

PREFERRED BIDDER DEBT FUNDING COMPETITIONS

Draft outline guidance for feedback

The purpose of this outline guidance is to introduce best practice in running privately led but publicly overseen Debt Funding Competitions after the selection of a Preferred Bidder for PFI projects. We refer to this process throughout this guidance as PBDFC.

The effective implementation of PBDFC is now being evaluated on pilot projects supported by Departmental PFUs. It is planned to develop and issue detailed guidance informed by experiences on these projects and from feedback from the stakeholders in this process (procuring Authorities, Departmental Private Finance Unit (PFUs) and PFI practitioners) on their experiences in applying this guidance. Until the detailed guidance is issued, Authorities should treat this draft outline guidance as best practice. Detailed guidance will also be subject to a feedback process in due course.

This guidance replaces the guidance dated 31st July 2002 “OGC Guidance on certain financing issues in PFI contracts – ensuring competition in the financing of contracts”.

HM Treasury

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Summary of acronyms

CDP	Competitive Dialogue Procedure
IPD	Invitation to Partake in Dialogue
IRR	Internal Rate of Return
ITN	Invitation to Negotiate
PBDFC	Preferred Bidder Debt Funding Competition
PFU	Private Finance Unit

1. Background

The Government has set out its policy on PBDFCs in the policy document “PFI: strengthening long-term partnerships”. The document confirms that the Government is committed to securing the benefits of private finance through open and transparent competition.

PBDFCs serve the purpose of providing a well defined process to ensure that the selection criteria applied to the choice of debt providers¹ are adequately developed, rigorous and based on a level of detail sufficient for the lenders to make an unambiguous commitment to lend.

It is not disputed that the private sector is already incentivised by the PFI procurement process to obtain competitive finance and at the time of issuing this guidance the terms and conditions upon which finance is being offered are evidence that bidders are securing competitive debt terms. Authorities will also recognise that the price of risk included in private finance debt, i.e. the net cost of private debt over conventionally funded procurement financed through gilts is a small component of the overall cost of the project, generally lower than 5 percent. Therefore it is important for Authorities to continue to focus their value for money considerations on defining their requirements and working with bidders to optimise value from the required level of design, construction, operation and maintenance responsibilities during the early stages of procurement rather than unduly weight consideration of the structure and terms of senior debt finance.

The Government recognises that in some circumstances the cost impact of running a PBDFC may outweigh the benefits (for example in procurement time and loss of innovation). Authorities should consult their departmental PFU as to whether a PBDFC is likely to be beneficial and how lenders should be involved in support of a bid. Local Government can also seek guidance from 4ps. Section 8 sets out certain factors that may influence an Authority’s decision.

The intention of this guidance is that running a PBDFC should be the default option for an Authority. However, should an Authority select not to do so and instead require bidders to submit underwritten bids to comply with the Competitive Dialogue Procedure (CDP) or firmly committed finance to comply with the Negotiated Procedure then a subsequent funding competition should not be run after the selection of a Preferred Bidder (PB).

2. Synopsis

Senior debt finance will in future be subject to competitive selection open to the oversight of the Authority on the following basis:

- a PBDFC will take place in every instance above an interim threshold of £50m;
- an Authority will state its requirements in the Invitation to Bid/Invitation to Partake in Dialogue;
- a PBDFC will be run by the PB with Authority oversight sufficient to ensure that the objectives in Section 4 are satisfied;

¹ The terms debt providers, lenders and senior debt are used interchangeably in this document to refer to private sector finance either from the bank or bond markets.

- a PBDfC should meet the requirements set out in Section 9;
- projects with a capital value over £500m (large projects) should in all circumstances undertake a PBDfC;
- an Authority, in consultation with its departmental PFU, may decide not to run a PBDfC if it believes that the costs will outweigh the benefits.

