UK - Launch of Private Finance 2: the new PFI

The UK Government has set out its new approach to PFI (known as "**Private Finance 2**" or "**PF2**"). This follows the Call for Evidence launched last year on the reform of PFI. Click here to view the new HM Treasury approach.

A draft version of the new SoPC (Standardisation of PF2 Contracts) has also been released to take account of the changes announced. The SoPC and related guide can be found here. This will apply to all new PF2 projects. The first confirmed project to which PF2 will apply is the Priority Schools Building Programme.

There are five main elements to the reforms, and the key changes are summarised below:

1 Debt and Equity Finance

- *Government to take a minority shareholding in future projects*: The proportion of equity the Government will take will be set out in the relevant project tender document. The shareholding is intended to allow for Government to share in ongoing investor returns, align the interests of the public and private sectors, and give the public sector the opportunity to participate in project governance (through board membership and the ability to appoint an observer at board meetings). The equity investment is to be managed by a commercially-focused unit within the Treasury, separate from the procuring authority. Investment will be on the same terms as the private sector. A form of shareholders' agreement is expected to be published for consultation shortly. The assumption is that the Government will act as a co-investor in all projects, but the Government recognises this may not always be appropriate (though this is not elaborated on).
- *Introduction of funding competitions for a portion of private sector equity*: A decision on whether to have an equity funding competition will be taken on a case by case basis. Where there is a competition, it will take place after the preferred bidder stage and it is intended to promote earlier investment (i.e. before financial close) by different types of investors. The Government is particularly targeting primary investment by long-term investors (such as pension funds) and hopes that the new PF2 structure will prove attractive to these investors. The competition will also help set the price for public sector equity.
- *Curbing of windfall gains on secondary market equity sales*: A number of measures are being introduced to curb the ability of investors to generate excessive profits on sale of their equity stakes, including a requirement to share unutilised funds in the lifecycle reserve.
- *Facilitation of alternative debt providers*: The tender process will require bidders to develop a long-term financing solution where bank debt does not provide the majority of the financing. This is to encourage the use of institutional investment in PF2 projects. The Government hopes that the new PF2 structure (in particular the use of public sector equity and increased equity funding resulting from the equity competitions) will encourage institutional investment.

2 Services

- *Removal of soft services from the project scope*: Soft services (such as cleaning and catering) will be excluded from the contract and provided separately through shorter term

contracts. This is to give the public sector more flexibility to alter such services (and responds to criticisms that contractors were charging too much for such services).

- *Greater discretion for procuring authorities over services*: The authority will be able to include certain minor maintenance activities at the project outset, and be able to add or remove certain elective services (which will be at a pre-agreed price) during project operation.

3 Risk Allocation

- *Greater retention of risks by the public sector*: This includes the risk of additional capital expenditure resulting from an unforeseeable general change in law. The arrangements for risk sharing of core required insurances in the operational phase of a project are also to provide for the public sector to take more risk to reduce the need for contractor's to build up reserves against increases in insurance premiums. Under PF2, public authorities may also offer to cover certain risks themselves, instead of requiring the contractor to insure these in the market (for example, material damage and business interruption insurances in the operations phase). Other risks which will be taken by the public sector include utilities consumption risk (subject to a two year handover test) and the risk of site contamination where the public sector has provided the site.

4 Transparency

- *Publication of information on equity returns*: Private investors will be required to provide actual and forecast equity return information for publication. The new SoPC sets out the way in which this information should be calculated and provided.

- *Control total*: This is a limit which will apply to the Government's commitments arising from off-balance sheet PF2 contracts. This is to increase control over the liabilities created by future PF2 projects. The Government will be required to report against the control total.

- *Government annual report*: This will detail project and financial information on all projects (including actual and forecast equity returns) where the Government holds an equity stake.

5 Procurement

- *Setting a procurement timetable*: The competitive tendering phase of PF2 projects (i.e. from tender to the appointment of a preferred bidder) must not be longer than 18 months. If the timetable slips, funding will not be approved by Treasury, unless there is an exemption from the Chief Secretary.

- *Launch of new standard documentation*: This is to speed up the procurement process and will include a standard shareholders' agreement, a standard facilities management service output specification, a pro-forma payment mechanism and new procurement and contract guidance. These are expected to be published for consultation shortly.

If you would like to discuss the new PF2 structure, please contact your usual Linklaters contact.