see, how under these circumstances, the public sector could then justify the increased cost of private sector capital over direct government funding.

Political Risk

Political risk is one of the main concerns flagged by institutional investors considering an investment in public private partnerships. Infrastructure investment entails very long time horizons and there is a risk that the client's behaviour may change during the life of a project as a result of shifts in political imperatives. Recent populist pressure to revisit the terms of existing PFI projects during times of austerity is an example of a political risk which causes serious concern to investors.

Although the strong contractual framework of PFI projects offers protection, this risk is far more significant if a public sector shareholder is in a position to use its ownership and voting rights in ways not anticipated when the project concessions were signed.

Global Investor Interest

The popularity of the PFI model around the world means that the UK is now just one of many jurisdictions where institutions may choose to invest. At this time we are not aware of the public sectors of other countries seeking to participate in the equity of PFI/PPP/P3 concessions. In our biggest current market, Canada, and the USA, which is opening up its P3 programme, there is no suggestion of it. So such a move by the UK is likely to put it at a competitive disadvantage in relation to attracting global investors including sovereign wealth funds.

Existing Solutions

HMT has explained that the objective of its equity investments is to ensure that the public sector benefits in the economics of project equity and to ensure transparency on the part of the private sector. Both of these objectives can be, and indeed are being, achieved through existing contractual arrangements which are transparent and do not cut across governance or investor return dynamics:

- Standard form concession agreements between public sector clients and private sector project companies now contain mechanisms whereby the client will participate in additional revenue or cost savings over and above those envisaged at inception of the project (e.g. sharing of third party income and savings in financing, insurance, facilities management or lifecycle costs). These arrangements capture almost all foreseeable equity upsides in these projects without undermining risk transfer. Arguably these are already causing disincentives to the private sector. For example there has been very little incentive to refinance a PFI project for over ten years now.

- Similarly, the concession agreements now contain extensive obligations on the private sector to share information with the public sector, together with rights for the client to audit certain information provided.

<u>Conclusion</u>

For the above reasons we would urge the government to reconsider the HMT proposal to take equity stakes in PF2 projects. The perceived benefits of such holdings may be accessed through existing contractual arrangements that do not give rise to the fundamental concerns about conflicts of interest, governance and the prospects for equity participation by global investors.

Where the government's desire is to control a project – as opposed to the objectives of sharing economics and transparency espoused by HMT – then this can be achieved through the use of traditional procurement and government funding.

Innisfree's Position

Innisfree has invested in 58 PFI/PPP/P3 projects in the UK, Canada, the Netherlands and Sweden. It has no public sector shareholders in any of these projects.

For the reasons set out above Innisfree, acting in the interests of its long term investors, would not be able to commit funds to future projects where the public sector is an equity investor in the project.

A response to the government consultation on a new approach to public private partnerships

Who we are...

The Intergenerational Foundation (IF) researches fairness between current and future generations in the UK, in order to protect the interests of younger and future generations, who are at risk of being ignored by current policy-makers.

Our response...

This is a general response to the consultation on the government's new approach to public private partnerships, rather than a specific response to any of the precise technical questions which were raised in the consultation document.

IF feels there are a number of problems with the way PFI deals have been used in the past. Public private partnerships have historically involved transferring a long-term financial burden onto future generations of taxpayers in order to satisfy short-term political objectives. According to figures released by HM Treasury, there were 719 separate projects with total outstanding liabilities of over £300 billion in March 2012 (Rogers and Ball, 2012). The investigation into PFI deals by the House of Commons Treasury Committee has criticised the public sector for commissioning new infrastructure without the spending this involves appearing on their budget sheets or being deducted from their capital budgets (House of Commons, 2011).

Passing on such a large financial burden to future taxpayers is intergenerationally unfair, especially when there is a strong likelihood that many of these projects will have become obsolete before the PFI debts have been fully paid off. In order to protect the interests of future generations, IF recommends that the following concerns should be taken into account when PF2 deals are being structured:

- **Conduct intergenerational impact assessments** – All PF2 deals should include an assessment of their likely financial impact upon future generations. This should attempt to quantify factors such as long-term economic impacts and the risk of obsolescence. IF could provide advice as to how such intergenerational impact assessments could be carried out in practice.
- **Assessment of lifetime value of projects –** An estimate of the likely useful lifespan of the infrastructure which is being built should be factored into PF2 deals at the planning stage,

so that future taxpayers will not be committed to paying for infrastructure – such as obsolete schools and hospitals – from which they do not derive any benefit. This is the fairest way of factoring the interests of future generations into PF2 deals.

