

Local Government PFI Project Support Guide (2009-10)

1st Revision (September 2009)

The Private Finance Initiative (PFI) enables local authorities to enter into a contract with the private sector for the provision of services involving new or improved capital assets. Support can be allocated by central Government departments towards the cost of the capital element of PFI projects (including the PFI element of Building Schools for the Future). Local authorities taking out leaseplus agreements with LIFT companies may also be eligible for such support. Notification that grant will be paid, the conditions and the level of capital investment which will be supported are set out by issuing a "PFI credit" in the form of a letter from the sponsoring department.

This guide provides advice to those local authorities seeking central government support for PFI or LIFT projects. Those authorities who wish to formally submit a grant claim should consult the *Local Authority PFI Annuity Grant Determination (No 1) 2009 [No 31/1352]*¹ or - if claiming grant on a declining balance basis - the *Local Authority PFI Declining Balance Grant Determination (No 1) 2009 [No 31/1353]*¹.

The guide is arranged as follows:

- Section A: Administrative arrangements for PFI credits
- Section B1: Endorsement letter
- Section B2: Promissory note
- Section B3: PFI credit letter
- Section C: OBC Guidance
- Section D: FBC Guidance
- Section E: Calculation of PFI credits
- Section F: Calculation of PFI grant
- Section G: Post contract signature changes
- Section H: Administrative arrangements for PFI grant
- Section I: LIFT projects

The interest rate used in the calculation of grant, and the discount rate used in the calculation of PFI credits, is determined to be 5.4% for all projects

¹

www.communities.gov.uk/localgovernment/localgovernmentfinance/pupprivatepartnership/centralgovernment/

endorsed in 2009-10 and 2010-11. The scaling factor, which is used for all projects other than HRA projects, is determined to be 1.0 for all projects endorsed in 2009-10 and 2010-11.

Significant changes from the 2008-09 Project Support Guide are:

- Expanded OBC guidance.
- New FBC (and 2nd Stage Review) guidance, particularly reflecting changes to the procedures under Competitive Dialogue.
- Revised accounting requirements.
- More flexibility in the use of PFI credits to support land acquisition.
- A requirement to report proposals for major variations to the sponsoring department.
- More detailed guidance on possible re-assessment of support resulting from termination or major variations.

Further changes in the 1st revision are to the accounting requirements.

SECTION A

ADMINISTRATIVE ARRANGEMENTS FOR CENTRAL GOVERNMENT SUPPORT

The following outline of arrangements applies to most PFI projects, but see Section A (6) below for differences in the approach for Building Schools for the Future (BSF) and LIFT projects.

(1) First Approach

(1.1) Invitation to produce an OBC. The procedures for applying for central government support vary between departments. Some hold annual bidding rounds inviting Expressions of Interest / Strategic Outline Cases, whilst others will assess proposals submitted at any time. To reduce the risk of abortive work, authorities are recommended to check on the procedures and to discuss their proposals with the 4ps and the department concerned at an early stage. However proposals are received, departments will invite authorities to produce an Outline Business Case (OBC) for those projects they wish to see proceed further. Authorities should appreciate that a firm commitment on revenue support towards the costs of the PFI scheme cannot be given at this stage.

(2) Project Endorsement

(2.1) Outline Business Case. See Section C which covers the Outline Business Case (OBC) assessment process by sponsoring departments and the Project Review Group (PRG), as well as guidance on the content.

(2.2) Endorsement letter. If a project is endorsed by PRG, the sponsoring department (or lead department in the case of a jointly sponsored project) will send a formal endorsement letter (the template at Section B1 provides a framework, and in some circumstances options, although each letter will be tailored to meet the specific needs of each sector and project – this will be especially so for BSF or LIFT projects). This letter will include standard and specific conditions, and set the endorsement date which is used to determine a number of rates used in grant and PFI credit calculations. Some conditions may need to be met before the project is taken to the market. A project with such conditions is nonetheless considered endorsed at the date of the relevant PRG meeting.

(2.3) Publication of the OBC. Authorities are urged to publish their OBC (bar commercially confidential information) on their website as soon as possible after endorsement. Some sponsoring departments will require the publication of the OBC as part of their funding commitment.

(3) Procurement to Preferred Bidder

(3.1) Procurement process. Since February 2006 authorities have been required to establish at the start of the procurement process whether they should use the Competitive Dialogue (CD) or Negotiated Procedure (NP) process. Although most PFI projects are expected to use CD each authority must ensure that they take a proper legal decision on a project specific basis.

(3.2) Value for Money. Throughout procurement local authorities are expected to undertake Stage 3 of the Treasury standardised Value for Money (VfM) assessment procedure², and report any problems to the relevant sponsoring department.

(3.3) Additional Support or Reduced Outputs. Although the aim is to avoid such a situation, in some cases a project may prove to be unaffordable as set out in the OBC. In such cases a request for additional support and/or a reduction in outputs/ benefits (“de-scoping”) may be proposed (note: de-scoping should not be confused with innovation where the outputs/benefits are achieved in a more efficient way). In general both approaches are bad practice - the project will generally have been prioritised because it delivered a certain set of benefits for a certain cost, i.e. it was better VfM (in its broad sense) than other projects. A change in the VfM could bring into question the original decision. However, in some cases a department may conclude that the revised project remains VfM and a decision on the balance of additional support or reduced outputs needs to be made by the sponsoring department, in the context of both the project and the overall programme.

If the increase in PFI credits is over £20 million or 20%, whichever is the lower, that project will also need to be re-submitted to PRG for further approval. If the increase is below that level, but there is any indication that the request has been deliberately engineered to avoid the limit, then the sponsoring department is advised to consider whether it should nonetheless still approach PRG for advice. Where reduced outputs are concerned, it is likely that quantification will be more difficult, but to the extent possible a reduction of more than 20% should be treated in the same way as a similarly sized increase and the scheme referred to PRG for advice.

(3.4) Second stage reviews and Final Business Case. See Section D, which covers the range of procedures, including 2nd Stage PRG reviews and the Pre Preferred Bidder Final Business Case (FBC), which need to be completed before a preferred bidder can be selected.

(3.5) Promissory note. A promissory note does not need to be sent at any particular stage if the authority does not require it, but may be requested to provide assurances about the continued support in principle of the department if that is requested/needed. If that is requested prior to the FBC being agreed a template for use is at Section B2. More usually the promissory note is requested shortly before contract signature and the FBC will have been approved – a template for use in these circumstances is at Section B3 (note

² www.hm-treasury.gov.uk/documents/public_private_partnerships/additional_guidance/ppp_vfm_index.cfm

that the comments about the endorsement template at para. 2.2 above also apply to these letters).

(4) Contract signature

(4.1) Financial Close. Guidance on the Pre Financial Close FBC is given in Section D. A target date for the project to reach financial close will have been agreed between the local authority and department and recorded in the endorsement letter. Should that target date be missed, any possible action will be a matter for the sponsoring department. Authorities are urged to alert departments as early as possible if that seems likely to happen.

(4.2) PFI credit letter. The authority should send written notification of the date financial close is reached. A PFI credit letter (template at Section B4 – note that the comments about the endorsement template at para. 2.2 above also apply to this letter) will always be sent by the sponsoring department when the project reaches financial close. This letter is the formal date at which a PFI credit is issued, and is the record of all factors used in calculating PFI grant.

(4.3) Publication of the FBC. Authorities are urged to publish their FBC (bar commercially confidential information) on their website as soon as possible after financial close. Some departments require publication of the FBC as a condition of providing PFI funding support.

(5) Operational Projects

(5.1) Post contract signature evaluations. All projects will be expected to carry out post-contract signature project evaluations, which they will submit to the sponsoring department. A random sample of these will be sent to the Treasury.

(5.2) Major post contract signature variations. Any major variation which is being considered must be reported to the sponsoring department before it is agreed, including any contract extension (whether PFI credit support is being sought for that extension or not). Where there is a change protocol which defines major variations that should be used. Where that does not exist, there is no simple definition of whether any variation is major or not. However, the standard change protocols can be used as a guide, and if in doubt the sponsoring department should be consulted. A department may wish to look at the VfM or legal aspects of any such variation.

The possible impact of such changes on the level of support is covered in Section G.

(6) Building Schools for the Future (BSF) and Local Improvement Finance Trust (LIFT) projects.

(6.1) BSF. BSF projects receive endorsement from a separate panel, rather than PRG, but the purpose is essentially the same. This panel - the Main Review Meeting (MRM) – is chaired by Partnerships for Schools (PfS) with attendees from the Department for Children, Schools and Families (DCSF), Partnerships UK (PUK) and HM Treasury. Standard letters are significantly different, particularly as approval is for more than PFI, also covering Design & Build and ICT. As PRG is not involved in endorsement there are no second stage reviews, but PfS provide constant monitoring and liaise as necessary with PUK and HM Treasury.

(6.2) LIFT. Unless advised otherwise by the sponsoring department, the general PFI procedures apply to LIFT projects, both during initial procurement and later phases / tranches of work. Some variations for projects involving a leaseplus agreement with a LIFT Company are set out in Section I of this Guide.

SECTION B1

ENDORSEMENT LETTER

I am writing to inform you that consideration of the outline business case (OBC) you submitted on *[date]* for the *[name of project]* PFI project has been completed. I am pleased to be able to tell you that your project was endorsed by the Project Review Group (PRG) on *[date]* as ready to enter into procurement *[subject to the conditions set out below]*. We expect that central Government revenue support will be given based on PFI credits of *[£... million]*. *[For jointly sponsored projects: This comprises £... million from ... and £... million from ... This department will be the lead sponsor for your project.]* Your scheme should be developed so that it is affordable within this offer.

This letter is without prejudice to any other consent that may be required, for example, in connection with planning legislation.

Conditions

Support for this project depends on the project continuing to meet all the published criteria in the Department for Communities and Local Government Local Government PFI Project Support Guide. In particular, you are reminded of the requirements on the use of standardised contract documentation; and on sharing documentation, including publication of your OBC (barring any sensitive information) on your website as soon as possible.

[Departments should set out any conditions imposed by PRG and any that they may wish to add].

