Public Private Partnerships - Technical Update 2010

The Government has confirmed it remains committed to Public Private Partnerships (PPP), including those delivered via the Private Finance Initiative (PFI), and that such arrangements will continue to play an important role in delivering Britain's future infrastructure[1].

To strengthen the current regime for PPPs, and increase the confidence of both public and private sector participants in this market, HM Treasury and Infrastructure UK, in coordination with government colleagues, have been focusing on the following areas:

- changing the way local authority PPPs are supported by central government;
- increasing the transparency of our commitments;
- reviewing our approach to project scrutiny and testing value for money; and
- updating our guidance relating to financing.

This note sets out recent changes made and confirms the delivery framework that remains in place going forward.

For the purposes of this note, PPP is defined as joint working between the public and private sectors, which may be by contract or through a joint-venture, to deliver infrastructure assets and services. The PFI is a long term contractual arrangement for the design, build, financing and operation of the services and the form of PPP most often used in the UK.

Infrastructure UK

Infrastructure UK sits within HM Treasury. It is focused on the improvement of the Government's long-term planning, prioritisation and delivery of infrastructure and enabling greater private sector investment in infrastructure. This includes setting the framework for PPPs. Infrastructure UK provides guidance, scrutiny and support to help the public sector harness the benefits of the UK's mature PPP industry, while ensuring partnerships are efficient and effective.

1 Speech by The Commercial Secretary to the Treasury, Lord Sassoon at the PPP Forum annual dinner, 3rd November 2010. http://www.hm-treasury.gov.uk/speech_comsec_031110.htm

1 Recent Developments

- Reform of the PFI credits system
- Increased transparency requirements
- Cessation of funding for The Infrastructure Finance Unit (TIFU)
- Pursuing savings from operational contracts

Reform of the PFI credits system

1.1 As part of the 2010 Spending Review, HM Treasury has introduced a change in budgeting policy affecting the 'PFI credits' system. PFI credits provided central government funding to local authorities to deliver PFI projects.

1.2 Previously, departments wishing to support a programme of local government PFI projects were given a provisional allocation of PFI credits at a Spending Review. PFI credits represented a notional capital sum and were intended to support the capital costs of a project. Departments awarded this funding to individual projects, subject to approval from the Projects Review Group. The funding was then paid to the local authority through a series of grants; these were usually calculated on an annuity basis.

1.3 These grant payments were top-sliced from Revenue Support Grant within the overall local government Resource Departmental Expenditure Limit (RDEL) allocation. This ring-fenced funding gave additional spending power to central departments wishing to deliver PFI projects through local authorities.

1.4 As part the 2010 Spending Review the system of PFI credits was ended. From April 2011 Departments will be required to take on responsibility for making grant payments to local authorities. Previously these payments were made from local government RDEL and were administered by the Department for Communities and Local Government.

1.5 Departments wishing to support new local authority PFI projects will need to prioritise this grant funding from their own RDEL budgets. Departments have been provided with the necessary funding to enable them to continue to provide grant funding to their existing committed local authority projects.

1.6 This change means that, in future, departments will need to consider the economic case of a PFI project and compare this on a like-for-like basis with other calls on their budget. It will also ensure local authorities select the delivery route which provides the best value for money. Both of these points will help to ensure that the limited resources available to departments are focused on spending which provides the best economic return.

1.7 Infrastructure UK will issue updated guidance to replace the current Department of Communities and Local Government PFI Support Guidance.[1]

Transparency

1.8 There is currently a good level of information publicly available on PFI projects. Government resource accounts summarise financial liabilities and HM Treasury will continue to publish project-level PFI data on its website.

1.9 Government has set out the need for greater transparency across its operations. Transparency of commitments will be increased further through the Whole of Government Accounts and by the new requirement to publish tender documents and contracts for all central government projects, and all central government expenditure over £25,000.[2]

Existing PPP disclosures

Budgeting and Accounting

1.10 Government reports on two bases – departmental resource accounts treat contracts according to International Financial Reporting Standards (IFRS)[3]; National Accounts treat contracts according to European System of Accounts 1995 (ESA 95) standards[4]. It is the National Accounts which are the basis for the fiscal framework.

1.11 HM Treasury has issued a Guidance Note to Departments[5] on how to classify PFI and similar transactions and continues to work closely with departments on this complex issue.

Published PFI data

1.12 The House of Lords Economic Affairs Committee[6] commented positively on the reporting of PFI liabilities in March 2010. At the June 2010 Budget, the Office of Budget Responsibility noted that the Treasury currently collects and reports on PFI data and expects the Treasury to continue to publish data at regular intervals.[7]

1.13 HM Treasury publishes the following aggregated data: i) Departmental estimate of capital spending by the private sector (signed deals); ii) Estimated aggregated capital value of projects reaching preferred bidder stage; and iii) Estimated payments under PFI contracts through to contract end (signed deals).

1.14 The most recent set of aggregated data published can be found in tables 2.6, 2.7 and 2.8 of the supplement to the June 2010 Budget document:

http://www.hm-treasury.gov.uk/d/junebudget_supplementary_material.pdf

1.15 In addition to this aggregated information, HM Treasury publishes the raw data from which this is drawn on its website. HM Treasury commissions central government departments to provide detailed information on each PFI project they sponsor, be they delivered centrally or via local authorities.

1 http://www.communities.gov.uk/documents/localgovernment/pdf/1350075.pdf

2 For the purposes of transparency policy, central government means all government departments, including their agents and agencies , all Non-Departmental Public Bodies, National Health Service and trading funds. Other public bodies, including local authorities, may already or in the future adopt similar transparency policies.

