The Public-Private Partnership Law Review

Sixth Edition

Editors
André Luiz Freire, Thiago Luís Santos Sombra
and Raul Dias dos Santos Neto

The LawReviews

THE

Public-Private Partnership Law Review

Sixth Edition

Editors
André Luiz Freire, Thiago Luís Santos Sombra
and Raul Dias dos Santas Neto

THE LAWREVIEWS

PUBLISHER
Tom Barnes

SENIOR BUSINESS DEVELOPMENT MANAGER
Nick Barette

BUSINESS DEVELOPMENT MANAGER
Joel Woods

SENIOR ACCOUNT MANAGERS
Pere Aspinall, Jack Bagnall

ACCOUNT MANAGERS
Olivia Budd, Katie Hodgetts, Reece Whelan

PRODUCT MARKETING EXECUTIVE
Rebecca Mogridge

RESEARCH LEAD
Kieran Hansen

EDITORIAL COORDINATOR
Tommy Lawson

PRODUCTION AND OPERATIONS DIRECTOR
Adam Myers

PRODUCTION EDITOR
Sarah Kelleher

SUBEDITOR
Claire Ancell

CHIEF EXECUTIVE OFFICER
Nick Brailey

Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34-35 Farringdon Street, London, EC4A 4HL, UK

www.TheLawReviews.co.uk

ISBN 978-1-83862-494-1

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ASAR – AL RUWAYEH & PARTNERS

BOMCHIL

BRYAN CAVE LEIGHTON PAISNER LLP

EKP LEGAL COUNSEL

G ELIAS & CO

HENGELER MUELLER PARTNERSCHAFT VON RECHTSANWÄLTEN MBB

HERBERT SMITH FREEHILLS

HOUDA LAW FIRM

JPM JANKOVIC POPOVIC MITIC

LEE AND LI

LIEDEKERKE WOLTERS WAELBROECK KIRKPATRICK

MATTOS FILHO, VEIGA FILHO, MARREY JR E QUIROGA ADVOGADOS

NADER, HAYAUX Y GOEBEL, SC

NISHIMURA & ASAHI

RAISIN GMBH

TMI ASSOCIATES

URÍA MENÉNDEZ

VELMA LAW

VIEIRA DE ALMEIDA

WEERAWONG, CHINNAVAT & PARTNERS LTD

WHITE & CASE

YOON & YANG LLC

ZHONG LUN LAW FIRM

CONTENTS

PREFACE

We are pleased to present the sixth edition of *The Public-Private Partnership Law Review*.

Public-private partnerships (PPPs) are increasingly becoming a solution to a gap in public investment that derives from natural budgetary constraints all over the world. Therefore, combining private and public efforts by means of a long-term contract becomes essential for tackling infrastructure matters that require massive investment for upgrading and expanding services' networks.

PPP contracts are a way of delegating the provision of public services and utilities to the private sector. Such practice induces effectiveness by bringing private sector solutions, technologies and investments, without excluding public sector oversight.

The formation of well-adjusted PPP contracts is no simple task, as they are marked by substantial complexity. In a single contract there are elements revolving around engineering, construction, financing, legal and regulatory aspects that must be addressed for the success of a given PPP.

A comparative study comprising practical aspects and different perspectives and viewpoints on PPP issues serves to spread knowledge of this contractual model around the world in the hope of consolidating a relevant benchmark worldwide. For instance, the United Kingdom is known as one of the pioneers regarding the use of PPPs and has structured projects ranging from telecom, power (electricity and gas), water and waste, and logistics (airports and railways). This experience, as well as the experience of other countries, certainly may serve as useful guidelines for the implementation of PPP projects

Therefore the purpose of this edition is to clarify and explain legal and other practical aspects involved in the formation of PPP contracts for disseminating best practices used by private professionals and governmental entities that rely on PPP projects for the provision of key infrastructure and public services and utilities. A comparative study is always useful for anyone who wants to know more about some phenomenon, and this edition will help those interested in PPPs.

The sixth edition brings chapters regarding PPP practices prepared by distinguished law firms from countries such as Argentina, Australia, Belgium, Brazil, China, France, Germany, Japan, Korea, Kuwait, Lebanon, Mexico, Nigeria, Portugal, Russia, Senegal, Serbia, Spain, Taiwan, Tanzania, Thailand, the United Kingdom, the United States and Vietnam.

We hope you enjoy this sixth edition and that it serves as a definitive and comprehensive guide for topics related to PPPs.

André Luiz Freire, Thiago Luís Santos Sombra and Raul Dias dos Santos Neto
Mattos Filho, Veiga Filho, Marrey Jr e Quiroga Advogados
São Paulo
March 2020

Chapter 22

UNITED KINGDOM

Mark Richards, Katherine Calder and Alexander Hadrill[1]

I OVERVIEW

i Background

Public-private partnerships (PPPs) are infrastructure delivery models based upon joint working and risk sharing between the public and private sectors. Generally, these are long-term models, with the United Kingdom's Private Finance Initiative (PFI) structure (until recently the UK government's preferred PPP model; see below) typically existing over a concession period of 25 to 30 years.

There are many forms of PPP, from private contracting as part of a state business through concession-based PPPs to regulated private sector entities. The key forms are described in greater detail in Section III.

In respect of PFI, the Chancellor of the Exchequer announced at the 2018 Budget that PF2 (the updated PFI model) would no longer be used to procure infrastructure. This announcement did not affect existing projects procured under these models, though (except in the case of the Silvertown Tunnel project for Transport for London, which is a devolved authority); projects that were intended as PF2 projects (at cancellation of the model) have either been cancelled or suspended or are being funded through public finance. A consultation, the Infrastructure Finance Review,[2] has been run by the government in connection with a new PPP model (or models), but while the consultation closed to responses in June 2019, its results have not yet been reported on by the government (though a report may be published around March 2020). In the absence of a replacement preferred model (or models), this chapter concentrates on the prevailing PFI/PF2 models.

PFI projects can arguably be characterised as having been a continuation of the privatisation programme pursued by the UK government under Prime Minister Margaret Thatcher, where publicly owned utility companies such as gas, electricity, water and telecommunications were privatised with the intention of both facilitating new capital investment in these sectors and reducing (on the balance sheet) government liabilities.

However, while certain sectors, in particular prisons, hospitals, schools and the Ministry of Defence estate, were not considered practically or politically suitable for full privatisation, the intention to reduce government liabilities and increase capital investment through private sector financing could still be fulfilled through the use of PFI projects.

1 Mark Richards is a senior partner, Katherine Calder is a senior consultant and Alexander Hadrill is an associate at Bryan Cave Leighton Paisner LLP.

2 'Infrastructure Finance Review' HM Treasury and Infrastructure and Projects Authority, https://www.gov.uk/government/consultations/infrastructure-finance-review (last accessed 14 January 2020).

The UK government first adopted the PFI model of contracting in 1992 (pre-PFI examples of the United Kingdom using PPP procurement models include the Dartford Crossing and Severn Bridge, commissioned in 1987 and 1990 respectively). The PFI model was generally a design–build–finance–operate or design–build–finance–maintain PPP structure. While, as with PFI, most UK PPPs are funded through availability payments made by the public sector, a minority of PPPs (mainly road projects and bridges) are funded by the end user (for example, through road tolls). PFI projects were generally structured so that no demand risk is taken by the private sector contractor.

By contractually transferring delivery, cost and performance risk to the private sector, the government sought to protect the public sector from delays, cost overruns and poor performance in the delivery of infrastructure,[3] while utilising private sector depth of expertise, management and commercial skills and procurement experience (arguably problematic deficiencies in the public procurement of infrastructure).

However, as a fundamental tenet of PPP, best practice dictates that risks should be allocated to those parties best able to manage their occurrence and impact. Some commentators argue that PFI attempted to transfer too much risk to the private sector, with the private sector pricing projects accordingly to cover this inefficient transfer of risk, resulting in projects that were more expensive for the public sector than if the public sector had retained certain risks (and the costs associated with those risks). This, among other factors, has led to the increased questioning of whether PFI represents value for money.