Procedures

Please keep in touch with us about the progress of your project during procurement. In particular, you must inform us immediately if you wish to change aspects of the project in any material way from the case agreed. That particularly includes the scope, need for PFI credits, or the timetable, where we have agreed that you are aiming to reach financial close by *[date]*. If changes are required to any of these aspects of the project you will need to obtain the Department's written agreement in good time before the contract is signed. Failure to obtain any of these could potentially mean withdrawal of support for the project, and would invalidate any undertaking by the Department or PRG to support your scheme.

You will need to discuss any potential derogations to the standard contract with this department as soon as possible, and more formally ensure that decisions are reached on the full list for each bidder prior to the close of dialogue. A Final Business Case (FBC) should be submitted at least four weeks prior to selection of the preferred bidder; and *[a supplement to][revised version of]* this should update the case prior to financial close. Finally, you

should send a letter confirming the date financial close is reached. Providing there are no outstanding issues, we will then formally issue a PFI credit letter.

The PFI credit letter will provide you with details of how and when revenue support can be claimed *[as set out in the Local Government PFI Annuity Grant Determination for the financial year in which grant is first claimed.] [as HRA Subsidy.]* The interest rate which will be applied in calculating grant for your project will be ..%, and the scaling factor ... Your authority will need to ensure that funds are available to cover that part of the payments to the contractor which will not be met by central Government.

You will be eligible for grant when *[the [first] permanent asset is completed, which should be taken to mean ...][responsibility for the maintenance of assets is transferred]. [If PFI credits are to be phased this must be set out, citing the level of PFI credit for each phase and when support for each will start].*

Revenue support is not intended to match or correlate directly to the payments that arise under a PFI contract. However, the Government is committed to supporting good PFI projects and to assisting the development of PFI in the local authority sector. Its policy is therefore to maintain revenue for PFI projects in the long term, consistent with the long-term nature of PFI contracts, even though formally such support cannot be guaranteed.

SECTION B2

PROMISSORY NOTE (prior to FBC)

I refer to our earlier correspondence letting you know that the Project Review Group had endorsed this project. I note from your letter of *[date]* that your project continues to meet the relevant published criteria and the conditions set out in the endorsement letter of *[date]*. I confirm that if the transaction is entered into on these terms, this Department will issue your authority with a PFI credit letter for an amount of *[£... million]*. *[This includes £... million provided by [other department].]*

All terms, and eligibility for grant, are as set out in the endorsement letter *[and subsequent letter(s) of [date(s)]]*. *[If there have been any changes agreed to the scope or PFI credits, these should be referred to.]*

You should continue to seek prior approval if, between now and contract signature, different terms are negotiated which affect either the nature of the scheme or the potential amount of the PFI credit, or if those terms differ from those in the relevant PFI standardisation documents. Any departure from these terms could affect your authority's entitlement to PFI credits, and will in any case risk delay to the project if PRG decides to have the proposed departures reviewed. Should we wish to support the revised project we would issue a further letter.

SECTION B3

PROMISSORY NOTE (post FBC approval)

Thank you for the final version of the Final Business Case for this project, which you sent to this Department on *[date]*, *together with a number of supporting documents*. *[Refer to any subsequent changes agreed.]*

I confirm that if the transaction is entered into on the terms set out in the documents noted above, this Department will issue your authority with a PFI credit letter for an amount of *[£... million]*. *[This includes £... million provided by [other department].]*

You should continue to seek prior approval if, between now and contract signature, different terms are negotiated which affect either the nature of the scheme or the potential amount of the PFI credit, or if those terms differ from those in the relevant PFI standardisation documents. Any departure from these terms could affect your authority's entitlement to PFI credits, and will in any case risk delay to the project if PRG decides to have the proposed departures reviewed. Should we wish to support the revised project we would issue a further letter.

SECTION B4

PFI CREDIT LETTER

Thank you for confirming that financial close was reached on the above transaction on *[date]* and that the contract was agreed on the terms set out in your FBC *[plus any subsequent agreements]*. This Department is therefore now formally issuing PFI credits for this project for an amount of *[£... million]* *[subject to the following conditions]*. *[This includes £... million provided by [other department].]*

You are required to send a copy of the signed project agreements in electronic form to: PFIcontraxxx@xxxxxxxxxxxx.xxx.xxx.xx This will be used for compliance monitoring purposes. You should also publish your FBC (barring any sensitive information) on your website as soon as possible.

You will be eligible for grant when *[the [first] permanent asset is completed, which should be taken to mean ...][responsibility for the maintenance of assets is transferred]*. *[If PFI credits are to be phased this must be set out, citing the level of PFI credit for each phase and when support for each will start]*. Revenue support will be paid *[once a valid claim form has been received, as set out in the Local Government PFI Annuity Grant Determination for the financial year in which grant is first claimed.] [as HRA Subsidy.]* The interest rate which will be applied in calculating grant for your project will be ..%, and the scaling factor ... Your authority will need to ensure that funds are available to cover that part of the payments to the contractor which will not be met by central Government. More information on PFI grant, including the *Local Government PFI Project Support Guide* and grant claim forms, are available at www.communities.gov.uk/localgovernment/localgovernmentfinance/pupprivatepartnership/centralgovernment/

Revenue support is not intended to match or correlate directly to the payments that arise under a PFI contract. However, the Government is committed to supporting good PFI projects and to assisting the development of PFI in the local authority sector. Its policy is therefore to maintain revenue for PFI projects in the long term, consistent with the long-term nature of PFI contracts, even though formally such support cannot be guaranteed.

Termination or variation of a PFI contract could in some circumstances (as set out in the *Local Government PFI Project Support Guide*) lead the Government to reassess the level of revenue support based on the extent to which the anticipated capital investment is delivered. Any plans for a major variation (including extension) to the contract must therefore be reported to this department before it is agreed.

SECTION C

OBC GUIDANCE

Procedures

A key stage in the procurement process of PFI, following on from any Expression of Interest or similar document, is the development of a business case. An Outline Business Case (OBC) should be an integral part of an authority's decision making process, but is also the primary document for the assessment of projects by government as being sufficiently well developed to be ready to go to market.

The Outline Business Case (OBC) provides a comprehensive document which demonstrates that the project (i) is sufficiently developed to be commercially viable / bankable; (ii) has demonstrated that PFI is the best value for money procurement route; (iii) is affordable, taking account of the agreed level of PFI credits; and that the authority (iv) is committed to the use of standard contract conditions and to good quality design; and (v) has the strategy and capacity to undertake the procurement.

In drafting an OBC, authorities are advised to take account of the advice in procurement packs and departmental guidance as well as the general guidance below.

A first assessment will be undertaken by the sponsoring department – in some cases in conjunction with its relevant NDPB. With the exception of Building Schools for the Future (BSF) and most street lighting projects, there is then a second assessment by the PFI Project Review Group (PRG). A department will send an OBC to PRG if all criteria are met satisfactorily, and if the project has ministerial approval. PRG then takes a period of 5 weeks to assess the project.

A project that is not endorsed at a PRG panel meeting may be invited to do more work in particular areas and return for re-consideration. Further guidance on PRG procedures can be found in the PRG Code of Practice, available on the Treasury website³.

Endorsement is also a pre-requisite for access to the Treasury Infrastructure Finance Unit (TIFU).

Content

In a number of sectors sponsoring departments require published templates to be used in preparing an OBC. These all follow the basic requirements set out below, but are tailored more closely to the specific type of project.

³ www.hm-treasury.gov.uk/d/prg_code_of_practice_v3_2009.pdf

General guidance is given below.

1. Executive Summary and Council approvals

The OBC should start with an executive summary of the scheme. The level of detail will vary according to the type and complexity of the scheme but it should include the key points and conclusions from each of the main sections described below in as concise a way as possible.

The OBC should include evidence, in the form of Cabinet minutes and reports to Cabinet (or equivalent), that members have agreed the OBC and a specific long term Council contribution. It should also include the equivalent approval of a budget for the council's procurement costs (inc. for external advisors). Where, unusually, it is felt that either cost can be covered by existing budgets and delegations the OBC should include details.

Details of delegated authority for agreeing any subsequent changes to the member agreements should also be included, along with details of where and to whom authority has been delegated to take decisions during the procurement process.

The OBC should include a covering letter from the section 151 officer endorsing the final version of the OBC submitted. The letter should demonstrate authority ownership of the underlying financial assumptions and calculations on which VfM and affordability (based on the council contribution agreed by members) is based, and belief in the deliverability of the project.

2. Scope

Any OBC must describe how the project is scoped, and why it is scoped as it is. These are primarily areas for sponsoring departments to assess.

(2.1) Description of project. The way in which the scope is described will clearly vary depending on the sector, but may cover the type and number of assets being proposed, where those assets are being built, the services being delivered from them, and the nature of any soft services.

The scope may need to cover wider associated works which are not part of the PFI contract, but are part of the project in the wider sense.

The project scope should also cover the length of the contract. If a timescale different to most in the sector is envisaged, an explanation must be provided justifying it on value for money grounds (note: VfM rather than affordability).

(2.2) Strategic Context & Business Need. The proposal needs to be supported by an appropriate analysis of the need or rationale for the service or facility. It should demonstrate why the project is a real strategic priority for investment (rather than having been put together with a view specifically to securing PFI credits), and the contribution the service can (or could) make to

the broader strategies of the Local Authority and to regional and national priorities. A well-developed OBC will be able to demonstrate that the project forms a logical and coherent part of and flows from the authority's plans and priorities, including Best Value Performance Plan and Community Strategy, the Capital Strategy and Asset Management Plan and/or the relevant strategic service plan. This analysis should include consideration of the long term demand for the service / assets proposed in the scheme (including any other assets facilitated by the PFI).

Although this section of the OBC is an important element of the submission, it is commonly unduly lengthy and detailed compared to other sections of the OBC. Authorities should therefore be concise when pulling together their strategic analysis, which does not need to try to itemise every target or strategy which a project might contribute to.

(2.3) Output specification. The OBC should include a well-developed draft of an Output Specification where all the key principles have been agreed. It should be set out as a clear definition of the objectives and outputs needed, with the standards required and not a description of an asset (though this may also be appropriate in respect of particular essential service and asset elements). This is a key characteristic of PFI contracts and allows for innovation and efficiency on the part of the private sector. The OBC should also include a commentary on how the Output Specification will be developed further.