3 http://www.hm-treasury.gov.uk/frem_index.htm

4 http://epp.eurostat.ec.europa.eu/portal/page/portal/product_details/publication?p_product_code=KS-42-02-585

5 http://www.hm-treasury.gov.uk/d/tech_guidance_nataccounts_for_pfi.pdf

6 http://www.publications.parliament.uk/pa/ld/ldeconaf.htm

7 http://budgetresponsibility.independent.gov.uk/d/pre_budget_forecast_140610.pdf (see section 5.31)

1.16 The dataset contains details of signed PFI projects, projects in procurement and a list of those holding equity stakes in operational PFI projects. This can be found at:

http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm

- **Signed PFI Projects**: Information requested includes constituency and regional information, procurement information, length of contract, balance sheet treatment under ESA 95 and IFRS standards, capital value, expected capital spend over the next 3 years and the actual historic and expected future unitary charge payments for the lifetime of the contract. The next update will take place in advance of Budget 2011.

- **PFI Projects in Procurement**: These statistics were last updated in advance of Budget 2010. Before Budget 2011 HM Treasury will work closely with departments to update this information to reflect the impact of the Spending Review.

- **PFI Equity Holders**: Infrastructure UK monitors on a continual basis the identity of the holders of equity stakes in PFI projects. It will continue to collect and publish this information, and will continue to monitor the secondary equity market to ensure a comprehensive view of PFI equity holders.

Increased transparency requirements

Whole of Government Accounts

1.17 Whole of Government Accounts (WGA) are full accruals based accounts covering the whole public sector and audited by the National Audit Office. WGA is a consolidation of the accounts of about 1500 bodies from central government, devolved administrations, the health service, local government and public corporations.

1.18 WGA will be published for the first time for the year ending 31 March 2010. It will treat PPP commitments according to IFRS and will include a table summarising the long term contractual commitments held by all bodies listed in 1.16which are, or are similar to, PFI projects.

1.19 Further information on WGA can be found on the HM Treasury website at:

http://www.hm-treasury.gov.uk/psr_government_accounts.htm

Publishing central government tender documents, contracts and expenditure

1.20 As part of the transparency agenda, Government has made the following commitments with regard to procurement, contracting and expenditure:

- all new central government tender documents for contracts over £10,000 have been published on a single website since September 2010[8];

- all new central government contracts over the value of £10,000 to be published on a single website from January 2011[9];

- new items of central government spending over £25,000 (starting with the April to October 2010 spend) to be published online from November 2010[10]; and

8 http://www.ogc.gov.uk/policy_and_standards_framework_transparency.asp

9 http://www.ogc.gov.uk/documents/Published_Guidance_-_Publication_of_new_central_government_contracts.doc

10 http://www.hm-treasury.gov.uk/psr_transparency_index.htm

- all new central government ICT contracts over the value of £10,000 have been published online since July 2010[11].

1.21 These commitments include all central government PPP projects and expenditure made by central government directly to local authority PPP projects. In some circumstances, limited redactions will be made to some contracts before they are published, in line with the exemptions under the Freedom of Information Act, for example commercially confidential information. It is for departments to decide on a case by case basis whether information should be redacted.

1.22 SoPC4 contracts already allow for the possibility of the public sector publishing the contract. This change means a move to publishing proactively all new contracts, rather than the previous policy of publishing if requested.

The Infrastructure Finance Unit

1.23 The 2010 Spending Review document outlined changes made to The Infrastructure Finance Unit (TIFU). The statement confirmed there is no separate funding provision for TIFU interventions within the HM Treasury's spending settlement; TIFU will, therefore, no longer have the capacity to make new loans to PFI projects.

1.24 HM Treasury will continue to lend in accordance with its commitments on the loan made to the Greater Manchester Waste Disposal Authority. In line with the policy announcements made at the inception of TIFU, HM Treasury officials will continue to monitor market conditions and seek a value for money sale of the loan at a suitable time.

1.25 HM Treasury will maintain TIFU's commercial expertise within Infrastructure UK, and will continue to monitor the market and offer advice to departments and local authorities where required.

Savings from operational contracts

1.26 The current fiscal environment requires all areas of public spending to be scrutinised for possible savings. Operational PPP/PFI contracts are not immune. Infrastructure UK has been working with both the public and private sectors to develop value for money options for reducing the cost of operational contracts.

1.27 Most PPP/PFI contracts are long-term arrangements involving complex risk transfer. It is important to ensure any measures that are adopted provide long term value for money, rather than a short term gain for the public sector.

1.28 The work is progressing through two strands – project-level work and central cross-industry engagement. Authorities are leading discussions on their own PFI projects supported by sponsoring departments and guidance soon to be published by Infrastructure UK.[12] From the centre of government, Infrastructure UK has met with major PFI equity holders and others in the industry to help facilitate savings.

11 http://www.ogc.gov.uk/policy_and_standards_framework_transparency.asp

12 Guidance will be published on the HM Treasury website shortly

1.29 The HM Treasury Operational Taskforce now operates from within Infrastructure UK and is available to assist public sector bodies. It has a helpdesk to provide free expert advice to operational PFI projects (ph: 020 7270 5511). The savings work is one aspects of the Taskforce's role in helping authorities manage their operational contracts. It has also published guidance on the HM Treasury website in respect of Benchmarking and Market Testing, Project Transition Guidance, Variations Protocol and Contract Expiry Guidance[13].

13 http://www.hm-treasury.gov.uk/ppp_operational_taskforce.htm

2 Ongoing Framework

- Scrutiny and approval of PPP projects
- Use of SoPC and the derogations process
- Use of the PFI Value for Money Assessment Guidance and the Green Book
- Refinancing support
- Financing guidance (Annex A replaces the 2009 Application Note – PPP Projects in Current Market Conditions)

Scrutiny and approval of PPP Projects

2.1 In most cases PPP projects involve significant and long-term financial commitments. As a result PPP projects which are funded directly by central government – whether delivered centrally or locally – will require HM Treasury approval[1].