Uptake from the first PFI project, the Skye Bridge, was initially slow both in the number and value of projects, but accelerated with the election of Tony Blair's New Labour government in 1997 and the standardisation of the contracting approach (the current approach being Standardisation of Procurement Contracts, Version 4 (SOPC4)).[4] The number of PFI projects rose from no more than one a year up to 1995, to a peak of 68 in 2004 (with at least 45 projects a year between 1999 and 2007).[5] Since the global financial crisis of 2008 and the implementation of Basel III (making long-term debt more expensive as a result of creating stricter capital adequacy regulations), the number and capital value of PFI projects fell steeply, and no projects have reached financial close since 2016.

ii PFI to PF2

PFI, then being the UK government's preferred approach to PPPs, was updated in a second generation of the PFI model, PF2, in 2012. Since 2012, more than £1 billion of capital investment has been made in 46 schools and one hospital. However, no PF2 investment has reached financial close since the Midlands Metropolitan Hospital project reached financial close in 2016.

3 'Public Private Partnerships' HM Treasury, https://www.gov.uk/government/collections/public-private-partnerships (last accessed 14 January 2020).

4 'Private Finance 2 (PF2)' HM Treasury, https://www.gov.uk/government/publications/private-finance-2-pf2 (last accessed 14 January 2020).

5 'Private Finance Initiative and Private Finance 2 projects: 2016 summary data' HM Treasury, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/579271/PFI_and_PF2_projects_2016_summary_data.pdf (last accessed 14 January 2020).

As a result of PFI and PF2, PPPs have delivered in excess of £59 billion of private sector capital investment in over 722 UK infrastructure projects since 1992.[6] These projects included new schools, hospitals, roads, housing, prisons, and military equipment and accommodation.

PF2 involved a number of structural changes to the PFI model. The key changes included:

a the public sector taking a minority equity interest in PFI vehicles alongside the private sector (typically a 10 per cent interest);
b the introduction of funding competitions for part of the private sector equity interest in PFI vehicles;
c accelerating delivery by reducing the length of the tendering process;
d the removal of soft facilities management services (e.g., cleaning) from the scope of services, and flexibility on the potential exclusion of minor maintenance services;
e open-book approach and gain share mechanism for surplus life-cycle funding;
f greater transparency, including in relation to private sector equity return; and
g risk reallocation, with the public sector taking additional risk allocation, including the risk of additional capital expenditure arising from an unforeseeable general change in law, utilities costs, site contamination and insurance.[7]

While no PFI projects have reached financial close since early 2016, the 2016 Autumn Statement[8] provided that the government would develop a new pipeline of projects suitable for delivery through PF2 (it was stated these projects would likely focus on roads, education, defence and primary care). This pipeline was initially expected to be revealed in 2017, but tightened government departmental budgets combined with increasing political antipathy (see below) raised the question of whether this pipeline would actually appear. While some elements of the pipeline were announced, the cancellation of PF2 has brought into question how these projects will be financed (see below).

iii Political antipathy

Throughout the history of PFI, but with increasing frequency since the global financial crisis and the re-emergence of 'old' Labour, left-wing politics in the United Kingdom, there has been a growing political antipathy towards PFI, both from ideological and value-for-money perspectives. Combined with the recent coalition and Conservative governments' austerity policies since the global financial crisis, PFI has increasingly been characterised in the media as providing for excessive private profit at public expense (most often in relation to National Health Service hospital PFI projects).

This antipathy towards PFI/PF2 can be seen in statement in the Infrastructure Finance Review consultation that: 'The government is open to exploring new ways to use private finance in government

6 ibid.
7 See footnote 2.
8 'Autumn Statement 2016' HM Treasury, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/571559/autumn_statement_2016_web.pdf (last accessed 14 January 2020).

> *projects, but the benefits brought by private finance must outweigh the additional cost to the taxpayer of using private capital, and the government will not consider proposals demonstrating the same characteristics as PFI or PF2.*[9]

This sentiment is also echoed in Labour MP Stella Creasy's now rejected proposal for a windfall tax on the profits of PFI projects (proposed to be equivalent to removing any decrease in corporation tax the relevant companies have been subject to since the relevant PFI project reached financial close).[10]

Carillion insolvency events

The January 2018 insolvency of key PFI contractor Carillion plc (the second-largest construction group in the UK before its liquidation) further hardened public sentiment towards PFI. In particular, Midlands Metropolitan Hospital and other projects such as the new Royal Liverpool Hospital and Aberdeen Bypass, the latter being a non-profit-distributing (NPD) project (see Section I.iv), were heavily behind schedule and over budget at the point of Carillion plc's collapse.[11] In addition to political antipathy towards PFI, major contractors have increasingly moved away from large fixed-price construction contracts (a key risk transfer aspect of PFI) because of their often wafer-thin margins and the systemic risk they represent to those contractors. Subsequent to the collapse of Carillion, another major UK PFI contractor, Interserve, has had financial issues and as of the time of writing there remain significant questions as to the long-term financial health of a number of other major PFI contractors.

iv Varying approaches to PPP across the United Kingdom

The devolved administrations in Wales, Scotland and Northern Ireland have the capability to follow alternative PPP models (as do Transport for London). The Scottish and Welsh governments have previously used the NPD model, a model whereby there is no dividend bearing equity and capped return for private sector participants (any excess return is retained by the public sector). However, the extent of control and profit retained by the public sector under the NPD model has meant that these projects have been reclassified as 'on balance sheet' (increasing public sector debt) as a result of changes to EU rules (further below). This reclassification has reduced the attractiveness of procuring through the NPD model.

The Welsh government also has a mutual investment model structure, whereby the private sector builds and maintains assets, and in return the Welsh government pays a fee to the private sector to compensate for construction, maintenance and financing. At the end of a MIM contract, the asset is then transferred to public ownership.[12]

9 'Infrastructure Finance Review' HM Treasury and Infrastructure and Projects Authority, https://www.gov.uk/government/consultations/infrastructure-finance-review (last accessed 14 January 2020).

10 'Stella Creasy wants windfall tax on PFI companies to recover taxpayers money' BBC, www.bbc.co.uk/news/av/uk-politics-42732922/stella-creasy-wants-windfall-tax-on-pfi-companies-to-recover-taxpayers-money (last accessed 14 January 2020).

11 'The collapse of an over-stretched Carillion' *Financial Times*, https://www.ft.com/content/0e29ec10-f925-11e7-9b32-d7d59aace167 (last accessed 14 January 2020).

12 'The Mutual Investment Model' Welsh Government, http://gov.wales/funding/wales-infrastructure-investment-plan/mutual-investment-model/?lang=en (last accessed 14 January 2020).

v New models for PPP

With the PF2 model cancelled, and the MIM and NPD models currently subject to significant (if differing) questions over their future viability, the question arises as to what future role PPPs might have in the future infrastructure procurement in the United Kingdom. As exemplified in Section III, there is a range of PPP models that the United Kingdom could explore to procure infrastructure.

While one route may be to increase government borrowing through issuing gilts (currently relatively cheap by historical comparison), this may potentially create problems if it would result in the UK exceeding its 3 per cent and 60 per cent deficit-to-GDP and debt-to-GDP ratios respectively (under the Treaty on the Functioning of the European Union). Though the UK left the European Union on 31 January 2020, significant divergence from European law is (at least initially) unlikely, and (regardless of the applicability of European Law) the UK running significant debts or deficits may lead to a sovereign debt rating downgrade (making government borrowing more expensive and potentially reducing the finance available for infrastructure investment) or be problematic in the context of any future UK–EU trading relationship. If this were the case, the UK government may be hesitant in funding large-scale infrastructure investment via public borrowing through gilts.