The specification should be based on best practice and robust precedent from similar projects, and be consistent with affordability assumptions. Any high-quality, high cost standards which could be considered to be 'gold-plating' or unduly aspirational should be justified on strategic impact, innovation or value for money grounds. On the other hand, standards should not necessarily follow historical approaches and patterns of spend. This is especially important in relation to lifecycle costs, which have often been significantly underestimated or ignored completely.

An illustrative solution – the Reference Project - will be the benchmark solution against which bids are subsequently evaluated, and provides the basis for the financial analysis, but it should be clear that this does not constrain the final solution.

(2.4) Options Appraisal. An options appraisal needs to have been carried out to show that the solution (outputs and outcomes) which the authority has arrived at is the best way of meeting the business need and outputs identified. This is not (at this stage) a question of whether it is a PFI project or uses some other – possibly theoretical – means of procurement. It might, for example, explain why and how the choice was made on the site(s) for the asset(s), why new build or refurbishment is a better option, or a choice between different technologies. The decision on what is then the best form of procurement (PFI or some other) is discussed later in Section C (3.3).

Some form of qualitative means of assessing possible options should have been used to produce a short-list of 3 to 6 final options which can be assessed in further qualitative and also quantitative detail. A general requirement is that the options need to include 'do nothing' and 'do minimum' options, but there will also be a range of other options which may vary considerably to the extent that they would meet all of the project objectives.

The methodology used should be in line with the Treasury guidance Appraisal and Evaluation in Central Government (the 'Green Book'). The detailed assessment set out in the OBC will often include a qualitative non-financial element, often using a 'weighting and scoring' methodology. This element should include criteria related to wider benefits even if not directly related to the main purpose of the project. The usefulness of this exercise, however, is limited unless the benefits are related to costs in some quantified manner. Therefore the aim should be to value the benefits of the various options in an objective and rigorous way, and compare those to the costs of the options, producing a balanced qualitative and quantitative cost/benefit analysis.

(2.5) Design quality.⁴ Authorities are expected to demonstrate that they will give sufficient weight to design quality, taking account of the latest guidance on design quality in PFI projects available from OGC, CABE and 4ps. In some areas there may also be sector specific guidance⁵. Where relevant, projects must show that they contribute to the Government's commitment to achieving "Better Public Buildings". If the project involves construction work and life-cycle maintenance of buildings authorities should demonstrate how they intend to meet, as appropriate, the key objectives of the Egan Report.

The project should have a designated Design Champion within the project management structure, who will ensure that design issues are considered and factored into the project. The authority should demonstrate use of expert advice on design; and be accessible to the involvement of and committed to sharing their design proposals with CABE. Other design issues include the involvement of stakeholders; use of Design Quality Indicators (available from Construction Industry Council); and the extent to which design quality will be a key evaluation criteria for bidders.

(2.6) Sustainable development. Compliance with sustainable development principles is a very broad subject. However, projects should demonstrate an integrated approach to the social, environmental and economic well-being of the area, now and for future generations, in line with the OGC guidance note *Green Public Private Partnerships*. This covers the promotion of sustainable development in location, design, construction, operation and maintenance. Housing projects must conform to standards set out in the Department's Code for Sustainable Homes.

⁴ Note also guidance on design quality provided in Appendix 7 of the PRG Code of Practice (www.hm-treasury.gov.uk/d/prg_code_of_practice_v3_2009.pdf)

⁵ Including Defra's *Design in Waste*, CLG's *Achieving Design Quality in Fire and Rescue Service*, HCA housing standards, etc.

(2.7) General government objectives. An OBC should demonstrate how the project contributes to objectives such as diversity (including where relevant DDA), cohesion and empowerment.

(2.8) Consultation. In any PFI project there will be significant number of key players - generally characterised as stakeholders - who will have an interest in the project (including tenants in housing projects). The effective management and inclusion of stakeholders in the project development process is key to progress as it will avoid potential conflicts and subsequent delays. The OBC will need to set out the authority's plan for stakeholder management and involvement and provide results of any consultation work which should have taken place prior to finalising the OBC. That should address any contentious responses.

The authority must be open to consulting appropriate bodies such as Regional Government Offices, and the 4ps with regard to an individual OBC and a statement supporting this should be included in the OBC.

(3) Financial

Authorities are advised to ensure that the financial data used in different parts of the OBC, including for the financial model, PFI credit calculation, VfM and affordability sections is consistent. Different calculations may be done at different times and often to short deadlines as the OBC is submitted, and care must be taken to ensure that changes to one element are followed through to others.

(3.1) Basic Costs & Unitary charge. The OBC should include a financial model which set out the projected PFI service payments (the "unitary charge") for the reference project. The estimated unitary charge will then feed into the other financial models in the OBC. The model should show how the payments have been built up from basic capital and revenue inputs, including:

- Basic capital, lifecycle and revenue costs (including contingencies).
- Financing ratios and rates for debt and equity.
- Risk pricing.
- Inflation, indexation and interest rate assumptions.
- Value of asset contributions.
- Third party income received by the PFI contractor.
- Timing assumptions.

There can be a tendency to pay less attention to the basic costs than to financing factors since the latter tend to be more transparent. However, it should be borne in mind that the basic costs are often the largest variable in the overall cost of the project.

Although the overall estimated unitary charge can be benchmarked against other projects, it can often be easier to benchmark basic costs, such as unit costs e.g. build cost per m². This can allow for a better understanding of the

peculiarities of particular projects, and for comparison with a wider range of other projects. The OBC should therefore allow this to be done.

The costs may be based on a variety of sources, including sector specific benchmarks or recent market sounding exercises, and the OBC should state how they have been derived. There should be evidence that costs produced by external advisors have been signed off.

(3.2) Risk & Uncertainty. All of the financial aspects of the project will be affected by some element of risk and uncertainty. This can emerge in various guises. There is considerable reference material in the Treasury VfM assessment guidance and the Green Book, but the following is a summary:

- Contingencies - All large and/or complex contracts will include contingencies and these can be seen as being the same whether PFI or conventional contracts. The general methodology used to calculate contingencies is to start from a risk register estimating the chance of various risks happening and the costs if they did. The overall contingency required should not necessarily be the total of all costed risks, though, as a 'ground-up' approach may well result in an excessive and unacceptable level of contingency provision.
- Pre-FBC Optimism Bias - The concept of Optimism Bias (OB) was introduced to recognise that in practice the contingency amount included has in the past often proved to be inadequate for large complex projects. OB is therefore additional to contingencies. However, there will be some relationship between the two. If the contingencies analysis has been exceptionally thorough and/or generous that may be reason to consider a low OB appropriate - it may be useful to compare the list of risks used to construct the contingencies with the risk mitigation calculations for OB. The methodology for calculating an appropriate level of OB is discussed in the Treasury VfM assessment document.
- Post-FBC Optimism Bias - While some components of OB might be expected to relate equally to conventional and PFI projects, the expectation under PFI is that there should be no further price increases after FBC – after preferred bidder under competitive dialogue. Post-FBC OB therefore only applies to conventional procurement and is only used in the VfM calculation. For a PFI option it would be expected that to at least some extent the risks will instead be priced into the risk transfer costs. It may therefore be expected that a high Post-FBC OB would be mirrored by high risk transfer costs.
- Risk Transfer - For the PFI project, risks transferred to the private sector will be costed into the contract price. Where these can be passed on to sub-contractors they are reflected in higher Capex and Opex costs. Some risk will, however, be retained by the SPV and these will be reflected in the return on equity (higher IRR in the VfM model) and debt. It might therefore be expected that where there is

significant risk transfer (because of the range of risks and/or the level of uncertainty in the project) there should be a greater differential between conventional and PFI costs.

- **Sensitivities** - Even after having tried to cost uncertainty via all of the above, there may still be factors which could vary and change the outcome. Some sensitivity analysis is therefore always appropriate in addition to contingencies and OB. Authorities should identify and assess the high, medium and low likelihood of key sensitivities, including inflation, funding terms and timescale extensions, and their possible costs. An authority should present a realistic risk management and mitigation strategy.

Where small variations in any of the uncertainties change the results of the financial appraisals, the risks are likely to be significant and will need to be particularly carefully assessed and managed.

(3.3) Value for Money. Local authorities are required to show that the PFI is the best VfM procurement route. “VfM” is used here in the narrow sense of comparing PFI with acquiring the same outputs in a traditional way. The wider VfM of different outputs has already been dealt with in the Options Appraisal (see paragraph 2.4). It is important in this analysis that the outputs do not vary.

In general the analysis needs to show that the advantages of PFI in terms of quantified risk transfer and efficiencies are large enough to outweigh the disadvantages of the higher cost of finance. Even though there may be no realistic means of securing the desired outputs through a publicly funded option within a realistic timescale, a VfM comparison still needs to be completed. This should be done using the Treasury standardised VfM assessment procedure⁶. This includes both qualitative and quantitative elements, which should both contribute to informing a wider judgement.

Local authorities need to include a Stage 2 project assessment in the OBC, which will build on the Stage 1 programme assessment produced by the relevant sponsoring department. They should comment on any areas where their assessment differs from the general programme assumptions. Authorities should detail the sources of their information, and provide supporting material such as benchmarking against similar projects.

In the quantitative model, the PFI option should include contingencies, Pre-FBC optimism bias and the risk transfer element passed to sub-contractors in the Capex and Opex costs, but not Post-FBC optimism bias. The risk transfer retained by the SPV is reflected only in the IRR. The PSC option should include contingencies, Pre-FBC optimism bias and post-FBC optimism bias, but no risk transfer element. Sensitivities are not included in either option.

⁶ www.hm-treasury.gov.uk/documents/public_private_partnerships/additional_guidance/ppp_vfm_index.cfm

(3.4) PFI Credits. The methodology for calculating the level of PFI credit support is set out in Section E of this Guide. It is important to achieve a realistic indication of this figure at this stage so that the authority avoids getting into the position of either needing additional credits, which are unlikely to be made available, or proposing to significantly reduce project outputs, which is also unlikely to be acceptable, with the resultant affordability problem resulting in significant delays to or jeopardising the viability of a project.

The level of PFI credits which a department awards is always subject to judgement and is not totally a formulaic figure. This applies to a great extent to how uncertainties are treated. It is clear that reasonable contingencies should be included. Therefore, the OBC should clearly state the level of contingencies that have been included and how these have been calculated. Optimism Bias should not be included. Nor should sensitivities, although the OBC should set out a strategy for how the project would be afforded should any of the events considered under sensitivity testing actually occur.