- **Make sure all PF2 deals are recorded on balance-sheet** – In order to ensure transparency and accountability, all PF2 deals should have to be recorded as expenditure on balance-sheet, alongside estimates of the total lifetime liabilities arising from each PS2 scheme which have been calculated using a range of different discount rates.

- **Submit PF2 deals to FOI** – As another means of ensuring transparency and accountability, all PF2 deals should be subject to the Freedom of Information Act (2000). This should include making the private sector partner involved in a PF2 deal subject to FOI, in addition to the public sector body which commissions the project.

Conclusion...

In order to help put the interests of future taxpayers at the heart of the new PF2 deal structure, IF would be willing to discuss any of these ideas further with HM Treasury and Infrastructure UK.

For more information about the Intergenerational Foundation and its work, please visit www.if.org.uk or contact Liz Emerson, Co-Founder at

References:

- House of Commons (2011) *Private Finance Initiative – Seventeenth Report of Session 2010–12* London: House of Commons Stationary Office

- Rogers, S. and Ball, J. (2012) "PFI Contracts: The Full List" *The Guardian Datablog* Thursday 5 July 2012

HMT CONSULTATION ON PF2 - Intersave Developments

General considerations		
		Interserve Response
Question 1:	Please give your observations on the proposed investment appraisal and due diligence arrangements?	Acceptable
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.	Yes
Question 3:	Do you have any objections to disclosure of the Transparency Information? Please give reasons for any objections.	No specific 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)?	"Developers" will have different drivers. Where a Developer also has an equity investment arm, this affords the opportunity to take a holistic approach to bid costs. Already some Developers bid in conjunction with other Developers or third party equity as a means of mitigating bid cost risk. A developers bid should be based on its ability to define its total return. A PB equity competition would not enable it to do so. It is our view that a post PB equity funding competition, could reduce appetite of developers for some projects and potentially reduce the market for projects. We would suggest a reduction in the equity stake taken by HMT Co post the lock-in period would be a more appropriate manner in which to encourage new equity investors. Our view on a post lock-in period reduction of HMT Co equity is based on the provision mirroring that of the private sector Developer and affords the opportunity for increased value generation through the reduction of a combined (HMT co & Developer) stake.
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.	Where the working capital requirement is unsecured, it should fall to the Sponsors and should include any third party equity provider brought in through any PB equity competition.
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	Yes

	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?	Acceptable
Question 8:	Do you agree with the event of default and deemed transfer provisions?	Acceptable
Question 9:	Do you have any comments on the definition of 'Market Value' and the manner in which this will be determined?	Acceptable
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	Acceptable
Question 11:	Do you agree with the provisions relating to the chairman?	Acceptable
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?	Acceptable
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.	Acceptable
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.	Acceptable
Dispute resolution (SHA Clause 11)		
Question 15:	Please give your views on the proposed dispute resolution arrangements (SHA Clause 11).	Acceptable
Loan Stock Instrument		
Question 16:	Do you agree that shareholder loan stock should be unsecured?	Yes
Question 17:	The Bidder incurs costs and risk in bidding	Our view is that there should be no

	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?	differential rate of return per say. However, the issue is relevant and needs to be catered for. The premium bid by the third party equity provider could be proportioned to provide sufficient compensation to the Developer to compensate for the bid cost risk undertaken. Our preference remains there not to be a PB equity competition.
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.	1. Listing Rules to be added to the SH agreement 2. Warranties envisage company set up at same time as entering into Shareholder Agreement. Practically cannot do this (VAT / bank mandate etc to obtain) so additional warranties will be required.

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

Direct line:
Email:

By email

Date: 16 August 2013

Dear PPP Policy Team

PF2 Equity Consultation

I am pleased to be able to respond to HM Treasury's Consultation on PF2 equity.

Local Partnerships is an organisation focused on project delivery, spanning central and local public sector interests. I hope we have been able to bring a helpful and constructive perspective to the proposals.

We have drawn heavily on the experience within our ranks which includes ongoing PFI delivery, unlocking efficiencies from operational PFIs, and the development and implementation of the Non-Profit Distributing model, which had many of the same ambitions as PF2.

