

GUIDELINE

PFI

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Introduction

Over the last 10 years the Private Finance Initiative has become an accepted and important method of procuring the use of infrastructure, such as hospitals and schools, for government. Projects with a capital value of almost £60 billion have been completed or are in the pipeline. This guideline presents an outline of the PFI process and related issues. Under the PFI, rather than procuring a capital asset, such as a hospital, directly, the public sector purchases services from private sector businesses which create and manage the assets needed to provide them. Payments are then made for the services provided. The advantages of PFI include the transfer of risks to the private sector and an emphasis on the through-life costs of maintaining the assets.

Outputs not Inputs. Services not Assets

The PFI offers governments and other public bodies a modern and efficient way to procure services which require substantial capital expenditure for their delivery. It forces public sector purchasers to think about the services they want rather than worrying about the assets which are used to deliver those services. It harnesses private sector management and innovation to the provision of services to the public sector. In the process it offers better value for money to the taxpayer.

The Oyster Card: the London Underground Prestige Project

In 1998 London Underground Ltd (LUL) awarded one of the largest PFI projects to fund and deliver a new ticketing and revenue collection system serving London. The 17-year Prestige contract was awarded to the TranSys consortium comprising the Cubic Corporation, EDS UK, ICL/Fujitsu and WS Atkins and involved a £160 million investment in London's transport system.

TranSys funded the capital cost of the system and its subsequent operation. Payments to TranSys under the contract are directly related to performance, with TranSys taking on a substantial share of the risk of the initiative, including those associated with the assets. All newly procured assets are owned by TranSys and at the end of the contract they will transfer to LUL. TranSys and LUL share in the benefits of alternative revenue streams resulting from the commercial exploitation of the assets.

So your Oyster card is brought to you courtesy of the PFI.

PFI contracts are long term, typically between 20-30 years. The annual payment has to compensate the supplier for providing the assets which underlie the service, as well as the cost of the ongoing services, the maintenance of the assets and the cost of raising the necessary finance. They are therefore complex contracts involving large sums.

In a PFI project, both the public sector purchaser and the private sector bidder require a range of financial, legal, insurance and technical advice, which may be from internal resources or external advisers. Advisers on either side need a thorough understanding of the PFI process as well as an understanding of how the public sector works. This guideline introduces the subject, but it can only outline the basic knowledge required, not the detail required to advise on any particular transaction. Experience can only come from working on PFI projects.

1. What is PFI?

Conventional Government Procurement

Traditionally Government decided in detail what sort of an asset it wanted to buy. It then invited tenders to supply the asset and accepted the cheapest. The public sector client could change its mind many times during construction and each time the project was delayed and became more expensive. Little attention was given to how the asset was to be maintained and no budget was provided for maintenance. So the asset was not properly maintained and slowly fell into decay.

This scenario (called conventional procurement in this guideline) may seem exaggerated and is not a feature of all public sector procurement, but it has arisen far too often. By the 1990s Britain's public sector infrastructure was in poor shape.

There are few definite figures, but it is generally agreed that before the PFI no hospital or prison had been built either to time or within budget since the war using conventional procurement. An NAO study in 2003 showed the following results (see table 1) based on Government surveys in 1999 (conventional) and 2002 (PFI).

The Conservative Government looked around for a better way of providing services for the nation. It concluded that the private sector was more efficient and innovative and was likely to be better able to manage many of the risks that the Government had hitherto kept for itself.

This is not because the private sector is in any sense better or worse than the public sector. It is because competition keeps the private sector on its toes in a way that the public sector never is (a corollary is that it is unlikely to be good

Table 1: NAO study, 2003

	Conventional	PFI
Projects over budget	73%	22% ¹
Projects late	70%	24% ²

1. None of the increases in PFI price after contract award were due to changes led by the consortium alone. For example, in some cases the Department changed some of the specifications from those for which the consortium had bid, so the price increased to reflect the changes. Some of these specification changes arose due to new factors affecting the Department's needs after contract award. These changes would also have led to price increases under conventional procurement.

2. In only 8% of PFI projects surveyed did the delay exceed two months.

value for money to transfer risk to a private sector monopoly).

Furthermore, the checks and balances in a democracy mean that the public sector is less able to take risk. If the public sector builds 20 hospitals and one goes wrong, the Opposition in Parliament will want to know why and what action is being taken to stop this happening again. There is no reward structure for managing risk well in the public sector; the best that can be expected is to avoid blame.

There is also no incentive in the public sector to consider the future costs of operating and maintaining assets during the procurement process. Even under the Resource Accounting & Budgeting system, the Treasury earmarks part of each Government Department's budget as capital and that Department is not allowed to transfer spending from capital to resource (i.e. revenue) expenditure: higher capital spending does not come with a higher maintenance allowance. So future revenue expenditure related to current capital expenditure is largely ignored. In addition the public sector finds it difficult to spend to save – to incur capital expenditure so as to reduce future operating costs.

Outputs not Inputs

Under the PFI, the public sector concentrates on the services that it is seeking to procure rather than the assets that are used to deliver the service (in PFI jargon, it looks at outputs rather than inputs). For instance, the Home Office procures custodial services rather than prison buildings – its duty is to ensure prisoners are securely housed and looked after; it does not need to own the prisons itself.

DBFO Roads – the first PFI roads

The Highways Agency had contracted for 8 DBFO (design, build, finance and operate) roads with a combined capital value of £560 million and length of 580 km by 1997. The DBFO contracts run for 30 years. The Highways Agency pays a fee based on usage – a 'shadow' toll – such that traffic risk is shared with the operator. The operators are responsible for construction and operating cost overruns, the design of the roads and problems with road availability, such as safety performance and lane closures. The risks of protestors and latent defect to existing roads are shared in varying proportions.

Equity capital was provided by the project sponsors – mainly construction companies. Road Management Group used a bond to raise £165 million with a term of 25 years and a coupon of 9.2%. The other consortia used limited recourse bank debt with margins of 1.2%-1.4% over LIBOR.

A case study of the contracts concluded that they offered average cost savings of 15%-18% compared to conventional procurement. Above all whole life costing (see below) of roads was introduced into Britain for the first time.

The Highways Agency became an experienced PFI purchaser with standard documentation and a realistic approach to risk allocation. A new road operating market with 6 established players was opened up.

The Essence of the PFI

So the essence of the PFI is simple and clear:

Value for money: A PFI project should offer the public sector better value for money because it harnesses the benefits of private sector management, innovation and risk taking.

Transfer of risk: Risk should be transferred to the party best able to manage it because that will generally provide the best value for money.

It has six important subsidiary effects:

- **Whole life (aka 'through-life' or 'life cycle') costing.** The private sector makes proper provision for maintaining the assets it requires throughout their lives because it needs them to deliver the services it has contracted to supply. The public sector can no longer ignore maintenance. Under the contract it is obliged to make payments to the supplier that include an element for maintenance. Whole life costs have to be taken fully into account in bidding and operating PFI contracts.

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- **Close integration of service needs with design and construction.** The service operator has every incentive to ensure the project is designed and constructed so as to contribute to cost-efficient service delivery.
- **Incentive to innovate and perform.** The supplier is rewarded for managing the risks effectively from early design to operation and eventual decommissioning, disposal or handback. Part of this reward returns to the public sector as better value for money as a result of the competition to win the contract.
- **Better use of assets.** The PFI makes assets sweat as old or redundant assets are marshalled in novel ways to maximise revenue and economic benefits. The public sector is generally a poor manager of assets. The private sector finds it easier to spend money on assets to save running costs.
- **Pay later and only when service received.** The public sector pays for a PFI contract only when it receives services and when the quality of the services received meets pre-determined standards. There is no immediate cash outflow during construction, as there is under conventional procurement.
- **Flexibility.** Preparing the output-based specification forces the purchaser to consider and provide for mechanisms to change its requirements over time. This is a discipline that does not generally exist in conventional procurement.

Furthermore, governments are seduced by the PFI's effect of deferring cash outflows and delaying the project's impact on Government finances. While it might appear to be unfair to leave the cash to be found by future generations, there is logic to it: it is those future generations who benefit from the improved services. However, the cash flow effect should be seen purely as a side effect. The PFI lives or dies by whether it offers value for money.

Excluding the LUL PPPs, only 18.6% of PFI projects are classed as on the Government's balance sheet (the Treasury includes the LUL PPPs so that their figure increases to 50%).

The disadvantages of PFI are also now clear:

- **Complex and costly process.** A PFI contract is not just about building an asset but also covers the provision of services and the related finance over the contract term. This is typically around 25 years but it can be up to 60 years. So the procurement process is inherently more complex and costs more. The Treasury now advises against its use for projects with a capital value of under £20

million where the set up costs are out of proportion to the size of the contract.

- **Procurement takes a long time.** On average projects take over two years from advertising in OJEU to financial close. A project survey undertaken by the Major Contractors Group in 2005 found that the average procurement time was 27 months, not much changed from the 29 months in a similar study in 2003. Some Government Departments are better procurers than others. It is important that both sides have teams with experience of PFI. Where purchasers and suppliers have learned from experience, as in roads, hospitals and prisons, costs and procurement times have come down dramatically.
- **Private finance is more expensive.** The private sector needs to make profits to stay in business. The Government is the largest show in town and no one has a better credit rating. Private finance is inevitably more expensive than sovereign borrowing because it has to make a profit. However, part of the difference is due to the risk that the Government retains under conventional procurement and which goes unrecognised.

The private sector clearly needs to make an additional profit to compensate it for the risks it assumes under PFI. Against this, the private sector can normally save at least 20% on the cost of public sector services procurement and operation by being more efficient.

The Treasury defines the characteristics required for a successful PFI project as:

- Major capital investment programme, requiring effective management of construction and delivery risks
- Private sector has expertise to deliver the programme and offer value for money
- The service can be structured in terms of outputs, which can be measured over the contract life
- Risks can be clearly allocated between the public and private sectors
- The assets and services can be costed on a whole life basis over the contract life
- High value so that set up costs are not disproportionate
- The service is not subject to fast-paced change, particularly technology change
- The services are required over the long term

2. HISTORY AND CURRENT POSITION

History

The PFI was first announced in the Chancellor's 1992 Autumn Statement although little happened until 1994 when the Private Finance Panel was set up under the chairmanship of Sir Alastair Morton. The first proper PFI projects, such as Northern Line trains and Bridgend prison, were signed in 1995.