(3.5) Other sources of funding. Sources of funding available to the authority other than PFI grant must also be detailed. They may include:

- Existing authority budgets.
- Authority capital contributions (whether from receipts or grants from elsewhere).
- Asset transfer / Cross subsidy (with commentary on how the risk on land value will be shared / overage arrangements if appropriate).
- Third party income.
- Funding by partner organisations.
- Interest (at a conservative deposit rate) on any cash surpluses or authority contributions.

Any capital contributions planned will need to be agreed with Treasury, and an explanation of why they are necessary and how the risks involved would be mitigated must be provided.

(3.6) Affordability. A clear demonstration that the project is affordable over the life of the contract is one of the most important aspects of the OBC. Payments to the PFI contractor should be shown alongside funding from all sources over the whole life of the contract in nominal terms. In order to be financially prudent, the payments should include contingencies, Pre-FBC optimism bias and risk transfer costs.

This analysis will normally show that the payments exceed the PFI grant and other sources of funding. The difference will then need to be funded by the authority itself and is generally referred to as the “affordability gap”. The Council must demonstrate that members, senior management and budget holders are committed to meeting this affordability gap (see Section C (1)). The Council must also be committed to resolving key sensitivities that might arise, including, if necessary, making provision for funding high likelihood sensitivities from their own financial resources and assets. Some headroom should therefore be built into the level of funding approved.

Although the main focus of the OBC should be on the PFI contract itself, in some cases where they are essential to the whole project it will be prudent to detail costs which lie outside the PFI credits (e.g. infrastructure costs and contract monitoring costs) along with confirmation of how they will be funded.

(4) Contract

(4.1) PFI contract. A project contract must be based on accepted standardised contract documentation. With the exception of LIFT projects, this will be *Standardisation of PFI Contracts* (SoPC), as well as recognised sector specific guidance, including Building Schools for the Future contracts and 4ps procurement packs. The version used, any addenda, and possible agreement to any derogations, should comply with the most recent instructions issued by HM Treasury⁷. There may be occasions where the procurement pack contract has not yet been updated to bring it in line with a new SoPC version and, where that is the case, the new SoPC will take precedence. Treasury guidance on individual issues may also alter SoPC. The OBC should demonstrate that the authority understands and acknowledges this, and that it also understands the formal processes for agreement to derogations, including when Treasury agreement needs to be obtained (see Section D for more details). Derogations will rarely be permitted from SoPC and Sector Contracts. Where proposed, derogations must be justified on a scheme specific and value for money basis.

(4.2) Payment mechanism. As a result of following the standard contracts noted above, eligible projects will be structured so that the transaction includes payment of fees at annual or more frequent intervals. In most cases payments should not be made until works have been completed and accepted, and the level of payment will vary if the service is not delivered to the agreed performance standards, or the facilities are not available for use. The payment mechanism should be incentive based and not punitive; nor should it adversely affect risk pricing and value for money. Care needs to be taken to ensure that there is no double counting in terms of deductions.

At the OBC stage, the authority will need to have given thought to the components of the payment mechanism, and how the payment mechanism will interact with the requirements of the output specification. The OBC should include a summary of the key components of the payment mechanism and commentary on how the payment mechanism will be developed further. Again this should be consistent with any procurement pack.

(4.3) Risk register. Projects must supply an acceptable risk register (risk allocation), making a preliminary allocation of all the foreseeable risks associated with the scheme between the parties. Risks should be allocated to the party best placed to manage the relevant risk and on a value for money and therefore quantified and costed basis, which should be commercially sustainable in terms of affordability throughout the procurement process. This

⁷ www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_standardised_contracts.cfm

should reflect the contractual approach proposed, and follow standard form guidance including sector specific guidance where relevant such as 4ps procurement packs. Any departures from the standard should be justified in the context of project particulars.

(4.4) Indemnity or guarantees. No indemnity or guarantees must be given by the authority to any person in respect of any liabilities of the contractor with whom they enter into the contract (whether those liabilities were incurred in respect of the contract or otherwise).

(4.5) Preferred Bidder Debt Funding Competition. All projects are expected to comply with Departmental agreements on Preferred Bidder Debt Funding Competitions. In the absence of such an agreement, projects should comply with general HM Treasury policy⁸. As set out in the policy note, such competitions are expected to apply where the capital value of a project is £50m or above unless an authority shows on a project specific basis that it would not provide VfM. An initial position should be set out in the OBC. For larger projects with a capital value over £500m PBDfC will be held in all circumstances.

(5) Project Management

(5.1) Project team The Project Director plays a key role in delivering the project, and is therefore considered the most critical appointment to the project. The Project Director should be 'empowered' to do the deal, and the seniority of the person appointed will need to reflect the complexity of the project and the local authority's decision making structure. For most PFI projects, the Project Director will be supported by a Project Manager. They should be supported by a properly resourced multi-disciplinary project team with project management experience and the necessary range of skills and experience relevant to the project. This experience needs to be demonstrated in the OBC (in particular, any previous PFI experience).

The team need to be working within a suitable project management structure, which should be outlined with specific reference both to reporting lines to the project board and members; and to the delegation of suitable powers to allow effective management of the project. Depending on the project and team, either the Project Director or Manager plans and allocates responsibilities for the project's tasks and development as part of the project methodology and takes day-to-day responsibility for leading and managing the development, procurement, execution and delivery of the project. They will be responsible for leading the discussions and 'competitive dialogue' with bidding consortia.

Clear governance arrangements are especially important for any projects which involve joint working with other authorities, where the relationships and decision making processes need to be very clear.

⁸ www.hm-treasury.gov.uk/ppp_finance_guidance.htm

The project will be expected to be accessible to the involvement of the 4ps and departments.

(5.2) Sponsorship and support. Projects must have support from all key sponsors and stakeholders such as School Governors. A project owner or 'local champion' who will be sufficiently well placed to promote and pilot the project and drive it to successful implementation should be identified. Typically this would be the Director for the relevant service area, the Chief Executive, or the executive member who has the authority to negotiate and ensure that the project is completed. It is important that the necessary approvals from the relevant service Committee and/or Cabinet Member support the OBC, and that such approval is evidenced within the OBC (see Section C(1)).

There must be an effective communications strategy to consult and liaise with all interested groups and keep them informed of progress / key decisions. User support is usually crucial to the success of a project and there should be evidence of such support. Where the Local Authority has collected evidence of other stakeholder support for the project this should also be summarised within the OBC with any supporting documents attached to the OBC.

Where the viability of a project is dependent on other authorities or other bodies, including – but not only - where affordability depends on certain levels of funding from them, commitment by those bodies must be explicitly demonstrated.

(5.3) Internal Risk Register. A register should be included identifying all the risks to be managed by the public sector during procurement, ranking them in order of importance, and assigning risk owners and mitigation strategies. There should be regular reporting of risk management to the project board and a process to regularly update the risk register. If there have been any gateway reviews to inform the register, information on this should be included. Good practice is available in the OGC Management of Risk guidance⁹.

(5.4) Advisors. A project will need to demonstrate that suitable advisers are in place (or, if not, when they will be), with the necessary funding. These are likely to need to cover technical, financial, legal, and insurance matters. If the authority is using in-house resources they should demonstrate that they are suitably skilled and experienced.

For external advisors, the authority should ensure that it has the time of named individuals in the companies with a track record in advising on and delivering PFI or similar projects. The terms of appointment should be detailed (including requirements to share information, and arrangements for periodic review), and - if already appointed - their relevant sector specific experience. It is important to employ advisers who demonstrate a willingness to share lessons and approaches, without undue confidentiality and copyright

⁹ www.ogc.gov.uk/guidance_management_of_risk_4441.asp

constraints. The OBC should also cover the arrangements for periodic review of performance of advisers.

An appropriate budget needs to be in place to pay for the advisers and the overall transaction costs involved in procuring the project (see Section C (1)).

(5.5) Timetable. A timetable should be prepared covering all stages from submission of the initial proposal to start of service provision. In particular an achievable and realistic deadline should be proposed to reach contract financial close, taking into account all approval stages and known risks as well as accommodating some slippage for unforeseen delays. The stages of the process must reflect the competitive dialogue procedure. In considering the number of stages which will be used the authority needs to balance the costs and maximising competition in order to achieve the best overall value for money. This should be consistent with the model procurement timetables in sector procurement packs. Authorities are advised to ensure that the timetable and affordability assumptions are consistent.

(6) Land and Planning

(6.1) Statutory processes. The OBC should set out the Local Authority's proposed approach for dealing with statutory processes associated with the proposed project. The main one is usually planning permission, but others include compulsory purchase orders, road or lane closures, public inquiries, disposal of land below market value, listed building permissions, ransom strips, CPO and environmental issues.

Processes should either be complete or an authority will need to indicate how any potential problems will be resolved in the procurement process. That should include any risk mitigation strategy, a consideration of the potential impact on the timetable (pre and post service commencement), and a description of consultations possible at the stage reached. An authority should consult with the relevant sponsoring department and follow any additional guidance which may be available on what is expected on planning and site issues before a project goes to the market, and on the interaction between the planning process and competitive dialogue.

Local authorities should ensure early discussion with planning departments has taken place and the outcome should be summarised in the OBC. The proposals for bidder input into development and design proposals should be set out. If a project involves a listed building, this will affect the approach to planning permission.

(6.2) Land Availability & Sites. Where any new development is involved (including development which is facilitated by the PFI scheme but not directly funded by it), the availability of land will need to be addressed at an early stage of the project. The OBC will need to clearly identify the land required, the status and ownership of the land or sites, the position on planning requirements and permission, and the contractual relationship between the PFI work and development works. Where land is in external ownership the

OBC will need to state the acquisition plan and the level of certainty of acquisition. The OBC should also address, briefly, any infrastructure changes (e.g. road layout, utility service or amenity changes) which will be required.

(6.3) Stock, Ground and Specialist Surveys. For projects where refurbishment or upgrade is proposed, it is crucial that there is up to date knowledge of the existing assets in terms of their condition as this will inform the authority's project costs including risk pricing and risk allocation. An up to date survey of stock condition will enable the authority to robustly estimate the costs. Details of any specialist surveys should be provided with a summary of the findings. These may include structural, ground condition, asbestos surveys etc.