Should you wish us to expand on any of our comments please don't hesitate to get in touch.

I wish you every success with the PF2 initiative.

Yours sincerely

Judith Armitt
Chief Executive Local Partnerships

Local Partnerships LLP is a limited liability partnership registered in England and Wales with registered number OC346845 at 76-86 Turnmill Street, London EC1M 5LG

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Local Partnerships

HM Treasury PF2 Equity Consultation
Local Partnerships' Response

Local Partnerships LLP (LP) is a joint venture between HM Treasury and the Local Government Association (LGA) set up to assist with programme delivery at the local level by supplying commercial expertise to public sector bodies. We have extensive experience of helping local authorities and others to procure PFI and PPP projects, and of reviewing existing PFI projects on behalf of Government with a view to efficiencies and cost reduction.

Local Partnerships very much welcomes and supports the introduction of PF2. Our work to date in supporting HMT on the operational PFI/PPP savings agenda highlights clearly the benefits the additional flexibility and transparency PF2 will bring to longer term PPP arrangements, thus enhancing value for money for the public sector.

In responding to this PF2 equity consultation, we have focused in particular on the impact upon local authorities and other public bodies. It is our view that the primary concern of such local public bodies, and (perhaps in due course Local Enterprise Partnerships) which may undertake PF2 procurements, will be to ensure that the PF2 equity arrangements do not offer worse value for money (VfM) than the previous position. This may happen for two reasons:

– The PF2 equity requirements discourage some participants in the PPP market from bidding, hence reducing competition, and so making it likely that the cost of a PF2 project will rise.
– The requirement for a higher level of equity in projects increases their cost.

Local authorities and other local public bodies will also be concerned about any increase in the complexity of the procurement and contract management processes over that which they experienced under the PFI.

Local Partnerships has some questions and comments about these issues, as set out below. These general comments are followed by LP's answers to the Consultation questions.

1 Market Effect

In summary, PF2 requires bidders to bid for a project in which, if they are successful, they may be a minority shareholder in partnership with the public sector and a further 'unknown

private sector partner'. The principles supporting this approach are clear (in that it may drive down the cost of equity), however from the market perspective, bidders may potentially consider the involvement of the 'unknown private-sector partner' unattractive, given the uncertainty it brings to the process.

For example, the 'unknown private sector partner' may be one of the bidders' competitors, or another party with whom they do not want to co-invest. Bidders will also inevitably incur extra costs in negotiating these equity arrangements. (See further comments on the equity-funding competition in question 18.)

It is also worth noting that opportunities for PPP investment are now widely available internationally, with many new entrants into the market, *e.g.* US states. The British PFI programme is now significantly smaller than it was in the past. We are not aware of any other markets intending to introduce similar equity provisions, and at a time when economic renewal is of such significance we wonder to what extent there is a risk that Britain will not remain the attractive market for PPP developers it has been over the last 10-15 years.

2 Project Cost and VfM

A key aspect of PF2 is the deleveraging of the capital structure, with the aim of attracting institutional debt finance based on this reduction in risk. We understand that that the debt:equity ratio for projects will decrease from 90:10 to between 80:20 and 75:25. Assuming the original bidder retains equity of 10% of project costs, this means equity of 10-15% of capital costs will be priced in an equity-funding competition and split between HMT and a third party?

It is evident that this increased equity may increase total financing costs (even with a lower equity IRR), but HMT consider that this structure will improve VfM as "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" (Consultation §1.2).

We have assumed the VfM calculation which takes account of the investment return will deduct government's own costs of finance, and in considering this calculation HMT would not consider it appropriate to offset 100% of the projected equity return against the Unitary Charges, since the equity return is at a much higher risk (which is why it has a higher return). Similarly, in making an NPV comparison, we wonder how HMT foresee equity is to be discounted, as it would be largely unsuitable to use the risk-free Green Book rate for equity yielding, say, 10%.Taking these risk adjustment factors into account, and allowing for cost of funds and administration costs in HMT, is it still the case that the adjusted net project cost will be lower than an equivalent PFI structure, and can it be assumed that this will always be

the case?

It is not clear from the Consultation whether or how a local authority would benefit from HMT's equity investment. If the Unitary Charge increases as a result of the increased equity then it could be seen as inequitable that the local authority would not benefit. Other benefits such as transparency (which are clearly worthwhile) could be achieved by other means, which would not result in a higher Unitary Charge.

