

HOUSING CORPORATION

GOOD PRACTICE GUIDE

Good Practice Guide for Housing PFI

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FOREWORD

In 'Sustainable Communities: Homes for All' (ODPM January 2005) the Deputy Prime Minister confirmed once again that the Private Finance Initiative (PFI) is a key option for local authorities, and their tenants, to attract additional resources to help meet the Decent Homes target. Indeed Government allocated a further £1.22 billion to the housing PFI programme as part of the Spending Review 2004 to deliver decent homes and additional social rented housing. The PFI also has an important role to play in estate renewal. In this context the PFI represents both a business opportunity for housing associations as well as an opportunity to contribute to the delivery of high quality homes in the areas in which they operate.

However with opportunity comes risk. This is one of the reasons why I believe it is right for the Corporation to publish a guide that sets out what the PFI is and outlines the various stages, processes and risks involved. We have sought to identify the key risks rather than every risk that may be faced in each transaction, these will vary on a case by case basis. We also emphasise the importance of a robust risk management framework and governance structure being applied to PFI procurement. Whilst this is equally valid for all aspects of an association's business, the PFI will for many be a new business stream and may involve significant risk particularly given its long-term nature.

Thanks go to PricewaterhouseCoopers for producing this guide and their partners in this project, Pinsent Curtis, Harvest Housing Group and Hunter & Partners.

Jon Rouse
Chief Executive
Housing Corporation
February 2005

STRUCTURE OF THIS GUIDE

THIS GUIDE IS PRESENTED IN TWO PARTS.

PART A

sets out the background to the Private Finance Initiative (PFI) and its application to social housing projects. It identifies the roles that housing associations (associations) typically play in housing PFI deals, the issues and risks that they need to consider and provides guidance on how associations should manage their involvement in PFI schemes.

It also describes the regulatory role of the Housing Corporation (the Corporation).

PART B

takes the reader through the PFI procurement process highlighting, with the help of checklists, the main issues an association should consider in bidding for and delivering a PFI contract.

PART A

This part of the Guide sets out the background to the Private Finance Initiative (PFI) and its application to social housing projects. It identifies the roles that associations typically play in housing PFI deals and the issues and risks that they need to consider. It provides guidance on how associations should manage their involvement in PFI schemes and describes the regulatory role of the Corporation.

01 HOUSING PFI: BACKGROUND AND CONTEXT

02 PROCURING AND DELIVERING HOUSING PFI

03 ROLES, RESPONSIBILITIES AND RISKS

04 FINANCING AND GOVERNANCE

01 HOUSING PFI: BACKGROUND AND CONTEXT

1.1 GOVERNMENT POLICY AND THE DEVELOPMENT OF PFI

The Private Finance Initiative (PFI) was introduced in the UK in the early 1990s and has been used to deliver projects across sectors as diverse as roads, street lighting, schools and hospitals. PFI was first applied to public housing in 1999, when it was used for the provision of heating services to existing stock in Manchester.

In Sustainable Communities: Homes for All (ODPM January 2005) it states that:

Local authorities and their tenants have three options for attracting additional resources to help them meet the Decent Homes target:

- **Transferring homes to a non-profit making housing association, which can borrow money from banks and building societies outside public expenditure constraints.**
- **The Private Finance Initiative (PFI) which enables Government to provide financial support for partnerships between the public and private sectors.**

Although the local authority still owns the homes, in most cases the private sector manages them.

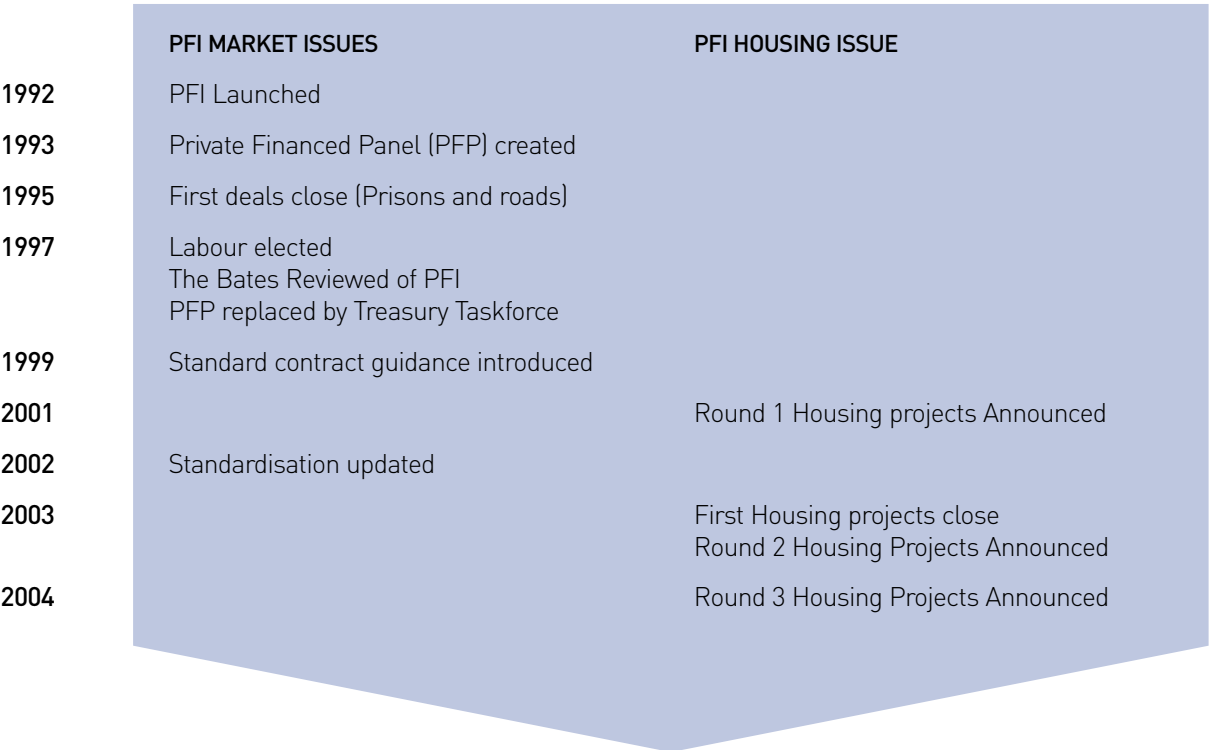
- **Creating an arms length management organisation (ALMO). An ALMO is a company owned by the local authority to manage its homes and make them decent. The local authority still owns the homes, but is free to focus on planning for the housing needs of the community.**