If an authority is proposing that any of these surveys will be undertaken during the procurement period, full details should be provided of how work will be specified, commissioned, warranted, undertaken and the findings and outputs reported and agreed, including contractual arrangements between the authority and bidders. The authority must factor such survey work into the procurement timetable, and consider any possible resultant risks.

(7) Miscellaneous

(7.1) Commercial interest. The authority should set out its approach to market sounding or bidder open day exercises, and provide evidence of the number of organisations contacted and their responses, including the individual responses from the potential bidders. Approaching the market will enable the authority to gain insight into the likely level of commercial interest in the project, although they must also be aware of the likely level of drop-off of interest. If there are likely to be factors which might hinder a good competition (e.g. geographic or sector related) these should be addressed. Responses from the private sector may also influence development of the project, including how a service provider might approach the delivery of the service and address local circumstances and project specific proposals and issues, and any such results should be summarised in the OBC.

(7.2) Accounting opinion. Local authorities will account for PFI projects in their financial statements in accordance with extant statutory guidance – currently Appendix E of the 2009 SORP. In accordance with International Financial Reporting Standards (IFRS) as they are applied in the 2009 SORP this introduces a control-based assessment of balance sheet treatment. Authorities should take an early view on the likely treatment, and confirm in their OBC, that the project is a service concession within the meaning of IFRIC12 such that the provisions of IFRIC 12 need to be considered. It is good practice for the authority to seek a view from its external auditor on whether the view is reasonable.

Providing that for financial accounting purposes the transaction has the general characteristics of a service concession, then the OBC also needs to include an initial view on the likely National Accounts balance sheet treatment

used for departmental budgetary purposes. This National Accounts determination will be based on standards laid out in part IV of the ESA95 Manual of Government Deficit and Debt. This is a risk-based analysis and the result may therefore be different to the accounting treatment. The analysis should follow the HM Treasury technical paper on how to apply these standards¹⁰.

The ESA95 analysis should comment on whether the project falls within the scope of "services purchased by government on the basis of dedicated assets". It should consider where the majority of risk lies in terms of construction, availability and demand and, where relevant, the other factors listed in the HM Treasury paper. The analysis should also comment on the extent that factors such as public sector financing, third party revenue and any pre-existing asset may impact on the conclusion. This impact could be to alter the outcome of the risk assessment or to require some form of split budgetary recognition.

Unlike the previous regime, there is no requirement for a view from the authority's external auditors as they do not have a locus in the assessment. However, as set out in the HM Treasury technical paper, it is essential that the analysis is carried out and documented in a rigorous and robust fashion. The analysis that supports the position in the OBC needs to provide sufficient detail in itself to reassure the sponsoring department on whether the view is reasonable. As a minimum the OBC should include a description of the factors considered in reaching a conclusion on each of the primary risk tests should be included, with an assessment of the degree of certainty around each element. Where the underlying assessment has identified that there are any complicating factors, more detail will be needed for the department to be able to take an informed view. As a result, we would expect in some cases authorities to document the assessment themselves, but in others, particularly where there are complicating factors, it may be appropriate to seek specialist external support in order to provide sponsoring departments with a rigorous and robust assessment.

Government continues to support the principle (set out in paragraphs 1.7-1.8 of the Treasury Value for Money assessment guidance) that the decision on whether or not to pursue PFI should be taken on VfM grounds, and not the National Accounts balance sheet treatment. However, the balance sheet treatment clearly has a major impact on the budgets of sponsoring departments and it is essential that they both have the best possible early view; and that they are notified immediately should it appear possible that the initial view might change.

(7.3) Sharing of Information. The local authority must confirm that they will be ready to share experience and contract documentation throughout and at the end of procurement, at no cost, with other local authorities procuring similar projects, with Government departments, their agents and with the 4ps. This information will be held as confidential, but any information of genuine

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

commercial sensitivity (which is expected to be minimal) may be withheld. Authorities should make clear to potential contractors that this information-sharing requirement is a formal condition imposed by the Government as a condition of support.

(7.4) Operational phase. The authority should show that it has a strategy to ensure a smooth transition from procurement to the operational phase of the project. It should also include the authority's preliminary proposals for monitoring the Service Provider's performance in the delivery of the service, how it proposes to develop its approach to contract monitoring, the expected level of client-side involvement, and information on a reasonable level of budget to cover contract monitoring. Depending on the size and complexity of the project it is advisable to have at least one full time post for contract monitoring purposes. The contract manager will need to have sufficient skills and experience to manage complex projects. The authority may also wish to have access to other technical skills as appropriate, including to its procurement advisers for a period overlapping with contract commencement and a 'bedding-in period' Authorities are advised to refer to the Operational Taskforce Note Project Transitional Guidance¹¹.

¹¹ www.hm-treasury.gov.uk/media/2/3/pfi_projecttransition_210307.pdf

SECTION D

FBC GUIDANCE

(1) Procedures under the Competitive Dialogue Process

Under Competitive Dialogue (CD), a single Final Business Case (FBC) delivered shortly before financial close is no longer sufficient to inform the final assessment of a project. Instead there will be three phases:

- Decisions need to be taken on all potential legal derogations prior to the close of dialogue;
- The Pre Preferred Bidder FBC should be assessed during the period between run up to close of dialogue and approval given prior to selection of the preferred bidder; and
- A supplement to, or revised version of, the earlier Pre Preferred Bidder FBC should be approved prior to financial close.

There must be a continuous dialogue as issues emerge, managed around the specific phases, so that any difficulties are picked up and, if possible, resolved, as soon as possible and certainly before the final document is submitted.

Departments should inform local authorities of the time they will require to complete their assessments of each phase. That should take account of the need to harness specialist legal, financial and technical expertise within the sponsoring department, in order to ensure a robust process.

Where a PRG 2nd Stage Review is being undertaken as part of the first and second phases, PUK require an additional 3 weeks to complete their work on each phase.

(1.1) Compliance with Standard Form Contract Guidance

Although derogations from standard contract conditions need to be identified and resolved as soon as possible whenever they arise, without waiting for any particular event, there needs to be a comprehensive exercise to ensure that all potential sector and/or project-specific derogations for each solution are resolved prior to the close of dialogue and call for final tenders.

It should be noted that requests for derogations that do not relate to project or sector specific issues will not be accepted, and those based upon a preference for alternative drafting face a presumption that they will be denied. This process applies even if the derogation is one that has previously been agreed on another project.

In all instances, the local authority must support the need to derogate and provide a copy of the project agreement black-lined against SoPC4 or, where applicable, a Treasury endorsed sector specific contract; together with a

detailed report from the Authority's legal advisors detailing where, with sector/project specific justifications, the project agreement deviates from SoPC4.

Possible derogations should firstly be reviewed by sponsoring departments (and, where appropriate, their agencies), using whatever legal advice they deem necessary. They should consider and agree with the local authority which ones they support, before sending these to PUK. PUK will, in turn, consider and make recommendations to Treasury for final approval or rejection.

Where there is a PRG 2nd Stage Review, the processes described above form part of that process. Where a 2nd Stage Review is not being undertaken, departments will initiate the work.

(1.2) Pre Preferred Bidder FBC

CD requires that after close of dialogue any further discussion must be very limited, with clarification, specification or fine-tuning allowed but no further negotiation or amendments to requirements or terms¹². An authority needs to have agreed substantially all aspects of the project (technical, commercial, financial and contractual) and bidders' proposed solutions during the dialogue phase.

An initial formal assessment of the project needs to be conducted starting in the period leading up to close of dialogue (i.e. at the same time as derogations are being considered) and ending before the preferred bidder is selected. The Pre Preferred Bidder FBC (referred to as the Appointment Business Case in the Department of Health) should cover all significant aspects of the final assessment. Any anticipated or potential changes possible within the constraints of CD should be outlined, along with any remaining risks to the project and how this will be mitigated. The areas to be covered are described below under 'FBC Content'.

The balance of when the bulk of this work occurs may vary depending on the project. However, departments and authorities will want to consider the scope to make changes in reaction to any conclusions, together with the completeness of the information available. The aim should be to get as much clarity as possible before close of dialogue, whilst bearing in mind that any conclusions will need to be checked after final tenders have been submitted and the local authority's financial, technical and legal evaluation process is complete. Where there is a PRG 2nd Stage Review, the PUK assessment of the affordability position will be based on final tenders. A final formal approval of the Pre Preferred Bidder FBC must be completed prior to the announcement of the preferred bidder.

¹² See "Competitive Dialogue in 2008 – OGC/HMT joint guidance on using the procedure" - www.ogc.gov.uk/documents/OGC_HMT_2008_Guidance_on_Competitive_Dialogue.pdf

If the review of affordability concludes that there is not sufficient funding in place then the sponsoring department may consider additional support, depending on its general policy, and bearing in mind established PRG rules and general advice set out in Appendix 3 of the PRG Code of Practice¹³. A local authority should, however, never assume that additional support can or will be made available, and should have worked with bidders to reach affordable solutions for their projects to avoid such a position. A department may, rather, require the authority to commit additional funds of its own and/or reduce the bidder(s) price. If the latter involves reducing the scope of the project, then the authority will need to demonstrate that the procurement still satisfies value for money requirements and does not conflict with EC procurement rules.

The aim should be for the final level of support to be set at this stage. However, it needs to be borne in mind that there will be continue to be some risks after selection of the preferred bidder which could impact on the final financial position (for example, a decision to undertake a funding competition). Departments may adopt different strategies for managing the implications of this for the final PFI credit amount, in some cases by including risk buffers or contingencies.

(1.3) Pre Financial Close FBC

A final report will need to be approved by the relevant department prior to signature of the final contract. The content will vary depending on the details of the procurement process, but it should address at least final design and funding issues, any contractual changes, and how expected risks finally eventuated. It can take the form of either a supplementary document; or a complete revision of the earlier Pre Preferred Bidder FBC. A decision on which is needed should be agreed in advance and will depend on the general preferences of the department, the time which has elapsed since the Pre Preferred Bidder FBC was written, and the extent of changes to the project since then.

The precise timing for submission of this document will also need to be agreed in good time, balancing the need to ensure that no further changes will be made, against the time needed for the department to complete its assessment.

Guidance requires that the authority publish the final report (with any commercially sensitive elements removed).