3. Summary changes

Existing Guidance	New Guidance
PBDfC are an option for the procuring Authority	PBDfC will be the default option above a threshold (subject to the exception in 2 above)
Running a PBDfC after the selection of a PB has often been a supplementary step	Additionality removed
PBDfCs were discouraged on large or complex projects	PBDfCs will take place for all large projects
Financial benefit and risk shared between Authority and Contractor	Financial benefit and risk generally lies with the Authority
The policy imperative was to drive more competitive terms	The policy imperative is full transparency
There was only limited Authority oversight of financing	There will be more open access and oversight by the Authority of the funding process

4. Objectives of Preferred Bidder Debt Funding Competitions

The objectives of the Government's approach are to:

- make the terms of debt finance and the process of securing debt finance transparent and open to Authority scrutiny;
- avoid unnecessary duplication of effort by the finance community for those projects that do not require early lender support in order to quantify the terms under which debt finance may be made available;
- capture best value in the terms of finance - whilst recognising that lowest cost is not the sole determinant of value and that the profit element in senior debt finance is a small component of the overall cost of the service; and
- ensure that lenders to PFI projects are selected using open competition with appropriate selection criteria and also that the principles of best practice are shared between projects through Authority oversight and guidance.

5. How will the process work?

5.1 *Competitive Dialogue Procedure*

The process envisaged by the Authority should be cognisant of the CDP. This outline guidance does not attempt to provide definitive guidance on CDP and Authorities should satisfy themselves that nothing in their proposals for PBDfC would conflict with the requirements of CDP.

Under CDP the Authority may “request the participant identified as having submitted the most economically advantageous tender (the Preferred Bidder) to clarify aspects of the tender or confirm commitments contained in the tender, provided that this does not have the effect of modifying substantial aspects of the tender or of the call for tender and does not risk distorting competition or causing discrimination”² The introduction of CDP is therefore likely to severely curtail the possibility for post-PB negotiations. Consequently in order to avoid duplicating fully committed finance and extensive due diligence procedures for every bid, the Authority should consider the benefits of PBDfC and for those projects that match the criteria in Section 5.3, reduce the evaluation of finance for the PB selection stage to a binary pass/fail test.

5.2 *Bidder’s responsibilities*

Irrespective of whether a PBDfC is to be run, it is for the bidder and its financial advisor to submit (in accordance with current practice) a detailed financial model complete with assumptions as to tax, accounting and financial structuring for its bid, including a summary term sheet with margins and terms upon which senior debt will be made available in accordance with Section 5.3. The Authority may apply standard financial terms and pricing in accordance with 5.3.1.

5.3 *Applying standard terms*

Before the ITN is issued the Authority must decide whether:

- 5.3.1 It wishes to apply standard financial terms and pricing to each bid; or
- 5.3.2 The bidder will be given the freedom to predict the terms upon which it believes finance can be made available for its bid.

The Authority will be guided by its financial advisor on these matters but it may be appropriate to apply standard financial terms for projects where:

- analogous projects in the same sector have already been successfully delivered by a range of bidders;
- the likelihood of procuring senior debt finance is not in question;
- the project is not novel, complex, large or likely to involve non-traditional funding sources;

² Paragraph 28 of Regulation 18 of the new Public Contracts Regulations 2006.

- experience on successive projects has shown that the terms of senior debt finance are reasonably predictable and therefore the Authority's advisors should be able to anticipate the terms and margins of senior debt; and
- Innovation in financial structuring is unlikely. (However, standard terms should not prevent new ideas being proposed by a bidder and its financial advisor or introduced by a lender as part of the PBDfC process).

5.4 *Lender support for large, complex or novel bids*

If the project is either novel, large or complex it is likely that financial structuring will play a more important part in evaluation. Innovation may be possible, allied to which the Authority may want additional assurance that finance will be available for a bidder's proposals. In this case, Authorities should consider specifying that bids should be accompanied by support from one or more lenders. To encourage lenders to undertake the necessary due diligence and demonstrate the level of additional commitment required for such projects under CDP, it may be necessary to offer lender(s) a "right-to-match" a percentage of the total funding, at the winning terms of a PBDfC. This option should be commensurate with the size of the lenders commitment and the extent of the work undertaken. We would not envisage a "right to match" extending beyond 50 percent of the loan size. Authorities should be guided by their departmental PFUs and advisors. The CDP requires that all such arrangements be fully described in the early bid documentation.

6. Options available to the bidder

6.1 *When might bidders wish to secure early lender support?*

There may be reasons associated with a bidder's financial standing or its proposed financial or contractual structure that mean that the bidder perceives it could be disadvantaged if the Authority chooses to proceed as in Section 5.3.1. If this is the case the bidder may decide, for reasons specific to its bid, to submit a variant bid with the support of its finance providers.

