Financial arguments ‘not always most powerful’ for public sector

Traditional restructuring options are limited, cash envelopes are finite and key points are often ‘lost in translation’. **Dan Hurd** spoke to **Natasha Rouse** about the practical challenges for restructuring professionals involved in public-private sector contracts

DH: The new government is talking about adjusting some of its fiscal rules to allow for more investment or the raising of debt to invest in infrastructure assets again. The real question for me is whether they establish a new set of PFIs or change the rules. One of the big advantages of the PFI structure, and often a hurdle to a restructuring, is that they are off the government’s balance sheet, so the risk has largely been transferred to the private sector. That’s a great thing for the government, but it also leads to some interesting challenges when they go wrong.

NR: The UK has a backlog of between £50 billion and £300 billion of capital maintenance in the public sector and social infrastructure facilities. That’s all of the infamous hospitals’ sewers backing up, and reinforced aerated concrete roofs in schools and potholes on our roads. Why does this backlog happen? I believe this is because of the squeeze in public sector finances, and because our public sector bodies are having to balance their operational cash requirements with what they can afford to retain for capital maintenance in the future.

That brings PFI more to the centre of the debate across spectrums political, economic and fiscal. Learning lessons from where things work well and what solutions exist for the old model is important, both for preservation of investments and stakeholder interests, but also in terms of broader strategy for the Government and what they are going to do.

> In the restructuring world, collapses and administrations are normal, but PFI failures are very loud because there’s not supposed to be failures. This is the public sector

Dan Hurd is a partner in turnaround and restructuring at EY. He is currently the administrator of the holding company that owns the PFI for Birmingham Highways.

DH: There is a raft of challenges, both operationally and financially, but the problems are driven predominantly by operational issues linked to contracts. Those PFIs have either already gone through some form of restructuring or failure, or it will bubble up over the next few years where there is still a risk of debt being underwater or equity being lost. Potentially, they may have to fail or go back to the public sector sooner than was expected. There have been PFI failures and restructurings for a number of years, but with the additional pressure on government, local authority, and government spending, everybody’s looking for levers to try and save cash and cost, and that’s creating a dynamic that puts more pressure in the system.

NR: Fundamentally, the PFI industry suffers from a loss of institutional memory. In the first 10 years after the start of PFIs, when investment was ramping up, the industry developed a lot of expertise and knowledge, both on the public and private side. Long-term PFI contracts were meant to be relational, not transactional. They were set up by people with knowledge of the PFI structure who negotiated the investment pipelines in social infrastructure and transport. Now, 15 or 20 years down the line, the people who negotiated and structured those contracts are largely gone. Most of them are retired and the institutional memory is rapidly disappearing.

Natasha Rouse is a director within the asset management team at Equitix. She leads Equitix’s social infrastructure portfolio including investments in UK PFIs covering schools, hospitals, social care facilities, and leisure infrastructure. She has worked with Dan for the last five years as the CEO of the SPV established by the Birmingham Highways PFI.

In a lot of cases, our public sector counterparts may not fully understand why the contract is what it is. And without using expensive, but sometimes self-serving, advisory services, the so-called ‘performance improvement’ industry that has developed around PFIs, the public sector has no chance of dealing with contracts. As a result, we finish up with quite a lot of well-meaning decisions with unintentional consequences that are being made almost at all levels within the government.

It’s one of the factors causing a few spiky situations in the management of PFI contracts and a number of collapses within PFIs. In the restructuring world, collapses and administrations are normal, but PFI failures are very loud because there is not supposed to be failures. This is the public sector.

Loss of knowledge is not the only cause. PFI contracts are long-term and over the years changes and challenges happen. How

Goldilocks zone: successful restructurings of PFIs find the right rebalancing of the contract specification, risk transfer and value for money to the public sector

> **Where collaboration and constructive relationships break down, the contracts conflict and in some cases, complete project collapses can occur**

these are dealt with defines if the contract is a success or a failure. An example of such changes is the drive for net zero, which of course did not exist and was not foreseen in contracts when they were set up.

DH: That applies to changes in regulation as well.

NR: And changes in geopolitical environments. At the core of PFI contracts was an assumption that the public and private sectors would work together to solve problems. Contracts where this approach still applies are the ones performing in a stable manner. Where collaboration and constructive relationships break down, the contracts conflict and in some cases, complete project collapses can occur.