2.2 The existing Project Review Group (PRG) will scrutinise PPP projects. It will retain its focus on testing affordability, value for money, deliverability and readiness to engage the market. HM Treasury will look to integrate the PRG more closely into its other scrutiny and approval processes.

Standard contracts and derogations

PFI contractual arrangements

2.3 HM Treasury developed the Standardisation of PFI Contracts (SoPC) guidance to set out a standard approach to risk allocation between the public and private sectors to be applied to all PFI projects.

2.4 The first edition was published in July 1999; the latest version, SoPC4, was released in March 2007. The main objectives of the guidance remain unchanged and are to:

- Promote a common understanding of the main risks which are encountered in a standard PFI project;
- To allow consistency of approach and pricing across a range of similar projects; and
- To reduce the time and costs of negotiation by enabling all parties concerned to agree a range of areas that can follow a standard approach without extended negotiations.

2.5 Since version 3 of SoPC (published in 2004) there has been a mandatory requirement for all authorities to comply with SoPC, or approved sector specific contracts based on SoPC, when entering into PFI contracts. Compliance means including all of the "required drafting" referenced in paragraph 1.4.1 of SoPC4 and adhering to the "clear contractual principles"

1 Managing Public Money, HM Treasury. Page 13. Box 2.3.

(without specific drafting) set out. Together, the required drafting and the mandatory contractual principles are referred to as the "Core Areas". Where projects wish to derogate from a Core Area, they must submit a derogation request to HM Treasury for approval.

2.6 Feedback from departments, local authorities, the market and the NAO is that standardisation has been beneficial. The combination of SoPC4, sector-specific contracts and the derogations process ensure the lessons learned from over 680 closed projects are not lost. Continuing this good practice will safeguard the quality, value for money and risk transfer within complex PFI projects. It will help maintain discipline and focus dialogue during the procurement process. This central support can also help departments and authorities hold the line in contract negotiations with the private sector.

2.7 In light of the experience to date, HM Treasury has concluded that all PFI projects supported by central government – whether delivered centrally or at the local level – should continue to follow the standard guidance and seek approvals for derogations from HM Treasury where necessary. Compliance with SoPC4 or the relevant sector-specific contract will be a key consideration of HM Treasury's approval of the business case.

2.8 Departments should agree with HM Treasury at an early stage of the assurance and approval process which projects will be expected to comply with the standardisation and derogations process. Further information about the derogations process can be found at Annex B.

PPP contractual arrangements

2.9 The risk allocation inherent in SoPC4 is well understood and is capable of delivering value for money. HM Treasury recognises, however, there will be circumstances where departments and local authorities wish to adopt alternative PPP arrangements. HM Treasury encourages departments and authorities to think carefully about the most appropriate delivery route for their projects, and to consider new approaches where they believe these are value for money.

2.10 HM Treasury will work with colleagues across government to ensure the lessons learned about risk allocation, which have been captured through SoPC4, can be utilised in new delivery approaches. HM Treasury will also consider how the disciplines associated with the PFI assurance and derogations processes can be harnessed to scrutinise more effectively alternative PPP arrangements.

2.11 One of the benefits of standardisation is that the commercial aspects of a project can be understood, assessed and scrutinised relatively quickly. Where authorities are looking at other forms of PPP – particularly where these involve long term financial commitments – HM Treasury will pay particular attention to assessing the commercial structures being proposed. In particular departments will need to address how the commercial arrangements will drive VfM and what the associated deliverability risks are. Departments and local authorities should highlight non-standard projects at an early stage of the assurance and approval process. For example, there will be a need to demonstrate that the additional cost of placing private finance at risk is capable of delivering commensurate benefits.

2.12 While PPPs will not be required to adhere to SoPC4 or other standard form contracts such as the ICT model contract[2], these should be a useful reference point for Authorities in developing alternate approaches.

2.13 HM Treasury has also provided guidance for public bodies entering into joint ventures. It looks at the issues associated with the creation and use of joint venture entities across the wider procurement spectrum and can be found on the HM Treasury website.[3]

2 http://www.ogc.gov.uk/policy_and_standards_framework_model_ict_contract.asp

Value for Money

2.14 HM Treasury's Green Book and the PFI Value for Money Assessment Guidance together set out the core principles and approach for analysing the investment case and value for money of projects[4]. The quantitative value for money assessment model and associated user guide will shortly be updated to reflect changes in market conditions. Departments should ensure they use this up to date model and user guidance which can be found on HM Treasury's website[5].

2.15 HM Treasury last published value for money assessment guidance for PFI projects in November 2006. To ensure we remain at the forefront of international standards and to reflect lessons learnt over the course of the last four years, HM Treasury will undertake a review of current guidance.

2.16 The review will reflect on areas of the guidance that require updating and the challenges raised by other parties. For example, the current guidance focuses on ex-ante evaluations and should be expanded to ensure the value for money of projects continues to be assessed throughout their life, value for money continues to be achieved and valuable information is provided for new projects. This is in line with the NAOs recommendations on value for money.

2.17 The review will consider the form that ex-post value for money assessments for PPPs should take, including how various groups of costs and benefits should be incorporated within the assessments, for example, how to treat costs that have already been incurred.

2.18 We will also further define what constitutes a "material change" for the purposes of rerunning a value for money assessment, in line with recommendations by the NAO[6]. Any revisions or additions to existing guidance will remain consistent with the Green Book.

Refinancing support

2.19 The refinancing taskforce was established in 2002. It was set up to monitor and implement the Code of Conduct on the Refinancing of Early PFI Transactions[7] and previously was operated by Partnerships UK on behalf of HM Treasury.