This route should be an exception for bidders and not a default solution to every financing uncertainty. Before selecting this course of action a bidder should discuss its intent with the Authority. If the Authority does not subsequently ratify the terms of the competitive process for selecting lenders any right-to-match given by the bidder to the lenders will be forfeited if the Authority selects the variant.

6.2 *Bidder flexibility*

Bidders may decide to run a competitive process for the selection of lenders prior to ITN/IPD bid submission in order to produce a variant bid with:

- 6.2.1 the financing sources (for bank and/or bond) selected and with indicative but uncommitted funding terms supported by letters of support and term sheets. The lenders in this bid accept that they may be subject to further competition if they achieve selection as the PB and the Authority exercises its requirement to run a PBDfC. In this circumstance it should not be assumed by the lenders that they would be given an automatic right-to-match; or

- 6.2.2 with selected lenders willing to offer agreed terms and cap elements of the debt terms including maximum risk margin and fees. Under this route the variant bid will be evaluated on the capped financing terms. The subsequent PBDFC could offer the lenders a “right-to-match” up to 50% of the senior debt being raised.

In either circumstance above, if the bidder can provide sufficient evidence that competition has been held in a manner consistent with Section 9 of this guidance and the Authority’s financial advisor believes that the terms secured are in line with current market expectations and would not be improved by further competition then an Authority may decide a PBDFC will not improve value for money and consequently is not necessary.

7. Evaluation

The extent of lender support in Section 6.2 may re-assure the Authority as regards particular financing aspects of a bid but variant bids submitted in this way should not otherwise score more highly in evaluation.

In either case in Section 6.2, the bidders will specify the return that they require for the risk capital they propose to contribute either by way of common equity or shareholder loans. Those returns will be isolated from the PBDFC process (i.e. the equity IRR is fixed). The Authority takes the risk that finance cannot be procured on the terms and cost assumed in the bid. Any difference between the assumed rate of finance for the bid and the actual rate achieved from the PBDFC will be solely for the account of the Authority.

7.1 Optimism bias

If the Authority and its advisors allow the bidders the freedom to predict the terms upon which finance will be made available to their bids (as in Section 5.3.2), it would be reasonable for the Authority to normalise what they consider as aggressive terms for the purposes of evaluation.

8. Factors that may affect the Authority’s decision to run a PBDFC

In deciding to run a PBDFC the Authority should consider the following factors:

8.1 *Reducing bidding costs and saving time before selecting a Preferred Bidder remains a priority.*

It is possible that anything up to 6 bidders may be running competitions for the provision of finance. This is inefficient, as each bidder will seek exclusivity with lenders supporting its bid, thereby naturally limiting full and efficient competition. Furthermore the indirect opportunity cost of lenders’ PFI teams being tied-up allied to due diligence being repeated is not good VfM nor the best utilisation of the lending supply chain.

8.2 *Deliverability is no longer an issue for traditional PFI.*

It is now very likely that senior debt will be available for conventional PFI and subsequently deliverability has limited significance in the evaluation criteria.

8.3 *It remains important that the Authority is confident that finance will be available on the terms and conditions envisaged.*

Whilst lenders' support is not committed and may be only subject to very limited desk-top due diligence at ITN, certain elements of a bid will need more scrutiny by the Authority and its advisors if lenders have not been engaged prior to the selection of PB.

Bidders have varying credit standing with lenders. In some contractual structures the protections and contingencies for contractor failure may not always be deemed sufficient by lenders. Equally, the risk apportionment as between sponsors and sub-contractors, or between construction contractors and FM providers may not be attractive to the widest cross section of bidders. Authorities should however be re-assured where the bidders can demonstrate experience of successfully raising finance on similar terms in the same sector in the recent past.

8.4 *Experience has shown that the mature market in funding conventional PFI projects has largely settled with little sign of continuing innovation.*

In these circumstances, undertaking a PBDFC after the selection of PB should reduce pre-selection bidding costs for participants and shorten the timetable to the selection of PB. Allied to which, there is very little evidence in conventional PFI selection criteria that funding structures or lending margins have been significant factors in the selection of a PB. The more compelling evidence is that, in the majority of cases for conventional PFI, the selection of senior debt providers has become very price sensitive. PFI standardisation appears to have reduced the capacity for lenders to differentiate themselves as between the terms upon which finance would be made available. Innovation by the lenders in financial structuring is still possible as part of the PBDFC.