www.odpm.gov.uk

Delivering housing investment through the PFI therefore remains one of the three primary tools available to local authorities for delivering investment in existing stock. Three Housing Revenue Account (HRA) PFI deals have been signed at September 2004 and, in each case, the PFI project is being used to assist in the delivery of the Government’s housing objective of bringing social housing up to the Decent Home Standard by 2010.

The Government supports the cost of local authority PFI projects through the provision of PFI credits. PFI credits supplement an authority’s revenue resources and

DIAGRAM 1 PFI MILESTONES SINCE 1992



are used to help meet an authority's payment obligations under a PFI contract. The overall level of credits available is determined by the tri-annual Comprehensive Spending Review (CSR). PFI credits are available for schemes that are being sponsored by a specific Government department and which have been approved through the Inter-departmental Project Review Group (PRG). The sponsoring Government department for housing PFI is the Office of the Deputy Prime Minister (ODPM).

The then Department of Transport Local Government and the Regions (now ODPM) first invited expressions of interest (EoIs) from local housing authorities for the refurbishment of existing Housing Revenue Account housing stock through PFI and eight Pathfinder schemes were announced in 1999. The second round of schemes was launched in 2001–02. To date, over £1bn of Government funding has been identified for housing PFI schemes. The development of PFI over the last ten years is mapped out in Diagram 1.

Given the prominent role that associations have in the provision and management of social housing they have, by definition, a pivotal role to play in the delivery of housing PFI projects. PFI is a radically different form of provision and procurement which is likely to be new to associations and their management teams and therefore needs to be carefully considered and evaluated at every stage. Accordingly, this guide seeks to:

- help associations understand the key features of the PFI procurement process;
- encourage associations to consider whether or not they should participate in PFI projects through a better understanding of the roles they might play and the risks they might bear; and
- provide guidance to association boards so as to assist them in ensuring that management and delivery of projects is subjected to an appropriate governance and risk management regime. For the purposes of this document, the terminology used to describe any party bidding to deliver a PFI project, including associations, is the “private sector”.

Prior to the introduction of PFI, the standard procurement approach of Government was for the public sector to determine and manage the delivery of public sector assets, whether schools, roads or housing. Under PFI, whilst the public sector continues to define its requirements, the private sector designs, builds, finances and operates (DBFO) the asset. The emphasis of PFI is not on the

acquisition of the asset but the provision of a stream of services or procurement of a serviced asset. The private sector receives a payment for delivering these services or serviced assets.

In summary, a PFI project contains a number of distinct features:

- 1 the public sector states its requirements in the form of **outputs** rather than defining **inputs**. This incentivises the private sector to focus on ‘what’ it needs to deliver, not ‘how’ it should be done. This should encourage innovation and efficiencies;
- 2 it is a long-term contract – 25 to 30 years is typical. This removes the focus away from upfront capital costs to ‘whole life’ costing models;
- 3 some of the **risks** associated with ownership are transferred to the private sector for the life of the contract (design, build or refurbish, repair and maintenance) in accordance with the principle that risk should reside with the party best able to manage and price it;
- 4 sufficient risk must be transferred to the private sector for the transaction to be defined as “**off balance sheet**” for Government accounting purposes;
- 5 the public sector typically retains demand risk (usage risk) and residual value risk (the assets revert to the public sector at the end of the contract). In the case of Non-HRA PFI projects the assets remain with the operator; and
- 6 the public sector pays for the services it is receiving by means of a single **unitary charge** and the actual payment made varies in accordance with the levels of performance achieved by the private sector.

1.2 THE ROLE OF THE HOUSING CORPORATION

In its role as regulator of associations, the Corporation seeks to be proportionate, consistent and transparent. It uses an assessment of risk to determine the level of its regulatory engagement with associations. The Corporation’s regulatory role is set out in the Regulatory Code, a copy of which is available from its website at www.housingcorp.gov.uk The Code is focused on the three fundamental areas of:

- viability;
- governance; and

- management.

Inspection of associations is used to assess the standard of service delivery to tenants. This is carried out on the Corporation's behalf by the Audit Commission.

The Corporation's approach to specific PFI transactions is informed by their regulatory view of the association concerned, as expressed in its Housing Corporation Assessment (HCA). However, associations are independent businesses and the Corporation expects associations to have prepared a business case and undertaken a comprehensive risk analysis for all new business streams before any investment decision is taken. This discipline is particularly relevant for PFI contracts given their long-term nature.