2.20 Infrastructure UK will continue to provide refinancing support, offering advice to departments and to ensure they make good value for money decisions when considering and implementing the refinancing of their projects. Specifically the role will include:

- Monitoring refinancing activity and maintaining a record of all refinancing and the gainshare accruing to the public sector;
- Gathering information from market participants on trends in refinancing;
- Ensuring that refinancing of early PFI deals complies with the Code of Conduct; and
- Providing guidance and support to authorities planning or involved in refinancings, including interpretation of HM Treasury's application note on value for money in refinancing.

2.21 The refinancing arrangements set out in SoPC4 were amended in October 2008 and again in April 2009. The amendments introduced a sliding gainshare scale, rising to a 70% share

3 http://www.hm-treasury.gov.uk/d/joint_venture_guidance.pdf

4 http://www.hm-treasury.gov.uk/data_greenbook_index.htm and http://www.hm-treasury.gov.uk/ppp_vfm_index.htm

5 http://www.hm-treasury.gov.uk/ppp_vfm_index.htm

6 http://www.nao.org.uk/idoc.ashx?docId=D430D1C9-6A12-40CF-BC43-B5C0CBF6561F&version=-1

7 http://www.hm-treasury.gov.uk/d/PPP_Refinancing_Code_of_Conduct.pdf

above a refinancing gain of £3m, and the right for an Authority to request a refinancing. The April 2009 addendum remains the current policy position.[8]

2.22 The April 2009 refinancing addendum should be read in conjunction with SoPC4, the Application Note: Value for Money in Refinancing February 2005[9] and the Guidance Note: Calculation of the Authority's Share of a Refinancing Gain.[10]

8 http://www.hm-treasury.gov.uk/d/sopc_4_addendum_apr09.pdf

9 http://www.hm-treasury.gov.uk/d/application_note_value_for_money_280205.pdf

10http://www.hm-treasury.gov.uk/d/pfi_refinancingguidance21307.pdf

A Annex: Financing guidance

A.1 HM Treasury issued an Application Note[1] in August 2009 to help Authorities address the impact of financial market dislocation on the procurement of PPP projects. Since TIFU was created in March 2009, approximately 50 projects have reached financial close with TIFU only being required to lend on one project in April 2009. This is evidence of a partial recovery in the financial markets.

A.2 The Application Note expired on 31st August 2010. However, some of its principles remain relevant and have been restated herein. This annex has broad applicability to PPP projects where private finance is being proposed although is written specifically with the PFI in mind.

A.3 This Annex is organised based on the procurement phases traditionally associated with the Competitive Dialogue process.

Pre-OJEU phase

Authorities should:

- have a strategy for accommodating changes in market conditions
- accommodate the possibility of public sector funding/financing (such as capital contributions) in affordability estimates, VfM assessments and procurement documentation
- undertake suitable sensitivity analysis on the level of their financial resources as well as project costs
- seek early input from the sponsoring department if derogations from standard form contracts are envisaged
- consider the suitability of a preferred bidder debt funding competition, allocate resources accordingly and (in any event) reserve the right to require such a competition to be run

Overall timing and context

A.4 An Authority might take the view that financial markets will continue to improve and/or remain stable. This is not a robust approach. For Authorities to engage with the market effectively during the bidding process, it will be necessary to make clear that they have a robust strategy for accommodating both current and future market conditions. This is particularly important if market changes are sufficiently material to trigger a VfM re-evaluation (see 2.18).

A.5 The key requirement for any Authority is to run a procurement which is robust to future market changes and is seen as such by the market.

1 http://www.hm-treasury.gov.uk/d/market_dislocation_280809.pdf

A.6 To reduce the risk of infringing procurement procedures, the OJEU notice and tender documents should be drafted sufficiently broadly to allow for the possibility of public sector financing and funding, including capital contributions.

Flexibility, affordability and value for money

A.7 When preparing their Outline Business Cases (OBC), Authorities also need to plan for flexibility with regard to:

- project costs, including underlying construction, service costs and the terms and costs of finance;
- inflation assumptions; and
- the financial resources available to the Authority at the time of contract award and through the life of the project.

A.8 An appropriate range of assumptions in these areas should be reflected in the sensitivity analyses and/or optimism bias assumptions considered in the OBC.

A.9 In relation to the detail of contract design and risk allocation, for many areas there is standard drafting set out in departmental standard form contracts and SoPC4[2]. Authorities should assume that these positions will not change, but if there are particular areas where an Authority may want to derogate from these positions they should seek input from their sponsor department as early as possible. Authorities should be careful not to undermine the risk transfer inherent to the PFI model, which relies on incentivising contractors to design a sustainable construction and service model.

A.10 Where an Authority is considering making a capital contribution to a project, this should be considered as part of the OBC in both the affordability and VfM assessments. Capital contributions should be considered sufficiently early in the procurement to allow any issues to be dealt with under competitive tension.

Capital contributions

A.11 For standard accommodation projects, attaining completion generally marks a point of diminished risk for an Authority and the treatment at SoPC4 paragraph 3.9.1 follows: "in the ordinary course of events no public sector capital contributions should be made to the project, and no unitary charge should be payable, until the works have been completed and accepted".

A.12 Concerns about affordability have led to proposals from Authorities to make capital contributions to projects and to pay them earlier, in some cases prior to completion of construction (to lower the external financing requirement). Risk transfer is a cornerstone of PFI and the amount and timing of capital contributions should not undermine this.

A.13 Authorities should more generally consider the balance of incentives on the sponsors and lenders, in particular once the capital contribution(s) have been paid. See comments related to Payment Mechanism in Box 2.A.

A.14 Authorities are reminded that levels of subcontract security should remain at the same levels regardless of any public sector capital contribution. See SoPC4 paragraph 3.9.2.

A.15 It is possible that the risk characteristics of some complex projects, in particular those with challenging construction techniques, technological / commissioning risk, high operational

2 http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm

gearing or volatile cash flows associated with demand risk, will make them unsuitable for any funding by Authority capital contributions.

