PF2 – A new beginning for PFI?

Tom Pemberton and Pasquale Pisanelli of Beale and Company outline reforms to the private finance initiative, PF2, that are hoped to generate increased infrastructure investment. Although the new regime is in use for school building, doubts remain whether they will attract investment funds.

**KEY POINTS**

- PF2 introduces some significant reforms to the PFI model, including an overhaul of the equity structure for future projects.
- There will be quicker and more efficient procurement with the introduction of an 18 month procurement deadline and oversight of all PF2 procurements by the Central Government Unit within the Treasury.
- The public sector will have scope to retain a limited number of risks which are currently transferred to the private sector.
- To promote savings and flexibility, soft services such as cleaning and catering will be removed from the scope of the project company’s FM services.
- There will be increased transparency requirements.
- A key difference between PF2 and the Scottish Non-Profit Distribution model is that PF2 does not prohibit dividend distributions by the project company, and returns to the private sector are not capped.

In its Autumn Statement in December, the government announced details of a new approach to PFI, which it dubbed PF2, introducing the most significant reforms to public private partnerships in over 15 years. It followed a year long review in which various criticisms of PFI were considered, including public sector concerns over value for money and insufficient transparency, and private sector complaints about the delay, uncertainty and expense associated with the process of tendering for PFI projects.

The reforms are detailed in the government’s new policy document entitled ‘A new approach to Public Private Partnerships’. Detailed drafting guidance is set out in the document entitled ‘Standardisation of PF2 Contracts’.

The fundamental principles of PFI will be retained, and the government has reaffirmed its commitment to the continuing role of private sector investment, innovation and skills in the delivery of future public projects. The reforms are particularly aimed at tackling inefficiency, attracting new sources of finance, shortening procurement periods and increasing transparency.

**Equity finance**

The government has proposed significant reforms to the equity structure of project companies. Key features include:

- increasing the equity funding requirement for PF2 schemes from around 10% to between 20% and 25%. The government hopes to achieve the investment grade ratings required to encourage new sources of long-term funding from the capital markets and institutional investors;
- the government taking a stake expected to be between 30% and 49% in the overall equity of PF2 projects thereby sharing the potential ‘upside’ of the return earned by the project company as well as the risk of the ‘downside’ of project company losses;
- establishment of a Central Government Unit (CGU), within the Treasury, for the purpose of...
making commercial investment decisions and managing the future portfolio of investments. The CGU will be independent of the procuring authority, and will be managed by individuals with the appropriate professional skills;

- introducing funding competitions for equity investors at the preferred bidder stage of procurement. The government expects that this will enable new equity to be invested in projects at competitive rates alongside the existing preferred private sector bidder and the public sector investor. In addition, the government expects that the use of funding competitions will control the higher costs typically associated with equity finance as opposed to debt finance; and

- ensuring that the public sector equity is invested on the same terms as that of the private sector. As a shareholder of the project company, the public sector (through the CGU) will be entitled to appoint two directors to the board of the project company.

**Procurement**

To address the high costs and delays associated with its predecessor, the government has committed the public sector to a more efficient procurement approach by:

- limiting the procurement period to 18 months from publication of the OJEU notice to appointment of the preferred bidder, with the threat that funding will not be approved if the preferred bidder is not appointed within that timescale. There has been speculation that the government may reimburse companies for some or all of their bidding costs in this eventuality although no detail has yet been disclosed;

- requiring authorities to consider the appropriate scope of the design requirements for the projects under procurement and maximising value for money in relation to design by, for example, batching projects such as primary or secondary schools and (in this example) encouraging bidders to show, as part of the competition, how standardised design could be used for each school;

- introducing centralised procurement through departmental procurement oversight units to increase consistency and efficiency by the public sector; and

- streamlining the procurement process by introducing a standardised procurement protocol and a comprehensive suite of standard procurement documents. The government will also publish an amended version of the ‘Lean Sourcing’ guidance for PF2 projects. It is hoped that these steps will improve efficiency and reduce costs.

**Services**

The range of services included in PF2 projects will be reduced to provide greater flexibility and efficiency. In particular, ‘soft’ services such as cleaning and catering will be let under separate short term contracts, rather than included in the PF2 contracts. In addition, procuring authorities will have discretion to include or exclude certain minor maintenance services such as low level inspections and minor repairs at the project outset; and to transfer certain other elective services during the lifetime of a PF2 contract arising from such matters as demographic change and technical progress.