One additional point, related to equity returns, is the use of indexation indices. We have observed through our PFI Operational Efficiency Programme that there has been a material divergence between the Retail Price Index (which the Unitary Charge of many projects are linked to) and the Average Earnings Index (more likely to reflect the cost base of soft FM and a large proportion of hard FM). We believe that this is resulting in the additional profitability of contracts (against the levels envisaged when the contracts were initially signed), leading to increased upside returns to the equity holders (currently held by the private sector).

PF2 offers an opportunity to partially address such excess profits and equity returns being received solely by the private sector. In particular, the public sector equity stake ensures that the public sector receives a proportionate share of all equity returns, including those resulting from variations in the Retail Price Index and the Average Earnings Index.

3 Consultation Questions

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

Consultation §4.3: It is unclear to LP when this stage will be carried out, whether it is before or after selection of the preferred bidder. It was also not clear why there was to be no participation by bidders' external advisers. Is this because there is no sanction if the information is not complete or accurate? If so what is the purpose of providing this information at this stage?

Consultation §4.5: Is HMT confident legal advisers are willing to provide such a Due Diligence Memorandum? We wondered what would happen if risks occur which have not been mentioned in this document, bearing in mind that a Project Agreement is necessarily an 'incomplete contract' which will never foresee everything which might occur. The legal adviser may have to rely on information from other advisers to identify risks, in which case the former is unlikely to be willing to be liable for mistakes of the latter.

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.*

Yes, but it is important that clear and detailed SoPC-style regulations (and perhaps documentation) are also provided (see Question 18 comment 1).

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

No

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

a) Equity-funding competition post appointment of preferred bidder?

See comments above

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

Will this affect the long-term VfM / affordability aspects of the project for the local authority (assuming it benefits from the equity return)?

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.*

Working capital is as much a project cost as the construction cost, and as such should be financed accordingly by debt and equity in the agreed ratio. If for some reason Senior Lenders are not willing to finance working capital, there is no reason for the Developer alone to be responsible for this: it is clearly a general requirement for the SPV's business, to which all shareholders should contribute.

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)?

Yes as this would be normal practice. If this were not done, and some shareholders hold loan stock and some do not, there are likely to be conflicts of interest.

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

We anticipate there will be challenge as to why the Developer should be required to enter into a pre-emption agreement with parties which it did not choose as partners. We would also question why the third-party equity, which is supposed to be from a long-term investor, should be allowed to sell its shares as quickly as the Developer.

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

In what sense are the Events of Default an issue for the SPV or the other 'non-defaulting' shareholders? From the documentation to hand it is not clear to LP why the deemed transfer provisions are considered necessary.

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

Should 'market value' (lower case) in SHA 9.3(a) be 'Market Value'?

Given that there is no actual default, *e.g.* non-payment, by the 'defaulting' shareholder why should the latter, or its administrator, be constrained in this way?

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.

If there are 3 shareholders (Developer 10%, 3rd party 7.5% and HMT 7.5% of the total cost, *i.e.* 40%, 30% and 30% respectively of the share capital), this means that each party appoints 2 directors, which seems a reasonable size for the board. However the result of this formula is that although the Developer has a greater shareholding it does not have more directors than the other 2 shareholders.

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

Yes

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?

LP thinks it would be a stronger position if the appointment of a board observer was not linked to an HMT shareholding, but applied in all cases on transparency grounds. Where it is, say, an authority-procured project the appointment should be made by the local authority. This is already the case in Scottish NPD contracts

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.

The list of Reserved Matters seems reasonable. But a key issue is probably whether a Developer will be content to be in a position where it can always be outvoted, even on issues which are not Reserved Matters.

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.

No objection, assuming that the principle is agreed that a Material Shareholder can vote on an issue where it is conflicted.

Dispute resolution (SHA Clause 11)

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

LP can think of instances where an accountant would not necessarily be the appropriate Expert. There are situations where, for example, a lawyer or an engineer would be more

appropriate.

Loan Stock Instrument

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

This would normally be the case. It would, in any event, be deeply subordinated to the senior lenders.

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?

There are two related issues which need to be addressed: the equity-funding competition must result in a lower cost for the local authority, and the Developer must get a higher return than the 3rd Party or HMT.