Given the likely implications of any new large-scale government borrowing programme (with the government intending to spend between 1 per cent and 1.2 per cent of GDP on infrastructure between 2020 and 2050),[13] there would, however, appear to be a continuing opportunity for private finance in delivering infrastructure in the United Kingdom, with Her Majesty's Treasury announcing an infrastructure investment programme of around £600 billion up to 2028, of which the UK government anticipate almost half will be privately financed.[14] For nearly £300 billion of investment to be privately financed over a 10-year period, it has been suggested that public sector support for private sector infrastructure investment will continue, including through Contracts for Difference (a subsidy mechanism for low-carbon energy investment that guarantees a certain price for energy), the UK Guarantees Scheme (see Section VI.ii), and the Regulated Asset Base (RAB) model (see Section III.i).

Another possible solution may be for the government to increase the use of direct procurement (currently used for regulated utility infrastructure provision, for example, the Thames Tideway Tunnel) in the wider provision of infrastructure. Increased competition and innovation through competitive tendering of project financings (combined with minimum stipulated government contractual protections) certainly has the potential to address any value-for-money concerns over PFI/PF2.

It is not clear exactly how the role of private finance will develop in the provision of UK infrastructure, but it is clear that new models and risk allocations are needed. If the government wants to increase infrastructure investment, as it has evidenced in its 'Northern

13 'National Infrastructure Commission Autumn Statement Response: Government acceptance of NIC recommendations most welcome – Armitt' National Infrastructure Commission, https://www.gov.uk/government/news/national-infrastructure-commission-autumn-statement-response-government-acceptance-of-nic-recommendations-most-welcome-armitt (last accessed 14 January 2020).

14 'Written questions and answers' Parliament.uk, https://www.parliament.uk/business/publications/written-questions-answers-statements/written-questions-answers/?page=1&max=20&questiontype=AllQuestions&house=commons&keywords=%22private+finance+initiative%22 (last accessed 14 January 2020).

Powerhouse' and 'Midlands Engine' strategies and in recent statements around rebalancing the economy geographically (i.e. away from London),[15] PPP innovation will be required. A Delay in publishing the results of the Infrastructure Finance Review consultation and announcing a new preferred model (or models) for PPP may delay decisions on and construction of new infrastructure (to the extent that that infrastructure cannot be procured through existing schemes such as the Contracts for Difference model or the RAB model). The UK government's next budget announcement in March 2020 is likely to have significant details on the government's plan for infrastructure investment.

II THE YEAR IN REVIEW

i Brexit

As a result of a general election victory with a large majority for the Conservative government in December 2019, the UK left the EU on 31 January 2020. As at the time of writing an 'in principle' withdrawal agreement has been agreed with the EU, subject to ratification by both parties. Discussions have identified the likelihood of a transition period until 31 December 2020 to allow the parties to move to agree a post-Brexit trading model, but it is not yet clear what this will entail (or whether, ultimately, a deal will be agreed by the end of 2020 or the transition period will be extended).

It is the intention to retain all EU-derived procurement law in the United Kingdom immediately following Brexit. Procurement law that is compatible with Europe's will be vital to ensure that cross-border trade is encouraged, and the United Kingdom is still considered not only 'open for business', but likely to treat non-UK based companies on a level playing field. It is also likely to be a requirement of any future UK–EU trade deal. In any event, the UK will need to retain procurement law which is compliant with the World Trade Organisation Government Procurement Agreement to accede to that agreement in its own right post-31 January 2020.

However the current draft EU (Withdrawal) Bill indicates that there may well be divergence with EU Interpretation of procurement law in the future. Not only does it allow the UK's Supreme Court to diverge with ECJ case judgments on the interpretation of the procurement Directives/Regulations, but it opens the doors for lower courts also to potentially do so. Therefore while the UK statutory provisions will remain aligned with their EU Directive predecessors, how the legislation is interpreted and implemented may well diverge in the future.

Continued uncertainty over the future relationship between the United Kingdom and European Union has negatively impacted and, at least in the short term, is likely to continue to negatively impact inbound investment by overseas infrastructure investors in UK-based infrastructure projects. The United Kingdom may, in the medium to long-term take the opportunity outside the European Union to consider its wider procurement laws and labour law standards, which could have a positive effect on the United Kingdom's competitiveness.

15 "Infrastructure revolution' in March Budget', BBC , https://www.bbc.co.uk/news/business-51011000 (last accessed 14 January 2020).

ii Infrastructure Finance Review

The government's Infrastructure Finance Review consultation was issued in March 2019 and closed for consultation responses in June 2019. While the government is yet to report its conclusions from the consultation (which we believe it may do in or around March 2020), this consultation highlights the government's continued commitment to certain public support schemes for financing infrastructure investment, such as the UK Guarantees Scheme (a scheme for guaranteeing debt repayment on nationally significant infrastructure projects), Contracts for Difference (a subsidy/price support mechanism for low carbon energy generation), RAB models (for privatised industries such as airports and water/waste) and co-investment funds (for new technology infrastructure investments such as digital infrastructure and electric vehicle charging infrastructure). While loans for Infrastructure investment are available to local authorities (through the Public Works Loan Board (PWLB)), the public support schemes for infrastructure investment do not necessarily cover large sections of infrastructure, such as hospitals, roads, prisons and schools. If these types of infrastructure are to be privately financed, then a new model (or models) would be needed for such investment.

Further, the consultation also covered the potential for the incorporation of a new UK infrastructure finance institution, perhaps similar in structure to public infrastructure finance institutions found in Japan (Development Bank of Japan), Canada (Canada Infrastructure Bank) and Germany (KfW). This follows the National Infrastructure Commission's 2018 National Infrastructure Assessment recommendation that the incorporation of such an institution (with governance making it independent of political interference) may be an appropriate response to the UK's withdrawal from the EIB and the reduced role of the EIB going forwards in funding UK infrastructure. The UK has recent experience of incorporating a successful infrastructure finance institution with the Green Investment Bank (now sold to Macquarie) and the government may well be interested in incorporating another such institution if it believes that such would 'crowd in' further private sector investment (as opposed to 'crowding out' such investment, an accusation often levelled at the EIB by its critics).

iii Future role of the European Investment Bank in UK infrastructure

One key impact on UK infrastructure from Brexit may be the United Kingdom's withdrawal as a shareholder from the European Investment Bank (EIB) and what may have to be paid on leaving the EIB. In the short term, post-2020, UK projects have been warned[16] that they may have to insure against the risks of Brexit, and in the long-term, lending from the EIB may reduce or end completely (it has reduced by 87 per cent between 2016 and 2019),[17] cutting off an important source of funding. Addressing this concern, the joint report on preliminary matters released on 8 December 2017 expresses the United Kingdom's hope that a relationship with the EIB can be maintained, saying: 'The UK considers that there could be mutual benefit from a continuing arrangement between the UK and the EIB. The UK wishes

16 'EU infrastructure bank warns of Brexit hit to UK', *Financial Times*, 16 October 2017, www.ft.com/content/aaaaa9cc-b1b2-11e7-aa26-bb002965bce8 (last accessed 14 January 2020).

17 'U.K. Projects Face Multi-Billion Pound Funding Gap When Brexit Cuts Off EIB', Bloomberg, https://www.bloomberg.com/news/articles/2019-01-31/british-projects-face-funding-shortfall-as-brexit-cuts-off-eib (last accessed 15 January 2020).

to explore these possible arrangements in the second phase of the negotiations.'[18] There has been little by way of further clarification of the potential role of the EIB in a post-Brexit United Kingdom.

iv The National Infrastructure Commission

The National Infrastructure Commission (NIC) was established in 2015 with the remit of providing expert and impartial advice on infrastructure to the government, in part, by providing a report on the long-term infrastructure requirements once in each parliamentary term (through a National Infrastructure Assessment, the first of these being published in July 2018).[19] The NIC's reports, when coupled with the United Kingdom's government's commitment to spend between 1 per cent and 1.2 per cent of UK GDP on infrastructure,[20] should ensure that a 'short-termist' approach can be avoided for a more beneficial, long-term vision of what infrastructure the United Kingdom needs.