Restructuring is the penultimate avenue for resolution in these contracts. The recent White-Fraser report commissioned by The IPA advocates for a reset of relationships in PFI and public-private partnerships. The report recognises that there's been a move, in some parts of the public sector, from working with the private sector to improve the service to penalising the private sector through deductions. Deductions are a blunt instrument, which in a lot of situations can backfire and doesn't achieve the performance improvement objective. Within a finely balanced financial framework of a PFI contract, this approach is the root cause of a lot of the problems that lead to a need for restructuring.

DH: If you're going down the route of dispute where everybody's poring over the contract and arguing for penalties and deductions, the relationship and the longer-term knowledge are no longer there. In our experience, that's a short-term gain that causes a long-term problem. It massively destabilises the project and potentially puts at risk both the contracting party and the SPV, because [the SPV] has borrowed money and has covenants that it needs to maintain and repay debt. Those deductions often flow through to the provider or subcontractor and may have a serious impact on their financial health or even bring down the project. It could also drive cost into the project, because other stakeholders want their own advice, and it has to come out of the envelope of money that's available within the project.

> **The usual restructuring and turnaround tools are hard to apply within PFIs**

NR: Within a PFI the income envelope is fixed. If it gets severely reduced through the strategic application of deductions, it leads to a contract collapse as the project companies rarely have sources of capital other than the payments received from the public sector. This then transfers all risk back to the public sector, as PFI assets are public service facilities. The usual restructuring and turnaround tools are hard to apply within PFIs. The ability of the project company to cut costs is very limited because, fundamentally, the whole structure is built around a contractual specification that needs to be delivered. There's nothing to sell within the PFI structure. You can't break it up. You can't consolidate it.

> **There's only so far you can go with the renegotiation of the contract, because if you end up transferring more risk back to the public sector, it may no longer be a PFI and qualify for the funding**

DH: You can replace a subcontractor if the subcontractor is underperforming if you think that is going to improve the service levels. But the challenge is the fixed envelope of cash and the service requirements. There's only so far you can go with the renegotiation of the contract, because if you end up transferring more risk back to the public sector, it may no longer be a PFI and qualify for the funding.

One of the challenges of trying to use something like a restructuring plan as a tool is that arguably, legally, you could use the plan to amend the terms of the contract, but the problem is that if the contract then doesn't fit the requirements of a PFI, then the whole thing falls apart. Traditional restructuring options are limited. You either have a failure, where the project collapses and goes into administration or some form of insolvency and transfers back to the public sector along with the risk, or you have to reach some kind of consensually negotiated solution that could involve equity putting a bit more money in.

NR: The legal enforceability of a restructuring plan in a PFI would be an interesting case to follow. It's an attempt at a solution. Successful restructurings within PFIs find that 'Goldilocks zone', the right rebalancing of the contract specification, risk transfer and value for money to the public sector. It's not impossible, the structure allows for this to happen, but a successful PFI restructuring requires a move from an adversarial to a partnering cultural approach between public and private sector. Company administration is never a nice thing to go through, but a pragmatic and productive administration can bring an external perspective and an ability to understand the interests of all the stakeholders involved, and find ways of negotiating and balancing those interests.

> **A successful approach to restructuring PFIs only arrives when whoever is attempting it has an understanding of the complex, multi-stakeholder environment we work in and the limitations of the levers available**

