The UK updates PFI: What it means for infrastructure investors

By Richard Threlfall, KPMG in the UK

It has been 20 years since the United Kingdom introduced the Private Finance Initiative (PFI) as a vehicle for funding public infrastructure projects with private capital. Since then, the scheme has financed scores of schools, hospitals, roads and other infrastructure through more than 1,400 projects totaling some £55 billion.

But familiarity alas breeds contempt. In 2010 the incoming coalition government cancelled or suspended much of the PFI program, and in late 2011 a comprehensive review was announced. To many outside the UK this is all quite incomprehensible. Why would the UK, as architect of such a well-copied model, suddenly choose to question it? The answer lies largely in politics – in the inconvenience for a government engaged in austerity to be locked into 30-year contractual obligations, and in the need to deal with media and parliamentary scrutiny over transparency in contracts and "excess" private sector profit in the provision of public services. Thankfully, that is all behind us now; we have a new model that seeks to draw a line under these debates.

PF2 unveiled

On 5 December 2012, the Chancellor of the Exchequer George Osborne unveiled the much-anticipated Private Finance 2 (PF2), while reaffirming its commitment to private sector investment. The pronouncement capped a year-long process of consultation and input from stakeholders in the public and private sectors.

None too soon, one might argue. UK infrastructure will need more than £300 billion in private capital investment by 2020, according to Infrastructure UK. Pressure will also mount as the country's population balloons by around 17 percent between 2011 and 2035 – putting significant strain on a nation whose infrastructure in many sectors is already operating near full-capacity.

A mixed bag

Dig under the covers of PF2, however, and you will find a mixed bag of initiatives – some welcome, some uncontroversial and positive, and others that should hopefully evaporate in the reality of implementation.

Greater transparency is absolutely welcome. PFI has been vilified – often undeservedly so – because it is easy to find examples where the private sector

What is inside

Transparency: The government will require private investors to publish equity return information, and will issue annual reports detailing project and financial information on projects in which it holds an equity stake.

Equity: Government will act as a minority equity co-investor in some PF2 projects – up to 49 percent – and will work to attract long-term investors such as pension funds. It is suggested that the typical 90:10 debt/equity gearing should fall to accommodate those investors, though it is unclear what direct role, if any, government proposes to take in trying to influence capital structures.

Accelerating delivery: Government is threatening withdrawal of funding for PF2 projects that take longer than 18 months to reach preferred bidder.

Flexible service provision: Procuring authorities may add or remove soft services – such as cleaning – once a contract is in operation, and a new mechanism will facilitate the sharing of any surplus lifecycle funding.

More efficient risk allocation: Change in law risk is in future to be taken by Government, and there are various other detailed risk allocation changes for example around insurance.

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has reaped huge financial rewards. But those media stories usually leave out the fact that private investors take significant risks on major construction projects and take the financial consequences when things go wrong. More sunlight is in everyone's interests.

Equally positive is greater public sector involvement, particularly since it is proposed that public sector representatives on boards will be from a team within Infrastructure UK, independent from the contract counterparty and experienced in infrastructure investment. The result should be better alignment of the public and private sectors – a real partnership rather than just a contract.

Uncontroversial, from most perspectives, is removing soft services from contracts. It is welcome that the government has kept hard (maintenance) services in the model, preserving the core concept of long-term contracts in which the private sector is incentivized to build and maintain an asset at the lowest cost over its whole life.

From the practical and positive to the rather more dubious? The 18-month limitation on the procurement process addresses the right point but in the wrong way. It introduces significant risk for both public authorities and bidders as projects could be cancelled after years of investment for reasons that, in some cases, neither side can control. The market has predictably responded in favor of bidders asking for their bid costs to be reimbursed each time a procurement is quashed.

And the move to a lower gearing? Leverage in any deal is driven by risk transfer. If government seeks to impose lower gearings, deal finance will become more expensive, with no corresponding gain. The government seems to think that lower gearing of itself will attract pension fund investors. That seems unlikely, and to achieve best value for money the private sector should be allowed to bid the most efficient financing for the risk it assumes.

Keep moving

Many of PF2's changes appear to be born from a belief that the public and private sectors are trying to outwit one another. That narrative helps sell newspapers, but is rarely the truth. Two decades of experience shows that both sides benefit from robust deals with partnership at the heart. Government has walked a tightrope between the headlines and its own recognition that the PFI model can deliver the UK's much-needed infrastructure on-time and on-budget.

On the whole, PF2 is a rebadging, minor adjustment and hence endorsement of a program that has served the UK well and will continue to do so. Now we all look forward to getting back to doing deals.

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Designed by Evalueserve. **Publication name:** Foresight. **Publication number:** 121570. **Publication date:** February 2013