v Regulated Infrastructure Investment model

'Regulated Infrastructure Investment: Innovation and Opportunity',[21] a report published by industry body The Infrastructure Forum (TIF) in January 2020, calls for the expansion of the RAB model to further infrastructure sectors including rail, telecoms, transport, energy, EV charging infrastructure and social housing through a 'Regulated Infrastructure Investment' (RII) model. Adapting the Thames Tideway Tunnel model, risk would be shared between the public sector, private investors and consumers, for example with the public sector taking low-probability but high impact extreme risks and construction risk being shared between the private investors and consumers. It is likely, given the cost of a regulatory structure, that this model may only be truly viable for projects with a significant capex (or where projects are 'aggregated'), but it provides an example of a potential new model for private investment in infrastructure.[22]

vi Secondary market

The UK PFI market has benefited from an active secondary market in equity stakes in PFI projects. The United Kingdom, by volume, has historically been a very active secondary market for the trade in PPP equity stakes. However, the number of secondary market trades has been reduced as the number of newly originated greenfield PFI projects has halted. When coupled with the desire of close-ended equity infrastructure funds holding their equity stakes to maturity, we anticipate the volume of sales of PFI equity stakes on the secondary market to

18 'Joint report from the negotiators of the European Union and the United Kingdom Government on progress during Phase 1 of the negotiations under Article 50 TEU on the United Kingdom's orderly withdrawal from the European Union', 8 December 2017, European Commission, https://ec.europa.eu/commission/sites/beta-political/files/joint_report.pdf (last accessed 14 January 2020).

19 National Infrastructure Assessment, NIC, https://www.nic.org.uk/wp-content/uploads/CCS001_CCS0618917350-001_NIC-NIA_Accessible.pdf (last accessed 15 January 2020).

20 'Autumn Statement 2016' HM Treasury, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/571559/autumn_statement_2016_web.pdf (last accessed 14 January 2020).

21 'Regulated Infrastructure Investment: Innovation and Opportunity', The Infrastructure Forum, https://fea715ce-3c56-4c71-9893-f1a800dfb282.filesusr.com/ugd/d9a995_fc8eadfc7e074489bae9077bfd16dd23.pdf (last accessed 15 January 2020).

22 See also 'RAB-style model mooted for greenfield *infra*' InfraNews Daily Briefing, 15 January 2020.

continue to reduce. While the volume of equity trades is reducing (due in part to long-term investors holding assets to maturity), equity holders have an opportunity to take advantage of historically low interest rates and significant debt liquidity, including the use of holding company leverage in their acquisitions.

vii Budget 2020

There was minimal coverage of infrastructure and PPPs in the 2019 Budget, but the 2020 Budget (scheduled for 11 March 2020) should contain significant detail on infrastructure investment (including in respect of the current government's stated intention to expand infrastructure investment outside of London, particularly in the North and Midlands through its 'Northern Powerhouse' and 'Midlands Engine' strategies).

viii Preferred PPP Model review

In October 2017, the government commissioned a review of SOPC4 with the intention that a new generation of PFI projects could be developed to revitalise the infrastructure sector. However, the National Audit Office's recent review of PFI dampened the government's plans by suggesting that PFI has not provided value for money for the taxpayer. The subsequent cancellation of the PF2 model means that any updated SOPC may coincide with the government announcing a new preferred model for private investment in PPPs.

We understand that the government's review of SOPC will identify changes to reflect recent EUROSTAT regulatory changes. In addition, as a result of recent political events, the government may also take the opportunity to incorporate additional changes to the SOPC, reflecting upon lessons learnt from the Carillion insolvency and other incidents associated with PFI/PF2 service delivery. But it is not clear, and there has been no current indication from government, as to exactly what form the new model will take. We would, on balance, suggest that it may be a model where the private sector participants received a capped return.

III CONTRACTUAL FRAMEWORK

i Types of public-private partnership

Outside of PFI/PF2, there are several other forms of PPP used in the United Kingdom, considered below.

Concessions

Under a concession, a private entity is granted an exclusive right to build, maintain and operate specific assets for a period of time. These projects are financially free-standing and usually the contractor is paid through usage charges, availability fees or a combination of both to ensure the operating model can encourage both ongoing capital expenditure and service delivery innovation. This structure is often used for projects such as tolled roads and river crossings.[23] The United Kingdom's rail franchise model is also a form of concession operating in a highly regulated industry.

23 For example, the M6 toll road, the Second Severn Crossing and the QE2 Bridge at Dartford.

Strategic infrastructure partnerships

In a strategic infrastructure partnership, a public sector body enters an arrangement with a private sector partner as a joint venture or under a contract. This structure is usually suitable where there may be several phases of works or where several similar small projects are bundled together.

Public delivery organisation (integrator)

The public sector appoints a contractor to adopt a 'client-side' role and manage the delivery of a project from preparation to operation. The contractor will usually only manage rather than deliver the project. This approach may be suitable where the project is long-term and requires a flexible approach.

Regulated asset base structures

The regulated asset base model structure is used to license out a commercial activity, and the licensee will recover returns on expenditure used to develop and operate the assets. Competitions are held for the award of the licence, and the activity and returns on investment are usually subject to independent regulation. The regulated asset base model has been used successfully in the regulated water, power distribution and airport sectors.

With a regulated asset base model, the initial value of assets (often at privatisation) is added to the cost of further investment allowed by the regulator (each subject to depreciation) and the value realised from any disposal is subtracted. This regulated asset base (RAB) (also known as a regulated asset value) is then subject to indexation, creating a net invested capital value.

While models vary dependent on industry, the RAB (i.e., CAPEX) is, in basic terms, then used to calculate the required revenue for the provider through a (risk-weighted) allowed return (which will take account of a number of factors including the provider's weighted average cost of capital) being applied to the RAB. This allowed return is then (subject to an amortisation allowance) added to allowable OPEX costs to calculate a total required revenue. This required revenue is then raised from customers (subject to provision of any grants or other funds from the public sector) through their usage or bills. Potential further uses for a RAB model include nuclear power generation and carbon, capture, usage and storage (CCUS) (see further the Department of Business, Energy and Industrial Strategy's 'Business Models for Carbon Capture, Usage and Storage' consultation[24] and TIF's 'Regulated Infrastructure Investment: Innovation and Opportunity' report).[25]

Direct procurement

Ofwat, the water sector regulator, and Ofgem, the electricity regulator, exemplify a further procurement option. Ofwat has used direct procurement to deliver large-scale assets. This model encourages partnership arrangements for the delivery of an asset to increase competition for financing with the hope of driving down financing costs. Thames Water's

24 'Business Models for Carbon Capture, Usage and Storage', BEIS, 'Business Models for Carbon Capture, Usage and Storage' (last accessed 28 January 2020).

25 'Regulated Infrastructure Investment: Innovation and Opportunity', The Infrastructure Forum, https://fea715ce-3c56-4c71-9893-f1a800dfb282.filesusr.com/ugd/d9a995_fc8eadfc7e074489bae9077bfd16dd23.pdf (last accessed 15 January 2020).

Thames Tideway Tunnel project is an example of the use of direct procurement in the regulated water sector. In the case of the energy sector, Ofgem has used direct procurement methodology for Offshore Transmission Operators and had previously intended to use direct procurement for its Competition in Onshore Transmission programme (a programme that has now been suspended).[26]

Joint ventures

The government may adopt a joint venture model to deliver a project utilising limited companies or partnerships. Joint ventures may be adopted to operate a public service where the revenue does not cover the operational costs, or to realise development potential in publicly owned real estate.

Government-owned, contractor-operated companies

An authority may want to retain control of a strategic asset but will need a contractor to operate it for the duration of the services. Once in operation, the asset will be transferred back to the government.

Hybrid projects

Structures may develop that combine together aspects of the above structures and these may be used for specific one-off projects that have special requirements.