By the May 1997 election considerable progress had been made in refining the PFI process and changing the public sector culture to accept this new form of procurement. Where there was a strong single public sector client, such as the Prison Service or the Highways Agency, good progress had been made in refining the process. For instance Bridgend and Fazakerley, the first two PFI prisons, took 18 months to financial close but the third, Lowdham Grange, only took 11 months.

In 1997 the new Government commissioned a review of the PFI by Sir Malcolm Bates, which endorsed the use of the PFI and made a number of recommendations to improve the process, which the Government accepted in full. A new Taskforce within the Treasury replaced the Private Finance Panel.

A major obstacle to PFI was private sector concern over the *vires* of many public sector purchasers, i.e. their legal capacity to enter into contracts. In the Allerdale and Waltham Forest cases, local authority contracts had been held to be *ultra vires* and were declared void. The new Government removed the *vires* problem by passing the NHS (Private Finance) Act 1997 and the Local Government (Contracts) Act 1997 and the first PFI hospital project, Dartford & Gravesham, was closed in July 1997. Since then health has become the most significant sector for the PFI industry.

The Present

In 2001 the Treasury Taskforce was itself part-privatised as a PPP and became Partnerships UK. 51% is owned by private sector institutions and 49% by HM Treasury and Scottish Ministers. The policy side of PFI has now returned to the Treasury, having been with the Office of Government Commerce.

The Government has made good progress in standardising the PFI process and PFI legal documentation in particular. It has concentrated on projects in health and education. There have been a few new prisons and defence projects but only two new road projects since 1997. In contrast the local authority sector has made good progress with a variety of PFI

The new Scottish Parliament Building – cost over-runs without risk transfer

An example of the public sector's difficulties in managing procurement and risk is the new Scottish Parliament building. The original estimate in 1998 was around £50 million and the building was finally completed in 2004 at a cost of £431 million. Part of the over-run was due to upgrades and changes in the specification and part just due to poor project control.

The Scottish Office rejected PFI for this project on the grounds that a PFI contract would take too long to procure. PFI contracts do take longer than conventional projects to procure, but considerably less than the two years by which the Parliament Building missed its original target.

A recent disclosure under the Freedom of Information Act indicates that a select group of MSPs was secretly advised halfway through the construction process that the total cost would be £225 million if they switched to PFI, so that over £200 million could have been saved.

In this project it is difficult to compare the initial and final figures as the Scottish Office inexplicably opted to develop the design alongside and during construction. As a result the final built design bears little resemblance to the initial design on which the budget was based. Lord Fraser's Report into this debacle concludes that some £150 million of the over-run was due to design delays, over-optimistic programming and uncertain authority (i.e. poor management).

schemes ranging from street lighting to police stations and leisure centres. PFI has been particularly strong in Scotland.

Table 2: Five largest PFI/PPP contracts

(excludes London Underground Ltd and Channel Tunnel Rail Link)

By capital value	Government	
	£'mn	Department
Skyenet – defence satellite services	1,079	MoD
PRIME – property services	959	DWP
Colchester Garrison redevelopment	539	MoD
Manchester Hospitals	512	DoH
M6 Toll Road	495	Dept for Transport

Source: HM Treasury

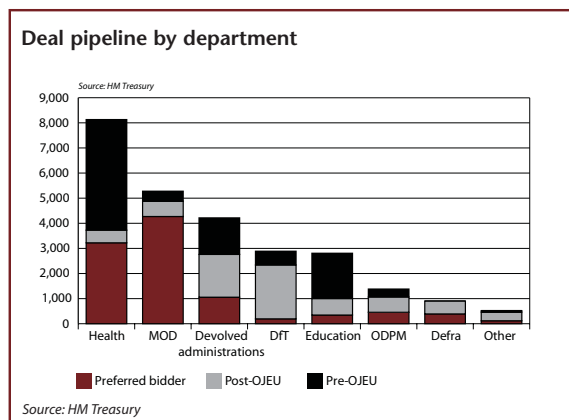
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The PFI industry in the UK is maturing and it is increasingly difficult for newcomers to enter the market. The UK now has a thriving market in all aspects of PFI contracts leading to intense competition for new projects and for shareholdings in existing projects. Much of this expertise can be put to use overseas, where the opportunities may be greater over the next few years.

As the Government seeks to bring public expenditure under control in 2006, new projects are increasingly being stalled. Nonetheless the Treasury estimates the PFI deal pipeline over the next five years to be around 200 projects worth £26 billion in capital value.

Attention is now focused on the huge Building Schools for the Future programme that is finally getting underway some



two years behind target. Under BSF the plan is to spend £2.2 billion each year to renew the secondary school estate, half of which is expected to be by PFI.

The lead PFI departments are Transport and Health with Defence and Education coming up strongly. Scotland has played a major role in PFI since the start. The list below excludes the PPP of LUL and the Channel Tunnel Rail Link (CTRL), which are both exceptional projects. Government net capital expenditure in 2006/7 is projected to be £29 billion. The PFI delivers contracts representing between 10% and 15% of Government capital expenditure and plays a small but important part in providing services to the nation.

The 2006 Budget Statement (table C19) shows the projected future annual cash outflow under PFI deals so there is full disclosure of the impact of PFI on the nation's accounts. The forecast payments are expected to reach a peak of £7.8 billion in 2016.

Table 3: Capital Value of Projects to March 2006
Sponsoring Department

Sponsoring Department	£'bn	%
Health	6.6	20%
Transport	5.7	18%
Defence	4.6	14%
Education & Skills	4.1	13%
Scotland	3.6	11%
Work & Pensions	1.3	4%
Home Office	1.2	4%
Department for Communities and Local Government	1.1	4%
DEFRA	0.7	2%
Wales	0.6	2%
Northern Ireland	0.7	2%
All others (<£0.4bn each)	2.0	6%
Total	32.2	100%

Source: HM Treasury

This figure has to reimburse the private sector both for capital expenditure with which to provide PFI services and for the services themselves. The services element would have been incurred in any case by future governments (much of Government spending is effectively a fixed cost and is not variable; children will always require education and prisoners still require locking up).

PPP

The Government is keen to talk about Public Private Partnerships (PPP) rather than just PFI, although ministers often use the terms interchangeably. A PPP is any contract where public and private sectors work together to provide a service.

The normal definition of a partnership is the sharing of profits and losses, but in practice the Government does not want to share losses. It talks of partnership more as a new, less antagonistic approach to working with the private sector.

The private sector is wise to seek a sensible, long term relationship with the public sector while being aware that it is unlikely to last, if a project goes wrong. So it is important to have a robust contractual framework in place for every project, even if there is a non-binding partnership agreement on top. The Railtrack misfeasance case showed the importance of a strong contract to underpin any partnership between the public and private sectors.

The Government itself defines PPPs as bringing public and private sectors together in long term partnership for mutual

benefit. The PPP label covers a wide range of different types of partnership, including:

- The introduction of private sector ownership into state-owned businesses, using the full range of possible structures (whether by flotation or the introduction of a strategic partner), with sales of either a majority or a minority stake. An example is QinetiQ plc, which now owns most of the former defence R&D operations;
- Selling Government services into wider markets and other partnership arrangements where private sector expertise and finance are used to exploit the commercial potential of Government assets; and
- PFI.

LIFT and BSF

There have been two important PPP initiatives in recent years:

- **LIFT:** Local Improvement Finance Trust. A series of PPPs aimed at renewing and improving the local health infrastructure in inner cities, especially GPs' surgeries. Much of the private sector interest centres on the opportunity to develop the property around the surgeries and bring together other health services, such as pharmacies and dentists. LIFT has delivered around £1 billion of investment in primary care infrastructure. See www.partnershipsforhealth.co.uk.
- **BSF:** Building Schools for the Future. A massive new programme to renew the secondary school estate in England, which aims to spend some £2.2 billion a year. The programme is running two years late and is widely felt to be unnecessarily complex, but there are signs that it is now getting going; the Local Education Partnership for the first scheme, Bristol BSF, was agreed in June 2006. The first three waves of projects are included in the project pipeline figures on page 6. See www.p4s.org.uk.

In the Treasury's view a key feature of both initiatives is that they provide a strategic framework for planning and delivering investment over the long term.

3. THE ORGANISATION OF THE PFI

The main organisations within government which deal with the PFI are:

3.1 The Treasury PFI Policy Unit

The PFI Policy Unit at the Treasury has ongoing responsibility for PFI policy and for establishing best practice. It publishes a range of guidance (see bibliography and its website) and helps Government Departments establish sets of model documentation and ways of doing business based on practical experience.

3.2 Departmental Private Finance Units

Each central government department is responsible for its own PFI projects and has its own private finance unit which works with line management to procure them, some more effectively than others. A list of departmental contacts is available on the contacts section of the Partnerships UK website or the links section of the PPP Forum website.

3.3 Office of Government Commerce

OGC is an independent Office of the Treasury. It acts as the procurement adviser to central government and is responsible for a wide-ranging programme which focuses on improving the efficiency and effectiveness of central civil government procurement and the wider public sector.

In addition, OGC develops and promotes private sector involvement across the public sector and it also has a key role in assisting departments with project and programme management.

3.4 Partnerships UK

Partnerships UK is itself a PPP which provides procurement advice to help the public sector deliver PFI and PPP projects. It is limited to working for the public sector in the UK and overseas.

3.5 The 4Ps

The 4Ps was set up in April 1996 by the Local Authority Associations in England and Wales to promote investment in local services through the PFI and other PPPs. Its work in the local authority sector combines that of the Treasury PFI Policy Unit and Partnerships UK in central government. The 4Ps assists local authorities in delivering a range of pathfinder projects and produces a range of best practice guides, case studies and other guidance material.

Local authorities account for around one third of all

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publicly sponsored capital expenditure, so they represent an important PFI market. PFI in local authorities started after central government and its progress was further delayed until the *vires* problem was solved in 1997. The sector is very fragmented as each local authority is autonomous.

Bundling – a better way of doing things

Attempts are periodically made to bundle together contracts involving a number of local authorities so as to achieve economies of scale and offer the private sector larger, more interesting projects. There are organisational and legal problems with bundling, but it can offer good value for money. The first bundled schools project in Falkirk was signed at the end of August 1998. Since then many Scottish authorities have issued multi-school contracts. Such contracts are now well accepted in the market and could provide a simpler way of meeting the Government's aims for schools than BSF.