The Corporation ordinarily expects to be informed of an association's plans in relation to PFI through the lead regulation process. However, where an association is planning to make a material investment in, or commitment to, a specific project, it is encouraged to discuss this with the Corporation at the earliest opportunity.

The Corporation will consider the following issues when deciding whether further information is required from an association on an individual project:

- the materiality of the proposed investment;
- previous experience and the level of involvement in similar business streams;
- the number of such schemes and other new initiatives being undertaken at one time;
- the relevant skills and experience of the board and senior management; and
- the association's overall role in the transaction i.e. contractor with the local authority, investor in the Special Purpose Vehicle (SPV) and/or sub-contractor.

In those instances where the Corporation decides that an initial assessment of the association's business case for involvement in a PFI project is necessary, this is likely to primarily focus on viability of involvement for the association and assurance that appropriate governance and management arrangements are in place. This will include an assessment of:

- whether suitable investment criteria have been established, including the level of return;

- the approach to the management of issues that could erode the rate of return;
- the management of financial and non-financial risks;
- the availability of appropriate skills and experience within the organisation; and
- the impact on the business overall.

Where the Corporation is not satisfied that these steps have been properly considered or identifies additional issues and risks from this initial work, a more detailed analysis will be carried out. In these instances, further information may be required on the following areas:

- the financial model – including sensitivity analysis, worst-case scenarios, exit routes, levels of returns and risks, cash affordability during the project;
- the effect on the core business – including the PFI transaction in the overall business plan and financial model, demonstrating continued deliverability of the business plan as well as considering the opportunity cost of the proposed investment;
- the risk register and how risks are to be managed;
- the key contractual elements of the transaction including benchmarking arrangements, decant arrangements, how right to buy is dealt with;
- relationships with, and risks associated with, the various sub-contractors;
- levels of contingencies built into plans/pricing;
- the impact of any changes to the SPV partners or sub-contractors; and
- compliance with the Corporation's policies, e.g. on diversification.

The above reflects the considerations for an association **before** it commits itself to involvement in a PFI scheme. General PFI guidance, background and advice is provided by ODPM and, through the Local Government Association (LGA) by their agency, the 4ps. A housing PFI Procurement Pack was published in November 2004 by the ODPM and 4ps and is a definitive "how to" manual for local authorities and bidders.

Further advice can be found on their websites: www.odpm.gov.uk and www.4ps.gov.uk.

1.3 TWO TYPES OF HOUSING PFI

This guidance is predominantly concerned with **housing PFI**, that is schemes that are sponsored by the ODPM and supported by credits from their housing PFI allocation.

Housing PFI schemes are for either:

- the provision of newly built or newly converted housing for social housing purposes (**Non-HRA housing PFI**),
or
- the refurbishment or re-provision of existing local authority housing stock held on the authority's Housing Revenue Account (**HRA PFI**), these can now support investment in newbuild social housing.

For both types of housing scheme, the operator will receive a unitary charge in respect of:

- making the specified number of dwellings available for occupation by the authority's tenants and applicants for re-housing;
- ensuring vacant dwellings are re-serviced to the specified standard and available for occupation within the specified time;
- maintaining the dwellings to the specified standard;
- providing specified housing services to the specified performance standard; and
- providing and monitoring this service for the duration of the contract.

There are, however, a number of key differences between Non-HRA and HRA projects.

In the case of **Non-HRA housing PFI** schemes, the dwellings will be owned by the service operator throughout the contract and remain in their ownership at the end of the contract. Tenants will be tenants of the operator, not the authority. An authority will define its requirements or **outputs** in terms of:

- the number, location and size of dwellings required;
- the standards to which the dwellings will be built/converted (currently the Corporation's scheme development standards – www.housingcorporation.org.uk/housingcorp.nsf);
- ensuring tenancy agreements confer assured tenancy status; and

- the ability of tenants to access a specified range of housing management services efficiently.

The unitary charge paid by the authority to the operator will supplement, and is net of, the income the operator receives in the form of rent.

Non-HRA schemes have been approved by ODPM on the basis that Value for Money (VfM) on the PFI project compares favourably with that associated with a scheme delivering the same outputs but procured using Social Housing Grant. This model is in the process of being updated and will be integrated with the HM Treasury value for money model.

HRA PFI schemes support investment in, and the refurbishment of, existing local authority housing stock held on an authority's HRA and/or the demolition and re-provision of local authority stock, as well as investment in new build social housing. The dwellings remain in the ownership of the authority for the duration of the contract and afterwards. As a result, tenants or lessees remain tenants or lessees of the authority and rents and service charges are set by the authority.

HRA PFI typically applies to a portfolio of dwellings from an authority's overall HRA stock. HRA PFI schemes are approved by the ODPM on the basis that VfM of the project compares favourably with a scheme delivering the same outputs but delivered by the authority directly or through stock transfer.

