



PPP Policy Team HM Treasury,
1 Horse Guards Road,
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Consultation on the terms of public sector equity participation in PF2 projects

In response to the PF2 consultation exercise, I am responding and an **individual** capacity and as somebody who has had significant exposure to the sector over many years.

I am not able to provide specific examples to demonstrate my points because this information has been obtained as a result of my employment and my contracts of employment require that this information remains confidential.

General considerations

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

Investment appraisal and due diligence needs to take into account the structure of the bidding consortia. It should consider that construction and FM contract margins could be artificially increased to reduce equity returns. This might be combined with benchmarking/market testing being delayed to ensure that higher FM margins are enjoyed for as long as possible

Letters of appointment for advisors would have to include Treasury PF2 Equity Unit provision of information and warranty requirements.

The financial close model provided to HMTCo would have to be that audited and approved by the advisors to the SPV/senior debt providers.

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.

Public sector equity guidance arrangements should be made available to the bidders. Previous attempts to streamline the bid process have not been entirely successful due in part to authorities not acting in accordance with it. The Treasury PF2 Equity Unit should be setting an example by standardising (as much as possible) requirements and thus agreements. Where bidders fail to meet the requirements, or meet the requirements but demonstrate a lack of transparency, or are unwilling to act 'in good faith' elsewhere, the Treasury PF2 Equity Unit would require powers to halt the procurement until requirements have been met.

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

There should be no objections, provided that this can be maintained as confidential. Required returns and the mix of margins are commercially sensitive. In addition, any models including taxation treatments, economic assumptions, profiled returns etc must remain confidential. The fact that HMT is subject to FOI requests will cause concern.

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

a) Equity funding competition post appointment of preferred bidder?

Equity funding based upon the modelled returns may drive the structure and risk allocation of consortia bidding a project. If there is an equity funding competition post appointment of preferred bidder, equity funders will be unwilling to invest in bid costs, thus pushing costs onto the D&B contractor/FM provider who may, or may not, be the same as the equity provider.

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

Reduction in HMTCo equity should be subject to the same change of control restrictions as other equity providers, but may be transacted during the Lock in Period. Since the Lock in Period exists to ensure the commitment of the parties to the SPV, I would suggest that it may demonstrate a lack of commitment to partnering if HMTCo were to sell out during this period, but in terms of ensuring that the contracts to the SPV are discharged, this lays in the hands of the SPV consortia.

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 requirements should be provided in the payment terms of the unitary charge and the service provision. The FM providers are effectively providing working capital. The Developer should not need to provide working capital since this should be provided by the capital funding. Developers can be very sensitive to cash flows and by including an expectation for a Developer to make provision, this could significantly increase costs, even after assuming that they have the capacity.

Shareholders Agreement and Articles of Association

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)?

Market pricing of the transaction should account for the risks attached to returns, however, if an investor acquires equity, but no loan stock, this could change the risk profile if the Directors fail to act in accordance with their obligation to promote the success of the SPV. The consent of ALL shareholders to de-staple the instruments should address this risk and retain some flexibility for investors to manage the risk profile of their portfolio.

Stapling equity and loan stock may also limit the investment to a wider network of bodies. Pension funds with liabilities maturing in the longer term (e.g. as a result of closed final salary

schemes) may wish to invest in equity where the profiled returns are at the back end of the contract. Whilst this may also be met by loan stock capital repayment profiles, the interest coupon may be a less attractive investment when considering the increased exposure to an individual project, rather than a portfolio of contracts which has to date driven them to invest in managed funds rather than directly.

If the Developer is expected to invest in Loan Stock, in addition to what may have been 'pin point equity', this could reduce the competition for the work as some Developers will not have that level of resource available. The Developer should be excluded from the requirement to provide sub-debt, but will be entitled to invest in equity.

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

I am content with the provisions

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

The event of default includes the receipt of a winding up petition. I've seen these used to press the settlement of bills even where there is a dispute regarding the works. The definition of an event of default may need to be adjusted to account for petitions received as a result of a desire to frustrate the company.

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

I am content with the definition and the manner in which it is 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.

I agree with the principles stated, although target of 4 Directors may be more manageable. This would mean that a minimum 25% HMTCo stake may be required and lead to issues splitting the remaining 75% between the Developer and 3rd Party Equity, although this may be no more problematic than the 15% HMTCo stake which already prevents the 50/50 Developer/Equity & Loan Stock provider relationships that have been common.

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

I agree with these provisions. Independent Chairmen can be very useful, especially where the interested of shareholders are not aligned and they are seeking to influence their nominated directors. Giving the Chairman a casting vote may help the Board to act in the best interests of the SPV rather than individual shareholders with dominant interests, however, the presence of an HMTCo nominated director and an Authority observer should help to moderate such behaviour.

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 I have no objections to the appointment of an observer, if this individual is routinely excluded from meetings and information is not made available outside of the meetings, e.g. copies of the last approved and models currently being discussed, this will limit the influence of the observer and the desire to encourage open collaboration between the SPV and the Authority. Guidance should be given as to when the observer may be excluded. The default position should be that the observer is in attendance.

I note that Schedule 7 Transparency Information does not include the last Approved Financial Model, or any financial model under discussion by the Board. This would make the role of the observer very difficult to carry out as they may have no view on the financial risk position of the SPV.

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 and an explanation for your views.

I am content with the reserved powers. However, I note that clause 7.1 of the Shareholder Agreement, Distributions, states that all lawfully available amounts will be distributed. This would mean that the SPV would be unable to reserve amounts where, for example; a shortfall in the lifecycle fund were identified, or a commercial settlement for a dispute, as been identified.

The Shareholders reserve powers include the setting of the dividend policy, so this may be sufficient to manage this concern.

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.

I would rather not comment on this matter.

Dispute resolution (SHA Clause 11)

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

I am content with the proposed arrangements.

Loan Stock Instrument

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

Given the very 'artificial' equity/debt ratios used in PFI/PPP arrangements, it makes sense that shareholder loan stock should be unsecured.

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

As noted above, the equity auction at preferred bidder puts much of the bid cost risk on the developer. This may be recouped by the developer including a success fee, or a higher contract margin. However, developers will generally look for primary equity investors to share the risk. By introducing competition at the preferred bidder stage they will be unlikely to do so. This may adversely impact Developers with fewer resources, limit competition and thus impact Value for Money.

The HMTCo target share should be capped as part of the invitation to tender. The introduction of other equity providers should also be addressed at a very early stage in the process or left until the end of the lock-in period when the market can value the equity.

If the intent is only to give more investors access to the market, it may be more appropriate for them to seek secondary market investments, until their expertise has increased.

If the intent is to limit equity returns, then the procurement process should be re-examined and HMTCo access to bid models should be used to encourage a more 'open book' process.

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.

PFI contracts have historically been bid as 'light touch' and SPV's considered to be a 'post box' between service providers and the authority. They have proven to be far from that, but have been shown to be very low risk investments.

The involvement of a HMTCo nominated Director and an Authority observer is a step in the right direction to help SPVs deliver both a service to the public sector and for the public sector to understand the costs of their service level requirements.

The role of a HMT nominated Director on the Boards of the SPV's will be challenging, but is essential to ensure that contracts are interpreted correctly and the equity providers risks/returns are balanced against service delivery to the authority.

The increased compliance regimes that Senior Funders are working within will frustrate both the service delivery and financial returns of PFI contracts unless PPP relationships improve.

I hope that this is useful to the development of PF2 and that we are able to move ahead in providing high quality public services.

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