3.6 Project Review Group

The PRG is a panel of public sector PFI experts chaired by the Treasury with permanent representatives from the Department for Communities and Local Government, 4Ps and

NAO Report June 2003 – Delivering better value for money from PFI

Summary

- PFI incentivises a consortium to take a longer term approach to design and construction
- PFI incentivises the consortium to deliver the built asset to budget and on time
- The whole life cost approach under PFI encourages good quality design and construction
- Expert opinion and experience support the conclusion that these incentives are working
- PFI projects surveyed delivered price certainty to the department, an improvement over historical experience
- Most PFI building projects were delivered by the time specified in the contract – a further improvement compared with previous procurement experience
- Most project managers were satisfied with the design and construction
- It is not possible to judge whether these projects could have achieved these results using a different procurement route

Falkirk Council – New Schools Project

In August 1998 Falkirk Council signed a £65 million deal to rebuild five of its eight secondary schools. The contract was for 25 years with a value of £340 million and provided new buildings and linked services for 5,000 pupils.

This was the first bundled schools project. Bundling created a sufficiently large transaction to afford the costs of project finance. Falkirk had the advantage of being able to build new schools on new sites near or alongside existing schools. This avoided the disruption and construction difficulties involved in refurbishment of existing schools.

The European Investment Bank provided £37 million of loans and the remaining bank debt was provided by Bank of Scotland. Equity was provided by a consortium of Ballast Wiltshier, Quayle Munro and Charterhouse Bank, which committed £6 million.

When Ballast Wiltshier went into receivership in 2003, its ongoing maintenance contract was taken over by MITIE with no impact on the local authority client. This is an example of the successful transfer of risks to the private sector.

The European Investment Bank is slow and bureaucratic and will not provide loans covering the construction period. If a project is considering EIB finance, it is important to have alternative finance set up so that the project can proceed without the EIB. Receipt of the cheaper EIB finance can then be regarded as a bonus.

Partnerships UK. Its current remit is to oversee the scrutiny and approvals process for allocating PFI credits to local authority projects in England.

The Treasury is now proposing that it will in future also review projects that are particularly complex, large or novel and that it will review projects from central government departments that do not have an active PFI programme.

3.7 National Audit Office

Although not strictly part of the organisation of PFI within government, the NAO's looming presence is a major influence on the behaviour of government departments. It has produced over 50 reports on PFI projects and they are worth reading for the insight they give into the NAO's thinking on PFI.

The NAO's power comes from its reporting line into the Parliamentary Accounts Committee of the House of Commons, which holds hearings into the NAO's most important reports. No senior civil servant relishes being

hailed (and mauled) in front of the PAC and it is one of the principal causes of civil servants' aversion to taking risks. Overall the NAO has been supportive of most PFI projects it has examined so far. While there are, unsurprisingly, some recommendations for refining the process, there is also endorsement that PFI can and does deliver significant value for money compared to conventional procurement

3.8 Audit Commission

The Audit Commission performs similar functions to the NAO in the local authority sector. Its remit covers a number of PFI projects in local government, housing, health, criminal justice and fire and rescue services.

3.9 PPP Forum

The PPP Forum is the trade body for private sector participants in PPP and PFI. Its website contains useful facts and figures and the links page has a list of contacts in Government bodies involved with the PFI.

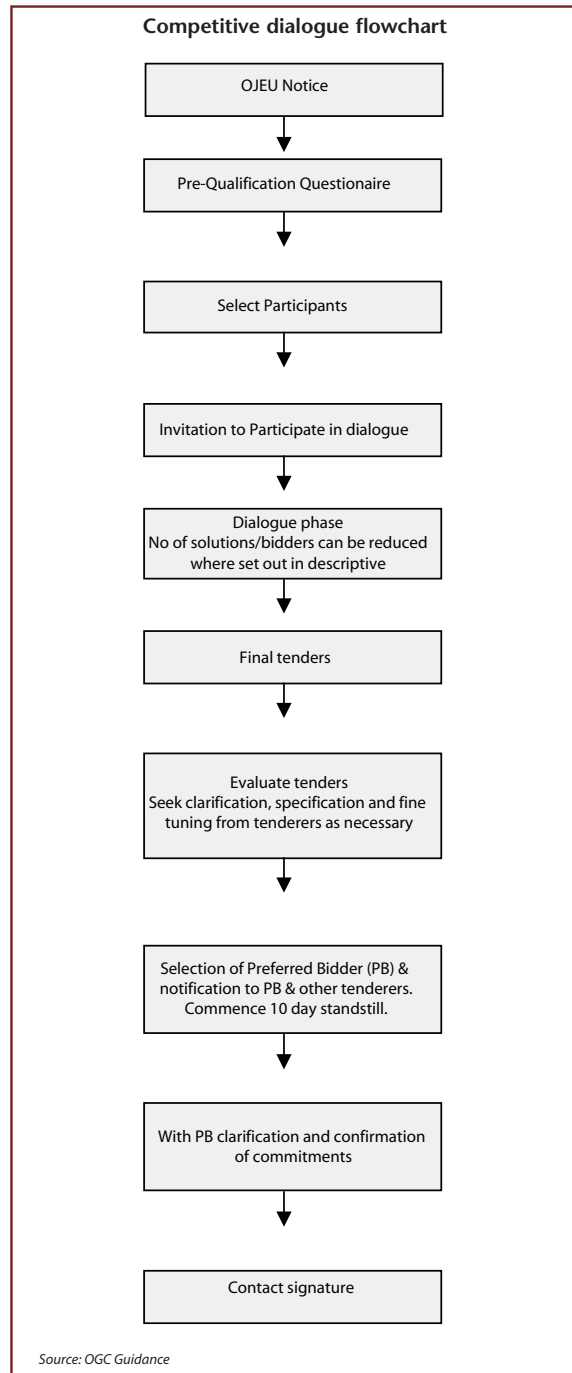
4. THE PFI PROCESS

In January 2006 new Public Contracts Regulations were introduced to implement the EU Public Sector Procurement Directive. They introduce the competitive dialogue procedure for complex contracts such as PFI/PPPs (see flowchart). Its effect is as yet uncertain. It is hoped that the new regulations will not require major changes to UK practice. The main features of the competitive dialogue procedure are set out in an OGC guidance note:

- dialogue is allowed with selected suppliers to identify and define solutions to meet the needs and requirements of the contracting authority;
- the award is made only on the most economically advantageous tender criteria;
- dialogue may be conducted in successive stages, with the aim of reducing the number of solutions/bidders; and
- there are explicit rules on post-tender discussion.

The Treasury Taskforce produced a Step by Step Guide to the PFI procurement process included in its Technical Note 6: *How to manage the delivery of long term PFI contracts*. It outlined three important steps:

- procurement, during which the Purchaser should establish its contract management ground rules for the life of the contract;
- development, from award of the contract to the start of payments on commencement of delivery of the services



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- required by the output specification; and
- delivery, covering the provision and use of the contracted services during the remaining life of the contract.

Previous advice had included a more detailed staged process. Although these stages have been superseded by Technical Note 6, appropriately modified they are still useful in understanding the main steps in PFI procurement:

1. Establish Business Need; 2. Appraise Options

The PFI is a procurement option. It is not a business strategy and has received much unfair criticism because purchasers have rushed into procurement before they have determined whether they have a business need or what sort of need they have.

Purchasers must first decide what they need to procure and then appraise the best way to procure it before they involve bidders in time and expense. In particular purchasers and their advisers must consider affordability – is the money available in their budget for the new project? They should not involve the private sector until the funds to meet the likely PFI charges are available and are committed.

3. Business Case and Value for Money

The purchaser will prepare an Outline Business Case which supports the case for expenditure and the use of the PFI. The purchaser must first prepare an output specification, which defines clearly the services to be delivered (but does not describe prescriptively the assets required to deliver the service as this is a matter for bidders). The Outline Business Case will include a Value for Money (VfM) assessment, looking at the non-PFI alternatives that the purchaser would procure conventionally if a PFI project were not to offer better value for money.

4. Develop the Purchaser's Team; 5. Decide Tactics; 6. Invite Expressions of Interest, Publish OJEU Notice

PFI projects are large and complicated and both purchaser and bidders must have competent, well-managed teams to support them with clear lines of command. At this stage the purchaser will appoint a financial adviser by competition. Before accepting the appointment the financial advisers should satisfy themselves that the client is well prepared, has a strong management team in place, has thought through the business need and can afford the project. Otherwise the failure of the project may reflect badly on the advisers.

All public sector projects over a minimum threshold are subject to the European Union Procurement Regulations and have to be let by competition. In practice this includes all PFI and PPP contracts. By law contracts over these thresholds must be advertised and it is now standard practice for all such projects to be advertised in OJEU. At this stage the purchaser's legal advisers will normally have produced a draft contract which is made available to shortlisted bidders.

7. Prequalification of Bidders; 8. Selection of Shortlist

The list of respondents to the OJEU notice is reduced to a shortlist or a longlist based on a pre-qualification questionnaire aimed at profiling suitable suppliers. For example, bidders may be assessed for general technical competence or financial strength. For a complex project this may require two stages, but the object should be to produce a shortlist of three bidders, or at most, four. It is expensive to bid for a PFI project and it is wasteful to cause bidders to incur abortive costs unless they have a reasonable chance of success.

9. Refine the Appraisal; 10. Invitation to Participate

The purchaser now refines the Business Case and confirms that the project still appears to be affordable. An ITP is put together covering all the information bidders require to formulate good bids. The ITP should be specific about:

- The services required, in output terms
- Any minimum constraints or boundaries on service, scope or engineering
- Proposed contractual terms and contract length
- Payment mechanism
- Timetable and negotiating process
- Evaluation criteria and the extent to which variations and innovation are encouraged

The bid preparation stage may be lengthy, from 3 to 4 months. Bidders have a lot of material to absorb and it will require a great deal of work to prepare proposals, draw up designs, cost them, obtain internal approvals and submit a formal bid.

There is much debate about the amount of due diligence which should be carried out before the bid is submitted and how much can be left until later. The purchaser will want as firm an indication as possible of lenders' commitments, particularly under the competitive dialogue procedure. Bidders and lenders will want to minimise the costs they incur before selection as Preferred Bidder.

11. Receipt and Evaluation of Bids; 12. Selection of Preferred Bidder

The purchaser's team reviews the bids received in accordance with the principles and criteria set out in the ITP. It checks that the bids represent value for money and are affordable. A preferred bidder is selected.

13. Contract Award and Financial Close

If best practice has been followed in the selection of the preferred bidder, the process should move smoothly to financial close. Final due diligence is undertaken by the lenders and final contract details are negotiated. In practice, contract award and financial close often take place together.