A.16 All proposed capital contributions will be assessed by Infrastructure UK as part of the business case approval and derogations processes. Any proposed changes to capital contributions from what was assumed in the original OBC need to be reapproved by Infrastructure UK.

Timing

A.17 Infrastructure UK has recently reviewed the timing of capital contributions. For the avoidance of doubt, the general policy remains as set out in SoPC4 at paragraph 3.9 and applies regardless of the size of the capital contribution.

A.18 However, for some projects, construction completion does not always mark a point of diminished risk. Authorities should demonstrate to Infrastructure UK the timing of capital contributions in the context of construction and operational risk posed to the Authority.

A.19 Funders, equity and subcontractors should not seek to have Authorities provide date certainty for payments or for payments to be made earlier than SoPC4 allows. The principles at Section 3.6 (Acceptance and Service Commencement) of SoPC4 apply to capital contributions. Where service commencement is phased and capital contributions are paid earlier than full service commencement, payment should be aligned with the services received and the level of risk retired at that point with provisions to cater for circumstances where full service commencement is not achieved.

Amount

A.20 The appropriate size of capital contributions appropriate will depend, *inter alia*, on the risk characteristics of the project. The overriding principle should be that sponsor equity and private sector debt should absorb all of the expected losses in the project as determined through stress testing of cash flows and construction period delay and all default scenarios.

A.21 It is unlikely that capital contributions in excess of 30% of the capital works value of a project will be appropriate.

Box 2.A: Issues related to capital contributions

Payment mechanism

The inclusion of a capital contribution will lower the total unitary charge by reducing the amount required to service finance; however, the unitary charge attributable to service providers will remain the same. The effect of this is to change the relative amount of unitary charge at risk to project sponsors once the capital contribution is paid. Where a capital contribution is introduced into a project, the Authority will need to review the payment mechanism / deduction regime to ensure it remains appropriately calibrated and appropriate incentives exist to ensure delivery of the contracted services.

Operational gearing

As noted above, the reduction in finance costs relative to service costs increases the operational gearing of the project. Authorities should therefore consider any related financial impacts (such as the sensitivity requirements of financiers) when analysing capital contributions.

Land

Authorities considering effecting a capital contribution through a transfer of land should incorporate provisions in the project agreement to protect their interest in the land until construction is completed.

Set Off

There must be no prohibition on the Authority's right to set off amounts owing to it against any capital contributions.

Debt funding competitions

A.22 The choice of whether or not to run a debt funding competition ("DFC") at the preferred bidder stage is a choice for the Authority, the sponsoring department and their advisers (financial, legal and technical). With input from advisers, the public sector should realistically assess the advantages and disadvantages of requiring a DFC at the preferred bidder stage. This is a complex judgement and Authorities should set out their chosen approach and supporting rationale in the OBC.

A.23 Factors in choosing to require a DFC at preferred bidder include:

- the novelty and complexity of the project[3] or the risk allocation between project parties;
- the size of the required financing, both in absolute terms and relative to the available capacity in the market, taking into account financiers' risk appetites and client relationships;
- differences in credit standing / commercial approach between the likely bidders;
- financing market conditions;

3 Including projects with core characteristics different to the majority of PPP projects financed to date (e.g. demand / third party revenue risk, significant retained estate, challenging construction requirements, technological risk, high operational gearing or non-standard capital contributions)

- length of time between preferred bidder and financial close / impact of the planning process; and
- the impact on time and resources for the both the public and private sectors.

A.24 Particularly for novel/complex projects and large projects where the financing package involves (or will involve) a significant proportion of lenders in the market, early lender involvement in some form is likely to be appropriate. This does not necessarily preclude a DFC but the Authority will need to consider how the two processes will interact (e.g. structuring banks, right to match, etc.)

A.25 Where applicable, projects should also allow time and resource in the procurement plan for running the DFC. Running an effective DFC, particularly under competitive dialogue, requires the appointment of public sector advisers with a good understanding of what the financiers will ultimately require. Using a preferred bidder DFC may also impact on the approach to due diligence (see A.27 to A.33 below).

A.26 Authorities should always reserve the right to require the preferred bidder to run a DFC.

Dialogue phase

Authorities should:

- keep themselves well informed about market financing terms. This does not, however, diminish bidders' responsibility for submitting financeable bids
- keep financing options open and consider encouraging bidders to explore alternative options (such as capital markets) where these offer deliverability and VfM
- work with their financial advisers to understand the uses and limitations of standardised financing assumptions
- seek suitable levels of funder commitment or pricing at this stage
- work with their financial advisers to understand the counterparty risk they are taking

Bidders remain responsible for financing

A.27 Throughout the dialogue period, Authorities should be well-informed about the state of the financing market to enable them to make independent judgements about the deliverability of financing terms submitted by bidders. However, this in no way diminishes the requirement for bidders to submit financeable bids and, where appropriate, demonstrate support from lenders.

A.28 It is important to recognise that bidders may need to engage with lenders to demonstrate confidence that their proposals are financeable. It is the responsibility of the Authority and its advisers to determine how much lender involvement is required prior to selecting a preferred bidder. This will have been considered as part of choosing the DFC strategy (see A.22). Once Authorities have determined the appropriate level of lender engagement, they should apply the chosen approach consistently for all bidders.

A.29 Where Authorities do plan to use a DFC at preferred bidder, they should ensure that they have sufficient understanding of financeability issues[4] prior to selecting the preferred bidder given that resolving such issues may impact the commercial package(s).

A.30 Where Authorities seek funder involvement prior to the selection of the preferred bidder, lenders should be asked to identify any aspects of the project that they believe would adversely affect their ability to obtain credit approval.

A.31 In general, Authorities should be confident that the contractor support package and overall risk allocation will be acceptable to lenders. Resolution of any issues whilst still in competition is desirable for transparency, VfM and affordability reasons. Authorities should also be mindful of procurement issues which arise where matters are left for resolution once dialogue is closed.

