Financial Services Authority

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Our Ref:

Your Ref:

Dear On-Yee,

THE FINANCIAL SERVICES AND MARKETS ACT 2000 ("FSMA")

The FSA has issued this guidance at the request of the PPP Forum. The guidance is given under section 157 of the FSMA and concerns the regulatory treatment under that statute of persons who manage PFI, PPP and analogous Project Finance projects ("PFI and other Project Finance Arrangements").

It should be borne in mind that the interpretation of the FSMA and its subordinate legislation is ultimately a matter for the courts to determine. The guidance is based on information concerning the typical features of PFI and other Project Finance Arrangements provided by the PPP Forum and which is summarised below. If individual PFI and other Project Finance Arrangements were to be materially different as respects any of the features set out in the summary below, our view might be different to that expressed in this guidance. It is, therefore, recommended that, where there are material differences, consideration should be given to the need for professional legal advice or individual guidance from the FSA.

This guidance complements the general guidance on the scope of regulated insurance mediation activity contained in Appendix 5 to our Authorisation Manual and which is accessible at http://www.fsa.gov.uk/vhb/html/auth/authtoc.html.

Summary of the typical features of PFI and other Project Finance Arrangements

This guidance applies to PFI and other Project Finance Arrangements to which the following description of typical features applies.

- The PFI and some other Project Finance arrangements will involve the provision of work and/or services by one party ("the Contractor" - typically a body in the private sector) to another ("the Grantor" - often a body in the public sector) and be governed by contract ("the Project Agreement").

- These arrangements will often be long term, typically 20-30 years. They will usually involve the Contractor financing any required capital investment, for example for works, through a mixture of debt and equity. Often (but not always), the Contractor will be a special purpose vehicle.

- The Contractor will be required by the Project Agreement to arrange, and pay for, insurance to cover its own interests, and those of its lenders, sub-contractors and the Grantor. It will also agree with lenders to include their interest and with sub-contractors to include theirs. This will usually be done by way of instruction to a broker. There will usually be a contractual requirement for insurances to be placed under the Project Agreement and lending and other project documentation. The agreements may also provide for the Contractor to process and handle insurance claims, and perform administrative functions connected with the insurance. However, given that all insurances are placed through a broker (who will be responsible for providing specialised insurance advice), the Contractor will have minimal involvement in the placement of insurances. The Project Contractor's role in this respect will be to instruct the broker as to the policies required and provide information as and when required by insurance underwriters. This task does not require any specialised knowledge and any costs of doing so are negligible and do not earn any form of fee from the broker.

- The Contractor's main motivation with respect to insurance will be to ensure that it complies with all insurance obligations under both the Project Agreement and the lending and other project documentation (where applicable). The Contractor will not be seeking to make any form of profit on insurance mediation costs.

- The Contractor will be paid for the provision of services. These services would usually be defined by reference to the different services specified by the Grantor. Any insurance mediation services would not normally form a part of the output services against which the contract's payment and performance regime is based.

- In order to bid for the project, the sponsors will have had to bid a specific price, which will usually consist of a monthly "Unitary Charge". The Unitary Charge will be a regular (typically, monthly or annual) lump sum payable to the Contractor by the Grantor to provide the relevant services. In order to determine the Unitary Charge prior to submitting their tender for the project, the sponsors would have to estimate:

    - the capital costs of the project;

    - the likely financing costs and, hence, debt service responsibilities of the Contractor;

- the operating costs of the project (including sub-contractor costs, administrative costs, employment costs, insurance costs, tax liabilities and other costs, expenses and fees); and

- any other costs, expenses and risks inherent in the project.

Taking into account all of these costs, the sponsors (in consultation with their financial advisers) will estimate the regular Unitary Charge which will be sufficient to cover all of these costs and provide a surplus by way of an equity return to the sponsors (usually by way of dividends or interest on subordinated loans).

The rate of return which the sponsors will specify in calculating the Unitary Charge will usually be determined in light of:

  - the sponsors' required rate of return on such projects to meet the threshold levels expected by their respective boards or investment committees;

  - the risks being borne by the sponsors and the Contractor and the risk profile of the project as a whole; and

  - the debt service and other financial cover ratio requirements of the lenders/funders (which may include a minimum surplus cover over estimated cost).

- The calculation of the Unitary Charge will not simply be a matter of calculating costs each year and adding a profit mark-up. PFI and other Project Finance projects, and their financial models, do not work on a "cost-plus" basis and there will not be any concept of broking commission being payable to the Contractor on the insurance premia.

- The payment may be subject to adjustment for increases (and sometimes decreases) in insurance costs. However, the arrangements will be such that any additional amount payable would never exceed the actual increase in insurance premia charged to the Contractor in respect of such increases. If the parties have agreed some form of insurance cost sharing mechanism, then the Contractor will inevitably share a proportion of any cost increase and the contribution by the Grantor toward the additional cost of insurances will never exceed the increase in insurance costs. In this event, any insurance cost increase will also reduce the Contractor's profitability and hence the level of return to the sponsors.

Regulated Activities

As stated above, we understand that it is usual in PFI and other Project Finance Arrangements for the Project Agreement to require the Contractor to procure insurance on behalf of itself, its subcontractors, the lenders and the Grantor in relation to the project. It is likely that the entry into of, and the carrying out of the insurance-related obligations under, the Project

Agreement will constitute the carrying on by the Contractor of regulated activities in relation to contracts of insurance where this takes place after 14 January 2005 (which is the date when FSA regulation of general insurance mediation activities begins). In particular, the Contractor may be carrying on the regulated activities specified in articles 21 (Dealing in investments as agent) or 25 (Arranging deals in investments) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "RAO") or both. The Contractor may also be assisting in the administration and performance of a contract of insurance as specified in article 39A of the RAO (but this is unlikely to be the case if all the Contractor does is to instruct the broker to deal with claims).

Need for authorisation or exemption

The need for authorisation or exemption will only arise if the Contractor is carrying on regulated activities by way of business. In terms of insurance mediation activity, this means that the Contractor would have to be taking up or pursuing the activities for third parties and for remuneration.

We have given careful consideration to the potential implications for Contractors in the light of the information provided by the PPP Forum. As a result, we have concluded that any Contractor who takes on contractual obligations in relation to the arranging of insurance on its own behalf and those of other parties involved in PFI and other Project Finance Arrangements in the circumstances set out under the section entitled "Summary of the typical features of PFI and other Project Finance Arrangements" in this guidance should not be regarded as providing insurance mediation services to third parties for remuneration.

As explained above, however, if the features of any particular PFI and other Project Finance Arrangement are materially different to the circumstances set out under the section entitled "Summary of the typical features of PFI and other Project Finance Arrangements" in this guidance, that difference might lead us to reach a different conclusion. Where this arises, Contractors will wish to consider seeking professional legal advice or individual guidance from the FSA.

This guidance is given under, and may be relied on to the extent set out in, Chapter 9 of our Supervision manual ("SUP9"). SUP9 is accessible at http://www.fsa.gov.uk/vhb/html/sup/SUPtoc.html

Yours sincerely,

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