BREXIT AND UK PFI/PPP INFRASTRUCTURE PROJECTS

In the wake of the 'Leave' outcome of the UK's EU referendum, we consider the potential impacts of a 'Brexit' on UK PFI/PPP projects in the infrastructure sector. Although it is impossible to reach any definitive conclusions due to the continued uncertainty surrounding the terms and timing of Brexit, this note highlights selected issues likely to be of relevance to transactions and to industry participants.

On 23 June 2016, the UK voted to leave the European Union (EU). This vote has no legally binding impact and there is no change to the legal or regulatory structure of the sector pending the UK actually ceasing to be a member of the EU. The longer term effects of a Brexit for the UK infrastructure sector, however, could be significant and will depend to a large extent on the precise terms on which the UK leaves the EU, which are yet to be determined. In this briefing, we focus on some key areas of the infrastructure sector which may be impacted in the longer term, as well as highlighting short-term considerations for existing transactions in the sector.

This briefing does not cover the impact of Brexit on the UK energy and resources sector, which is the subject of our separate briefing "Brexit and the Energy and Resources sector".

METHOD OF "BREXIT"

As explained in our briefing "The day after Brexit – what will happen if Britain votes to leave the EU?", there are five principal models for a future relationship between the EU and the UK. The method and terms of Brexit will be a primary factor determining its impact on the UK infrastructure sector and the wider economy.

UK INFRASTRUCTURE SECTOR

Infrastructure sector and "Mega Projects"

At present, it is uncertain whether Brexit would negatively impact both current large-scale infrastructure projects and the future flow of projects.

Recent media coverage has raised fears that large-scale 'mega projects' such as High Speed 2 (HS2) and the 'Northern Powerhouse' agenda could be at risk as a result of the decision for the UK to leave the EU (although we note that the recent appointment of Andrew Percy as the Minister for Local Growth and the Northern Powerhouse suggests that the new Conservative government will continue to support the Northern Powerhouse strategy).

That said, although the uncertainties arising from Brexit could result in projects not meeting deadlines and taking longer than expected to complete (both in terms of documentation and construction) and potential increased costs due to currency fluctuations, large-scale infrastructure projects are often resilient due to their long-term nature and, for some projects more than others, significant political backing. Generally, it is expected that those projects which are at advanced stages are more likely to survive than those which are at the early planning and development stage.

The recently established National Infrastructure Commission, an independent body headed by Lord Adonis, provides at least some comfort that there is long-term public sector thinking as to the needs of the UK infrastructure sector.

Should Brexit negatively impact the UK economy, the UK Government might have less appetite to support large-scale projects. This could result in the private sector being expected to "pick up the slack", increasing the number of potential PPP/PFI transactions. As further explored below, the ability of private developers to engage, however, will be limited by the amount of potential financing available.

Large-scale infrastructure projects are often resilient due to their long-term nature and, for some projects more than others, significant political backing.

On the other hand, in the event of a recession, the government might decide to underwrite more infrastructure projects or agree to more favourable pricing and incentives, in an attempt to develop key strategic infrastructure projects and reignite the UK economy. This has already been suggested by the new Prime Minister, Theresa May, who has indicated that she would be in favour of Treasury-backed project bonds to fund infrastructure projects.

Despite the uncertainties, industry response has been relatively positive, with AECOM, Alstom, Bombardier and Siemens confirming that they remain committed to the UK infrastructure market.

Similarly an announcement from the Department for Transport indicated that the "Government remains fully committed to delivering the important infrastructure projects it has set out".

Investment and financing

Investor uncertainty

In the short term, the uncertainties associated with Brexit may result in the deferral of some projects, either due to uncertainty as to the future direction of domestic policy in the UK or due to concerns about potential impacts on cross-border projects and international relationships.

Similarly, the combination of political, regulatory and economic uncertainties – even if, in the best case scenario, these are only for a relatively short term – presents a challenge to parties seeking to plan, authorise and model new investments. It is hardly surprising in this context that we are already seeing some indications that investors may 'pause for thought' or 'wait and see' rather than rushing forward with new investments.

Over the longer-term, supply chain and manufacturing costs and locations may be affected by new trade agreements (both tariffs and non-tariff related costs).

European Investment Bank (EIB)

A number of major infrastructure projects in the UK have benefitted from funding from the European Investment Bank – in 2015, the EIB invested EUR 7.8 billion in UK projects.