The contract will include default clauses which allow it to be terminated, if there is serious and persistent failure by the supplier to deliver the service as contracted. This is an extreme measure which should be highly unlikely to occur, but it does demonstrate how risk is transferred through the contractual terms from the public sector to the private sector.

14. Contract Management

The purchaser will need to put in place a monitoring system to ensure that the supplier delivers the contracted services. In theory the purchaser should not need to check on the construction of the underlying asset as it is only the provision of services that matters. However, in practice the purchaser will want to satisfy itself that the supplier is doing what it committed to do in case the project goes wrong and the supplier defaults.

Cleveland Police Authority – Action Stations Project

In March 2005 Cleveland Police Authority signed a £39 million contract with RHE, a consortium of Reliance Security, HBOS and Equion (part of John Laing plc). The 25-year contract provides for new custody facilities, improving existing police buildings and services to facilitate new work procedures and police technologies.

The project includes a new 50-cell custody suite in Middlesbrough and new operational and administrative district headquarters. The builders, Laing O'Rourke are sub-contractors and have no shareholding in RHE. Reliance, which is a shareholder, provides the FM services and building maintenance. Debt was provided by Bank of Scotland.

5. PROVING VALUE FOR MONEY

Before 2004 it was necessary to produce a public sector comparator – an estimate of how much it would cost to build and deliver the project conventionally. The aim was to provide an unbiased estimate of the cost of the best available method of delivering the services through non-PFI means. The PSC was used to demonstrate that the PFI contract is value for money compared to what else is available to the public sector.

However, it is extremely expensive to produce a full PSC. Most of the work required to produce a full project bid has to be undertaken, including:

- a full design and an estimate of cost of construction;
- an estimate of whole life maintenance costs;
- an estimate of annual operation costs of services included in the PFI project; and
- an estimate of the cost of risks retained by the public sector.

In August 2004 the Treasury issued Value for Money Assessment Guidance which dispensed with the PSC and substituted a staged assessment of VfM:

- qualitative, which is divided into:
 - Viability – can an operable contract with built-in flexibility be constructed and can strategic and regulatory issues be overcome?
 - Desirability – will PFI bring sufficient benefits to outweigh the expected higher cost of capital?
 - Achievability – is a PFI procurement likely to achieve completion, given purchaser-side capability and the attractiveness of the project to the market?
- quantitative – using department-specific generic VfM models which can be tailored quickly and cheaply for each project.

Generic VfM models and assessments work well on programmes of similar projects, such as hospitals or schools. But they are less easy to use in, say, defence, where many of the projects are one-offs. The Guidance is being clarified and revisions are likely at the end of 2006; it may revert partially to the use of a PSC for novel and unique projects.

The Treasury stipulates that the cash flows of the VfM model/PSC and the cash flows of the PFI bid should be compared by deriving a net present value based on:

- real cash flows excluding any inflation assumptions
- discounting the real cash flows using a discount rate of 3.5% per annum

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- adjusting for optimism bias – most projects underestimate their costs and timetables
- removing the tax differences between conventional and PFI projects
- valuing the benefits to the purchaser and to the Government more widely

The real discount rate of 3.5% is set to represent the Government's long term cost of finance without assuming any risk and is based on the time value of money to the public sector.

In comparing the VfM model or PSC with the PFI option, it is important to compare like with like and to eliminate any distortions due, for instance, to differences in retained risk, taxation, business rates, the treatment of pension costs or the time value of money.

6. RISK

6.1 Allocation of Risk

The allocation of risk is fundamental to negotiating PFI contracts. It is now considerably standardised and most contracts will be based on SoPC3, the latest version of the Treasury standard contract.

The fundamental principle behind the PFI is that risk should be allocated to whoever is able to manage it at least cost, whether that is the public or the private sector. Management may be by active management, mitigation, insurance or, where risks cannot be controlled, by having sufficient resources to absorb the consequences of the risk crystallising. So a full analysis of the risks involved with the project must be carried out.

There are two general principles:

- whoever is allocated risk must have the freedom to choose how to manage and alleviate it; and
- is the risk significant? The cost of quantifying a risk can be considerable and may outweigh the benefits of trying to transfer it.

There is much to be said for sharing risk so that both purchaser and supplier have an interest in managing it effectively. If the risk is all with one party, the other party has little incentive to help control it.

6.2 Transfer of Risk

Risk is generally transferred in a PFI contract in one of two ways:

Risk Transfer in Action

A number of contractors have run into well-publicised trouble on PFI contracts. John Laing under-estimated the cost of building the National Physical Laboratory to the agreed tolerances. This together with over-runs on its contract for the Millennium Stadium led to it selling off its construction business for £1. Laing has since reinvented itself as a successful bidder, manager and investor in PFI projects.

Ballast went into receivership in 2003 largely because it underestimated the cost of building PFI schools.

Problems with PFI projects contributed to the collapse of both Amey and Jarvis. Investors in the SPCs which had employed Jarvis as a contractor, also lost much of their money.

In none of these cases did the public sector client lose money, although service delivery was delayed in some cases: the transfer of risk to the private sector worked.

- the payment mechanism used to pay the private sector supplier; and
- specific contract terms.

Payment Mechanisms

Setting the payment mechanism is an important part of a PFI contract because it determines when, how and how much the supplier is paid for the services provided. The payment mechanism is critical to the transfer of risk; if the payment does not vary according to the quality or quantity of services provided, it is highly likely that the transaction is in substance a finance lease. A good PFI payment mechanism will reflect significant potential variation in payment arising both from the quality and quantity of infrastructure-based services provided. Both quality and quantity of service are important.

A good payment mechanism provides a real financial incentive for the service to be delivered to the required standard over the life of the project. Under an effective payment mechanism:

- the service provider should be incentivised to correct the problem rather than suffer deductions;
- the level of deductions for major issues should be more significant than those for small or unimportant ones;
- there should be a limited number of performance measures to encourage full and accurate contract monitoring;
- all important issues should be covered by payment deductions;

- payments should be scaled down to zero where the services are to all intents and purposes unusable;
- payments should be weighted to the benefit obtained by the public sector purchaser rather than to the costs incurred by the private sector supplier.

It is recognised that some payment mechanisms have become too complex and the Treasury is consulting on ways of simplifying them and making them more flexible so that the service provider is incentivised to perform better than required and more in line with user expectations.

Specific Contract Terms

Many of the risks will be dealt with by specific clauses in the contract. These should make it clear who is responsible for managing the risk and the consequences of default. For instance there will be clauses in the contract covering arrangements at the end of the contract, such as return of the asset to the public sector, changes to the service provided and adjustments for inflation.

6.3 Risk Analysis

The analysis and evaluation of risks forms a substantial part of the bid process. Risks will vary from project to project but the key risks are:

a. Bid Risk

Although not a risk which transfers from the public sector, bidders must be aware of the risk of substantial abortive costs. Bidding for a PFI project is much more complex than for a conventional project. The cost of designs, operating plans, legal and financial advice is significant. The costs for a large project can be over £1 million, particularly if the opportunity cost of staff time is included. If there are 3-4 bidders on the project shortlist, the losers have a proportionate chance of incurring abortive bid costs.

b. Design and Construction Risk

The responsibility for a design that is fit for its purpose and for constructing it to time and within budget is normally passed from the Special Purpose Company via a fixed price design and build sub-contract to a construction company.

c. Planning Risk

Planning consent, particularly outline planning consent, is a risk that the private sector is reluctant to accept. The planning process is long and costly and it is perhaps easier for a

government body to persuade the planning authorities to grant consent than for the private sector supplier.

The private sector may be asked to take the risk of obtaining detailed planning consent (that is the consent to the details of the proposed scheme rather than the overall size and usage of the scheme), as this is normally less contentious.

d. Operating Risks

The SPC will normally pass the risk of timely and cost effective operation within an agreed budget to a specialist operator or facilities management sub-contractor. The FM sub-contractor will bear the risk that it can deliver the service within the budget.

e. Business Interruption

The risks of damage and business interruption are insurable and passed to insurers.

f. Inflation

General inflation risk is retained by the public sector. The cost of providing maintenance and other ongoing services will vary in line with their related price indices. The contracts will therefore generally include an indexation provision normally based on the increase in the Retail Price Index possibly with provision for periodic reviews. The sub-contract operator will normally accept the risk that it can keep its costs within the agreed level of inflation although most modern PFI contracts and operating sub-contracts will include provision for periodic benchmarking or market testing, say, every five years.

g. Demand

The private sector is cautious about taking demand risk where it cannot control or assess demand. For instance, it has no say over the number of prisoners in a prison. In other instances, public sector assets have to be built to meet maximum expected demand, which can mean that in normal times they are underused. An accident & emergency hospital has to be ready for a peak in demand following an emergency situation.

Demand risk has been transferred on some light rail projects such as Manchester Metrolink and Croydon Tramlink, but the experience has not been happy for the private sector operators who have seen demand fall well below that budgeted while fare evasion has exceeded forecast.

Overseas there is more experience of the private sector taking demand risk, as in the French A28 motorway project where tolls provide the only revenue stream. To mitigate the

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A28 Motorway between Rouen and Alençon in France

The French motorway system has previously been built by state-owned concession companies taking responsibility for building the motorways and collecting the tolls to finance them.

In 2001 ALIS, a private sector company led by Bouygues, supported by CDC IXIS and HBOS, signed a 62-year concession to Design, Build, Finance and Operate the A28-E402 Toll Motorway, which is a 125 km motorway between Rouen and Alençon in Normandy. Finance comes from a mix of public and private sources:

	€'mn
Shareholders' subordinated debt and equity	60
SAPN subordinated debt (SAPN is a state-owned motorway operator)	18
Mezzanine bonds from HBOS	39
Senior index-linked bond AAA underwritten by Financial Security Assurance	460
Government capital subsidies	343
Total	920

As with UK PFI, the contractual structure largely seeks to pass construction and operational risk (except revenue risk) from the SPC to its subcontractors. However, in contrast to PFI, ALIS retained the risks associated with the development phase of land acquisition, obtaining the necessary consents and approvals, environmental problems and the risk of archaeological finds. It also retained demand risk that revenues from traffic using the motorway would meet budget.