Related services typically delivered under a HRA PFI deal include those necessary to ensure the continuing operation of the asset such as cleaning, heating and general maintenance, services known as "facilities management". For HRA PFI schemes, authorities are expected to be mindful of Government policy regarding the separation of landlord and strategic community housing functions. This encourages the inclusion of full housing management services. In addition, 4ps guidance recommends that the range of services is discussed with the private sector during the procurement process. HRA PFI contracts to date have included:

- refurbishment or re-provision of dwellings;
- reactive and cyclical repairs;
- voids management;
- lettings administration (although not allocations);

TABLE 1 KEY ATTRIBUTES OF NON-HRA AND HRA HOUSING PFI SCHEMES

ATTRIBUTE	NON-HRA HOUSING PFI	HOUSING PFI
Ownership	Owned during and post contract by the operator, currently this must be an association	Owned during and post contract by the authority
Tenure	Tenants are tenants of the association	Tenants are tenants of the authority
Outputs	Number and location of dwellings Tenancy conditions	Specified number of dwellings brought up to, and maintained at, specified standard
Service standards (for definitions please refer to the ODPM/4Ps procurement pack on Housing PFI)	Housing Corporation development standard Lettings management Access to services	Availability standards (Decent homes +) Repairs and maintenance Voids management Lettings management Rent collection and arrears management Tenancy management
Rent	Operator sets, collects and retains rent	Authority sets rent, operator collects rent but passes to authority.
Unitary payment	Unitary payment net of rent	Unitary payment set to cover all refurbishment, construction, financing, operating costs and returns
Public sector comparator	Scheme funded through Social Housing Grant	Scheme funded through the authority's own resources or through stock transfer

- rent collection and arrears management; and
- tenancy management.

Where the dwellings are on estates, estate management and maintenance as well as communal services – caretaking and cleaning – have also been included.

HRA PFI housing portfolios have typically reflected a geographic area, such as an estate or neighbourhood, or a particular archetype, building system or dwelling type. The number of dwellings has varied from between 350 to 2,500 and the size of the capital investment has varied from £30m to £150m. Non-HRA schemes have typically been smaller than HRA schemes ranging in size from 50 to 500 dwellings. As at September 2004 there are 16 HRA projects in procurement or development with a further three reaching contract signature. In addition there are nine non-HRA projects in procurement or development with a further five having reached contract signature.

The key differences between the two types of housing PFI scheme are summarised in Table 1.

An association's potential involvement in PFI is not restricted to housing schemes. Associations also participate in NHS Local Improvement Finance Trust (LIFT) schemes, student accommodation, work based accommodation (for key workers) or care home projects. Similar principles, processes, documentation and issues will apply to these schemes as apply to housing PFI schemes.

Whilst the allocation of risk in many PFI sectors is similar, there are a number of features of NHS LIFT projects that are worth highlighting. The LIFT initiative was launched in Spring 2002 with a view to improving the development and investment in primary and social care facilities and services with local communities within England. The Department of Health has set up a national

joint venture with Partnerships UK – Partnerships for Health – in order to develop the models to be used in the delivery of local LIFTs. As at September 2004, 42 projects have gone to market. LIFT schemes are different in form and content to mainstream PFI projects in that public sector sponsors (Partnerships for Health and the local health economy) retains around 40% of the shareholding in the LIFT Company, with the remaining 60% held by the private sector.

The LIFT Company will purchase the freehold interest in the sites and facilities that are developed and this transfer of residual value risk is not typical for PFI projects. In addition, the LIFT Company will also have an exclusive contract, for an agreed period of time, to provide additional services and facilities to be delivered by the Primary Care Trust and its partners. As many LIFT schemes are relatively small, it is hoped that this exclusivity will allow bid costs to be spread across projects in a manner that will enhance value for money.

1.4 ASSOCIATION INVOLVEMENT IN NON-HOUSING PFI

In addition to the usual business and risk assessment that associations carry out when considering a new project, they should also consider the following in relation to participation in non-housing PFI schemes:

- whether participation would be intra vires (within its powers) by reference to its governing documents;
- whether it has the experience and expertise appropriate and relevant to the proposed contract;
- whether the proposed scheme fits with its vision and business objectives; and
- whether the potential impact of the project on its principal housing objectives are manageable.

02 PROCURING AND DELIVERING HOUSING PFI

2.1 THE PFI PROCUREMENT PROCESS

Having provided some background context on PFI and identified key ingredients of HRA and Non HRA schemes, this chapter sets out the key stages or phases in a PFI procurement.

The stages are:

Expression of Interest – The authority registers its interest and submits an outline scheme to ODPM.

Outline Business Case – If the EoI is supported by ODPM, the authority submits an Outline Business Case (OBC) to ODPM and PRG for PFI credit approval. The OBC sets out:

- the scope and content of the project;
- the level of stakeholder support;
- the proposed approach to risk transfer;
- the value for money case; and
- the indicative project timetable.

Potential private sector operators may register their informal interest and may participate in informal consultation or Soft Market Testing.

Pre-Qualification to Shortlisting – Formal registering of interest by operators following the publication of an advertisement in the Official Journal of the European Union (“an OJEU notice”). Interested bidders will be required to complete a **Pre-Qualification Questionnaire** (PQQ). If an association controls the SPV or the contract is “on balance sheet” for the association and any of the sub-contracts exceeds the specific thresholds prescribed by the EU, the availability of these contracts should be advertised in the OJEU prior to the selection of sub-contractors. The thresholds are currently £3.8m for capital projects or an annual value of £150,000 for supplies, including services. Further guidance on

complying with EU procurement directives is available on the Corporation’s website. For more complex projects where more than four bidders meet the PQQ requirements, shortlisted bidders may be asked to prepare an **Invitation to Submit Outline Proposals** (ISOP) before three to four are selected to go forward. To date the ISOP phase has not been used in the housing sector.

Invitation to Negotiate (ItN) – After further clarification of requirements and, for HRA PFI schemes provision of detailed stock condition information, operators will be invited to submit a set of bid documents including financial models and a mark up of the key project documents (the output specification, the payment mechanism and the draft project agreement).

Selection of preferred bidder – A bidder will be selected based on a combination of its delivery solution and price (consisting of an analysis of the projects nominal price and the Net Present Value of the project price) and informed by the procuring authority’s confidence about the operator’s ability to deliver. Further clarification may lead to the need to submit a **Best and Final Offer** (BAFO) before final preferred bidder selection is confirmed.