8.5 *The financing markets are dynamic*

Constant movements in the financing markets have the capacity to affect the terms upon which PFI lenders will make funds available. Consequently it becomes difficult for Authorities to rely upon assumptions or undertakings made some months previously. A long period between the selection of the financing terms and financial close exacerbates the potential for change and capacity for disagreement between the parties.

8.6 *Projects with lower capital values require additional consideration*

Below £50m the Authority should satisfy itself before pursuing a PBDFC that the benefits of transparency are not outweighed by the cost of the PBDFC either in cost or financial terms.

Equally, below £100m projects may not attract the widest cross section of lenders if the Authority's chosen route envisages granting a right-to-match to an incumbent lender for a variant bid as described in 6.2.2.

8.7 *When can the project be rated?*

Financial structures that envisage all or part of the senior debt being sourced from the debt capital markets and guaranteed by a Monoline insurer require that the underlying project meets a minimum rating threshold ascribed by a Rating Agency. Whether the PBDFC can take place before the rating, or alternatively whether the two processes take place

simultaneously and if not, the chronology of the events is an important determination as to when a PBDFC should be run.

9. Running a Debt Funding Competition

9.1 *Preparation*

Prior to the commencement of a PBDFC (and as early as possible post-selection of the PB), the Authority and the PB should meet to agree and document the following aspects of the proposed process:

- the PBDFC timetable;
- the identity of the financial institutions (or “potential funders”) that the PB will invite to participate in the PBDFC;
- the content and format of the information that the PB will provide the potential funders;
- the elements of the required funding package that will be subject to the competition;
- the format and content of the responses that will be sought from the potential funders;
- the framework that will be used to evaluate the bids received; and
- to the extent not already agreed, the PB’s costs of running the PBDFC.

The Authority should seek appropriate advice from its Departmental PFU and also its financial and legal advisers at this early stage (and all future stages) in the PBDFC process.

9.2 *Timetable*

CDP requires that *all significant* commercial issues are finalised pre Final Tender. Therefore, in order to ensure that potential funders are able to return robust and deliverable bids, the Authority should seek to have finalised as many of the key commercial terms of the project as possible before selecting the PB and commencing the running of the PBDFC. This should include completion of as much of the Project Agreement drafting as is feasible. Key terms of other significant project documentation including any subcontracting arrangements should also have been agreed before selection of the PB.

Notwithstanding this, consideration must be given to the overall timetable to financial close that will have been agreed between the Authority and the PB. Where possible, the PBDFC process should be integrated into this project timetable without causing any undue delay to the anticipated financial close date. In this regard an Authority and its advisors should consider what elements of the information could be collated or produced prior to, or in parallel with, the announcement of PB such that a delay is not otherwise caused by the sequential timing of the PBDFC process.

9.3 *Potential Funders*

The nature and identity of the proposed funders will depend upon the anticipated financing solution(s) that might be appropriate for the specific project. Giving due regard to these anticipated financing solutions, the Authority and the PB should seek to agree a long-list of potential funders that might be interested in participating in the PBDFC.

Depending on the number of potential funders on this long-list, it may be appropriate to ensure that the PBDFC process incorporates a short-listing procedure. This should seek to identify approximately 4 to 6 potential funders (or groups of potential funders) where each is expected to bid on the basis of a fully underwritten offer for the total finance requirement (or in the case of a major project an agreed defined portion of the total finance requirement).

9.4 *The Information Package*

The information package that will be provided to potential funders is likely to include an Information Memorandum ("IM"), a summary of all relevant project documents, the Base Case financial model and any due diligence reports that may have been prepared on behalf of the ultimate funders.

The IM is likely to include:

- an overview of the project;
- a description of the proposed corporate structure and organisation that will be implemented by the PB to deliver the project;
- the Project Agreement or a summary of the key terms;
- a description of any subcontracting parties including information on their relevant experience of delivering similar projects;
- a description of the project requirements and the PB's proposed solution;
- a summary risk analysis;
- a description of the anticipated project costs and the financing plan as currently envisaged;
- a term sheet to be marked up by funders in the competition, and
- financial analysis, including a summary of the Base Case financial model and relevant sensitivity analyses.

