A new approach to public private partnerships: PF2

OECD Annual Meeting of Senior PPP Officials

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Concerns with the Private Finance Initiative

- In some cases the **returns to equity investors in projects have been too high** relative to the risks they bear; investors are perceived to have made “**windfall” gains** at the expense of the taxpayer;

- Off-balance sheet classification of many PFI projects has meant that there have been **budgetary incentives for departments to use private finance**;

- **A lack of transparency of the future liabilities to the taxpayer** given the majority of PFI projects are excluded from Public Sector Net Debt;

- **Long-term contracts for certain services can be too inflexible** given public sector changing needs;

- Questions about whether the public sector gets **value for money from fixed price lifecycle maintenance contracting over 25-30 years**;

- **Certain risks transferred to the private sector may not have provided good value for money**, resulting in higher risk premiums, inefficient capital structure and/or capital reserves being maintained;

- **Reduced availability and increased cost of long-term debt finance**; and

- **The PFI procurement process has often been lengthy and costly** for both the public and the private sector.
Reform of the Private Finance Initiative

Call for evidence

- At the end of 2011, the Government initiated a fundamental reassessment of PFI. The Government conducted a broad based engagement process, which invited all interested parties to respond to a call for evidence on the reform of PFI.

- 155 responses to the call for evidence were received in total. These have been published in full.
Objectives for the reform of PFI

A new approach to the delivery of public assets and infrastructure that:

- is less expensive, uses private sector innovation to deliver services more cost effectively;
- can access a wider range of financing sources, including encouraging a stronger role to be played by pension fund investment;
- strikes a better balance between risk and reward to the private sector;
- provides greater flexibility to accommodate changing public service needs over time;
- maintains the incentive on the private sector to deliver capital projects to time and to budget and to take performance risk on the delivery of services;
- delivers an accelerated and cheaper procurement process; and
- gives greater financial transparency at all levels of the project so that the public sector is confident that it is getting what it paid for, and that the taxpayer is sure it is getting a fair deal now and over the longer term.
On 5 December last year, the Government concluded its review of PFI and published full details of a new approach to public private partnerships, PF2. The Government remains committed to private sector involvement in delivering infrastructure and services, but has recognised the need to address the widespread concerns with Private Finance Initiative and the recent changes in the economic context.
PFI Reform – key themes

• Introduction of **public sector equity** to enable a genuine partnerships between public and private sector;

• **Improving transparency** will be at the centre of the new arrangements;

• **Service provision** will be more flexible with certain services excluded;

• Certain **risks** previously transferred to the private sector will now be retained by the public sector or in some cases be shared;

• Projects will be structured to facilitate **access to capital markets** or other sources of long term debt finance;

• **Procurement will be faster and less expensive**, without sacrificing quality and competitiveness.
Public sector equity

To strengthen the partnership between the public and private sector, Government will look to co-invest public equity in future projects as a minority shareholder. Key features include:

- Investment will be performed on a professional and **commercial basis through a central unit in HM Treasury**, separate from the procuring authority to minimise potential conflicts of interest;
- Public equity will be **priced at a market rate**;
- **Funding for equity investment provided by the procuring authority**. Returns made from the investment, in the form of dividends and interest payments or gains in the eventuality of any sale, will go back to the procuring authority (subject to costs of managing the investment);
- The **public sector will participate fully in project governance**. The central unit will have Director representation on the Board plus local observer;
- The central unit will **publish an annual report disclosing project and financial information for the equity investments it holds**.

Private sector equity

- Post preferred bidder **equity funding competitions** to increase the diversity of sources of equity financing, and to attract long term investors into projects at an earlier stage, with the expectation of positive impacts on equity pricing in the longer term.
- Private sector will be required to **provide actual and forecast equity IRR information which will be published**.
Increased transparency

Improving transparency for a wide range of stakeholders is central to PF2.