(2) Procedures under the Negotiated Procedure Process

Some projects may be using the negotiated procedure, including those which started procurement prior to February 2006. In these cases an FBC should be submitted shortly before financial close but when confident that there will not be further significant changes to the project. If there has been a 2nd Stage

¹³ www.hm-treasury.gov.uk/d/prg_code_of_practice_v3_2009.pdf

Review both derogations and affordability will have been assessed prior to selection of the preferred bidder. If not, the authority should still ensure that as far as possible derogations to the standard contract conditions have been agreed before it appoints the preferred bidder. However it is recognised that any such review will be subject to further changes as negotiations continue (and funders become involved), and a final PUK review of derogations is needed prior to financial close.

(3) CONTENT

(3.1) Final scope. The FBC should set out the final scope and design of the project, and show how this meets the aims & objectives as set out in the OBC.

Evidence should be provided on how and why any changes emerged during procurement, including how stakeholders (especially users of the services) were involved. The FBC should record where these changes were considered large enough to need prior agreement from the sponsoring department and, if there were very significant, with PRG.

(3.2) Procurement process / Competition. Details of the preferred bidder should be set out, with a history of how the procurement process led to the final decision. This should demonstrate that there has been a competitive procurement process. The level of competition at key stages (PQQ, ISOS, ISDS and ISRS) should be recorded. An assessment should be made of the quality of bids, as well as the quantity. The material here will be used by departments to provide an annual written summary of competition in recently signed projects to Treasury.

This section should set out how the procurement process was used to drive down costs and improve quality, outputs and outcomes.

The FBC should also outline how the decision was taken on whether or not to hold a funding competition for selection of the debt provider.

(3.3) Final Contract. The FBC should include an outline of the draft final contract, including its length, risk allocation, and payment mechanism.

There should be a record of the position reached on derogations following the process outlined above, and confirmation that no further changes have been introduced to the contract.

(3.4) Affordability. The Pre Preferred Bidder FBC needs to establish whether each bid is affordable by assessing costs against funding available to the local authority. Detailed guidance on the information required to undertake this work as part of a 2nd Stage Review is available in Appendix 6 to the PRG Code of Conduct. Where a departmental is carrying out the work without PUK, it will need the same range of material. That includes evidence to show that other sources of funding for the project (income and assets transferred) have been valued correctly.

The Pre Preferred Bidder FBC should seek to calculate the cost of any remaining risks, and show how they would be accommodated within the affordability analysis. The Pre Financial Close FBC will include an update on that work, including a reconciliation of risks identified then.

Members' commitment to allocating the final authority contribution should be evidenced, normally through a copy of the relevant Cabinet minute.

(3.5) Value for Money. There is normally no reason to re-do the Stage 2 appraisal. However, it may be necessary where there have been a material change to the scope such that it is effectively a different project; and/or where there has been a significant increase in costs (as required by para 1.21 of the HMT VfM guidance).

Any VfM assessment at this stage should follow the Treasury Stage 3 procedures¹⁴, i.e. "an ongoing assessment during the procurement phase of a project to ensure that the desired project can be delivered in view of, for example, the competitive interest and market capacity". This can all be done by reference to the previous section on competition and completion of Table 5.1 of the Treasury guidance.

(3.6) Accounting treatment. The FBC should state whether any reasons had emerged to change either the initial IFRS based accounting opinion or the ESA95 based National Accounts budgeting opinion, which should have already been provided (see Section C (7.2)). The initial opinions provided may have been in the OBC, but for projects signing in 2009-10 it is more likely that an opinion was provided separately for the sponsoring department. If, for some reason, an initial opinion has not been provided previously, then the full requirements of Section C (7.2) must be met.

(3.7) Looking forward. The FBC should set out a timetable and agreed protocol for reaching financial close, with details of the project team that will achieve this. Evidence should be supplied that members have formally approved the signing of the contract.

Any remaining risks should be identified together with mitigation strategies.

(3.8) Statutory processes / Consents. The FBC should record what statutory processes, including planning permissions, were required and whether they have been obtained. If any still need to be obtained, the timetable and strategy for achieving this should be set out.

For housing projects, consent from the Secretary of State (CLG) will be required for authorities who are proposing to give dowries as part of the agreement in the form of land or finance. Where the housing management function is being delegated to the contractor a S27 approval is needed.

¹⁴ www.hm-treasury.gov.uk/d/vfm_assessmentguidance061006opt.pdf

(3.9) Transitional arrangements and operational phase management. The FBC should update the information supplied in the OBC, cover the same areas but in more detail.

SECTION E

CALCULATION OF PFI CREDITS

PFI support is intended to be a contribution towards that portion of contract payments which could theoretically be attributed to the capital investment being undertaken - that is, the portion which would be classified as capital expenditure under Section 16 of the Local Government Act 2003 - if the asset had been procured traditionally, rather than by PFI.

(1) Scope of Project

(1.1) Reference Project. The PFI credit amount agreed at the OBC stage will generally be based on a Reference Project, although in some sectors a funding model or toolkit will be used. All parties wish to limit any increases in costs to a minimum. Sponsor Departments should seek to avoid increasing the level of PFI credit allocated after the OBC is endorsed, which means that it is important for the reference project to be as close to the final one as possible (without limiting the scope to innovate to reduce costs). See also Section A (3.2) on making changes in order to make a project affordable.

(1.2) Shared accommodation. In some accommodation projects, the local authority may share a building with another body. In such cases, the full costs should be split between the occupiers according to the relative proportion of usable space - the precise method for apportioning shared space, circulation, plant, etc. will need to be agreed with the sponsoring department.

(1.3) Associated work or receipts. It should be noted that the PFI credit can only support the capital value of the PFI contract itself. It cannot cover associated works under other contracts, even if these are linked as part of a broader project (but see Section E(3.3) below on the costs of land/assets purchased for the project).

There may also be associated receipts as a result of the sale of assets released by the project. Authorities are required to notify the sponsoring department at an early stage about these and agree how they should be used. Under BSF this is covered by a sharing mechanism.

(2) Standard Approaches to PFI Credit Calculation

(2.1) Toolkits. In a number of sectors, including schools and housing, the sponsoring department has a standard approach to calculating the level of capital investment which will be supported and provides a toolkit for completion (in the case of BSF the Funding Allocation Model (FAM) covers more than just PFI). In most cases they follow the same general principles as discussed below, although street lighting projects are based on the difference between the capital costs of the PFI option and the 'do minimum' option over the first 5 years - more detail is available in the 4ps street lighting procurement pack.

(3) Non-standard PFI credit calculation

The steps necessary to calculate the maximum PFI Credit permissible are as follows:

(3.1) NPV of unitary charge. The starting point for a sponsoring department in deciding on the level of support to offer is to calculate the NPV of the annual unitary charge over the anticipated life of the contract. To determine the NPV, the annual nominal (cash) costs should be discounted by the prescribed PFI discount rate for the financial year in which the OBC is expected to be endorsed by PRG (NOT at 3.5% + RPI). The prescribed discount rates for 2009-10 to 2010-11 are set out on page 1 of this document. The discounting should use the anticipated start date (see below) as the base date. The first 12 months of payments should therefore be Year 1, rather than actual or financial years.

(3.2) Revenue abatement. As noted above, PFI support is only for the capital element. There needs therefore to be a means of determining what proportion of the total NPV can be classified as capital, and what proportion revenue. This is referred to as the 'revenue abatement' figure. In some sectors, sponsoring departments may have agreed standard prescribed figures for this. For example, some accommodation projects (but not all) have used a revenue abatement figure of 30%, i.e. 70% of the total NPV is assumed to be capital and 30% revenue. Separate figures exist for some types of transport project, and authorities should consult departments for guidance on these standard revenue abatement figures.

However, in some cases the prescribed 'abatement' figure may not be appropriate, or there may not be one for the particular type of project (possibly because projects are one-off in nature). In these cases, a project specific revenue abatement figure needs to be calculated. To do this, the local authority needs to estimate how much of the regular unitary charge payments will be used to finance the various components of the project. Note that this means that it is the funding costs of the initial capex (interest and repayment of principle of the initial loans) which are being estimated, rather than the initial capex itself.

Each component of the unitary charge can then be identified as either capital or revenue. Classification will be determined by general accounting practice, but the following gives a broad indication of the likely results. Some of the costs are entirely capital and others revenue (although judgements between lifecycle (capital) and hard FM (revenue) will be less clear cut). Other costs are more generalised and relate to the project as a whole. The following gives a broad division, and any doubts should be resolved with the sponsoring department:

Capital:

Funding costs (i.e. principal and interest of senior and subordinated debt that has been used to fund initial capex (inc. prelims, fees, design, construction insurance, asset purchase, etc))
 Lifecycle costs and any other capital costs not funded from debt, inc. that funded by equity

Revenue:

Soft FM (cleaning, security, etc)
 Hard FM (buildings and grounds maintenance)
 Utilities (if in the unitary charge, not a pass-through cost)
 Buildings insurance (if in the unitary charge, not a pass-through cost)

General:

SPV set-up, overheads and running costs
 Tax

Note that if utilities costs and/or building insurance are treated as a pass through cost, they will be excluded from the initial calculation above of the NPV of the unitary charge.

Since the general costs are incurred in respect of the entirety of the services and the project, it is difficult to say that they are all definitely “capital” or “revenue”. Consequently they can be disregarded when calculating the 'revenue abatement' figure, which is instead the proportion of definitely capital items compared to definitely revenue.

Example:	NPV of unitary charge =	£60m
	NPV of Capital element =	£30m
	NPV of Revenue element =	£10m
	NPV of General element =	£20m
	Revenue abatement =	25% (£10m / £40m)
	PFI credit amount =	£45m (£60m - 25%)

In some cases, the total project costs may be partly funded from capital contributions. If that is the case, these contributions must be considered to fund the capital element only. As a consequence the balance of capital to revenue funded via the unitary charge will be somewhat different to the balance for the project as a whole, and this should be borne in mind when calculating the revenue abatement figure.

(3.3) Land or other assets sold or transferred to the project. It may be better in some projects for the local authority to provide the assets needed – including land – rather than the PFI contractor acquire them independently. In such cases, they may either be sold to the contractor or transferred in exchange for a reduced unitary charge. Any decision on which of these options to use should be made on VfM grounds.