In order that potential funders can prepare their bids in the light of some independent analysis of the project's risks, the PB should appoint appropriate legal and technical advisers to act on behalf of the prospective funders. It is suggested that a preliminary due diligence report from each of these advisers is provided within the information package. When the preferred funder is appointed, these advisors can be retained in order to finalise any remaining funder due diligence issues.

It may be appropriate that in addition to the provision of an information package, the PB will arrange for a presentation (or series of presentations) to be made to the potential funders. Authority representation may be required at these presentations.

Although production of the information package (and any proposed presentation material) should be the responsibility of the PB, the Authority and its advisers should have the right to review and comment on its contents prior to approving its release to potential funders. The Authority is to receive a copy of all information at the time it is provided to potential funders.

Both the Authority and the PB are likely to require all potential funders to enter into appropriate confidentiality undertakings prior to receiving the information package (or attending a presentation).

9.5 *What is being competed?*

The Authority and the PB need to consider in detail which roles and which elements of the anticipated financing solution(s) should be competed as part of the PBDfC process. It should be the Authority's objective to identify the key drivers of potential economic benefit of each possible financing solution, and, where possible, ensure that the PB establishes competition amongst each of these drivers.

For a typical financing solution, this might include:

- capital structure (i.e. gearing levels and cover ratio requirements)
- risk margins and other associated fees;
- reserve requirements;
- repayment structures; and
- hedging requirements³.

It is likely that the PB will wish to compete (via the PBDfC process) other elements of the financing solution that may have no direct impact on the Authority. Such elements might include conditions in respect of shareholder distributions, borrower default and support obligations in respect of the subcontracting arrangements. If this is the case, care must be taken to ensure that the evaluation framework addresses these issues in a manner that acknowledges any legitimate concerns of a bidder (eg support obligations) but does not detract from the principal objective of securing the best value financing solution.

9.6 *Responses*

Potential funders should be given clear guidance on the content and format of the responses that are required. Response requirements are likely to include:

- a term sheet (and any other supporting documentation) fully describing their proposed financing structure and their detailed terms and conditions of the offer;
- a letter of support confirming their ability to meet the project's timetable, outlining the resources they will commit to finalising the transaction, confirming their acceptance of the appointed due diligence advisers and describing the level of credit support that has been achieved; and
- a comprehensive commentary of any issues raised by their review of the project documentation (and preliminary due diligence reports) that they believe are a cause for concern in context of their bid.

Notwithstanding the above response requirements, flexibility should be allowed for in the content and format of responses, in order to encourage potential funders to submit proposals based upon any financing solution that they believe to be economically attractive to the Authority and PB.

³ Separate guidance has been issued on interest rate and inflation rate risks in PFI contracts. Within the context of a PBDfC, competition should be used to achieve the best overall outcome from hedging e.g. in terms of choice of hedging instrument, pricing, and execution

9.7 *Communication with Potential Funders*

The Authority should retain the right to attend any meetings that the PB and/or its advisers intend to have with the potential funders during the PBDFC process. If the Authority opts not to attend such meetings it may require the PB to provide it promptly with minutes of any such meeting.

The Authority may also wish to be copied with any other related correspondence that the PB has with the potential funders during the bidding phase of the competition. This may include clarifications (and any associated responses) asked of or by the potential funders.

9.8 *Receipt of Bids*

The Authority and its advisers should be provided with a timely copy of the bids received by the PB.

9.9 *Evaluation and Selection*

The evaluation framework that has been agreed between the Authority and the PB is likely to allow for both a quantitative and qualitative evaluation of the bids received.

The quantitative element will require an analysis of the impact on the anticipated NPV cost (and any other relevant financial measures) of the project to the Authority under the terms of the various bids. This analysis is likely to be undertaken using the PB's financial model.

The qualitative element will seek to assess the deliverability of the bid and its impact (if any) on the commercial terms that have already been agreed between the Authority and the PB.

The PB and its advisers will be responsible for evaluating the bids received and recommending the preferred funder(s) (and if relevant the preferred funding solution). This may take the form of an evaluation report to be submitted to the Authority.

The Authority should review the recommendation of the PB and ratify this recommendation. If there is disagreement on the proposed selection, then the Authority and the PB should meet to resolve such differences in opinion as early as possible. The final decision on selection rests with the Authority.

The model with the winning funding terms should be reviewed by the Authority's advisors to ensure that the benefit from the competition is retained by the Authority.