It is anticipated that the UK will relinquish its 16% shareholding in the EIB when the UK leaves the EU (although other arrangements will no doubt be considered). Although the EIB is permitted to fund projects outside the EU, it has traditionally done so to a lesser extent than in its shareholder countries, which would mean that EIB funding for UK projects can be expected to decline.

Export Credit Agency (ECA) supported financings

Lenders in UKEF supported financings, including financings which are fronted by another European ECA and co-insured by UKEF, typically treat their participations as sovereign exposures for regulatory capital purposes, including in terms of credit risk mitigation. The latest rating downgrade by Standard & Poor's of the UK's sovereign credit rating from AAA to AA may impact on regulatory capital requirements.

The export credit terms under the OECD Arrangement on Officially Supported Export Credits will continue to apply.

Solvency II

A preferential treatment for "qualifying infrastructure investments" has recently been introduced under Solvency II (the solvency and supervisory regime applicable to EU insurers and reinsurers), pursuant to which the capital charge related to qualifying infrastructure investments in bonds, loans or equity has been significantly reduced.

Any less favourable treatment post-Brexit could have an impact on the attractiveness of infrastructure investments to insurers.

However, whilst the Prudential Regulation Authority would be able to impose different and more stringent requirements on insurers if it so wished following the UK exit from the European Union, the UK is likely to maintain the Solvency II regime in order to seek Solvency II "equivalence" to benefit UK reinsurers of EU risks and UK headquartered groups. The FCA has indicated that firms should continue with their implementation plans in respect of Solvency II.

Infrastructure Funds and Asset Managers

As explained in our briefing "Brexit – assessing the impact on asset managers", one of the key consequences of Brexit for funds and asset managers is that, under the current rules, UK firms would lose passporting rights into the EU single-market.

Nevertheless, current passports remain valid while the UK remains a member of the EU, which is likely to be the case for at least the next two years.

In the longer term, depending on the outcome of the negotiations, there are likely to be a number of consequences of Brexit for infrastructure funds besides the loss of EU passporting rights, including changes to managing and marketing strategies for Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs), changes to the provision of portfolio management and investment advisory services, change of domicile and use of delegation arrangements and changes to investment mandates and parameters.

Project planning and development

Public Procurement

Some commentators have queried whether the UK would be able to liberalise public sector procurement rules (which are based on EU requirements) post-Brexit. It seems doubtful to us that this will be a priority, especially if the UK still seeks funding from EU institutions such as the European Investment Bank or from European ECAs. Moreover, trade agreements tend to operate on the basis of reciprocal treatment.

Certain projects (e.g. UK generation projects and projects in the defence sector) currently benefit from exemptions to procurement legislation and it will need to be seen if this is maintained post-Brexit.

EU State Aid rules
Whilst EU State Aid rules may cease to apply following Brexit, theoretically enabling the UK Government to support emerging technology and large-scale infrastructure projects, in practice, the EU is likely to seek reciprocal treatment in future trade agreements.

Even under a WTO option or bilateral agreement, the UK would be restricted in its ability to grant competition-distorting subsidies. However, this form of Brexit could provide the UK Government with enhanced flexibility to support projects.

Construction
With the proponents of the Leave campaign now giving nuanced opinions on the UK's ability to affect inward EU migration (a likely ticket price on any free trade agreement with the EU), concerns over the availability of migrant workers from EU countries for construction projects may have been overstated. Nonetheless, all construction companies will no doubt be planning scenarios for any developments in this area.

In due course, supply chain and manufacturing costs may be affected by new trade agreements (both actual tariffs and non-tariff related costs) but the current focus is likely to be on volatility/uncertainty of exchange rates and interest rates and the impact this may have on pricing and hedging requirements.

UK Environmental law

As further explained in our recent briefings "Brexit - What next for Environmental & Climate Change Law?" and "Brexit and the Energy Sector: UK Climate Change and Renewable Policy and Targets", much of UK environmental law derives from EU laws that have been put in place over several decades. It is possible that the UK will follow the example of Norway and keep in place most EU environmental laws to provide a basis for coordination on an issue that is clearly not just domestic in nature and to ensure the UK’s continued access to the European market. The potential downside to this approach for the UK is that it would have no ability to influence the EU environmental laws with which it would still be required to comply.