This is also the first example of a Euro-denominated bond being used for a PFI project.

risk of lower than expected traffic the debts are due to be fully repaid well before the end of the project. This allows longer to repay the debts if the revenues are below forecast although equity returns will fall.

h. Availability

In contrast to demand, the private sector can almost always control the availability of the service it provides and so this risk is often transferred to the supplier. For instance, a prison SPC will be paid if the required number of prisoner places is available each day for use by the prison service. The SPC will not be paid if the service is not available or is not to the

required standard. The SPC, in turn, will pass much of this risk on to the sub-contracted FM operator.

i. Technology or Obsolescence

The risk of the asset becoming obsolete because of technology advances is normally only significant in IT projects, where it is a risk normally accepted by the private sector. IT contracts are shorter than other PFI contracts because the assets become obsolete so fast. The difficulty of dealing with this risk is a major reason why the Treasury now prohibits the use of PFI for IT projects.

j. Residual Value

The transfer of residual value risk will vary from case to case. The Highways Agency has a statutory requirement to have the road back at the end of the contract; only HM Prison Service can let prison contracts, so there is no alternative use for a prison. In contrast, the private sector may be very willing to take the residual value risk of office accommodation or of other assets with an established second hand market. For instance, in the Defence Helicopter Flying School contract, the suppliers took the risk of the terminal value of the helicopters.

The supplier will be responsible for ensuring that the asset is in good condition at the end of the contract, if it is to be handed back or transferred to another supplier.

Because PFI contracts are long term, often 25 years or more, the effect of assuming a residual value in the financial model is often immaterial. However, residual value risk may well influence the balance sheet treatment of the asset (see section 13 below).

k. Regulatory and Legislative Change

The question of who should bear the risk of legislative change is a vexed one. The private sector does not see this as a risk it can manage, whereas the public sector sees it as a general risk of doing business. SoPC3 proposes that the purchaser should bear the cost of:

- Discriminatory changes in law aimed at the project itself;
- Specific changes in law aimed at similar projects, neither of which can be predicted by the supplier; and/or
- General changes in law which come into effect during the Service Period and which involve significant Capital Expenditure which was not foreseeable at the date of the Contract.

The supplier should bear the risk of general changes in the law or small regulatory changes, which affect every other business in the same way.

1. Finance Risk

The private sector is not normally prepared to take the risk that it will be able to raise the finance for anything but the smallest projects up to financial close.

The cost of finance as represented by changes in interest rates is a risk that the private sector is able to take because it can be mitigated by raising fixed rate debt finance. Bonds normally have a fixed rate of interest and bank debt can be converted to fixed rate by using appropriate swap arrangements.

7. CONTRACT ORGANISATION AND STRUCTURE

Single contractors or operators may bid for small PFI contracts on their own using their own technical and financial resources. However, now that small projects (under £20 million) are no longer procured under PFI, in the great majority of cases the supplier will be a consortium of companies, which brings together the necessary skills and finance to submit a credible and deliverable bid. The make up of the consortium will vary from project to project but will almost always include an operator or operators to provide the maintenance and other specified services over the period of operation of the contract.

The consortium will generally establish a Special Purpose Company as the bid vehicle. The SPC contracts with the purchaser and then sub-contracts design, construction and operation to specialists, who may, but need not, be

shareholders in the SPC. The finance is provided directly into the SPC, which is also the client of the financial and other advisers. A typical project finance contractual structure is normally adopted (see chart, below).

The direct agreement between the financiers and the purchaser is purely to determine the relative position of the creditors in the event of a default and it should be a standard document. Just as the public sector team requires strong management and senior level support, the consortium also needs to have a single, strong manager to steer it through the problems that inevitably crop up.

In due course some of the SPCs may become businesses in their own right. For instance, Trillium, which won the DWP's PRIME accommodation contract and has since been acquired by Land Securities, has its own management team and is bidding for further contracts from the public and private sectors.

8. TYPES AND SOURCES OF FINANCE

The financing of PFI projects is very similar to any other project finance transaction. Most of the finance is provided as debt secured on the underlying contract cash flows. The remainder, normally around 10%-15%, is provided as equity/subordinated debt.

Where small projects are undertaken by a company using its own cash or borrowing facilities, the asset and debt relating to such projects are included on the company's own balance sheet.

However, many PFI projects are large and much of the finance comes from non-recourse debt supplied by banks or bond investors. The equity element is raised from the project sponsors or third party equity funds. The ratio of debt: equity

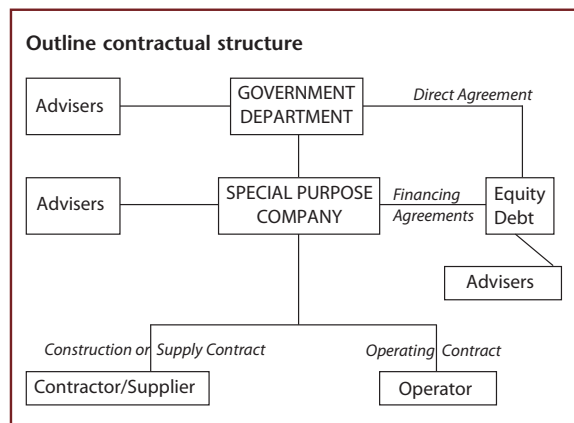


Table 4

Type	Term	Typical returns required	Comments
Equity	Project life	12%-15% nominal IRR over project life (from dividends, interest + capital appreciation)	Committed first but may be paid in later. Takes risk of abortive bid costs. Normally a mix of equity + subordinated debt. No security, but controls SPC.
Debt	18-30 years	0.6%-1.5% over LIBOR or gilts (for bonds)	Will require security. Paid back before equity

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will depend on the final amount of risk that is left in the SPC. Risk is transferred to the SPC in the contract with the purchaser and is then passed on from the SPC to its subcontractors.

If the debt providers can be convinced that the project cash flows are reasonably robust, the purchaser's covenant is good and there is an adequate safety margin in the projections to allow for unforeseen problems, they will typically accept a debt:equity ratio of around 90:10. This is a high ratio of debt by international standards and reflects the low residual risk in the SPC of a well-structured PFI project.

There may be several sub-categories of debt and equity. The most important are:

A. EQUITY

The SPC's promoters normally provide much of the equity and fund the bid costs in return for ordinary shares in the SPC. Promoters may be construction companies, FM operators or one of a number of specialised funds providing risk capital for PFI projects. The funds' required overall return will vary with the perceived risk of the project but is typically an overall nominal IRR of 12% to 15% per year over the project life.

Yields have fallen considerably since PFI started. This reflects mainly the general reduction in rates since the mid-1990s but also the greater liquidity in the market and lower perceived risk now that the process is better understood. For instance, in comparison to the figures above, in 1998 nominal equity yields were 17% to 24% per year over the project life.

i. Pinpoint Equity

Very often the pure share capital element of an SPC's funding is very small and it may be stapled to an equivalent amount of subordinated debt (in other words, the equity cannot be transferred without transferring the debt attached to it). As in any company, the ownership of the shares determines who controls the company and receives dividends.

ii. Subordinated Debt

The equity investors contribute most of their investment in the form of subordinated debt, which is tax efficient and gives investors slightly better security. There is little benefit in investing more than a minimum amount in ordinary shares:

- Subordinated debt is more tax efficient (interest payable is allowable for corporation tax purposes) and more flexible.
- It can be repaid easily whereas share capital can only be repaid by a share buyback or a capital reduction, each of

which requires complex formalities to be complied with.

- In the early years of a project's operation the SPC may have no retained profits and be unable to pay dividends, whereas it may be able to pay interest on subordinated debt, as long as it remains within its principal debt covenants.

B. DEBT

Debt is provided either by banks or via a bond issue. As in mainstream project finance, the debt is normally lent on a limited recourse basis, i.e. the lenders have no direct recourse to the project sponsors. The lenders' security is:

- the cash flows of the project;
- a charge over the shares in the SPC;
- the right to step in and take over the management of the project if the loan is in default; and
- various covenants to which the SPC has to adhere.

Because of the limited recourse nature of their lending, the lenders pay close attention to contract terms, risk allocation and project due diligence. They will appoint their own legal, technical and insurance advisers to carry out due diligence before getting the project approved by their internal credit committees and making the loan.

The Treasury and the public sector take comfort from the due diligence that debt providers undertake before they lend, particularly in analysing and apportioning risk.

i. Bank Debt

Most of the debt for PFI projects has so far come from the main project finance banks in the London market. There is generally good liquidity in the debt markets, with a number of established players seeking to provide loans to PFI projects.

The term of bank debt has extended as lenders have become more familiar with PFI and can now be as long as 30 years. Interest rates are currently very competitive and for good, large projects can be substantially below 1% over LIBOR. Lenders will require the SPC to remain within a number of covenants, of which the main covenants are:

- $$\text{annual debt service cover ratio} = \frac{\text{Cashflow before debt service}}{\text{Interest \& principal repayments for year}}$$

The minimum ratio is typically in the range 1.15 to 1.2.

- loan life cover ratio =
$$\frac{\text{NPV of cashflow over remaining project life}}{\text{Total debt outstanding}}$$

The minimum ratio is typically in the range 1.2 to 1.3.

- debt service reserve = cash required to service debt for the next period, normally 6 months. (Standby facilities sometimes replace a reserve now as funding competitions squeeze debt costs to a minimum.)

Sufficient cash to service the debt for the agreed period is retained in a separate debt service reserve account, which can only be accessed by the lenders.

ii. Bonds

Most larger projects (over £200 million) are financed using the bond market. The differences between bonds and bank debt for PFI have narrowed over the last few years as both markets have matured and compete with each other for lending. The advantages of bonds are broadly:

- Longer term finance, up to 50 years instead of 30 years for bank finance.
- Slightly finer lending margins.
- Fixed interest rates, although swaps can largely be used to fix interest rates on bank debt. (NB both can be index-linked, if required).
- Fewer active covenants constraining the shareholders.
- Bonds tap a wider spread of potential investors.

The disadvantages of bonds are:

- Inflexibility. Bonds are less flexible than bank debt. They are not easily repaid early and it is difficult to change or renegotiate their terms. So it is harder, for example, to raise additional funds for the project if it gets into difficulty or if the client wants extra services, which require additional expenditure. It is also harder to refinance the project once it is past its risky construction stage. Eurotunnel is the extreme example of this.
- Deliverability. It may not be entirely certain until a late stage in a project whether a bond issue will be successful in raising funds for the project. Much will depend on the state of the capital markets when the issue is placed.
- Cost. Bonds will normally cost more to put in place than bank debt.
- Need to involve rating agencies.

Bonds are only suitable for larger projects as the minimum issue size to provide liquidity and cover costs is around £75 million.