Contracts for difference

This is the UK government's main mechanism for supporting low-carbon electricity generation and works by pay the investor the difference between the 'strike price' (a price bid-in at auction reflecting investment costs) and a market reference price (a measure of average electricity prices in the Great Britain electricity market). If the prevailing market reference price is below the strike price, a 'subsidy' is paid by the private company administering the contract on behalf of the UK government (such subsidy being recovered from end users of electricity), and if the strike price is below the prevailing market reference price then the investor returns the difference. This mechanism therefore de-risks low-carbon electricity revenues by providing revenue certainty and stability.

ii The authorities

The following public bodies are responsible for PPP in the United Kingdom:

a Her Majesty's Treasury, which controls public spending and sets the general direction and policy on PPP. It also approves the project business cases;

b the Cabinet Office, which oversees the standards and efficiency of government functions and procurement and approves procurement structures;

c the Infrastructure and Projects Authority (IPA), which helps translate long-term planning into successful projects. The IPA publishes National Infrastructure Delivery Plans to cover infrastructure policy over a five-year period;[27]

26 See, for example, 'Competition in onshore transmission', Ofgem, https://www.ofgem.gov.uk/electricity/transmission-networks/competition-onshore-transmission (last accessed 28 January 2020).

27 'National Infrastructure Delivery Plan 2016-2021', Infrastructure and Projects Authority, www.gov.uk/government/publications/national-infrastructure-delivery-plan-2016-to-2021 (last accessed 14 January 2020).

d procuring bodies: the authorities that structure and procure projects. They are the contracting party and manage the project and pay the contractor;
e independent regulators: some areas of activity are regulated by a specific body, for example, gas and electricity, large airports, water, and environment;
f planning authorities that decide whether to grant development consent for a project. The size and location of the project will define who the relevant planning authority is; and
g the Comptroller and National Audit Office, which scrutinises government spending. The Comptroller and National Audit Office published an important report on the costs and benefits of PFI/PF2 in 2018.[28]

Post-Brexit much of the existing framework will remain in UK law but the extent of future application of EU rules will depend on any final agreements between the EU and UK.

iii PPP project requirements

In the United Kingdom there is no PPP law as such, unlike in many other jurisdictions outlined in this book. UK PPP projects are promoted under the general legislative powers of government and public bodies. A PPP concession is granted by government under English contract law (or under Scottish law where the concession is granted by the Scottish government using devolved powers), although in some sectors of government, primary legislation has been passed to enable PPP projects to be financeable. The powers of central government departments are mainly unfettered unless limited by common law or legislation. Local government and other public bodies will have more restricted powers conferred by legislation.[29]

The choice of what PPP model to use on each project is up to the procuring body to decide and there is no standard approach or correct structure when procuring a project. The Cabinet Office and Her Majesty's Treasury will oversee any decision on the structure of the project and ultimately (and most importantly) the source of funding for the project.

Similarly, the approach to PPP contracts will depend on the structure of the project. However, the contracts for PFI/PF2 projects have been standardised by Her Majesty's Treasury in SOPC4. SOPC4 sets out recommended and required provisions that should feature in the contract.

By way of example, in the United Kingdom, PFI/PF2 projects had to be approved before procurement and a typical framework for approval is:
a the Cabinet Office approves the procurement route. The IPA operates a staged assurance process that the project must go through when proceeding to procurement; and
b the strategic outline case, outline business case and final business case must be approved by Her Majesty's Treasury. The strategic outline case will be approved at the beginning of the project, the outline business case at the pre-market stage and the final business case before any final negotiations begin.

28 'PFI and PF2', National Audit Office, https://www.nao.org.uk/wp-content/uploads/2018/01/PFI-and-PF2.pdf (last accessed 14 January 2020).
29 For example, the National Health Service (Private Finance) Act 1997 which allows the NHS to enter into development finance agreements. Also, the Localism Act 2011 extended the powers of local governments.

Each procuring body must follow its relevant approval process. Local government bodies and other public bodies usually require sign-off from their sponsoring department.

All of these approvals are obtained by the procuring body and not the contractor. Once it has successfully bid for the project, the contractor will have to obtain various consents such as planning consents and environmental permits. The contractor is not required to obtain any PPP-specific consents.

IV BIDDING AND AWARD PROCEDURE

The procurement of works, goods and service contracts by public bodies in the United Kingdom mirrors the Public Contracts Directive 2014/24/EUas implemented in UK law in the Public Contracts Regulations 2015 (the Regulations).[30] Post-Brexit these Regulations will continue to apply with only practical adjustments. For example, references to the Official Journal of the European Union (OJEU) will be to a UK equivalent publication if there is a no-deal Brexit.

The Regulations apply when works, services or supply contracts are procured that have a value in excess of the published thresholds for that year and they are not excluded contracts.[31] It describes three regimes. The primary regime requires fully regulated procurement, and this applies to most contracts above the thresholds. It involves advertisement of the opportunity in the OJEU and compliance with detailed rules when carrying out the competition. This regime applies to the majority of PPPs.

The second regime describes a 'light touch' procurement process that must apply to a limited number of specific types of contract referred to as 'social and other specific services'.[32] There is a higher financial threshold, and while advertisement in OJEU is still required, the process itself is less prescribed. This process may be used, for example, in the procurement of medical equipment or social services.

Finally, there is very limited regulation in respect of 'below threshold' contracts that are between a *de minimis* threshold (£10,000) and the main threshold. The below-threshold regime requires advertisement on a national website, though not the OJEU. In the United Kingdom this website is Contracts Finder,[33] and will include most, if not all, contracts, whether above or below the thresholds. It is familiar to most contractors in the United Kingdom and the preferred source of contract opportunities.

There are two ancillary Directives/Regulations that may apply in specific circumstances:

a the Concessions Contracts Directive 2014/23/EU applies when public bodies procure concession contracts, that is, contracts where the contractor receives remuneration from third parties by exploiting the relevant asset or concession (e.g., toll roads). This came into force in the United Kingdom in 2016 under the Concession Contract Regulations 2016 (and will also remain post-Brexit); and

b the Defence and Security Directive 2009/81/EC applies to the procurement of contracts that require a higher degree of confidentiality and data security because of their sensitive nature and was transposed into UK law under the Defence and Security Contract Regulations 2009 (and will also remain post-Brexit).

30 This covers only procurements commenced after 26 February 2015.

31 Thresholds can be found at: www.ojec.com/thresholds.aspx (last accessed 14 January 2020).

32 These include contracts in the field of health, education and law.

33 See https://www.gov.uk/contracts-finder (last accessed 14 January 2020).

Though an OJEU notice is still required, the Concessions Contract Regulations offer less onerous rules of competition. Though it could apply to many infrastructure projects and PPPs, the public sector has been slow to make use of it in the United Kingdom, preferring the familiarity of the main Public Contract Regulations.

All of the Regulations require the application of overriding principles of fair procurement, namely: the equal treatment of all bidders; transparency of the procurer's requirements and decision-making processes to bidders; and non-discrimination.

Where the full regime applies; there is a choice of five procedures:

a the open procedure;
b the restricted procedure;
c the competitive dialogue procedure;
d the competitive procedure with negotiation (often referred to as the 'negotiated procedure'); and
e the innovation partnership procedure.

In summary, the open and restricted procedures do not allow any form of negotiation or discussion between the bidder and the authority (although clarification of proposals is allowed). They are generally considered unsuitable for procuring complex PPPs. Innovation partnerships are a new feature of the 2014 Directives but do not appear to have gained much traction. They are appropriate where the authority is looking to the market to develop a new product to meet its needs and be the 'first customer' of such product.

Common practice in the United Kingdom for PPPs has oscillated over the years between the negotiated procedure and the competitive dialogue procedure. An earlier version of the negotiated procedure was preferred until 2006, being extremely flexible and allowing the deselection of one bidder early in the process. However, the United Kingdom was heavily criticised for this and it was generally felt that the lack of competition during the key contract negotiations prolonged the award of the contract rather than facilitated it, as all terms were often erroneously considered up for negotiation by the 'preferred' bidder and the authority. By 2006, the United Kingdom had worked with the EU Commission to devise the competitive dialogue procedure as an alternative, which enabled negotiation with multiple bidders until the submission of final tenders only, after which there would be no further discussion. Between 2006 and 2015, the UK government championed this new process, but it was generally considered the worst of all worlds in practice. It required significant resources and time (for bidders and authorities) to negotiate more than one contract to the stage where a final tender could be capable of acceptance without further discussion.