The choices seem to be:

- The equity shares are sold to HMT and the 3rd party at a premium to par. The 3rd party bidding the highest premium wins. This premium is paid to the local authority. This has the advantage that after Financial Close there is complete alignment of interests between the parties as they are all sharing *pro rata* in the cash flow. It also ensures that the local authority gets the benefit of the equity-funding competition even if the project goes wrong later.
- The Developer receives a higher rate of return on the loan stock. This does not need to be 'structured' as suggested in the question, because it is the rate the Developer has bid? So the Developer's loan-stock coupon would be fixed, and the winning 3rd-party bidder would be the one that bids the lowest coupon on its loan stock? However this leaves the equity shareholders with differing interests in the cash flow, *i.e.* their equity interests are in a sense unstapled from the debt, which is probably not desirable.

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.

Equity-funding Competition

1. Regulations explaining in more detail how the equity-funding competition would work would be helpful.
2. Would there be any legally-binding agreement between the local authority, HMT and the bidder setting out the requirements for an equity-funding competition, and if so what would its key terms be? What would the sanction be for default under this agreement?
3. The Consultation §3.1 states that the government will determine on policy grounds whether or not public-sector equity should be invested at the OBC stage. Are these policy grounds known, or is it the case that these are "moving" investment criteria?
4. Consultation §3.1 says that 'the public sector would have a right to invest equity up to the quantum specified but it will have no obligation to invest.' If the decision to invest has been taken at the OBC stage why should there be a need to change that decision, which is very material to bidders, later on?
5. Consultation §3.2 says that 'it follows that a bidder must submit bids which are fully funded on the basis that no investment is made by the public sector' and §3.3 that 'bidders should continue to structure their funding as they deem most appropriate, including the respective amounts of share capital and shareholder debt and equity…' Does this mean that if HMT decides to invest, the absolute amount of equity will be increased, or that the project would retain whatever debt:equity ratio had been specified by the bidder? If the latter this is not in conformity with one of the originally stated features of PF2 (deleveraging). It would also mean that the bidder would get much less equity in absolute terms, and hence a much lower cash flow, than the basis on which it bid.
6. The Consultation §6.2 says that "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." What would be the basis for this evaluation other than price?
7. What happens if HMT or the local authority disagrees with the evaluation criteria, or considers that the required procedure has not been properly followed?
8. Would HMT have the right to tell the local authority to delay Financial Close until after the equity-funding competition? What happens if the equity-funding competition then delays Financial Close (*e.g.* because it has to be re-run, or because negotiations are still going

on with the bidder)? Who would bear the financial consequences, *e.g.* increase in construction cost?

9. This deleveraging is likely to result a large refinancing gain, through releveraging the project after completion of construction. It is obviously financially inefficient to build in a refinancing gain in this way, even if part of the gain would go to the public sector (*i.e.* presumably the local authority as normal under SoPC, plus HMT as shareholder)? Does this also potentially undermine the principle of reducing windfall profits for the private sector?

10. Is financial close the best time for an equity-funding competition? Bringing in new investors at this stage is not the market norm, precisely because it will not capture the benefit of the further reduction in yield in the secondary market? (Only part of the secondary-yield benefit would be recovered through the HMT investment.)

11. What happens if the bids in the equity-funding competition require a higher return than that originally bid by the Developer?

12. Can the Developer bid in the equity-funding competition, and if not why not?

13. Presumably the Developer would also get a development fee, being its development costs—which would form part of the project costs anyway? But would there be a need for a different formula if the Developer no longer has 100% of the equity, *e.g.* payment of a high rate of interest on development costs from the time they were expended up to Financial Close, reflecting the high level of risk the Developer took in incurring them (which would also increase project costs)?

Shareholders' Agreement

14. In general, this document seems to be written in the usual terms for a shareholder group which has chosen to work together, rather than one where the two outside shareholders have been forced on the Developer. In this situation, should the Developer be given more latitude in the day-to-day running of the project, *e.g.* through a Management Agreement? If so it would be helpful to make this clear, and set out the terms for a Management Agreement (and its cost implications, if any)?

Debt

15. Is any reduction in debt rates (reflecting the greater equity and hence lower debt risk) also expected? If so, it may be useful to highlight this point to the market.

Local Partnerships

16 August 2013