Contract completion – Final contracts will be signed and financial close achieved once the funders have completed their due diligence. The authority’s **Final Business Case** (FBC) will also need to be signed off by ODPM. It should be noted that contract completion will require detailed and time intensive contractual negotiations.

Contract Management Phase – this phase commences once contracts have been signed and service delivery has commenced.

Diagram 2 summarises the key phases and documents in the PFI procurement process. It also sets out the key tasks facing an association bidder at each key phase.

DIAGRAM 2 THE PFI PROCUREMENT PROCESS AND TASKS

PROCURING AUTHORITY TASKS

PROCUREMENT TASK

BIDDER/ASSOCIATION TASKS

- Prepare Expression of Interest and seek ODPM support

- Expression of Interest (EoI)

- Prepare business case for ODPM and Project Review Group (PRG) support

- Outline Business Case (OBC)

- Informal registration of interest
- Involvement in soft market testing

- Shortlist potential bidders
- Request initial proposals

- Pre-Qualification Questionnaire (PQQ)

Decide role
 Identify partners/sub-contractors
 Formally consider participation
 Assessment of risks
 Consider information requirements from authority

- Invitation to Submit Outline Proposals (ISOP)

- Draft proposals
- Seek Board approval

- Invitation to Negotiate (ItN)

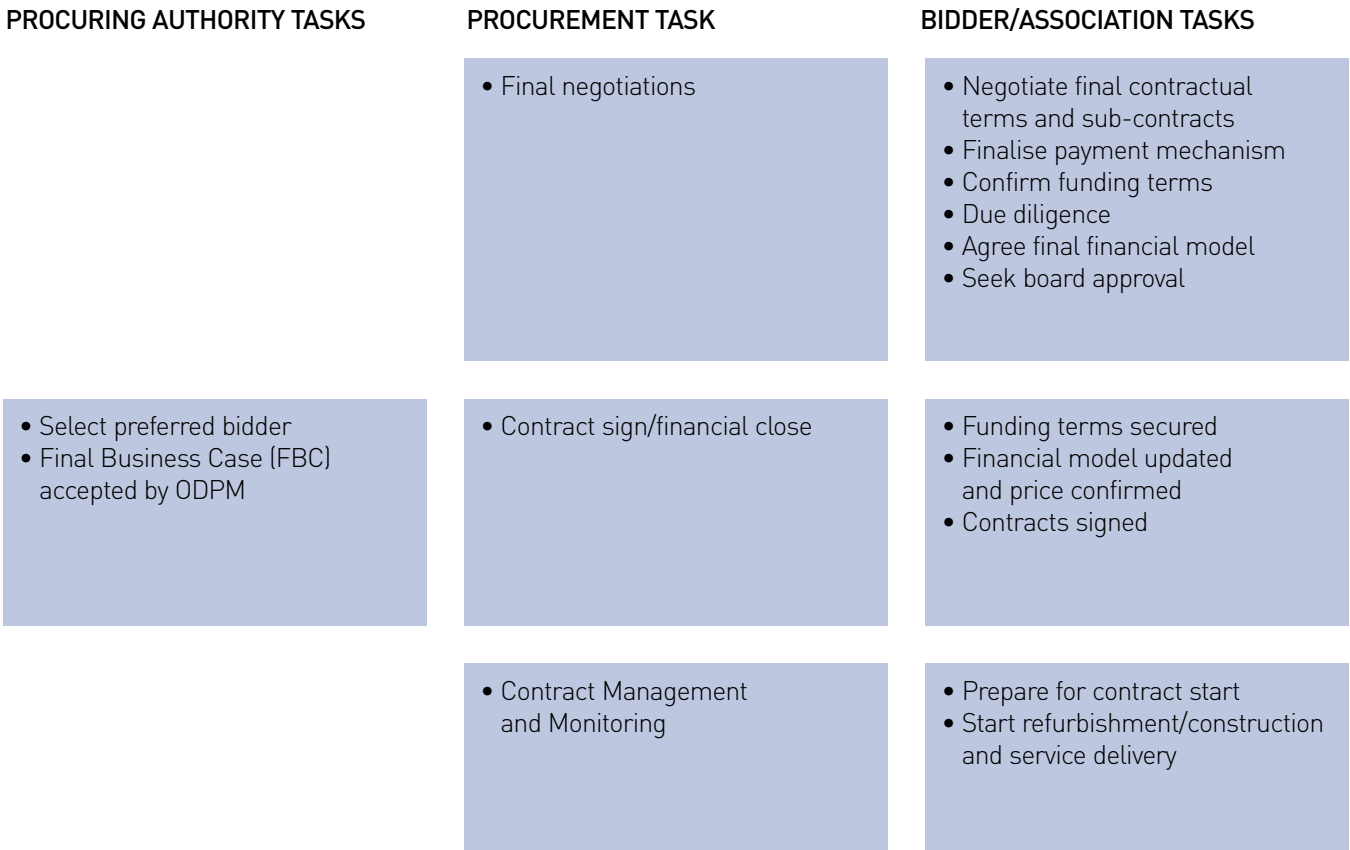
- Create bid team and appoint advisers
- Respond to consultation
- Identify funders and funding requirements
- Negotiate contract contents and risk allocation
- Evaluate output specification and payment mechanism
- Price contract documents
- Seek Board approval
- Submit priced proposals and financial models

- Commence negotiations

- Best and Final Offer (BAFO)

- Further consideration of risk
- Refine Price

DIAGRAM 2 THE PFI PROCUREMENT PROCESS AND TASKS (CONTINUED)



2.1 COMPARISON WITH OTHER PROCUREMENT PROCESSES

The nearest comparable procurement process to PFI that an association is likely to encounter is Compulsory Competitive Tendering (CCT) contracts for housing management and, to a lesser extent, reactive repairs contracts. However, neither of these contractual forms is as complex or integrated as a PFI deal and they run for a much shorter period of time. For example, CCT contracts do not require capital investment or a third party funder

and they usually run for a period of five to seven years. They are also typically contracts for a single service that is to be provided by a single service provider.