The 2014 Directives dealt with this criticism by amending the competitive dialogue procedure to allow some negotiation with the preferred supplier post-final tenders, provided there is no material modification. Meanwhile, the negotiated procedure in the Public Contracts Directive[34] no longer allows negotiation post-final tender.[35] Competitive dialogue is arguably now the more flexible procedure. Perhaps for this reason, the UK government has relaxed its policy prohibition on the use of the negotiated procedure and, ironically, public bodies have flocked back to it, perhaps in the belief that it still provides its previous flexibility. It is once again the most common procedure for large PPPs.

34 The negotiated procedure in the Utilities Contracts Directive remains flexible allowing negotiations with one preferred supplier from an early stage.

35 See Regulation 29(13).

Whichever process is chosen, lack of government resources and a tightening of legal budgets has led to a focus on reducing procurement timetables. To do this, public bodies tend to limit which areas they are prepared to discuss or negotiate. Often, the main terms and conditions may not be debated at all, only the technical solutions. As much as possible of any negotiations are also now conducted electronically by use of web-based applications. The days of PPPs taking three years to negotiate are long gone.

Procurement law provides a number of remedies to disgruntled bidders such as a right to damages and in some circumstances a right to have a contract rendered ineffective. These remedies can be found in the Regulations, though are subject to very short limitation periods. Courts in England and Wales have in the past arguably been unsympathetic to procurement law challenges, and litigation levels remain relatively low compared with the rest of Europe (and with a comparatively low success rate, though it has been steadily increasing over the past decade).

Procuring authorities are also subject to freedom-of-information laws and concluded contracts are generally published (usually with redactions of particularly sensitive information).

i Expressions of interest

All above threshold contracts to which the Directives apply must be advertised in the OJEU. The name, description and value of the contract is given together with the link or contact details for obtaining further information. This information usually consists of an information memorandum detailing the opportunity and background information, together with anticipated timescales and selection criteria for the initial shortlisting of those who will be invited to tender. It may also include a draft contract and evaluation criteria to apply to the tenders at the next stage.

Vitally, the information pack will also include a selection questionnaire to be completed by interested parties and returned within a 30-day period (other than in cases of urgency where this period may be reduced). Most public bodies now use the UK government's standard form questionnaire.[36] It asks a series of questions aimed at identifying the bidding organisation or bidding consortium, its financial strength and experience, and whether there are any mandatory or discretionary grounds for exclusion (e.g., a history of criminal conviction, fraudulent activity, tax evasion or poor performance on previously awarded public sector contracts).

Respondents will be assessed against their ability to meet the minimum thresholds with regard to financial standing, and technical ability or experience. Only those that meet the minimum requirements shall be scored, and a shortlist of usually between three and five respondents will be invited to the tender stage of the competition.

ii Requests for proposals and unsolicited proposals

Private parties often liaise with public bodies in an effort to persuade them to enter into PPP arrangements with them. These discussions more often than not take place in the context of official pre-market engagement exercises, which are now specifically allowed under the Directive and promoted by the government. Care must be taken by the authority to ensure they are transparent about these discussions and provide the same level of information to

36 See https://www.gov.uk/government/publications/procurement-policy-note-816-standard-selection-questionnaire-sq-template (last accessed 14 January 2020).

all interested parties (though information received in return should be kept confidential). Sometimes, however, discussions are entered into on an exclusive basis but an authority may not accept any unsolicited offer without considering whether the contract in question would be subject to the Directives. If it is, the body may not accept such offer without the risk of procurement law challenge, and the potential contract must be advertised in OJEU.

Assuming a contract has been advertised and pre-qualified respondents shortlisted as described in Section IV.i, then the shortlisted bidders will be provided with a suite of documents referred to as the 'Invitation to Participate in Competitive Dialogue', or 'Invitation to Negotiate' (as applicable to the chosen procedure). The documents will include: details of the timetable and process for negotiation, including whether it will take place in successive stages and whether bidders may be rejected at each stage; the technical requirements and specification; the draft terms and conditions; the evaluation criteria that shall be applied to each tender and the final tender; and the deadline by which initial tenders must be submitted.

iii Evaluation and grant

Following the receipt of initial tenders, there is a period of negotiation with each bidder. The authority may, in theory, discuss and negotiate all aspects of the tenders but must have regard to the core principles of equal treatment. This means that they cannot agree to change to their requirements with one bidder and not others. However, they must balance this against maintaining the confidentiality of each bidder's technical solutions.

As set out above, the scope of matters that are likely to be negotiated has decreased drastically over the years. Mark-ups of the draft terms and conditions are often not allowed at all and may result in exclusion, be limited to some clauses only, or be heavily penalised in the scoring. As a result of this, public bodies have ensured that by the time final tenders are requested, the contract has been largely accepted and there is minimal negotiation thereafter. Only time will tell whether this will produce long-term contracts that are truly fit for purpose.

Once the final tenders are received, the authority shall apply the evaluation criteria to the tenders. Evaluation criteria must be set out at the outset in the procurement documents and have the objective of identifying the 'most economically advantageous tender'. This means there must be a price-to-quality ratio applied to the weighting of scores. The contract may only be awarded to the bidder that receives the highest-weighted score. Following award, final negotiations may be carried out to finalise details of the contract if the competition dialogue process is used. In practice, it also takes place where the negotiated procedure is used, though this is now prohibited by Regulation 29(13).

Public bodies must notify all bidders of their intention to enter into the contract and refrain from signing the contract until a period of at least 10 days has elapsed from the date of the notification to give unsuccessful bidders an opportunity to issue a claim before the contract is signed.

V THE CONTRACT

This section focuses on SOPC4, which provides guidance and drafting for PF2 contracts. The SOPC4 was first released in 2012 and is currently being reviewed. Some PPP contracts use the PF2 position as a starting point but use their own template documents, for example, the Education and Skills Funding Agency and the Ministry of Defence. As mentioned above, it is understood that, in due course, a new preferred PPP model for the UK government will be announced; however, for the time being, the following note concentrates on the mechanics of existing PF2 contracts.

i Payment[37]

Under PFI/PF2, contractors are generally paid with a single unitary charge, which should not be paid until the commencement of the service. The payments will be linked to the 'availability' and performance of the service, and the contractor should be incentivised to provide quality services to the authority for value for money. Irregular payment profiles are not recommended as this may mean the project is more difficult to finance, and ultimately more expensive for the government.

Payment mechanisms are monitored and payments are indexed so that they can adjust for inflation and changes of law over the project term.

The payment and performance regime gives financial effect to the project's risk allocation. It is unusual for the contractor to take demand risk in PFI/PF2; however, in certain projects this may be appropriate.

ii Asset and land ownership[38]

The authority will usually own the land and lease or licence it to the contractor. However, where a project is equipment-based (rather than building-based), the contractor usually acquires the assets and the authority should be given the ability to use and, in certain cases, obtain ownership of the assets to fulfil its statutory duties.

iii Amendments and variation[39]

As PF2 projects are long term, the contract should allow flexibility to account for any changes in requirements; this includes the introduction of the small value change regime in PF2. In addition, PF2 model contracts seek to exclude certain auxiliary services such as cleaning and catering, as these were considered better value for money when delivered over significantly shorter and more flexible contract terms.

PF2 project contracts usually cover for three main changes, namely use or functionality of the asset, changes in capacity of the asset or service, and change in the specification and standards of the service.

If the contractor wishes to amend project and finance documents, the authority's consent will be required, though certain minor changes may only have to be notified to the authority once they have been amended.

Changes should be priced and agreed in accordance with the provisions of the contract, and it is prudent to allow for independent determination to resolve any disagreements.

37 Part H, 'Standardisation of PF2 Contracts' (2012), HM Treasury.

38 Chapter 4, ibid.

39 Part F, ibid.

iv Risk allocation[40]

The authority's main contractual protection will be the ability to withhold or reduce payment if the service stops or is not of an appropriate standard. The authority may also be given comfort through parent company guarantees from the contractor, letters of credit and other credit support. The contractor will indemnify the authority against damages resulting from death, personal injury, property damage, third-party claims and breach of statutory duty.