- **increasing transparency and control over the liabilities created by future PF2 projects** by introducing a new control total for commitments arising from off balance sheet contracts;

- publishing **readily accessible and easily understood information on current PFI and future PF2 projects**, and on the infrastructure and construction pipeline;

- publishing an **annual report detailing full project and financial information on all projects** where Government is a shareholder;

- requiring the **private sector to provide actual and forecast equity return** information for publication;

- **strengthening the information provisions in contracts** and the procedures for ensuring timely delivery of information;

- introducing an **open book approach to the lifecycle fund**;

- providing the procuring authority, or other local representative, with **observer status at project company board meetings**;

- introducing a **business case approval tracker on the Treasury website** providing a status update on the progress of projects through the public sector approval processes.
Flexible service provision

A number of measures will be introduced to improve the flexibility and value for money of service provision within new projects:

• **soft services**, such as cleaning and services, will be removed from all contracts going forward, other than where exceptional integration benefits exist which are essential to achieving project outcomes. The *ongoing replacement of furniture and loose equipment will also generally be excluded* from projects going forward;

• **procuring authorities will have discretion over the inclusion of certain minor maintenance activities, such as redecorating, at the project outset**. There will also be additional flexibility to add or remove certain elective services once a contract is in operation;

• **periodic efficiency reviews** will be introduced into all new contracts to assess whether the project is meeting the public sector’s requirements;

• an *open book approach between the procuring authority and the contractor to the lifecycle fund will be introduced*. Any genuine surplus in the lifecycle fund that is identified will be recorded and any *aggregate surpluses in the lifecycle fund at the contract expiry will be shared equally between the procuring authority and the contractor*;

• a *standardised service output specification template and proforma payment mechanism will be introduced for accommodation projects* to ensure consistency of approach across the asset class;

• authorities will be given flexibility over the programming of maintenance and the condition of assets to be transferred to the public sector at the end of the contract if this provides the opportunity for savings.
Improved risk allocation

Certain risks will be retained or in some cases shared in order to increase value for money. These include:

- the risk of additional capital expenditure arising from an unforeseeable general change in law will be taken by the public sector during the operational phase;

- utilities consumption risk will generally be taken by the public sector subject to a two year handover test;

- the risk of the site being contaminated by off-site sources will be taken by the Authority where it has provided the site;

- procuring authorities will be required to undertake adequate investigations into legal title for sites made available to bidders and provide a warranty to the contractor;

- where the authority provides the site for the project the authority will also be required to procure ground condition surveys and make them available to all bidders with the benefit of a warranty;

- new risk sharing arrangements for the provision of certain insurances and/or a reduction or removal of some insurance cover.
Long-term debt finance

The Government remains committed to the use of long term financing for long term projects.

- intention to retain the benefits of private finance due diligence;
- long-term bank debt markets remain constrained, costs have increased and availability has diminished;
- banks continue to offer short term finance but Government does not believe public sector taking the refinancing risk represents value for money;
- Government has engaged directly with institutional investors, banks and credit rating agencies to assess the range of alternative financing options available to support infrastructure delivery and the credit requirements and project characteristics required to meet investor requirements;
- focus will be on raising long term debt from the capital markets and institutional investors;
- enable banks to play a role in the financing of PF2 projects, through long-term loans or products to support institutional investment, including construction guarantees or mezzanine facilities;
- mandatory requirement for all projects to assess a range of debt financing sources including public and private bonds, commercial bank debt and multilateral debt products.
Faster and more efficient procurement

The Government is putting in place a number of additional measures aimed specifically at speeding up and reducing the cost of procuring projects, without sacrificing quality and competitiveness:

• a more robust pre-procurement approval check to ensure that projects are ready to enter procurement before issuing their OJEU notice. These additional checks will be assessed as part of the Treasury Approval Point (TAP) process;

• a Ministerial commitment to the project procurement timetable will be required when departments submit project’s Outline Business Cases for Treasury approval;

• projects required to appoint a preferred bidder within 18 months of issuing the project OJEU. After this point funding approval will not be granted, unless a ministerial exemption is agreed at the project’s outset;

• an associated bid compensation policy will be developed;

• Government will encourage centralised procurement, where appropriate, to avoid duplication and dilution of procurement capability, and enable the benefits of repetition to be realised;

• strengthening the mandate of Infrastructure UK and departmental capability reviews.
Documents

December 2012

• Policy document - “A new approach to public private partnerships”
• Detailed contractual guidance – “Standardisation of PF2 contracts” and companion user guidance

Consultation documents 2013

• Standard services output specification
• Pro-forma payment mechanism
• Shareholders’ agreement
• “Lean sourcing“ procurement guidance for PF2 projects
• Updated value for money guidance