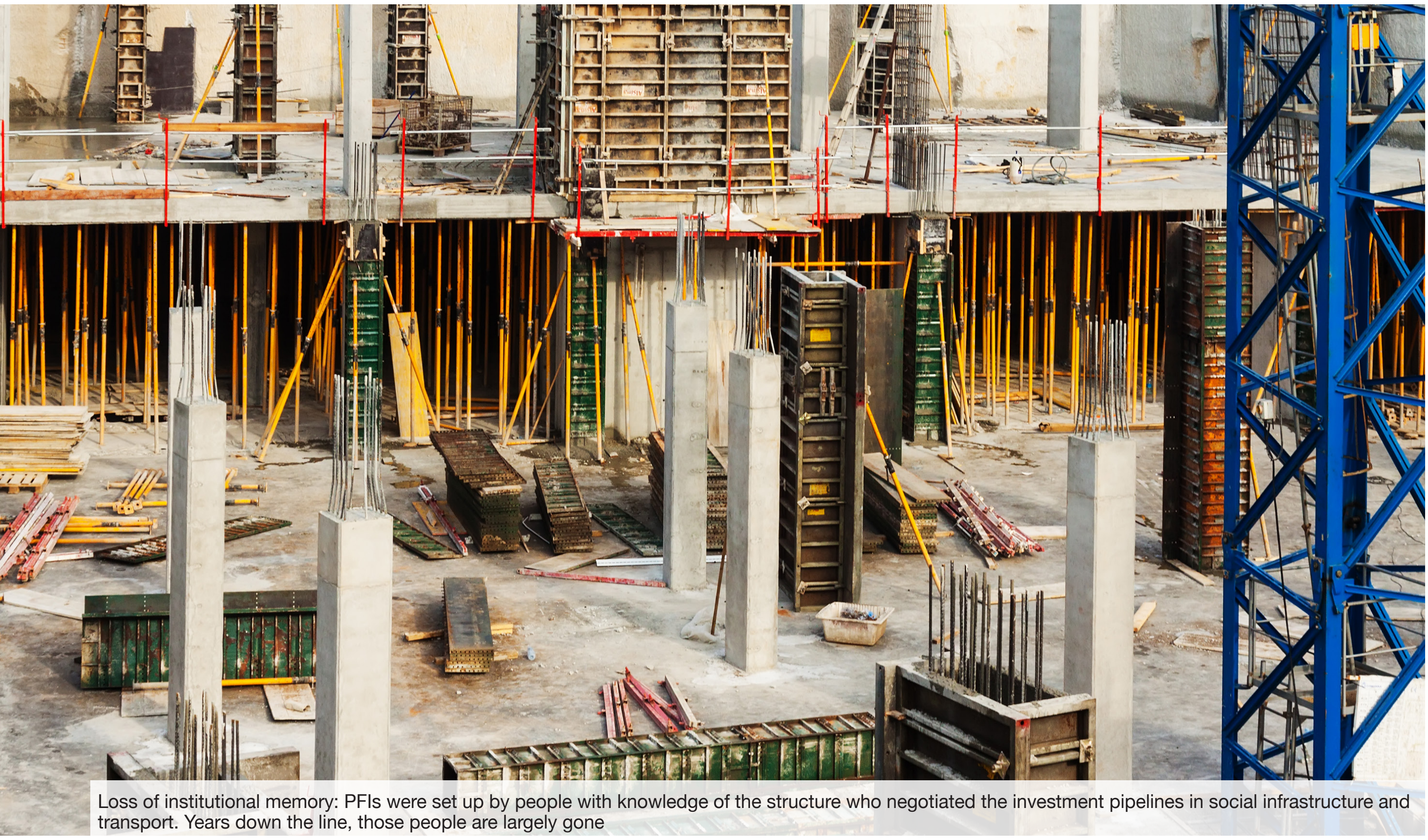
DH: What final advice would you give to restructuring professionals as the best way to approach these situations?

NR: For me, a successful approach to restructuring PFIs only arrives when whoever is attempting it has an understanding of the complex, multi-stakeholder environment we work in and the limitations of the levers available. The driving factor, I think, is the ability to manage interests through soft power rather than hard, convincing and persuading rather than forcing.

The financial levers are going to be quite obvious, and important, because financial restructuring is what we're trying to do. But financial arguments are not always the most powerful with public sector stakeholders. Their function, their job, is to provide a service to the public. We lose key points in translation because in meetings, public and private sector representatives often speak very different languages. From an equity perspective we might be presenting a very sound case that is cost effective for the public sector, but that may not do the job for our public sector counterparts because their key drivers may be completely different. Understanding that dichotomy in public-private sector contracts, is fundamental to success.

DH: I do agree with that. Understanding these structures and the finite envelope of cash is really important around the financial engineering. You need to know what will work within those constrained funds, but you also have to understand the stakeholders and what's driving them to know the dynamics of what's possible for them to agree to for a consensual outcome.

NR: And you need expertise. It's a specialist area. I would suggest any kind of restructuring and turnaround practitioner find expertise in the relevant sector for the PFI that is sound and pragmatic and going to aid the process rather than frustrate it.



Loss of institutional memory: PFIs were set up by people with knowledge of the structure who negotiated the investment pipelines in social infrastructure and transport. Years down the line, those people are largely gone