The way in which these costs may or may not attract PFI credit support depends on whether the land or assets were already in local authority ownership, or whether they were bought specifically for the PFI project. PFI credits should not be given in the former case and if existing assets are sold the value of the receipt should be netted off the PFI credit value.

If, however, the authority can demonstrate that there was nothing suitable available (but that it is still better VfM for them to purchase the land/assets in advance) then support may be provided. If sale is the better VfM option then receipts are not netted off the PFI credit value. If transfer is the best option, then the value of the land should be added to the PFI credit amount. The value of the land should be based on the cost of purchase, not the value of the receipt from the contractor.

(3.4) Residual value. In a few cases, most specifically non-HRA housing and LIFT projects, the asset becomes the property of the private sector contractor at the end of the contract period. In such cases, the unitary charge is less than it would otherwise be as there is a presumed residual value with the Contractor that will help meet part of the costs of the project. Under LIFT there may be an arrangement for the local authority to purchase the asset at the end of the contract, and in these cases, PFI credits can be issued to cover these costs.

(4) Final PFI credit award

(4.1) Offering less than the maximum. It is for the sponsoring department to conclude, based on the details of the project and the needs of its whole programme, whether to offer the maximum total capital value - calculated as set out above - or a lesser amount. Some Departments may offer less as a matter of policy in order to allow more projects to be supported. If a lesser amount is offered, particular attention needs to be given to affordability, i.e. how the local authority might fund the balance.

(5) Increases in PFI credits

(5.1) Discount rate. Projects seeking an increase in PFI credits prior to financial close should re-calculate the PFI credit amount by discounting at the rate in force when that project was originally endorsed or, for those endorsed prior to 2005-06, a rate of 6.3%.

SECTION F

CALCULATION OF PFI GRANT

(1) Annuity PFI grant

Most PFI projects now receive grant calculated on an annuity basis. The following description of the way in which that will be calculated is intended to supplement and interpret, but in no way to override the express terms of the formal 2009 determination - the *Local Government PFI Annuity Grant Determination (No 1) 2009 [No 31/1352]*¹⁵.

(1.1) Annuity calculation. A formula is provided in the determination as the means of calculating the annual annuity grant payments. However, in practice this can be done by using the Excel PMT spreadsheet function. The annuity calculation includes some simplifying assumptions:

- the interest in the annuity is calculated annually, using the opening balance to calculate interest for the whole year, even though payments are quarterly; and
- the length of the annuity is based on the mid-month points for the start and end dates rather than being accurate to the day. This is consistent with the way in which the level of grant is calculated in the first and last years.

The latter point does mean that the period assumed in the calculation will not always exactly match the contract length. However, that is more than outweighed by the first assumption.

(1.2) Interest rate and scaling factor. The interest rate and scaling factor for new projects will be set as that in force when the project is originally endorsed, as recorded in the endorsement letter sent by the sponsoring department. For all projects endorsed prior to 2005-06 an interest rate of 6.3% will be used. The rate will not change if the PFI credit amount is changed prior to financial close.

The interest rate matches the interest rate for the debt charges element of RNF in the financial year in which the project is endorsed, the main difference being that the rate does not vary for any particular project during the period it is paid grant.

A scaling factor was introduced for PFI annuity grant in 2005/06, with a maximum rate of 1.0. This factor is determined in consultation with Treasury and has been set at 1.0 for 2009-10 and 2010-11.

¹⁵

(1.3) PFI credit 'uplift'. In some earlier projects the PFI credit figure was increased to produce a different opening balance. This was intended to compensate for discounting applied to years between contract signature and service commencement, since contract signature was originally used as the base date for discounting. This methodology was changed at the start of 2002-03 and all projects which were eligible have now started receiving grant.

(1.4) Contract signature. In all cases contract signature is taken to mean financial close ('commercial close' was used in older projects).

(1.5) First and last years. Grant is reduced in the first year so that a proportion of a complete financial year's grant is paid based on the month in which start date (as defined in Section F(3) below) is reached. The calculation assumes a mid-month point so that a project starting in March will attract 1/24th grant (i.e. 1/2 month), one starting in February 3/24th grant (i.e. 1 1/2 months), etc. Grant will also be reduced in the final year, using the same method.

(2) Declining balance grant

When PFI annuity grant was introduced in 1 April 2005, operational schemes and those which had reached ITN were given the option of continuing to receive grant under the previous declining balance grant regime. Projects which opted for declining balance at the time may still chose to switch to annuity grant at any time, but a switch in the opposite direction is not permitted. Payment of PFI declining balance grant will therefore be restricted to schemes in the local authorities listed in the *Local Authority PFI Declining Balance Grant Determination (No 1) 2009 [No 31/1353]*. The methodology for this grant has not changed since 2006-07.

(3) Start dates

In all cases the date used in any grant calculations is the actual start date, not the planned date.

(3.1) New asset(s). When agreeing the value of the PFI credit sponsoring departments must, in addition to the value of the PFI credit being awarded, state how the "start date" will be recognised, i.e. when the authority will become eligible to claim PFI grant for that project. This should be when the asset becomes operational, defined as completion of acceptance testing or equivalent. For BSF projects it is referred to as the "services availability date"; for waste projects the start of "hot commissioning". It should not be determined by payment to the contractor for interim services or temporary assets (e.g. site security or assets used for decanting purposes). If there are multiple assets, then the start date should be taken to be when the first one is operational, subject to a consideration of whether support should be phased – see below. In particular, care should be taken to ensure that a single asset is not completed artificially early purely to attract grant.

(3.2) Refurbishment. Where permanent assets are transferred and there is a distinct refurbishment period, these should be treated in the same way as new build and the start date will be when the asset returns to being operational. However, where a network of assets is transferred along with responsibility for maintaining them in an operational state, and a programme of investment (e.g. a street lighting or roads maintenance project), the start date will be when the assets are transferred.

(4) 'Phased' PFI projects

(4.1) Number of phases. As projects become more complex with more assets being delivered (or phased delivery of one asset) sponsoring departments need to determine whether there should be one "start date" for the whole project or whether it should be considered to consist of more than one "phase". In taking such a decision the department should take account of the following general principles:

- Government Accounting requires that grant should not be paid in advance of need (i.e. the level of unitary charge being paid by the local authority in respect of the use of capital assets); and
- The pattern of "phases" should be designed so that no significant clawback of PFI grant would be necessary should anticipated work be cancelled.

These requirements need to be balanced with the need for the PFI grant regime to be manageable. To do this the sponsoring department will need to consider whether the pattern of individual asset start dates can be grouped together into more than one distinct "phase", separated by a significant gap; or whether it is more akin to a rolling programme of work on a network of assets. The specifics of each project are likely to vary widely, but the number of "phases" should be limited and appropriate to the overall size and timing of the project.

(4.2) Value of phases. If there are different phases, the PFI credits which apply to each phase must be stated in advance. It is for the sponsors to decide the level to be assigned to each phase. The capital value of each phase should be calculated separately as each will be a different base date for discounting. The interest rate (and discount rate) applied will be the same for all phases. However, the annuity length will be calculated separately for each phase.

(4.3) Phased project grant. Where there is more than one phase of a project, each phase will be treated as if it were a separate project for the purposes of calculating grant.

(5) HRA grant

There is no determination specifically setting out the calculation of the grant for HRA PFI schemes. The basic methodology is, however, the same as for PFI annuity grant with the exception that there is no scaling factor.

SECTION G

POST CONTRACT SIGNATURE CHANGES

Changes to the contract, including possibly termination, may occur after it has reached financial close and the PFI credit has been issued. Any major variation must be reported to the sponsoring department who will consider whether there are PFI support implications.

(1) Increases

One potential group of changes will be those which will increase the capital value of the project, either by adding to the scope or by extending the length of the contract. If a sponsoring department wishes to support such an increase, it will be treated for grant purposes as if it were a separate contract. The PFI credit calculation will use the discount rate in force when the variation is agreed, not that used for the original project, and a separate PFI credit letter will be issued. The same approach will be used in the grant calculation, i.e. the interest rate and scaling factor used will be those in force when the variation is agreed.

(2) Decreases

(2.1) Exceptional circumstances. Government reserves the right to stop support in exceptional circumstances. Such circumstances could be where continuation of support would unduly enrich or reward an authority, for example where a contract was terminated by the authority despite that approach not being the best value for money. As a first step, sponsoring departments will therefore consider the circumstances of any major variation in this light.

Even in such exceptional cases, steps would also be taken to ensure that the local authority was not thereby prevented from meeting in full the resulting liabilities to the PFI contractor and its funders for capital assets already delivered.

(2.2) Reduction in assets delivered. Termination or variation of the contract (including as a result of planning permission difficulties) could result in a reduction in the PFI credits and therefore grant. If substantially all of the assets have been delivered there will not be any change to the PFI credits or grant. However, if the change results in significantly reduced capital investment by the contractor, it will lead to a reduction in support.

The interpretation of whether a reduction is significant or not is a matter for the sponsoring department, and should always be considered on a scheme-by-scheme basis after taking into account all the relevant circumstances. Where there is one or a limited number of large assets, it will be easier to reach a decision since the non-delivery of any would clearly be a significant change. Where there are a larger number of smaller assets involved, a

decision will be more subjective, but a department needs to decide whether substantially all of the planned assets have been delivered or not.

(2.3) Change in assets delivered. In some cases the nature of the assets may change, e.g. a change in the number or location, but the overall capital value remain about the same. In such circumstances an authority should notify the sponsoring department who will consider whether the alternative proposals are acceptable to them. If they are, support will continue without interruption.

(2.4) Change in capital/revenue balance. The considerations in para 2.2 apply even if the reduced capital investment is balanced by increased revenue expenditure. It is recognised that this does impose considerations other than strict value for money on the freedom which the contractor has in responding to an output specification. Despite this it is felt important to maintain the principle that capital support should be for capital expenditure.

(2.5) PFI credit re-calculation. Where the procedures set out above have led to the conclusion that a reduction in support is appropriate, the PFI credit amount will be re-calculated, and that translated into revised PFI grant which will continue to be paid over the originally agreed contract period.

Where the change involves a contract variation, a re-calculation will be undertaken based on the same methodology as used in the original calculation, using the same discount and interest rates as used originally.