A.32 Project risk factors that might concern lenders include:

- sites with known adverse ground conditions or restricted accessibility;
- high operational gearing[5];
- substantial corporate support behind key subcontracts;
- significant refurbishment works;
- requirement for novel or unusual construction techniques;
- relatively long construction periods;
- construction materials or equipment with a unique supplier;
- fixed or unusually rigid construction programme delivery dates;
- assets that will be difficult to insure;
- demand or volume risk;
- unproven technology;
- training / educational outcome risk;
- unusual maintenance requirements;
- services requiring a unique supplier or very limited number of suppliers;
- funding solution that requires novel intercreditor arrangements;
- timing and conditions of Authority capital contributions; and
- multiple Authorities.

A.33 Authorities should understand which areas of the documents, financial modelling, contractual risk allocation (including subcontracts) and technical aspects of the project the funders have reviewed considered. Vague support letters stating that the project documents, preliminary technical report and financial model have been made available to funders should be discouraged in favour of disclosure of specific work undertaken by funders, listing any specific concerns and identifying work remaining.

4 Which might affect funder appetite for the project or give rise to higher financing costs, either directly through the credit margin or indirectly through performance bonding, reserve requirements and coverage ratios in excess of those required on standard PPP projects.

5 Operational gearing is the ratio of service costs to the total costs of the project company. As operational gearing increases, finance costs (which are a function of capital costs and financing terms) decrease relative to services costs (which are a function of operating assumptions).

A.34 Funders should explicitly acknowledge in any support letters i) the subcontract flow down inherent in the bid price and ii) whether any side letters or other conditions have been communicated to sponsors. Sponsors should have a parallel obligation to disclose such side letters or conditions as part of their bid. Where funders have supported the bid, these representations should be repeated in the preferred bidder appointment letter by the selected bidder and the funders.

A.35 The goal at this stage is not to have sponsors eliminate funders based upon their responses, but rather to allow the Authority to have early warning about difficult issues that would have arisen in any case later in dialogue or post preferred bidder.

A.36 One approach to managing the interface between competitive dialogue and a DFC is to appoint shadow lenders' advisers. The objective of this is to identify – prior to the closure of dialogue – issues likely to be raised by financiers. This approach can be effective, but factors to consider include:

- the difficulties advisers face in acting without a client;
- the cost and who pays it;
- terms and conditions of appointment, including duties of care and ultimate novation to financiers;
- confidentiality (particularly if one shadow technical adviser is appointed to review all the designs);
- managing the interfaces (i.e. between the shadow lenders' advisers as well as with the Authority's advisers) and incorporating the findings of the shadow lender advisers in the financial / commercial bid evaluation;
- ensuring acceptability of chosen shadow advisers to widest number of lenders; and
- managing the risk of lowest common denominator structuring and / or hidden sponsor points emerging through the due diligence process.

Managing the financial bid evaluation

A.37 Authorities should:

- work closely with their financial advisers to identify and monitor the development of project-specific issues that may affect the terms of finance;
- where the senior debt terms suggested by bidders are – in the view of the Authority and its financial adviser – not supported by market evidence, provide all bidders with standard financing assumptions;
- monitor the financing market and update their affordability and VfM sensitivity analyses and, where applicable, any standard financing assumptions provided to bidders;
- evaluate dialogue responses so as to understand the financial implications (such as operational gearing) for alternative bids e.g. where some bids are capital-intensive and others service-intensive; and
- seek guidance from their sponsoring department and/or Infrastructure UK on financing assumptions which might be appropriate for the project.

A.38 In addition to the assessment of a project's technical characteristics undertaken earlier in the dialogue phase, by late in dialogue, financial models should be sufficiently developed to reveal any unusual cash flow characteristics about which funders might have concern. To avoid difficulties following the announcement of the preferred bidder, financial advisers should run typical lender sensitivities on financial models to verify that there are no adverse results in the operational gearing, cash / ADSCR break-even and cost step-up sensitivities in particular. They should also verify that bidders' financial models do not rely upon unusual definitions of cash flow to achieve acceptable sensitivity results.

Standardisation of financing assumptions

A.39 Authorities should consider using standardised financing assumptions to assess bids when terms proposed by bidders appear off-market or there is a long period of time until planned financial close. These terms should be set by reference to financing terms available in the market for similar project risk at the time of the bid assessment. Projects that are novel, complex or large (or those that involved non-traditional financing sources) may not be suitable for standardised financing assumptions.

A.40 Standardised assumptions should include the underlying gilt or swap rates, swap credit margin, debt margins and debt tenor. Debt service coverage ratios may also be standardised unless there is a wide variation for different business models underpinning different bids. Care should also be taken in standardising assumptions such as maintenance and handback reserving requirements which may be highly dependent on the technical solutions of individual bidders. Once the preferred bidder is announced, financing terms for that bidder may be subjected to a DFC.

A.41 Authorities should continuously monitor the suitability of standardised financing assumptions and update their VfM and affordability analyses as required.

A.42 Authorities may consider making an exception from standardised assumptions for bids financed on a corporate basis but only if the Authority considers the offer of finance to be robust over a suitable time period.

Potential role of EIB in financing

A.43 Authorities should ascertain if the EIB has an interest in the project while recognising that the EIB will typically not engage in a discussion of terms until the preferred bidder has been selected. Authorities should be aware that the EIB operates a two-stage approval process. The first stage is to ensure that the project complies with its lending policies and to determine if it falls into any special lending category. This can be done early in the dialogue phase. The second stage is analogous to the credit approval process followed by commercial banks and will follow a similar timetable.

Price validity periods & firm prices - financing and subcontracts

A.44 Authorities should have a clear understanding of i) the period for which all pricing elements of each bid submission are valid and ii) any portion of the pricing elements that are not firm[6]. In respect of subcontracts, Authorities should continue to require prices to be held for a period standardised across all bidders and may wish to make an extension of the minimum price validity period an element of competition.