An alternative approach would be for the UK to continue its relationship with the EU on the basis of bilateral agreements, and energy and the environment are two areas where there is much mutual agreement as to what is critical. Indeed, the UK has often moved faster towards openness and integration than other EU member states in these areas.

It is at least possible that the UK will seek to roll back some of the protections provided by the Habitats and Birds Directives in relation to greenfield development. In particular, the need to demonstrate an IROPI (Imperative Reasons of Overriding Public Interest) case in the event of potential adverse impacts on the integrity of relevant European protected sites can be very challenging for developers and can require decision-makers to decline to grant

CLIFFORD CHANCE

permission. However, the UK would still be limited in its ability to implement change in this area as a result of its continuing international obligations.

Accounting and tax

European System of Accounts 2010 (ESA10)

In terms of projects involving the public sector, EU Regulation (No 549/2013) made the European System of Accounts 2010 (ESA10) applicable in the UK since 2014.

This has lead to some additional considerations with regard to project structures and their treatment as part of public sector net debt.

Despite any exit from the EU, we would expect ESA10 to continue to apply, as this derives from broader international agreements, and other non-EU countries (such as Norway and Switzerland) also use ESA10 and participate in European statistical cooperation.

Tax

The UK has arguably the most liberal regime in Europe as regards overseas corporates generally being permitted to do business in the UK across all sectors. This is deliberate and an essential aspect of the UK as an international financial centre. Our view is this is not going to change - we are confident that Brexit will not impact on multinationals' ability to trade in the UK.

The UK has arguably the most liberal regime in Europe as regards overseas corporates generally being permitted to do business in the UK across all sectors

However, Brexit is likely to have an impact on multinationals where there are different withholding and corporate income tax regimes on intra-group dividends (i.e. in relation to the taxation of dividends from UK subsidiaries to EU parent companies and from EU registered subsidiaries to UK parents). It is important to be prepared for these changes and we are advising a number of clients on mitigation strategies and on structuring options.

See our briefing "The tax impact of Brexit: what steps should UK and EU businesses take now?" for further details.

IMMEDIATE CONSIDERATIONS FOR CONTRACTS

We have identified below some key pointers for industry participants looking at the terms of existing contracts or considering whether a new approach should be taken to the drafting of any provisions in contracts going forward.

No change in law

As explained in our briefing "The UK vote to leave the EU - immediate issues and implications", since the referendum outcome, nothing has changed legally. Any contractual provision which relies on a "change in law" trigger (for example, an increased cost clause, an illegality event or mandatory change procedures in concession contracts) will not have been activated by the result. The position may evolve once the UK commences the formal process of withdrawal from the EU.

Market volatility

As a separate matter, continued market volatility and the consequences thereof (e.g. reduced liquidity of affected banks) may trigger other clauses, such as market disruption provisions in facility agreements or 'market MAC' clauses. However, currently, we see no evidence of this and as the market stabilises, it will become less relevant.

English law and English courts

Our briefing "Brexit and jurisdiction clauses: post-referendum considerations" examines the impact of UK withdrawal on recognition of parties' chosen governing law and jurisdiction in contract in detail, but the key points for infrastructure sector participants are as follows.

Governing law

Parties should have no concerns about existing or new contracts being governed by English law. If English law was (or would have been) chosen to govern a transaction before the referendum vote, there is no need to change that decision as a result of the referendum and even following Brexit the substance of English contract law will not be impacted.

English commercial contract law is largely unaffected by EU law. Even in those marginal areas where English law has changed as a result of the UK's membership of the EU (e.g. Late Payment of Commercial Debts (Interest) Act 1998), the efficacy of that law does not depend upon continuing EU membership.

Further, EU courts are required under the Rome I Regulation to uphold the parties' choice of law for contractual obligations; this should not change if the UK leaves.

Choice of Jurisdiction

There are many reasons why parties choose the English courts as the jurisdiction for dispute resolution and the factors that play into this decision again are not affected by Brexit, save for one potential change in the ease of enforcement of judgments across the EU.

A judgment given by the English courts is currently enforceable in all other EU member states under the Brussels I Regulation. Whether that will be the case after Brexit will depend upon the continuing relationship agreed by the UK and the EU. Parties may want to consider whether any change in the jurisdiction clause is necessary for particular contracts, in which case further detail is set out in the briefing mentioned above.