Where the change is due to termination, the re-calculation will be based on a level of borrowing which would be required to make the termination payment (excluding any redundancy element), although - as with the original PFI credit calculation (Section F (4.1)) - a sponsoring department may choose to vary the actual amount offered.

(2.6) Grant recovery. Where PFI grant started being paid before all of the assets were delivered future grant may be reduced to take account of this. A calculation will be made to determine the amount of grant actually paid in excess of the amount which would have been paid based on the revised level of PFI credits. That will be recovered by deducting the amount from subsequent grant payments. Actual recovery of grant already paid would only be necessary where the excess was larger than could be recovered from future payments. Where an overpayment has been made the Secretary of State shall specify such an amount due to him by notice in writing before any recovery is made.

(2.7) Lump sum payments. Although termination may require an authority to make a lump sum payment to the contractor, PFI grant will continue to be paid over the previously assumed life of the contract. There is no facility to commute grant and pay early as a lump sum.

(2.8) Changes to services or financing costs. A variation may be agreed which reduces the local authority's costs because of changes in the service

element or financing costs. Neither of these would result in any reduction in support. It is established policy that in the case of refinancing the benefits will be shared between the contractor and the local authority, and not by central government.

SECTION H

ADMINISTRATIVE ARRANGEMENTS FOR GRANT

(1) Legal basis of payments. Grant for all projects other than those which involve HRA housing will be paid under section 31 of the Local Government Act 2003 to receiving authorities listed in Local Government PFI Grant Determinations.

(2) Claim forms. The conditions for payment of grant are set out in Annex C of the relevant determination and include receipt of a valid claim. A valid claim is one which is made on the form PFIG1, signed by the authority's Chief Finance Officer, copies of which can be printed from this department's website¹⁶.

The claim form should initially be sent to the sponsoring department. If a project is jointly funded one claim should be submitted to the lead department. The form should be accompanied by sufficient supporting documents to allow the form to be checked. This should include:

- a copy of the PFI credit letter to confirm the PFI credit amount (and the date of financial close where needed);
- a copy of the endorsement letter to confirm the date the project was endorsed;
- copies of the invoice and BACS remittance slips or receipt from contractor relating to the first payment; and
- relevant extracts from contract documentation as evidence of contract end dates.

Once a claim has been checked by the sponsoring department they will send it to Communities & Local Government, asking that grant be paid. The authority will receive notification of the amounts of grant and the dates on which each instalment will be paid.

A claim form only needs to be submitted when a project first claims grant. Subsequent years' grant will be based on that original claim form. The determinations set out how this will be done.

(3) Phased projects. Where there is more than one phase of a project (see Section F (4)), each phase will be treated as if it were a separate project for the purposes of claiming grant. Therefore a new claim form needs to be sent for each phase, and each phase will generate separate payments of grant.

(4) Variations. If a post-contract signature variation is agreed – including any extension - and the sponsoring department has issued additional PFI credits a separate PFI grant claim form should be submitted.

¹⁶

www.communities.gov.uk/localgovernment/localgovernmentfinance/pupprivatepartnership/centralgovernment/

(5) Disputes. Any disagreements over any relevant factors, inc. most commonly contract signature dates, must be resolved between the authority and the sponsoring department.

(6) Audit requirements. There is no longer a requirement to send an audit form to Communities & Local Government. However, authorities are reminded of their continuing duty to ensure that accounting records are kept.

(7) HRA grant. Grant for HRA housing projects is paid as part of HRA subsidy rather than as a separate grant. There is no grant claim form, and payment is triggered by authorities sending a copy of the contract confirming the contract signature date to the Homes & Communities Agency PFI team. The Communities & Local Government HRA team will then liaise directly with the authority to agree the Special Determination which will trigger the subsidy. Grant for the PFI scheme will then be paid as part of HRA subsidy until the end of the contract.

SECTION I

LIFT PROJECTS

This section sets out areas where LIFT projects differ from PFI. This replaces the separate note issued by ODPM in April 2005, which is now withdrawn.

In discussing LIFT and PFI some care needs to be taken with terminology, as terms do not have precisely the same meaning in the two contexts. In this Section:

- A *tranche* in LIFT consists of the collection of projects or schemes prioritised and funded by one Fund Co, which will be developed together so that the various approvals, inc. financial close, will be given for the whole tranche.
- A *project* or *scheme* in LIFT refers to an individual asset / building within a tranche.

In many ways, therefore, a LIFT tranche is most equivalent to a PFI project, which can often include several assets.

(1) First Approach.

There is no separate allocation of PFI credits for local authority involvement in LIFT projects and any proposals must be assessed and prioritised against other competing possibilities. Proposals will be prioritised based on the quality of the scheme itself, rather than whether or not it is intended to use LIFT. A proposal may either be developed as the LIFT Co is being procured, or - more likely now - involve an existing LIFT Co.

A local authority may wish to include projects which they anticipate developing in different tranches in one proposal. In such cases, the sponsoring department may choose to endorse and thus provide a level of assurance of funding for the whole proposal. However, any such proposal should not be for tranches too far in future since that would tie up resources too far in advance of any prospect of the assets being delivered.

(2) OBC

(2.1) Procedures. Whilst projects in more than one tranche may have been supported, the OBC should cover only those in the tranche being developed (though still set in the wider context of the whole proposal). A series of OBCs may therefore be necessary. It is, however, likely that the work involved in preparing later OBCs can be reduced by referring back to the first OBC unless different projects are very varied.

Working up the OBC parallels the development of a New Project Proposal under LIFT to Stage 1 approval. The areas which need to be covered in the OBC are broadly similar. The OBC should be submitted in sufficient time to be

endorsed before LIFT Stage 1 approval, but not so far in advance that there might be changes between OBC endorsement and Stage 1 approval. It must include the Design Brief / Participants Requirements on which the LIFT Co will base its outline design proposal, and this should form the basis of the financial calculations.

(2.2) Content. Most of the guidance in Section C applies equally to LIFT projects. Areas which differ from PFI projects or which are of particular importance are discussed below.

(2.3) Commercial interest. Details of discussions and agreements with the LIFT Co should be included, including where the project has reached in terms of being included in the SSDP. A description of how the scheme(s) fit into the whole tranche of work should be provided together with the funding arrangements proposed for this. Where it involves projects in the first tranche and the LIFT Co is being procured, a description of the procurement process also needs to be included.

(2.4) Value for Money. Unlike PFI projects, individual LIFT projects may be VfM with a capital value of less than £20 million. In such cases the authority should show that the LIFT project is better VfM than conventional procurement but PFI need not be considered. Projects with a capital value of over £20 million should, however, be compared to both conventional procurement and PFI. As with all VfM assessments the overall conclusions will reflect both qualitative and quantitative considerations, backed up by evidence of assumptions and assertions used (eg if it is felt that LIFT can provide outputs more quickly than other means that should be demonstrated by reference to other projects), and will follow the Treasury guidance as described in Section C (3.3). The impact on options of any exclusivity deals signed under LIFT should be discussed here.

The government recognises that there are a number of areas where the Treasury quantitative model does not accurately reflect LIFT, but does not believe that the differences are material. The authority should, nonetheless, comment on areas where the Treasury model does not take account of LIFT particulars. This will most obviously be in the following areas:

- Transaction/procurement costs. The model uses a minimum value of £750,000 for public sector costs and built-in assumptions about private sector costs. These are appropriate for PFI, but likely to be too high for LIFT projects. Authorities should in all cases provide separate estimates of public (reflecting the complexity of the tranche) and private sector transaction costs.
- Residual value treatment. Unlike most PFI projects, some of the construction costs under LIFT will be recovered via the residual value of the asset which the LIFT Co will own at the end of the contract. This means that the financing and profile of payments will be different to those the model assumes. It may be useful to provide estimates of the difference if possible. For a leaseplus agreement, the assumed

reduction in the charge due to residual value and the proportion of debt covered by the residual value should be set out. (Note: any discussion must be clear about where the values being used are existing use and where alternative use).

- Unitary charge escalator. Under PFI an RPI escalator typically applies to only part of the unitary charge (not including the element relating to initial capex). However it applies to 100% of the LIFT leaseplus charge.

The LIFT process has various processes built into it to demonstrate VfM and the results of these should also be set out. At Stage 1 the LIFT Co is required to demonstrate VfM by benchmarking the overall Lease Plus Payment and each cost element against latest market tested costs and the CHP benchmarking database, and demonstrating that each contingency is reasonable. This should be checked by technical and financial advisors as appropriate. An indicative judgement by the District Valuer should also be available.

(2.5) Affordability. In many cases LIFT projects are joint procurements with the local Primary Care Trust (PCT). Where that is the case particular attention is drawn to Section C(5.2) which describes the need for explicit funding approval from partner agencies.

(2.6) Soft FM. A description of how 'soft FM' services (cleaning, security, etc) and the provision of fixed furniture and fittings and ICT will be handled must be included. Although this is generally true of PFI projects as well, it is especially relevant for LIFT projects as these items may not be part of the standard leaseplus agreement.

(2.7) Calculation of PFI credits and grant. There are no differences in the method of calculating PFI credits or grant compared to PFI. Sale of land to the LIFT Company and the use of residual value to cover a proportion of capital costs are issues of particular relevance to LIFT projects, but both are covered in Section E.

(3) FBC

(3.1) Procedures. A FBC should be submitted shortly before Stage 2 approval. As with the OBC, there needs to be sufficient time for agreement before LIFT Stage 2 approval, but not so far in advance that there might be changes. It is expected that financial close would be reached shortly thereafter to avoid the danger that changes to the FBC may need to be agreed.

(3.2) Content. Most of the guidance in Section D applies equally to LIFT projects. For VfM, copies of the material used to demonstrate VfM at Stage 2 approval should be provided, i.e. independent cost reports (from technical and financial advisors as appropriate), plus District Valuer sign-off. The results of market testing of the supply chain (or benchmarking if that has, exceptionally, been agreed to be acceptable) should be set out.

(3.3) Derogations. Derogations from standard LIFT documentation should be agreed with the sponsoring department before any contract is signed. If the department believes these to be significant, and not project specific, advice will be sought from the department for Health.

Where a local authority and a PCT are taking head leases in the same building, both bodies do not need to get approval for the same derogations. Approval by one can be taken as approval for both. However, if any of the local authority derogations are unique to them, they will need approval in the normal way.