6 A firm price contract is a type of fixed price contract that is not subject to any adjustment. This is distinct from other types of fixed price contract that may be adjusted in certain circumstances. Terminology can vary so Authorities should have a clear understanding of the underlying principles.

Variant financing options

A.45 Where appropriate for the project, Authorities should encourage bidders to identify variant financing solutions (such as capital markets) that offer robust deliverability and VfM.

A.46 Authorities entertaining financing structures outside of the traditional project finance model should consider how they will be evaluated and consult with their sponsoring department or Infrastructure UK at an early stage.

A.47 Authorities may be asked to consider proposals to change risk allocations to elicit more attractive financing terms, in particular in respect of margin and maturity. Any variant requiring risk allocation that differs from SoPC4 will require Infrastructure UK approval.

A.48 Authorities should be clear in their instructions to bidders that, while they wish to receive innovative proposals that will lower the cost of financing, a variant that requires derogations from SoPC4 will not necessarily be approved. Authorities should consult with Infrastructure UK before progressing with a bid that is affordable only with a derogation from SoPC4.

Due diligence by Authorities on financial health of project parties

A.49 Authorities will typically include questions within the pre qualification questionnaire ("PQQ") to elicit information on the financial robustness of bidders. Throughout the procurement period it is essential that Authorities and their financial advisers continue to monitor the financial health of critical members of each bidder's supply chain, including sponsors, key sub-contractors and lenders.

A.50 Authorities should consider:

- for key subcontractors, the size of the subcontracts relative to their balance sheets i.e. market capitalisation / tangible net worth;
- how far into the supply chain to extend their due diligence work, recognising that early in the procurement the proposed supply chain may not yet be complete;
- when to repeat their PQQ due diligence exercise in respect of the financial health of bidders, sub-contractors and lenders; and
- how to flag these requirements to bidders in bid documentation.

A.51 The historical PQQ assessment should be monitored and updated as required throughout the procurement period, subject to compliance with EU procurement rules. Financial advisers should play a key role in this activity which is likely to involve monitoring of credit ratings, balance sheet strength / tangible net worth / market capitalisation, share price volatility, investment research reports and independent financial analysis where third party assessments are not available. Particular attention is required where the supply chain includes scarce resources and Authorities should seek to ascertain if the supply chain encompasses any such participants.

A.52 In terms of responses to potential problems with the financial robustness of relevant organisations, Authorities should consider whether the most suitable response is to disqualify the bidder, amend the procurement plan or seek to remedy the potential problem, perhaps by encouraging a change to the risk allocation within the supply chain or by encouraging some form of financial support. Authorities should be mindful of the trade-off between cost and project robustness.

Preferred bidder phase

Authorities should:

- be aware of issues around hedging
- consider whether they need to exercise their right to require the preferred bidder to run a debt funding competition

Hedging matters

A.53 HM Treasury's May 2006 Application Note "Interest-rate & Inflation Risks in PFI Contracts"[1] (Interest-Rate & Inflation Application Note) contains guidance on hedging issues for projects at various stages in procurement through to financial close. In particular, it includes guidance on the execution process for interest rate swaps that are common to most PFI projects (see section 2.7 of the note).

A.54 The interest-rate swap is a very important part of the cost of the overall financing arrangement and it is important that Authorities are aware of the issues which arise and able to manage the process so as to protect their interests.

A.55 In addition to those set out in the Interest-Rate & Inflation Application Note, Authorities should consider the following points:

- credit spreads have increased significantly since the Note was published. Authorities should be mindful of how these spreads are set and how long lenders will hold them for;
- credit spreads should be set under a competitive process where practical, similarly to loan margins. As such they should be considered within the context of any funding competition;
- as well as credit spreads, transparency in the underlying swap rate is also critical. Where a competitive process cannot be adopted for the determination of that rate then it is important that it is rigorously benchmarked (both the underlying rate and the execution spread) by the Authority's financial advisors or a specialist in this area; and
- swap credit margins can have implications for compensation on termination and refinancing calculations in a way that increased loan margins generally do not. The termination of a swap generally involves the payment of the present value of future swap margin whereas the prepayment of a loan normally does not involve any recognition of future margins forgone. This acceleration of the swap credit spread following prepayment may have a significantly adverse effect on the value for money assessment of any future refinancing.

A.56 Funders committing to a loan on a take and hold basis typically amortise the upfront fee over the loan life. However, in some cases the value of the swap credit spread is recognised upfront and by a different department within the financial institution. This has a number of implications:

1 http://www.hm-treasury.gov.uk/ppp_finance_guidance.htm

- deciding which lenders will arrange the swap(s) and whether or not they can be removed from the financing / swap provider group should be a key part of the financing competition / book-build process rather than an afterthought. In some cases, a separate swap competition may be appropriate. This arrangement is a matter for the bidder but the public sector should understand and agree the key aspects of the process given they take the price risk on swap rates;
- not all lenders in a club are equally positioned when it comes to providing hedging. For example, building societies are generally unable to provide swaps but may provide other solutions. The Authority and its advisers should seek to understand the bidder's overall hedging strategy early on and in particular whether it requires any derogations from SoPC4; and
- particularly for larger transactions, there is a balance to be struck between too many swap participants and too few. If every lender in the club is given the right to participate there may be a large number of participants seeking to execute trades at the same time which may lead to market confusion. Alternatively, if there are too few swap participants, the Authority may lose the option of removing a swap provider / lender from the transaction should they no longer offer value for money.

A.57 Further to section 3.2 of the Interest-Rate & Inflation Application Note, the VfM baseline should be a matching of indexation of the service charges to the underlying inflation exposure of the contactor's costs[2] during the service delivery period. Any Authority seeking an alternative treatment will require the approval of Infrastructure UK as part of the business case and VfM assessments.