Under PFI, an authority is procuring a complex array of services which are to be delivered under one overall contract. Delivery typically means an association will align itself with other providers of complementary services as it is not typical that one party has all the expertise to finance, refurbish, manage and maintain dwellings over the project duration.

03 ROLES, RESPONSIBILITIES AND RISKS

3.1 THE ROLE OF ASSOCIATIONS

Whilst PFI projects offer additional business opportunities to associations, the size, contractual complexity and long-term nature of PFI deals mean that PFI projects are not without significant risk.

In addition, in assessing whether to participate in the PFI market, the Board of an association should have a clear understanding of its financial capacity and determine the importance of PFI amongst the competing priorities for this capacity.

The Corporation's Good Practice Note No. 9 "Regulating a diversified sector" (GPN No. 9, May 2004), states that an association's principal object should be the provision of social housing. The involvement of associations in PFI schemes is seen as consistent with this object providing they involve the ownership or management of social housing. Involvement in HRA and Non-HRA PFI schemes will be consistent with an association's principal objectives and should be based on a robust business plan which demonstrates the association's capacity and experience to deliver the contract and manage the risks involved.

It follows that PFI schemes that do not meet the social housing criteria are not considered by the Corporation to be part of an association's principal objects. Such projects might include student accommodation or residential care. Whilst this document does not seek to describe non-housing PFI projects, associations should properly consider the scope and content of non social housing PFI schemes. This should include an assessment of whether the impact of involvement on turnover will require separate reporting of diverse activities in their annual accounts and whether it will increase turnover derived from diverse activities to over 50% (GPN No. 9).

Irrespective of the nature of the PFI scheme, associations, in line with paragraph 1.2 of the Regulatory Code, "must operate a framework that effectively identifies and manages risks, identifying all major risks that might prevent them achieving their objectives, with the necessary arrangements to manage risks and mitigate their effects".

Satisfying this requirement is core to an association's involvement in a PFI scheme and this section looks at the roles associations can play, the risks associated with those roles and how they can be managed.

3.2 HOUSING PFI – THE ROLES PERFORMED BY ASSOCIATIONS

There are two roles that an association might perform on an authority sponsored PFI transaction:

- it could act as a project sponsor or co-sponsor, taking an equity stake in the project company or SPV (See Chapter 4 for role of a SPV); or
- it could act as a sub-contractor to the SPV providing repair and maintenance and/or housing management services.

This section looks at the considerations an association should take into account when deciding which of these two roles is appropriate. The typical methods used to structure and finance housing PFI projects are set out in Chapter 4.

Association as a co-sponsor or an equity investor

An association will be a co-sponsor (or an equity investor) if it believes it can make an acceptable return on its investment through its effective management of the risks involved and does not prejudice its overall business plan. As an equity investor in the project company, the association will be represented on the board. This arrangement may breach Schedule 1 of the Housing Act 1996 as it will involve the granting of a benefit (the equity stake and the housing management or other contract, as well as any payment and insurances to appointed Directors) by an association to a body trading for profit of which employees of the registered association will be principals. The association will, therefore, need to apply to the Corporation for a special determination to allow any payment made or benefit granted under the terms of the agreement between the parties.

It is common in PFI contracts for co-sponsors to bid through a consortium in order to share risk (and costs) and to ensure the right depth and breadth of expertise is available to deliver the bid. For housing PFI, a consortium might comprise:

- a refurbishment and/or development contractor;
- a day to day repair and maintenance contractor for the contract duration;

- a cyclical maintenance contractor for the contract duration;
- a housing manager; and
- a funder.

These roles do not all have to be carried out by separate organisations. Some could be combined e.g. housing manager and facilities management contractor to undertake day-to-day repairs and maintenance. The co-sponsors in the consortium will appoint sub-contractors to deliver all the services. In any event, the association must satisfy itself it is able to fulfil the role it is due to undertake and ensure its partners are similarly competent. It is important that the relationships are established between organisations at a senior level, not just with key project team members, to ensure that these relationships are robust, sustainable and will survive changes of personnel.

An equity investing association will need to work with its partners and legal and financial advisers to ensure that its equity is priced appropriately for the risk that it is bearing (see chapters 5 to 9 below for details). An association will wish to ensure that its investment is safeguarded and that it provides the optimal return for the organisational and financial risks being shouldered. As all sponsors are bearing the same risk, an association should price its equity return at rates which are consistent with its private sector partners. An association should:

- make a **judgement** on the nature of the prospective involvement in a project by reference to its own strategic and operational objectives;
- consider the **procurement costs** – the costs and resources necessary and expected to be incurred prior to the selection of a preferred bidder, and identify the resources it will need to dedicate to the project during procurement and any payments that will fall due before financial close;
- identify and earmark the **level and timing of investment** (money, time and resources) the association will need to commit to the project post-financial close, to meet its funding obligations as a project sponsor (the commitment of share capital);
- satisfy itself that its **cost base** is appropriately and accurately modelled in the SPV's financial projections, that, to protect the returns, the indexation provisions of the unitary charge offer protection against cost base

inflation and that adequate provision exists for equitable remedy from legislative changes;