Bonds can be issued with or without enhancement of their credit rating to AAA grade from a specialist credit insurance company known as a monoline insurer (because they concentrate on this one line of business). With credit enhancement (sometimes called 'credit wrapping'), the AAA-rated monoline insurance company guarantees the bonds in return for an insurance premium, which is paid by the borrower. As a result the bonds become a less risky investment for investors, who will then accept a lower coupon.

All but one PFI bond have been issued with credit enhancement as it improves the long-term liquidity of the bonds in the after-market, although it seems to make less difference to the borrower. The finer margins of credit-enhanced bonds are offset by the charges of the credit enhancer and additional legal and due diligence costs.

The big advantage of credit enhancement is that there is greater certainty of obtaining the finance once the insurer has agreed to underwrite the bond.

The major reason why bonds have not been issued without

Colchester Garrison

In February 2004 a large defence PFI project to re-develop the Colchester Garrison site closed. The project had a capital value of £539 million and construction is expected to complete in 2008. The shareholding consortium consisted of Sodexho, WS Atkins and Sir Robert McAlpine.

This huge project will provide serviced living and working accommodation for over 3,500 army personnel and around 700 civilian staff. More than 110 buildings are included in the concession contract, which is worth £2 billion over its 35-year life.

Debt finance was by a £580 million bond credit enhanced by Ambac and, therefore, rated AAA. The coupon was 5.337% and the bond is due for repayment in 2038, leaving a year's tail in case of problems. Part of the finance came from the sale to Taylor Woodrow of a large parcel of unwanted MoD land adjacent to Colchester town centre.

This is a large and complex project but, like many MoD projects, it took too long to complete. The OJEU was issued in February 1997. Frequent changes of staff on the client side were one of the reasons for the delay, a point picked up in the more recent Treasury guidance.

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credit enhancement is that the credit rating for an un-enhanced bond has been below investment grade at around BB-, which limits the investors who would be allowed to hold such bonds. The rating agencies have a role to play in opening up this market. At present many practitioners seem to be taking an unduly cautious view of PFI projects without credit enhancement.

How much finance is required? The Financial Model

The purchaser's financial adviser is often asked to advise on the VfM assessment or prepare the PSC. The bidder or its financial adviser will also prepare a bidder's financial model. If the advisers do not prepare the model they may be asked to audit the model to ensure it performs as expected.

Financial models for PFI contracts are essentially elaborate long-term cash flow projections. However, balance sheets and profit & loss accounts are important to provide logic and ratio checks, such as gearing and interest cover, and to check the headroom within proposed bank covenants. The models can become complicated because of the number of variables and the size, complexity and long time frame of the projects they model. However, there can be a tendency among some advisers to make PFI models over-complicated; this should be resisted.

The model will be used by bidders as a tool to minimise the net present value of their bids using the Treasury's discount rate of 3.5% in real terms.

It is important to be consistent about indexation. The model should be designed so as to be capable of producing output either in today's money (real terms) or allowing for inflation (nominal terms). Because inflation is now low and expected to remain lowish, models tend to be produced in nominal terms and nominal yields quoted. Whichever is used, costs and revenues must be treated consistently.

9. REFINANCINGS

When a PFI project is first signed, the facility still has to be constructed and the operation is untested; this is the time of greatest risk so the initial investors will expect a higher risk premium to compensate them. Once construction is complete, the handover to operation has taken place and the contract is operating smoothly, the risks remaining in the project are considerably diminished. At this stage many of the risks have already been successfully overcome, so investors require a lower risk premium.

For this reason, it has been common for projects to be refinanced after the construction phase. At this stage banks

are usually prepared to lend on finer margins for longer periods and with less onerous covenants. This applies particularly when bank interest rates have fallen since the original financing was put in place. Such refinancings maximise returns for the project shareholders.

In the early PFI projects investors were allowed to keep all the refinancing gains. This makes sense as long as the purchaser is not adversely affected: the investors have taken the risk of managing the construction, so they should be rewarded.

However, three very large refinancing gains on early hospital projects caused a political outcry that private investors were profiteering at the expense of the public. In June 2000 the NAO produced a report into the refinancing of Fazakerley Prison which concluded that the public sector must ensure it is not exposed to increased risk through a refinancing. This can happen if the public sector is left with higher termination liabilities in a project that now has more debt in it.

A Refinancing Code produced by the OGC has become accepted industry practice. Refinancing gains are now shared between the public and private sectors as follows:

- Early projects – public sector 30% of gain unless lower figure agreed in contract
- Projects signed since 2002 – gains shared 50:50

The public sector may take its share of the gain in a number of ways such as:

- Cash up front
- Reduced charge for future services provided by private sector
- Improved level of services at no extra cost

Refinancings should benefit both purchasers and project sponsors. Nonetheless the Parliamentary Accounts Committee remains hostile to them, particularly where the private sector benefits from a significant increase in investment returns. As a result, refinancings came to a halt in 2005 and the first half of 2006. Two refinancings, the M6 toll road and Swindon hospital, were completed in mid-2006 and have hopefully broken the logjam. However, there is less scope to refinance more recent projects which have been subject to greater competition and negotiated in a period of lower interest rates.

Darent Valley Hospital

Investors in the Darent Valley Hospital at Dartford, Kent, put up £13 million to build the hospital in 1997. Within three years of it opening, they had earned profits of £37 million, according to a report by the NAO in January 2005.

Under the voluntary Refinancing Code which applies to early projects, as part of the refinancing the Trust received an immediate lump sum of £1.5 million and a reduction of £2 million to its annual contract price over the remainder of the contract as a result of sharing in the refinancing benefits and agreeing to extend the contract period.

Post-refinancing the total benefits the shareholders now expect over the life of the contract are £51 million in present value terms, an increase of 74% over what they were expecting prior to the refinancing calculated using the agreed 15% nominal discount rate.

The NAO's conclusions were generally positive:

Service

- New hospital delivered early.
- Subsequent service delivery overall has been satisfactory.

Relationships with contractor

- Now good after some initial settling in problems.

Price

- Initially in line with the contract and reduced since 2003 following the refinancing.
- Low level of payment deductions.

Dealing with change

- New Trust management have been appointed and have achieved three star status for the Trust.
- The Trust has shared in 30% of the gains.
- The contract period has been extended.
- There is the possibility of increased termination liabilities.
- An additional building programme is in progress, not all under the PFI contract.
- In managing the risks arising from future change the Trust must make effective use of contractual mechanisms to maintain value for money. (In other words it should be tougher).

10. THE SECONDARY MARKET

As PFI has matured so a liquid market has developed in the equity of PFI projects. A number of specialist funds have been set up to invest in PFI projects. With over 600 projects now signed with a capital value of £32 billion, the equity invested in PFI projects is around £3 billion. Because of the general fall in interest rates since PFI started and the lower risk of operating assets that are past their construction stage, the value of this equity has increased substantially.

Yields on projects operating without problem have now fallen to around 7%-9%. However, it is important that investors remember they are investing in operating assets; things will go wrong and it is dangerous to bid prices up so far (and therefore bid yields down) that the risk premium above gilt yields becomes too narrow.

The equity and debt in operating PFI projects are ideal investments to match the long-term liabilities of pension funds and insurance companies and a number of investment funds are being structured to attract these investors. For instance, in July 2004 the first quoted PFI investment vehicle was launched when the PFI Infrastructure Company plc was listed on the AIM market. This company aims to provide a steady 7% yield from holding PFI investments for the long term. HSBC launched HSBC Infrastructure Co. Ltd on the Stock Exchange in February 2006 to acquire a portfolio of PFI assets which HSBC had built up. It is targeting a return of 7%-8% over the long term.

As more projects reach maturity, investors are devoting increasing resources to reducing costs. For instance, insurance costs can be reduced by bundling a number of projects together and lifecycle maintenance costs are best controlled by experienced and active management.

11. OPERATIONAL ISSUES

PFI has now delivered over 500 operational projects, including:

- 185 new or refurbished health facilities;
- 230 new or refurbished schools; and
- 43 transport projects.

As more PFI projects move into their operational phases, attention will be focused on the successful long-term management of the projects. The successful players in the long run will be those who earn a reputation for providing good, long-term service to their customers. Financial engineering alone will not be enough.

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The Treasury has set up an Operations Taskforce to examine operational issues in PFI. The first topics on its agenda are:

- Benchmarking and market testing guidance. The guidance will be issued late in 2006 and is likely to emphasise market testing over benchmarking.
- Payment and performance mechanisms in operation.
- Insurance and refinancing issues.
- Contract variations.

Research from 105 operational projects commissioned by the Treasury from PUK in 2005 found that in general users of PFI projects are satisfied with the services they provide:

- 80% of projects' customers reported that service standards are delivered always or almost always.
- Public authorities report good overall performance and high levels of satisfaction against contracted levels of service. Purchasers report that the overall performance of 96% of projects is at least satisfactory and with 66% it is very good or good.
- The appropriate services are contracted for some 83% of projects' customers reported that the PFI contract always or almost always specified the services they require, with the results getting better for more recent projects.
- Effective partnerships between the public and private sector have been established. Over 70% of public sector managers believe that their relationship with their private sector partners is very good or good.

The research also indicated that the incentives within PFI contracts are working. Payment deductions have been low reflecting the generally high levels of performance. Where deductions have been applied, almost all projects subsequently report satisfactory levels of service and 72% report good or very good performance.

It is now regarded as good practice to develop a simplified contract manual that can be used by the operations personnel on both sides without recourse to the detailed contract. The manual should be agreed between both sides before operations begin.

Most PFI projects have not yet been operating sufficiently long to have reached the stage at which benchmarking or market testing of their services is carried out. However, it is widely expected that benchmarking and market testing will in due course become sources of conflict between purchasers and service providers. The private sector will be looking to recoup its cost increases while the public sector will be looking to reduce the cost of the services it receives.

Another area where problems can be expected in the future is around the cost of life-cycle maintenance. The public sector will push for earlier and more frequent refurbishment with less attention to cost. The private sector will seek to minimise its costs and thereby improve its returns. Over a 30-year contract this tension will require sensible management on both sides.

In most PFI projects the variation mechanism works effectively. Over 75% of projects have made changes to the contract, most of them small. Bigger variations are more problematic to negotiate. The Treasury is concerned that all projects should have separate mechanisms for small variations, many of which can be agreed informally, and for large variations, which will require more detailed negotiations. This distinction is now included in the standard SoPC3 contract.

Few projects have so far invoked the dispute resolution procedure which is included in all PFI contracts, including the now-standard SoPC3, so there is little experience of how it will work in practice.