The contractor's main protection will be regarding supervening events, namely:[41]

a compensation events – events whereby the risk should clearly lie with the authority and the contractor should receive compensation on a 'no better, no worse' basis;

b relief events – management and financial risk of these events (generally capable of being insured) should remain with the contractor as they are best placed to deal with the events; however, they should not lead to termination (but during operations can lead to payment deductions);

c force majeure events – limited circumstances (generally not capable of being insured) that are neither party's fault and best managed by the contractor. Termination rights may arise if the event cannot be addressed within a reasonable time frame; and

d a change in law – the contract will also provide protection to the contractor for any changes in law that cause the costs of the project to increase.

v Early termination and compensation[42]

The authority will generally have the ability to terminate the contract for contractor default or persistent breach. The project contract should allow the contractor time to rectify breaches. Authority termination rights will usually be subject to the step-in rights of the project's senior funders. In some circumstances, the authority may have to compensate the contractor on termination if, for example, termination leads to the automatic acquisition of the asset or land necessary for the project. The project contract may include rights for the authority to voluntarily terminate the contract, and in this case the contractor should be fully compensated, including the repayment of project senior debt and the contractor sponsor's equity returns.

The contractor will usually be able to terminate the contract for authority default, which will include non-payment, breaches that frustrate the services and breach of assignment restrictions (including lock-in periods). Usually, the contractor will be fully compensated in these circumstances. Continuing force majeure events that cannot be resolved within a reasonable time frame will lead to termination. As these events are neither party's fault, the financial consequence should be shared, and as such, compensation will be on a no-fault basis. So while senior debt will be repaid, the contractor sponsor's equity will be repaid back at 'par' only.

The contract will set out in detail the provisions for calculating any compensation owed under it. This is a fundamental requirement for project's senior funders and equity investors.[43]

40 Part G, ibid.

41 Chapter 15, ibid.

42 Part I, ibid.

43 Chapter 24, ibid.

vi Refinancing

Standard form PF2 contracts include provisions for sharing of refinancing gains. The authority should have the right to approve any refinancing, and provisions should be included in the contract to allow the authority to share in any qualifying refinancing gains achieved through refinancing.[44]

VI FINANCE

PFI/PF2 projects are financed by a mixture of debt provided by lenders on a limited recourse basis (i.e., the lenders' principal recourse is to the project's cash flows only and does not extend to other assets of the project or the project's equity investors, subject to any further credit support, such as construction guarantees or letters of credit, that may be given) and equity. PFI/PF2 projects have a high level of debt-to-equity, typically a ratio of 90:10. Recently, the public and private sectors have been exploring alternatives to the traditional sources of funding, which have become more limited following the 2008 global financial crisis, and innovative solutions to improve the financial models for such projects.

i Equity

PFI projects funding generally comprises approximately 90 per cent of debt and 10 per cent of equity and is set up as a conventional holding company-project company structure. Historically, it was the building contractors bidding for the projects that provided the equity capital investments. More recently, however, equity funding from third-party financial investors (such as equity infrastructure funds) has become more common as a result of market growth and contractors' capital constraints.

One of the fundamental differences between PFI and PF2 is government involvement in the project equity structure. In PF2 projects, the UK government, through an arm's-length HM Treasury unit, is given the opportunity to provide an element of the equity capital into the project vehicle.

In recently financed PF2 projects, Her Majesty's Treasury will, via a wholly owned company, take a minority stake (typically 10 per cent) in the project and are under no obligation to provide further funding to the amount agreed at financial close. It is hoped by the government that taking an equity stake in PF2 projects will strengthen the collaboration between the public and private sectors, and enable the public sector to benefit from increased financial transparency and decision-making capabilities on such projects.

Her Majesty's Treasury also stated[45] that holding a minority stake in the project would lead to better value for money through its entitlement to a percentage of investment returns, which in turn reduces the cost of funding these projects to the public sector. In practice, the developer, third-party equity provider and Her Majesty's Treasury enter into a shareholders' agreement, under which equity is provided in the form of subscription monies and subordinated debt, the latter issued by way of unsecured loan notes by the holding company SPV to the shareholders. Colloquially, this subordinated debt is regarded as equity for financial 'gearing' ratio purposes.

44 Chapter 28, ibid.

45 Paragraph 3.6, 'PFI and PF2', National Audit Office, https://www.nao.org.uk/wp-content/uploads/2018/01/PFI-and-PF2.pdf (last accessed 14 January 2020).

Another key change that was proposed in Her Majesty's Treasury's PF2 launch document is the higher levels of equity (20 to 25 per cent) compared with the debt-to-equity ratio commonly found in PFI projects. However, from information publicly available, none of the PF2 projects that have reached financial close have achieved a high level of equity, with debt-to-equity ratios remaining at approximately 90:10. Her Majesty's Treasury's rationale for the proposal was to widen the investor base to attract pension funds, insurance companies and institutional investors (Other Investors) to invest in PF2 equity, and thereby reduce the cost of debt and circumvent the perceived shortage of available debt funding in the market. However, no Other Investors had participated in any of the six PF2 projects as at January 2018 (and the debt-to-equity ratio remained the same as for PFI for all six PF2 projects).[46] This, coupled with the improvements in the conditions of the lending market, led Her Majesty's Treasury and the IPA to ultimately scrap the proposal.

ii Debt

Senior debt from banks and other financial institutions was traditionally the most common type of the majority of the financing for PFI projects.

Another debt financing source is the debt capital markets. Bond finance products have been developed for the financing of projects following the construction phase or the refinancing of completed projects on more favourable borrower terms. With banks having been increasingly reluctant to issue long-term loans because of stricter regulatory requirements and capital constraints as a result of the 2008 financial crisis, public bond financing was seen as a possible source of alternative sources of debt financing to fill the void. The reality, however, was somewhat different as a wide variety of sources of financing from insurance and pension fund investors, private placements and an active monoline insurer has provided a large amount of infrastructure debt liquidity.

As discussed in Section VI.i, the Other Investors have not been keen to take equity stakes in PFI/PF2 projects. They have, however, taken on a much more active role in relation to the debt financing aspect, both through the PFI/PF2 schemes and direct investment in such projects. Furthermore, greenfield PFI/PF2 projects have seen debt funding from infrastructure debt funds at pre-development and refinancing stages.

Another policy that was established to encourage alternative debt funding is the UK Guarantee Scheme (the Scheme), under which the government guarantees debt raised by the borrower (i.e., the holding company or project company) of infrastructure projects of national significance. The government announced in November 2016 that the Scheme will continue until at least 2026, and ten projects covering different sectors and deal sizes have already benefited from the Scheme since its inception. Since borrowing guaranteed under the Scheme would in effect render it to be classified as sovereign-backed debt, borrowers are generally able to achieve more favourable funding terms.[47] While the Scheme has been utilised on a number of projects, many commentators see the Scheme as unnecessary for the majority of well-structured investment-grade infrastructure projects.

46 ibid.

47 'UK Guarantees scheme for infrastructure' (2015), National Audit Office, https://www.nao.org.uk/wp-content/uploads/2015/01/UK-Guarantees-scheme-for-infrastructure.pdf (last accessed 14 January 2020).

VII RECENT DECISIONS

Perhaps the notable PPP/PFI decision in 2018 was *Tees Esk & Wear Valleys NHS Foundation Trust v. Three Valleys Healthcare Limited and Bank of Scotland PLC*, which concerned the ability to terminate a project agreement pursuant to the service of termination notices under a funders' direct agreement (FDA), The FDA provided that two specific notices had to be served by the public authority. The funders disputed the validity of the second notice on the basis that the notice was to detail amounts owed by the project company to the public authority and other obligations of the project company (the public authority having made 'proper enquiry') but did not contain such information and was therefore invalid. The intention of this second notice was to give the funders the opportunity to assess whether it wanted to step into the project, and the funders' argument was that the second notice delivered by the public authority was invalid as it contained insufficient detail (with some heads of claim marked 'TBC'). The funders also argued that there was no evidence that the public authority had made 'proper enquiry'. The judge ruled against the funders, detailing that if the funders had chosen to step into the project following the second notice, it would have only been liable for the quantified liabilities. However, the public authority did not have to quantify the other obligations, and there was no (implicit) obligation on the public authority to provide evidence of its enquiries for the notices to be valid.