- satisfy itself that it has or will have sufficient **investment resources** to meet its requirements and these have been appropriately costed. There must also be an assessment of the consequences on the association if the whole investment were to be lost;
- satisfy itself that there is a direct link, and therefore parity, between the **underlying resource base** used to deliver the output specification and the cost base on which financial projections are based;
- satisfy itself that the partners in the SPV and its sub-contractors are able to **deliver the required contractual outcomes**. For example, to protect the assumed level of the unitary charge, whether the refurbishment contractor is incentivised to deliver on time, through use of liquidated damages or retention amounts;
- satisfy itself that the timing of anticipated **equity returns** (these are typically towards the back end of a project) will not in any way leave the association with a shortage of resources in the short to medium term;
- be fully aware of any **risks left residing in the SPV** (i.e. those that cannot be passed to sub-contractors) as these may impact on the level of returns that are realised;
- understand that whilst the level of SPV risk is also a key issue for funders (and comfort can be gained from **funders' due diligence**), associations should recognise that funders' due diligence is undertaken to protect the interest of lenders not project sponsors. In particular, the association must understand the circumstances under which the funder can step in to the role of the association and manage the project. The association must understand the financial and reputational implications of the contract being terminated;
- understand when **payment deductions are passed to sub-contractors**, and at what point these cease with deductions then affecting the returns generated by the SPV;
- understand the impact of **sub-contractor termination** specifically the point at which termination of sub-contractors, bank step in, or project wide termination could be invoked and any decisions that need to be made in regard to the pay out of termination amounts;

- quantify best case to worst case **financial scenarios** and their probability in order to quantify the impact of such outcomes on the association's core business;
- understand that there can be **no certainty of equity returns** being earned at the levels modelled or projected; and
- understand that **bidding for PFI projects** is time consuming and expensive and that in the event that a bid is unsuccessful bid costs will not be recoverable.

Association as a sub-contractor

An association's role as a sub-contractor to the SPV is separate and distinct from that of project sponsor. As a sub-contractor to a SPV, an association will be required to deliver specific services to a specified standard and at an agreed price. If it fails to deliver services to the required standard it will suffer performance deductions. In the worst case it could have its contract terminated. If an association is to act as a sub-contractor it is important that it:

- clearly understands its **performance requirements** and the service levels it needs to meet in order to obtain full payment. Poor or sub-standard performance will result in deductions. The association must understand and accept the risks it is shouldering in the sub-contract. Any reservations should be conveyed in writing to the SPV both as a caveat on the association's price and to allow the SPV to make its own commercial decisions in relation to how to manage such risks;
- understands its **relationship** with, and obligations to, other sub-contractors and the SPV, particularly in the circumstances where failure to perform could have adverse consequences on other operators. It should also have a good understanding of the overall deal and an awareness of the relationship between the SPV and other sub-contractors. The bidding and negotiating process will be the foundations on which long term relationships are built. Associations must be aware that failure to perform to the standards in the contract will result in a financial deduction on the association;
- understands that the **fixed price** offered for housing management services is fixed in real terms for the life of the project (typically for 25 to 30 years). The association must price its services by reference to the output specification and not its ordinary operating business. The price offered to the SPV must allow for overheads, employers costs and margins. The risk of mis-pricing costs, revenues or performance can be

critical. PFI deals are long term and there is no contractual remedy if a sub-contractor has 'got it wrong';

- understands that it is normal practice under PFI for **risks undertaken by the SPV to be transferred to the sub-contractor** where possible. Any sub-contracting association should ensure that the risks being passed to it have been appropriately quantified using a robust methodology and that it has the ability to negotiate with the purchasing authority when risks relevant to its sub-contract are discussed;
- develops a **cost information strategy** to decide how much it wishes to allow the SPV to see, opting perhaps to offer a single line price, as opposed to a full cost breakdown. The association should be mindful of how this interrelates to any other information requirements of the procuring authority;
- ensures that its **cost base modelling** is accurate and appropriate in the SPV's financial projections and the timings of payment from the SPV's model match the invoicing and payment provisions of the proposed sub-contract. Similarly, the indexation provisions in the SPV's financial model must match that of the sub-contract;
- confirms that the **benchmarking and market testing provisions** being passed down to it through the sub-contract are reflected in its business plan assumption;
- understands and has assessed the **risks associated with the termination** provisions in the sub-contract as well as the step-in provisions of funders and the termination provisions of the PFI contract; and
- should, prior to offering priced information to the SPV, carry out **sensitivity testing**, particularly in respect of down side outcomes and risks, to ensure the robustness of the price offered. These should be factored into any decision to participate in a project. It should engage advisers to test the robustness of the commercial and financial assumptions of any bid, in particular:
 - any changes to **inflation rates** affecting both the price received via the sub-contract from the SPV and the association's underlying cost base;
 - divergence between the **inflation rate** on the price received from the SPV and inflation rates that may apply to the underlying cost base;
 - consequences of **delayed payment** by the SPV and remedies open to the association;
 - its ability to continue to provide the appropriate

level of service should **benchmarking/market testing** provisions be invoked or a variety of levels of payment mechanism deductions be levied against the association; and

- the ability to continue to provide the appropriate level of service before any sub-contractor, or project wide **termination provisions**, are invoked.