Notwithstanding the above, from recent experience, we believe it to be standard practice in UK PFI/PPP projects to choose arbitration (or an arbitration option) as a preferred forum for dispute resolution and arbitration provisions will remain unaffected by Brexit (see further below).

Arbitration

Disputes in UK PFI/PPP projects, particularly disputes arising under primary concession and other related project contracts, are commonly referred to arbitration.

Arbitration is contractual in nature and is governed by the arbitral rules chosen by the parties. The primary legislation governing arbitration in England and Wales (the Arbitration Act 1996) does not derive from EU laws. As such, Brexit would not impact on the jurisdiction of properly drafted arbitration provisions.

Similarly, the enforcement of arbitral awards in the UK and Europe should be unaffected by Brexit, as this is regulated by the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. The New York Convention provides for the enforcement in participating states of an arbitral award given in another participating state. As the UK and all other EU member states are separate "Contracting States" under the New York Convention, and not party through the EU, arbitral awards granted in an arbitration seated in the UK will continue to be enforceable in any EU member state, and vice versa, following Brexit.

CLIFFORD CHANCE

EU derived legislation and sanctions

As an EU member state, the UK is subject to EU-wide legislation, including, for example, the EU Insolvency Regulation (EUIR) and the Bank Recovery and Resolution Directive (BRRD). The unravelling of UK domestic laws and EU laws will be a significant aspect of Brexit. For now, parties should retain references to such legislation in their English law governed agreements, as applicable.

In addition, as an EU member state, the UK is required to implement and enforce any EU sanctions (including export controls) and UK residents and entities are subject to EU sanctions-related obligations. Parties will need to undertake separate assessments of the application of EU and UK sanctions to their transactions, depending on how these are addressed under Brexit.

CONCLUSION

In the short-term, market participants in the UK infrastructure sector are grappling with challenges stemming from political uncertainty and general market volatility. The medium to long-term effects are harder to gauge and will depend in large part on when and on what terms the UK actually leaves the EU.

The UK Government will need quick and clear guidance from the private sector as to concerns and priorities on the Brexit arrangements, on future trade agreements and indeed in determining what legislation can be safely repealed and what needs to be retained. We anticipate that much of this will be undertaken through trade representative bodies, but active developers, financiers and investors will no doubt wish to take control of their own destinies and make representations to the UK Government.

FURTHER RESOURCES

Clifford Chance Brexit Guide:
https://financialmarketstoolkit.cliffordchance.com/en/topic-guides/brexit.html

Financial Markets Toolkit:
https://financialmarketstoolkit.cliffordchance.com/en/home.html

CONTACTS

Michael Pearson
Partner, London

T +44 (0)20 7006 4753
E michael.pearson
@cliffordchance.com

David Bickerton
Partner, London

T +44 (0)20 7006 2317
E david.bickerton
@cliffordchance.com

Nigel Howorth
Partner, London

T +44 (0)20 7006 4076
E nigel.howorth
@cliffordchance.com

David Metzger
Partner, London

T +44 (0)20 7006 4240
E david.metzger
@cliffordchance.com

Clare Burgess
Partner, London

T +44 (0)20 7006 1727
E clare.burgess
@cliffordchance.com

Paul Carrington
Partner, London

T +44 (0)20 7006 8124
E paul.carrington
@cliffordchance.com

Brendan Moylan
Partner, London

T +44 (0)20 7006 2386
E brendan.moylan
@cliffordchance.com

Amy Mahon
Partner, London

T +44 (0)20 7006 2111
E amy.mahon
@cliffordchance.com

Ed Bretherton
Senior Associate, London

T +44 (0)20 7006 4856
E edward.bretherton
@cliffordchance.com

Michael Coxall
Senior Professional Support Lawyer, London

T +44 (0)20 7006 4315
E michael.coxall
@cliffordchance.com

Kirsty Souter
Lawyer, London (Country Qualified: Australia)

T +44 (0)20 7006 4178
E kirsty.souter
@cliffordchance.com

Philip Walsh
Associate, London

T +44 (0)20 7006 3361
E philip.walsh
@cliffordchance.com

Eimear O'Dwyer
Associate, London

T +44 (0)20 7006 3985
E eimear.odwyer
@cliffordchance.com