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Sale of Equity in PFI Companies

Executive Summary

1. Government monitoring of the sale of equity in PFI companies is inadequate, infrequent and underestimates the scale of transactions. Meanwhile banks and construction companies are extracting large profits from what is ultimately publicly financed investment.

2. The sale of equity is significantly higher than that the sales identified in the HM Treasury PFI equity database and estimated by the National Audit Office. The ESSU PPP Equity Database identifies:

- 240 PPP equity transactions involved 1,229 PFI projects (including multiple sale of some projects) valued at £10.0 billion.
- Average profit was 50.6% (compared to average operating profits in PFI construction companies of 1.5% between 2003–09).
- £517.9 million profit from a sample of 154 PFI projects. If the same level of profit were maintained for the 622 PPP project equity transactions the total profit would be £2.2 billion.
- Profits could be as high as £4.2 billion if the same level of profits is obtained by the sale of secondary funds as in the direct sale of equity in PFI companies.
- Two sectors had higher than average profits, health (66.7%) and criminal justice (54.9%) with transport (47.1%) and education (34.1%) below average.
- An increasing number of PFI projects are registered in tax havens.

Sale of PFI Equity and Growth of the Secondary Market

3. There are basically two types of PFI equity transactions. Firstly, SPV shareholders selling equity in individual projects or in a group of projects. Secondly, the sale of secondary market infrastructure funds that have a portfolio of PFI equity stakes in SPVs. In both cases the partial or full ownership of equity in the SPV transfers to a new owner. PFI equity ownership also changes when a construction company is subject to a takeover or merger, however, the value of PFI assets will normally be reflected in the overall takeover price and will not be identified separately.

4. The PFI contract will normally impose a restriction on the sale of equity prior to the completion of the building works and commencement of the service. Once operational, contractors can sell their equity and are only required to inform the authority within 30 days of any change of ownership. Refinancing and the sale of PFI equity comprise the secondary market.

5. Some PFI companies have a policy of retaining ownership of equity in SPVs whilst others recycle their investments by selling equity to help finance new PFI projects. Four trends are evident in the secondary market:

- portfolio building by some construction companies;
- recycling and profit-taking by other construction companies;
- growth of joint ventures between PFI construction companies and banks, infrastructure funds and pension funds; and
- growth of secondary market infrastructure funds (listed and unlisted).

Government Adopts "Hands-off" Attitude

6. Although public sector consent and profit sharing is required when PFI projects are refinanced, there are no requirements when the equity of PFI companies is sold. The Treasury has regarded the sale of PFI equity as a transaction solely between private companies in which the government has no involvement. It argues that a change in the equity ownership of the project is part of the normal takeover or merger of companies and is different from refinancing projects. The National Audit Office (NAO) position is:

> "In general, the shareholders of a project company are allowed to trade their PFI shares freely, as they would any normal shares of a limited company. Only occasionally would a public authority have a say in such trades, such as a right to consent (not unreasonably withheld) in certain Defence

contracts. The public authority is not a party to such trades and does not share in any proceeds. It is therefore important that the expected return to the shareholders over the course of the whole contract be carefully scrutinised during the contract tendering" (House of Lords, 2010b).

Longer-term Consequences Ignored

7. The NAO recognises that the risk of the consolidation of PFI equity could lead to "…disproportionate market power, and particular asymmetry of power over small public authorities tendering and managing single PFI contracts. We would be concerned if we started to see a few consolidated owners dictating contract and commercial terms. We do not have evidence that this is happening" (ibid). It concedes that "…the lack of visibility over the secondary market it is difficult to ascertain the effects that the secondary market has had to date" (ibid).

8. The Treasury and NAO are either unaware, or have decided to ignore, the excessively high profit levels obtained in PFI equity transactions. The NAO assumes that the growing secondary market will have little or no effect on PFI projects, services users, staff and public bodies. However, *Global Auction of Public Assets* raises a number of important issues about the potential effects of the sale of PFI equity and the growth of secondary market infrastructure funds:

- invalidation of value for money claims because high profit levels appear to indicate significant overpayment for risk transfer;
- allocation of benefits from operational efficiencies;
- privatisation of gains from publicly financed investment and development;
- erosion of democratic control;
- increasing secrecy;
- acceleration of the marketisation of public services; and
- longer-term implications of the growth of secondary market funds and the potential effect on the delivery of core services (Whitfield, 2010).

Continues as Public Accounts Committee evidence September 2011.