Operations managers should be introduced into projects during the procurement phase to ensure they are committed to the operational aspects and to allow them to become familiar with the project. The staffing of contract management on both sides needs to be flexible over the life of the project. Additional resources will be required at key times such as early operational ramp-up, refinancings, benchmarkings or major variations.

12. ACCOUNTING ISSUES

13.1 Whose is the Asset?

Accounting for PFI is straightforward once it has been established on whose balance sheet the asset should be. However, it is not always clear whose balance sheet that is. Much depends on who bears the risks of the project. One of the attractions of the PFI to Government has been that properly structured PFI projects (and their debt funding) should be off the public sector balance sheet. The appropriate accounting treatment has been a matter of dispute between the Treasury and the ASB.

The relevant accounting standards are:

- FRS 5: Reporting the Substance of Transactions
- Amendment to FRS 5: Application Note F, PFI and Similar Contracts
- SSAP 21: Accounting for Leases and Hire Purchase Contracts

Both the Treasury and the ASB agree that the starting point is an analysis of which party bears the key risks of a project and receives any variation in benefit. Under the general principles of FRS 5, the party which bears the key risks has the asset.

For the purposes of this analysis any risks relating purely to the provision of separable services, particularly ancillary services such as catering and cleaning, are ignored. Such services are never capitalised under current accounting rules.

There is also general agreement that there should always be full disclosure of the public sector's future commitments under PFI contracts so that analysts can judge for themselves the impact of PFI on the national accounts. These commitments are shown each year in the Budget Statement (the Red Book).

i. The ASB - the Private Sector

The ASB released its Amendment to FRS 5, Application Note F, PFI and Similar Contracts, in 1998. The ASB uses the term 'property' to refer to the road, hospital, prison etc that is at the heart of the PFI contract and it reserves the term 'asset' for items recognised in the balance sheet. AN(F) sets out a two stage process:

Stage 1. Separate out the property elements of the contract from the elements which relate only to services and which operate independently of the property elements, where this is possible. Examples of service elements might be cleaning, laundry or catering. AN(F) stipulates that any elements that relate solely to services should be ignored because they are not relevant in determining which party has an asset of the property.

Once any separable service elements have been excluded, PFI contracts can be classed into:

- a) Those where the only remaining elements are payments for the property. These are in substance leases and SSAP 21 should be applied.
- b) Other contracts where the remaining elements include some services. These fall within FRS 5 and the property should be on the balance sheet of whichever party bears any variations in property profits or losses.

Stage 2. Assess who has the benefits and risks of the property. It is they who should recognise an asset on their balance sheet. This is done by assessing who bears the potential variations in property profits (not the services profits!). AN(F) sets out 3 principles for this analysis:

- a) The overall effect of the factors which determine who bears the variations in property profits.
- b) Ignore any variations in profits that relate purely to the provision of services.
- c) Give greater weight to those features that are more likely to have a commercial effect in practice.

ii. The Treasury Position – the Public Sector

The Treasury's position is set out in PFI Technical Note 1: How to Account for PFI Transactions.

It is in the separation of a PFI contract into its components that there has been most disagreement between the Treasury and the ASB. The Treasury stipulates that a PFI transaction should be considered as a whole and not broken down into separate components, unless both the following factors apply:

- The service payment is separable. The contract is structured so that elements of the service payments operate independently from each other and the cost of different elements of the service or the underlying asset can be identified; and
- The contract is separable. It is separable in substance, such that separate elements of the contract run for different periods or can be terminated or re-negotiated without affecting the continuation of other parts of the contract.

If the ASB required all operating leases to go on the lessee's balance sheet, it would be difficult for the PFI community to disagree with its proposals for PFI. Good PFI projects are very like operating leases.

The Treasury says it accepts that some PFI projects will end up on the public sector balance sheet. It claims that 57% of projects are treated as on-balance sheet, but on further analysis this figure reduces to 19% if the LUL PPP projects are excluded.

13.2 Balance Sheet Treatment

If the analysis indicates that SSAP 21 should apply, the key question is whether the lease is a finance lease or an operating lease. A finance lease is one that 'transfers substantially all the risks and rewards of ownership of an asset to the lessee' (SSAP 21, para 15). The ASB states that in the context of a lease, the principal risks are demand and residual value.

In practice most contracts falling under SSAP 21 are likely to be finance leases (since most operating leases would pass the separability test (see 13.1 i. above) and would fall to be accounted for under FRS 5).

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It is increasingly common for the private sector to account for the asset as a long term receivable from the public sector purchaser, represented by the amounts receivable under the Project Agreement. This is called the composite trader treatment (see section 14). So it is possible for a property not to appear on either side's balance sheet as a fixed asset.

13.3 Profit and Loss Account Treatment

The balance sheet treatment makes no significant net difference to the profit and loss account for the supplier and little difference to the purchaser under Resource Accounting. It will, however, alter the balance between operating income and expenses and finance income and expenses.

Under Resource Accounting, service charges for off-balance sheet contracts are debited each year to the Operating Cost Statement (the public sector term for Profit and Loss Account). For on-balance sheet contracts a depreciation charge will be debited each year. In the later years of a project the picture becomes more complicated as the fixed asset will be revalued each year to its depreciated replacement cost value, which may increase the depreciation charge. The revaluation surplus/deficit will be taken to a revaluation reserve.

13.4 International Financial Reporting Standards

The introduction of IFRS, which are now mandatory for listed companies, creates a number of problems for companies involved in PFI, which will require specialist advice, including:

- **Consolidation** – under IAS 28 Investments in Associates investors may be forced to consolidate or equity account SPCs in which they have a significant shareholding. This will result in the SPCs' debt appearing on the balance sheet of the listed parent, even though that debt is non-recourse to the parent. This dramatically changes the consolidated balance sheet ratios and may affect the group's banking covenants.
- **Valuation of fixed interest loans.** Most PFI debt is swapped into fixed interest debt. IAS 39 Financial Instruments: Recognition and Measurement requires such loans to be valued at 'fair value' using the interest rate at the balance sheet date. As rates have dropped since many projects were signed, the fair value of the loan will have increased and the additional costs will have to be written off over the life of the contract. This will introduce unnecessary volatility into company profit and loss accounts and undermine the original purpose of the swaps, which was to reduce volatility, although they still reduce cash flow volatility.
- **Intangible assets** (IAS 36 Impairment of Assets, IAS 38

Intangible Assets, IFRS 3 Business Combinations). The difference between purchase consideration and the fair value of assets acquired is split into relevant intangible assets, not simply goodwill. So more intangibles are likely to be recognised with varying useful lives. Goodwill is no longer amortised. Each intangible asset must be reviewed for impairment and all impairment losses go to the income statement, not just permanent diminutions. This is likely to result in more profit volatility.

- **Balance Sheet Treatment.** No international equivalent of AN(F) to FRS 5 yet exists to guide the balance sheet treatment of PFI and similar contracts under IFRS. Exposure drafts D12, D13 and D14 were issued in 2005 by the International Finance Reporting Interpretation Committee of the IASB covering service concessions such as PFI schemes, but these drew largely unfavourable comment from users in respect of matters such as (i) the exclusion of all projects without any residual interest and projects with pre-owned assets, (ii) the basis for recognition of property plant and equipment by reference to control rather than risk and reward, and (iii) the dividing line between treatment as intangible asset or financial asset. Revised drafts are expected to be re-issued later in 2006.

13. TAX ISSUES

In general tax has no effect on the public sector overall. The only change is in the allocation of funds between Government Departments, which end up paying for VAT or corporation tax, and the Treasury, which receives the tax payment. Consequently when comparing a PSC with its PFI alternative, it is important to ensure that any distortions due to tax are eliminated. The PFI option should not be unfairly penalised because of higher payments due to tax.

The taxation of PFI projects follows the usual rules and should not present undue problems. However, as always with tax matters, specialist advice should be obtained earlier rather than later. Key areas to watch are:

i. Capital Allowances

Normal capital allowances should be available to the SPC on any movable equipment, fixtures and fittings it purchases for its trade and which it owns, typically 30% of the capital cost. Public sector purchasers, such as NHS Trusts, may not be taxable and cannot benefit directly from claiming capital allowances. So care must be taken when drafting the contract to ensure the ownership of such equipment is clearly in the hands of the SPC.

Capital allowances should be available to the SPC whether it accounts for the property as a fixed asset or as a lease debtor. However, increasingly departments are insisting that projects adopt composite trader treatment (see below) so that capital allowances are no longer relevant.

ii. Composite Trader treatment

On the composite trader basis of accounting, the principal asset of the SPC is a long term debt from the public sector purchaser and 100% of the debtor is written off to revenue for tax purposes.

This has considerable tax benefits to the SPC which tend to be shared with the purchaser through a reduced unitary charge. To ensure this tax treatment is acceptable to HMRC, it is normal to seek a so-called COP10 confirmation from them before the unitary charge is set.

Composite trade treatment is not possible if the SPC has an "interest in land" and the project documentation must therefore be written on the basis that the SPC only has a licence to occupy the land rather than a lease.

iii. Consortium Relief

Consortium relief is often used to offset the SPC's initial corporation tax losses against the profits of its shareholder companies. Consortium relief is available where the shareholders are British companies, each owns at least 5% and between them they own 75%+ of the ordinary share capital of the SPC. Each shareholder should then be able to use such fraction of the SPC's losses as equates to its shareholding against its taxable profits.

iv. VAT

VAT will generally be chargeable by the PFI contractor on the project fees. The recoverability of this VAT by the purchaser will depend on its status and the type of service being provided.

Most Government Departments (including their Executive Agencies) are able to recover VAT on certain services designated in a Treasury Direction that is updated annually. Local authorities are subject to different rules. Generally, VAT incurred by local authorities on PFI projects that relate to the performance of their statutory duties (e.g. education or housing) is fully recoverable.

Other bodies, such as universities or charities, may commission PFI projects. Their recovery of VAT will be determined by the use to which the facility is to be put. In certain circumstances, it may be possible to take advantage of zero-rating reliefs.

v. Abortive Bid Costs

Bidders need to take steps to ensure that abortive bid costs are eligible for corporation tax relief. For instance, if the costs are incurred by an SPC and the bid is unsuccessful, the SPC will have no taxable income against which the costs can be set. Many of the bid costs will legitimately be incurred by subcontractors where tax relief should be available.

14. THE FUTURE

The PFI will never be the only way that the UK Government procures infrastructure-based services, but it is now established as a valuable option. It is likely to be used in future to deliver projects with a capital value in the range £3 billion-£5 billion each year.