A.58 In addition, Authorities should note that the inflation swap market is smaller and less transparent than the interest rate swap market and therefore more difficult to benchmark. As such, the principles set out herein are particularly important for inflation (e.g. RPI) swaps.

A.59 These are complex matters with significant commercial importance to the participants. Authorities should therefore seek input from their financial advisers and/or Infrastructure UK.

Exercising the reserved right to require a DFC

A.60 As noted in A.26, Authorities should reserve the right to require the preferred bidder to run a DFC. Factors to be considered in deciding to exercise this right include the length of time between preferred bidder and financial close, the materiality of market movement since the submission of financing terms, the deliverability of the existing funding package and the degree to which the bidder can demonstrate competition in assembling its proposed finance package.

2 Selection of indices is covered at paragraph 15.2 of SoPC4 and section 3.3 of HM Treasury's May 2006 Application Note "Interest-rate & Inflation Risks in PFI Contracts"

B Annex: Derogations

Approval of Sector Specific PFI Contracts and Submission of Derogations from "Standardisation of PFI Contracts Version 4" (SoPC4): An Update

Application of SoPC4

B.1 SoPC4 applies to all PFI contracts in England. PFI is not suitable for projects with a capital value of less than £20 million, nor should it be used for IT projects.

B.2 SoPC4 may also be applied to PFI contracts in Wales, in which case the Welsh Assembly Government will determine the detail of such application.

B.3 PFI contracts in Scotland and Northern Ireland must comply with guidance relevant in those jurisdictions.

Definition of compliance with SoPC4

B.4 In order to comply with SoPC4, each PFI contract must include all required drafting, as referenced in paragraph 1.4.1 of SoPC4. In addition, there are a number of clear contractual principles (without specific contractual drafting) set out in SoPC4 which must be complied with. Together, the required drafting and mandatory contractual principles are referred to as the "Core Areas".

B.5 If a PFI project wishes to derogate from a Core Area, it must submit a derogation request to Infrastructure UK for approval.

B.6 Where permissible alternative options to required drafting are provided in SoPC4, specific derogation approval is not required when using these alternatives (subject to compliance with relevant conditions of their use).

B.7 Where SoPC4 sets out "suggested" (as opposed to "required") drafting or approaches, individual procuring bodies and sponsoring departments will be responsible for assessing whether the approach taken in their contract is reasonable and compliant with the overall approach of SoPC4. HM Treasury will not require sight of these aspects of individual contracts.

Sector specific contracts

B.8 A number of departments have developed sector specific contracts, which are based on SoPC4 but reflect the inevitable differences in PFI procurement in different areas of economic activity. In addition there are a number of sector specific procurement packs, produced by Local Partnerships, which in each case contain both the contract and sector specific guidance on PFI contracts. Where these have been approved by Infrastructure UK they will appear on the HM Treasury web site. Where a derogation from a Core Area has been approved in a sector specific contract, there is no need to seek further approval for such derogation.

B.9 Departments should ensure that PFI projects which they sponsor fully comply with the relevant sector specific contracts.

B.10 Most sectors have now developed standard form "Change Protocols" which have been approved by HM Treasury as being in line with HM Treasury Change Protocol Principles[1]. Where a sector specific Change Protocol is used it is only necessary to revert to Infrastructure UK with any material changes which are at variance with the Change Protocol Principles. Where no sector specific Change Protocol has been approved by Infrastructure UK the relevant project's Change Protocol must be in line with HM Treasury's guidance on change, and any material changes submitted to Infrastructure UK for approval as part of the derogation process.

Individual contract derogations

B.11 HM Treasury believes that derogations from SoPC4 or approved sector specific contracts should only be made in exceptional circumstances on project-specific grounds. We would emphasise that it is essential that sponsoring departments take an active role in ensuring that the policy on standardisation is implemented.

B.12 If sponsoring departments are aware that individual PFI projects (for which they have oversight) are seeking to derogate from the Core Areas they should, in the first instance, directly assess the specific derogations and work with the Authority in order to reduce these to a bare minimum before presenting a case to Infrastructure UK. Sponsoring departments should avoid approaching Infrastructure UK without having first convinced themselves through detailed assessment that there is an exceptional project specific need for any such derogation.

B.13 If Infrastructure UK is presented with extensive derogations reports it is likely to revert to the department to challenge this position. It should also be borne in mind that the more extensive the derogations presented the longer it is likely to take to reach an agreed position. Such timing concerns should be taken into account in timetables for closing deals. While Infrastructure UK will make every effort to be responsive to the needs of Authorities and departments, the last minute provision of extensive derogations will be likely to slow the procurement process. Where significant changes to Core Areas are sought, it is advisable to seek guidance from Infrastructure UK earlier in the procurement process.

B.14 Subject to the above, Authorities should seek derogations approval once contractual drafting is settled. In the case of a procurement using the competitive dialogue procedure, as there can be no significant changes to the PFI contract following final tender, approval for any necessary derogations should be sought in respect of each bidder prior to conclusion of the dialogue.

B.15 It is not expected that further derogations would arise after this time, but if they do, they must be submitted to Infrastructure UK for approval prior to financial close of the project. Infrastructure UK should, in any event, be notified when the project reaches financial close.

B.16 Infrastructure UK would not normally expect to directly engage in contract discussions relating to derogations with private sector parties involved in PFI deals such as lenders and equity providers. Infrastructure UK's contact would usually be through the public sector bodies responsible for the contract. This is to ensure that there remains a clear line of communication and responsibility in such negotiations.

Consequences of non-compliance

B.17 Projects that are non-compliant with SoPC4 and have not had their derogations or sector specific contract approved by Infrastructure UK will not have their Final Business Cases approved.

1 http://www.hm-treasury.gov.uk/d/pfi_change_protocol_principles.pdf