Notable recent procurement law decisions in 2019 include the Court of Appeal decision in *Ocean Outdoor UK Ltd v. Hammersmith and Fulham LBC.*[48] This upheld the previous view of the Technology and Construction Court and gives definitive guidance as to when certain concession arrangements fall within the full scope of the EU procurement regime as 'service concession contracts' or whether public bodies are free to negotiate directly. It concerned leases for advertising space granted by a local authority on its land. The Court found that concessions that did not include any explicit obligations to build anything or to deliver services to the public body that the public body would otherwise have to perform or were for the benefit of the Council or residents were not covered by the procurement regime. This was despite rental payments being made on the assumption advertising services would be undertaken and a termination right existing if rent was not paid. This rent was not pecuniary interest for services. Moreover the exemption for land agreements would apply.

The key takeaway for large PPP procurement is whether public bodies will use this precedent to argue some types should be exempt as the public body would not be otherwise obliged to provide the services themselves and such projects are to generate revenue only (e.g., certain development or energy transactions).

In *AEW Europe LLP & Ors v Basingstoke And Deane Borough Council,*[49] the UK courts took a further step away from ECJ interpretation of the availability of remedies. It has long been considered the case that where an OJEU process has been undertaken the remedy of ineffectiveness may still be available if a claimant discovers during a period for six months post signature that the contracting authority allowed substantial modifications to the contract from that which was advertised pre-signature of the contract. The remedy is available if 'substantial modifications' were agreed post signature. In this case a preliminary issue was put to the court asking it to confirm that the remedy would be available on the assumption that a modification so significant had occurred that a new OJEU notice would have been required

48 [2019] EWCA Civ 1642.

49 [2019] EWHC 2050 (TCC).

and was not published. The court however said it would not. It applied a mechanistic test as first set out in a previous case (*Alstom*)[50] which says one simply compares the wording of the original OJEU notice and the signed contract and if the latter could reasonably fall within the description in that notice the remedy would not be available. This was despite the fact that in that previous case a new OJEU notice would not have been required (as per the assumption) because it concerned a qualification system. Leave to appeal was denied.

This case limits the rights available to unsuccessful bidders in UK procurements and essentially gives contracting authorities the ability to permit any number of changes to their contracts by preferred bidders after they have been appointed but prior to signature. It is a worrying progression, and one that we believe may be challenged in the future

Both *Ocean Outdoors* and *AEW v. Basingstoke* indicate a deliberate move away by the UK courts from ECJ interpretations of the Regulations, which may be helpful to challengers to UK public contracting decisions.

VIII OUTLOOK

It is clear, with the government discontinuing PF2 but outlining an intention to procure nearly £300 billion of infrastructure through private finance up to 2028, that the private sector will continue to play a key role in future infrastructure investment in the United Kingdom. New sectors, such as digital infrastructure (including data centre and broadband rollout investment) will drive change in the infrastructure market, as will (increasingly) UK government net-zero carbon targets, electric vehicle charging infrastructure and subsidy free/merchant energy projects. However, what exactly this role will be and what models will be used to procure such investments is not clear and may, to a large extent, depend on the outcome of the government's Infrastructure Finance Review..

A new preferred PPP model (or models) will invariably seek to address the key political and financial concerns in respect of PFI/PF2, including potentially being simpler, more flexible and providing value for money through amended risk allocations (including, potentially, the public sector retaining risk associated with low probability, high impact risks). We tentatively suggest that mechanisms may be introduced into the new model to mitigate against possible private sector windfalls (including in relation to future reductions in tax rates) and there may even be a cap on rates of return (or some other form of regulation of return). We expect that any new model would (to some extent) reflect existing models, such as the mutual investment model and even PF2 (though the political toxicity of the phrase means that 'private finance' is unlikely to be used and any model will be intentionally distanced from PF2). The model will also likely seek to comply with current Eurostat guidance such that these investments are classified as not being on the government balance sheet for net public sector debt and deficit calculations.

RAB models have been strongly promoted by the government (including as a potential solution to investment in nuclear power),[51] but these can inherently only provide a partial solution (even through an RII/other applied RAB model) – RAB models are only of relevance to privatised sectors (where there is a clear route through to end users) so it is difficult to see how these structures could be applied in part, if at all, to sectors such as defence or to

50 *Alstom Transport v. Eurostar International Limited* [2011] EWHC 1828 (Ch),

51 e.g., 'Regulated asset base model could benefit nuclear industry', UtilityWeek https://utilityweek.co.uk/regulated-asset-base-model-benefit-nuclear-industry/.

prisons, hospitals or schools. While investment in utilities and airports (and hence the RAB model) may take up a significant part of the circa £300 billion, a further PPP model is likely to be needed for non-privatised industries: the public sector may be funding previous 'PF2 projects' such as Glen Parva prison, the A303 Stonehenge tunnel and the Lower Thames Crossing tunnel, but public finances are still significantly restricted and private investment in PPPs is likely to be necessary to build much-needed infrastructure. Inevitably, the political reality of Brexit may delay consultation on or announcement of a new preferred PPP model, but it is clear that this model is greatly needed and will hopefully be confirmed in 2020.

Appendix 1

ABOUT THE AUTHORS

MARK RICHARDS

Bryan Cave Leighton Paisner LLP

Mark heads Bryan Cave Leighton Paisner LLP's EMEA environmental, energy and infrastructure finance team. Mark provides multidisciplinary advice to public and private sector clients on a wide range of complex, high-value and innovative energy and infrastructure projects structured using PPP, external finance and government contracting techniques.

With over two decades of experience, Mark has been involved in some of the most high-profile infrastructure deals in the United Kingdom and overseas, including advising on equity (including secondary market trades), debt structures, infrastructure fund trades, leasing and structured finance, and concession-based structures.

Mark is a non-executive director of the International Project Finance Association and is recommended as a leading expert on PPP in the *The Legal 500* and *Chambers and Partners* legal directories.

KATHERINE CALDER

Bryan Cave Leighton Paisner LLP

Katherine Calder is a senior consultant with Bryan Cave Leighton Paisner LLP with 18 years' post-qualified experience of advising utilities, and public and private bodies on public procurement, state aid and public law/*vires* issues. Katherine has acted on a wide variety of PPPs, PFIs, regeneration and outsourcing projects over the years, and is familiar with all common contracting models and procurement structures, from the early days of PFI, Building Schools for the Future, NHS LIFT, to PF2, 'Alliance' models and complex frameworks. Katherine's portfolio also includes contentious procurement work. Katherine has been instrumental in persuading a number of public bodies to retake their award decisions and also advises public bodies on how to successfully defend such attempts.

Katherine also holds a diploma in UK local government law and has been ranked as a noted practitioner for procurement in *Chambers and Partners UK* and for government contracts in *Who's Who Legal* for some years. She is a member of the Procurement Lawyers Association and writes on procurement law matters for PLC (Practical Law) and other publications.

ALEXANDER HADRILL

Bryan Cave Leighton Paisner LLP

Alex works on all aspects of projects, energy and infrastructure finance transactions across the project life cycle.

He has experience in acting for lenders and developers (both in the public and private sectors) on greenfield and brownfield developments, on the negotiation, completion and variation of projects, the financing of new projects, the refinancing of existing projects and the sale of equity and debt interests in project vehicles.

He graduated with a degree in geography from Oxford University and qualified as a solicitor in England and Wales in 2016.

BRYAN CAVE LEIGHTON PAISNER LLP

Adelaide House
London Bridge
London EC4R 9HA
United Kingdom
Tel: +44 20 3400 4603 / 4298 / 4740
mark.richards@bclplaw.com
katherine.calder@bclplaw.com
alexander.hadrill@bclplaw.com
www.bclplaw.com

an LBR business

ISBN 978-1-83862-494-1