The market in the UK is now well developed with an excess of funds seeking to invest in PFI projects compared to the number of new projects coming through.

Above all it is to be hoped that in future the PFI will be judged by whether it offers value for money. Value for money is its key feature.

International Developments

Overseas there is increasing acceptance of the PFI both from the private sector and from overseas governments, which are taking a close interest in it. British expertise in PFI is now being exported around the world as more and more governments around the world are considering using some form of PFI. Projects have been completed in, for example:

- Portugal – Tagus bridge
- Australia – many projects, including the Newcastle Mater Hospital PPP Project
- South Africa – Gautrain Rapid Rail Link
- Netherlands – N31 Motorway, High Speed Rail Link

Small Projects and IT Projects

In PFI: meeting the investment challenge the Treasury stopped the use of PFI for small projects (under £20 million capital value) and for IT projects.

Although PFI can ensure that small projects are delivered on time and meet client expectations, their procurement takes as long as larger projects and the costs involved are disproportionately high. So they offer less good value for money, unless the same legal and financial structure can be used again and again without much additional cost.

IT projects have been disappointing, because they have been mixed up with major changes to public sector methods of working so they can be very complicated and are shorter

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term than projects involving new buildings. Because of the continual change in technology, IT projects need to be more flexible than other comparable projects. The majority of successful IT projects renegotiated their contracts after signature to achieve ongoing flexibility.

Funding Developments

i. Credit Guarantee Finance

The Treasury is experimenting with a number of pilot projects to test a new method of raising the senior debt for PFI projects, which it calls credit guarantee finance. The Treasury is seeking to separate funding from risk taking and is looking for guarantors who are rated A+ or higher.

Under this approach bidding consortia will include financial partners who will guarantee to pay the debt principal and interest. At contract completion, the Government will lend to the SPC the sums needed to provide the senior debt portion of the overall financing package. The loans will be protected by the guarantee from the credit provider.

Two pilots have been selected so far:

- Leeds Hospital. Financial close achieved and debt syndicated.
- Portsmouth Hospital. £225 million site reconfiguration. Financial close December 2005.

£220 million Leeds Hospital – first project with Credit Guarantee Finance

In October 2004 the contract to redevelop St James University Hospital and Leeds General Infirmary was closed. Part of the contract is the construction of a new oncology wing providing 300 inpatient beds and it is one of the first to require the contractor to maintain complex technical equipment.

The contract runs for 30 years. Equity was provided by Bovis Lend Lease and HBOS. Bank of Scotland also acted as principal debt guarantors. This was the first contract completed using the Credit Guarantee Finance scheme.

It is not yet clear whether this approach offers value for money. The extra costs of legal work together with the guarantee fee largely offset the interest rate saving. The benefit seems to relate to the spread between gilts and the cost of interest rate swaps: if the swap rate is close to the rate on gilts, the benefit will be less. The Treasury admits that most of the cost savings it has identified on the first two projects have come from Portsmouth hospital, the project

using bond finance. Another approach might be for the Government to provide the senior debt itself without a guarantee, leaving the private sector to provide the risk capital and manage those risks that it can manage better. The cost of debt could then be reduced to gilt rates. However, this would result in the debt being on the public sector balance sheet.

The US Department of Transportation has the legal powers to allow it to guarantee loans to part finance infrastructure projects. The British Government adopted a similar approach with the Channel Tunnel Rail Link (CTRL). In both cases the risk of the loan being called is said to be low so that there is no immediate impact on the national accounts.

ii. Funding Competitions

The Treasury has issued draft guidance on the introduction of funding competitions to provide senior debt after the selection of the preferred bidder. The preferred bidder would be selected without a debt provider in the consortium and a competition would then be run to find the cheapest debt finance for the project.

The approach is anathema to banks as it emphasises that debt is a commodity. Bidding consortia would also prefer to have banking partners alongside them during the bid process so that their requirements and ideas can be built into the bid.

iii. NPDO (non-profit distributing organisation)

NPDOs represent an attempt to make PFI more acceptable to some local authority clients in that profits are reinvested or paid out to charity. Under the NPDO structure there is no shareholder equity and the project is 100% funded by debt and subordinated debt. Shareholders' returns can only be improved by repaying subordinated debt early.

Argyll & Bute Schools NPDO

The first NPDO scheme closed in Sept 2005. It was awarded to a consortium of the PFI Infrastructure Co. plc and Royal Bank of Scotland and involved a bundle of schools for Argyll and Bute Council. The project has a capital value of £87 million and lasts for 30 years. Any profits are recycled to a charity to promote educational facilities in Argyll and Bute.

One of the side benefits of the NPDO structure is that there are Council representatives on the SPC Board. This has enabled them to be fully involved in the workings of the project and improves communication between the two sides.

Forward Thinking

i. Government Shareholdings

Where Government facilitates a project, in particular by providing a subsidy, it should consider taking a shareholding in the project or at least an option to acquire a shareholding. An example would be a light rail scheme which was not viable without a public subsidy. The Government adopted this technique in refinancing CTRL.

Bidders could be asked to bid with and without giving the Government a shareholding, so that the cost of the shareholding could be ascertained (it might not be good value for money).

ii. On Balance Sheet Projects

If the Government accepted that a project was going to be on its balance sheet, it could concentrate on obtaining value for money. There would be no pressure to bundle other services into the PFI contract because it would no longer have to ensure

that enough risk had been transferred to make the project off balance sheet. The downside is that the debt would have to be taken into account in calculating the UK's debt ratios.

iii. Full Service PFI

At present the Government limits the services included within hospital and schools PFI projects for political reasons. It would be better value for money to put a whole hospital (including clinical services) or a whole school (including teaching) out to PFI.

The service could still be free to the consumer at the point of delivery. GPs are already self-employed. There is no reason why hospital doctors have to be employed directly by the NHS.

When the author of this Guideline made this suggestion in 1998 it was completely off the political agenda. Today it is centre-stage. The marketplace continues to evolve and PFI will evolve to meet its demands.

Abbreviations and definitions

AN(F): Application Note F to FRS 5, which deals with PFI and Similar Contracts

ASB: Accounting Standards Board

BSF: Building Schools for the Future, a major PPP programme to renew secondary schools in England

DBFO: Design, build, finance & operate. The Highways Agency term for PFI

DCMF: Design, construct, manage & finance. The Prison Service term for PFI

FM: Facilities management, the provision and management of building and other services such as security and cleaning

IFRS: International Financial Reporting Standards

ITP or ITN: Invitation to Participate (or Negotiate), the information provided by a purchaser to bidders on the basis of which they prepare their bids

LIFT: Local Improvement Finance Trust, a PPP covering GP surgeries and community care services

LUL: London Underground Ltd

NAO: National Audit Office, the body responsible to Parliament for most public sector audits

OGC: Office of Government Commerce, the Government's buying agency

OJEU or OJEC: Official Journal of the European Union, the publication in which all PFI projects of any size have to be advertised

PFI: The Private Finance Initiative

PRG: The Project Review Group of public sector PFI experts tasked with scrutinising and approving local authority projects

PPP: Public Private Partnership, a generic but ill-defined term encompassing a range of transactions in which the public sector contracts with the private sector to provide services, of which the PFI is the main category

4Ps: Public Private Partnerships Programme, the body promoting PFI within the local authority sector

PSC: Public sector comparator, a conventionally procured alternative to the PFI contract

PUK: Partnerships UK, a PPP which provides guidance to public sector bodies undertaking PFI projects

Purchaser: The entity (usually a public sector body) that procures services under a PFI contract

SoPC3: Standardisation of PFI Contracts Version 3, the standard PFI legal contract produced by HM Treasury in April 2004

SPC/SPV: A Special Purpose Company (or 'Vehicle') set up by a bidding consortium to contract with a purchaser to supply services under a PFI contract

Supplier: The entity (usually a private sector SPC) that provides services to a purchaser under a PFI contract

VfM: Value for Money, where a project is good value to the public sector

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BIBLIOGRAPHY AND USEFUL LINKS

The best place to start is:

The PFI Policy Unit

HM Treasury

1 Horse Guards Road

London SW1A 2HQ

Tel +44 (0) 20 7270 4558

[www.hm-](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/)

[treasury.gov.uk/documents/public_private_partnerships/](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/)

See in particular the Treasury report issued in March 2006:

PFI: Strengthening Long Term Partnerships from which some of the statistics in this Guideline are taken.

Treasury publications include:

- Standardisation of PFI Contracts (SoPC) Version 3 (April 2004)
- Value for Money Assessment Guidance (August 2004)
- Appraisal and Evaluation in Central Government ('the Green Book') January 2003
- Technical Note 1: How to Account for PFI Transactions
- Technical Note 3: How to Appoint and Manage Advisers to PFI Projects
- Technical Note 4: How to Appoint and Work with a Preferred Bidder
- Technical Note 6: How to Manage the Delivery of Long Term PFI Contracts
- Technical Note 7: How to Achieve Design Quality in PFI Projects

Accounting Standards Board

- Application Note F to FRS 5: Private Finance Initiative and Similar Contracts (September 1998)
- UITF abstract 34: Pre-contract costs (Issued May 2002)

Construction Industry Council

- Constructors key guide to PFI 1998
- Financing infrastructure projects (Tony Merna & Cyrus Njiru) 2002

Specialist subscription journals on PFI and related issues are:

- PFI Journal, published by PSCA International, Newcastle-under-Lyme (01782 620088)
- PPP in Depth, published by City & Financial Publishing
- PPP Bulletin, published by Rockcliffe Publishing

Department for Communities and Local Government
www.communities.gov.uk/

Office of Government Commerce
www.ogc.gov.uk

Competitive Dialogue Procedure guidance is at
www.ogc.gov.uk/documents/competitive_dialogue.pdf

Partnerships UK www.partnershipsuk.org.uk/

4Ps, (0207 808 1470), produce a range of guidance for the local authority sector www.4ps.co.uk
Map of the PFI Process may be found at
www.4ps.co.uk/Documents/DocStore/A%20Map%20of%20the%20PFI%20Process.pdf

National Audit Office, London

See its recommendations database
www.nao.org.uk/Recommendation/

and its publications

www.nao.org.uk/publications/nao_reports/chronindex.asp?type=vfm

Recent reports cover:

- Dartford & Gravesham Hospital (HC209) 2005
- Extension of the DWP Accommodation Services PRIME contract (HC 181) 2005

PPP Forum www.pppforum.com/links.html

The trade body for the private sector involved in PFI and PPP

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