These changes should go some way to address concerns about the limited scope the public sector has to vary the services provided by the private sector in order to maximise value for money. However, there will remain a challenge for those drafting output specifications to allow sufficient flexibility to accommodate inevitable changes in demand for services over the lifetime of a PF2 contract arising from such matters as demographic change and technical progress.

**Risk allocation**

PF2 will also allow the public sector to retain risks which have hitherto been normally transferred to the private sector, including the need for additional capital expenditure arising from unforeseeable general changes in the law; and contamination from off-site sources. These changes are expected to lead to better value for money for the public sector, since the private sector will no longer need to include contingencies or reserves for such risks in their pricing model, which experience indicates would be unlikely to be called upon.

**Insurance**

The public sector is permitted to cover some risks during the services phase by way of indemnity where it has established a business case that this would provide better value for money than requiring the contractor to procure insurance. The guidance makes it clear that this would not be appropriate in respect of risks which are normally covered by insurance during the construction phase.
Governance
The government has outlined a range of benefits arising from its proposal to act as a minority equity co-investor in future projects, and to participate in the governance of the project company through public sector directors who will be appointed to the board of the project company. In particular, the government believes that the partnership between the public and private sector will be strengthened and will lead to a more collaborative approach.

However, some challenges face the public sector’s directors, similar to those faced by those of the banks in which the government has taken a similar stake, where there has been a tension in some instances between the financial sector’s strategic aims and the government’s duty to protect the public purse.

Improving efficiency and promotion of savings
A number of mechanisms are proposed under PF2 which seek to encourage efficiency. These include the introduction of contract efficiency reviews throughout the life of the project on the basis that any savings are to be shared between the public sector and the project company. The guidance suggests that the public sector should take 75% of any savings with only 25% being retained by the private sector, which may be thought insufficient to incentivise the project company and its FM sub-contractors to engage whole-heartedly in the review process.

Furthermore in a new approach to life-cycle surpluses, the guidance indicates that any savings against budgeted costs should be split 50:50 between the public and private sectors. Again, in negotiating the lifecycle gainshare arrangements, the parties will need to consider whether the private sector is sufficiently incentivised to find savings.

Transparency
The government is committed to ensuring greater transparency by introducing a number of measures including:

- the publication of annual reports giving full financial and other details on all projects where the government is a shareholder; and
- requiring the project company, as part of its services, to provide such financial and other details on a regular basis to the public sector authority, with sanctions by way of financial deductions and ultimately termination for persistent breach if the project company fails to do so.

Comparison between PF2 and the Scottish NPD (Non-Profit Distribution) Model
There are a number of obvious similarities between PF2 and the Scottish NPD (Non-Profit Distribution) Model. NPD, of course, has had a head start, with the first wave of projects to be procured under this model being close to financial close. The two models take a similar line on risk, insurance, the exclusion of ‘soft’ services from the scope of the project company’s services, and a greater flexibility in relation to the inclusion or exclusion of minor maintenance services.

A key difference, reflecting different political drivers in England and Scotland, is that whereas under NPD, there are no dividend distributions and private sector returns are capped, under PF2 distributions are allowed and returns are not capped (subject to the gainshare mechanisms) on the basis that the public sector would have a share in distributions and ‘surplus’ returns by virtue of its shareholding in the project company.

Conclusion
The reforms announced by the government were initially given a guarded welcome, but significant doubts that PF2 will be a ‘game-changer’ have subsequently been expressed in view of the continuing difficulties experienced by the private sector in obtaining long term debt finance, and scepticism about the take-up of equity by institutional investors.

However, while the impact of PF2 on the level of investment in future infrastructure projects in the UK remains to be seen, the government has confirmed that PF2 will be applied to the £1.75 billion Priority Schools Building Programme. In addition, the Ministry of Defence and the Department of Health are said to be considering how PF2 can be applied to future procurements. With the government also announcing details of over £5 billion of investment in roads and schools in its Autumn Statement, it is hoped that the reforms outlined in relation to PF2 will encourage much needed investment in public infrastructure projects. CL