3.3 KEY PROJECT RISKS IN HOUSING PFI

In considering whether to extend the range of business activities they undertake, associations must take account of what activities are permitted by their governing instrument and more generally of the permissible purposes or objects as specified in s2 of the Housing Act 1996 and relevant Statutory Instruments such as The Social Landlords (Additional Purposes or Objects) (No. 2) Order 1999.

Effective and quantified risk management across all activities must be central to associations' governance and operations and be embedded in the culture of all associations. The framework for identifying and managing risk should be capable of differentiating between risks

associated with current activities and those that arise from new and diversified activities. The balance of risks and rewards can then be assessed before deciding to undertake new activities, or to continue existing ones. The underlying principle as to the allocation of risk within a PFI project is that risk should be allocated to the party best placed to manage it. In order for a PFI project to be 'off balance sheet' for the procuring authority for public sector accounting purposes, it needs to be demonstrated that the private sector operator is bearing more risk than the authority. This has been the case on each of the three HRA PFI deals that have closed to date.

Like project funders, associations are exposed to long-term project risk. Consequently, pricing the bid correctly during the ItN phase is of paramount importance. Errors in the financial model or mis-pricing key cost assumptions could have serious long-term consequences. It is for this reason that the funders require sophisticated financial models (which must be independently audited prior to financial close). These financial models act as tools to measure the financial impact of different long-term and short-term risk scenarios. The likely allocation of the key risks in a housing PFI deal are set out in Diagram 3 below

DIAGRAM 3 TYPICAL ALLOCATION OF RISK IN A HOUSING PFI

"RISKS SHOULD BE ALLOCATED TO THE PARTY BEST ABLE TO MANAGE THEM"

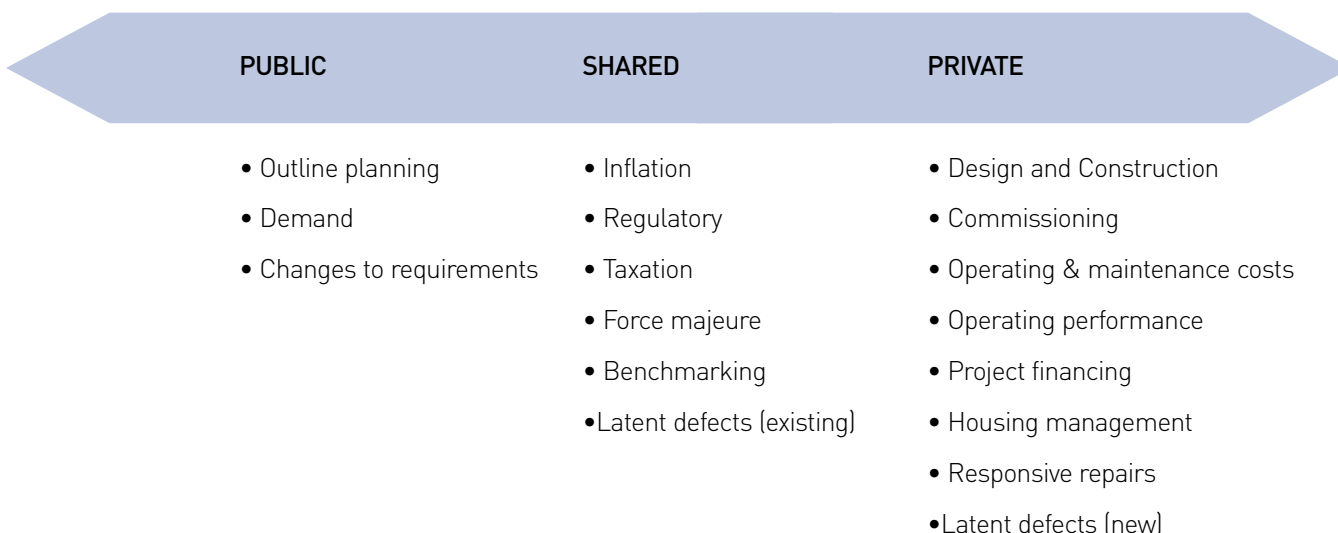


TABLE 2 TYPICAL RISK ALLOCATION AND MANAGEMENT

	PROJECT RISKS	PUBLIC	SHARED	PRIVATE	HOW RISK CAN BE MANAGED BY THE SPV/OPERATOR
1	Outline Planning	•			
2	Demand	•			
3	Requirement Changes	•			
4	Latent defects (existing)	•			
5	Inflation		•		Variable element of the Unitary Charge to be indexed
6	Regulatory		•		Use of allocated reserves
7	Taxation		•		Part of day to day business risk quantified through tax planning
8	Force majeure		•		Agree “no loss” contract clause in project agreement
9	Benchmarking		•		Competitive pricing within sub-contracts
10	Design and construction			•	Fixed price sub-contract with liquidated damages
11	Commissioning			•	Fixed price sub-contracts with liquidated damages
12	Operating and maintenance costs			•	Fixed price sub-contract with collateral warranties
13	Operating Performance			•	Pass down of deductions to relevant sub-contractor
14	Project Financing			•	Fix financing costs in model at financial close through hedging agreement (e.g. interest rate swap)
15	Latent Defect			•	Contractors warranties with sub- contractor
16	Housing Management			•	Fixed price contracts with sub-contractor, and pass down of deductions to sub-contractor.
17	Responsive Maintenance			•	Sub-contractors price on basis of perceived business risk with and pass down of deductions for poor performance to sub-contractor.

and for risks borne by the private sector, or shared with the authority, a typical means of risk mitigation has been identified.

Professional advice from legal, financial and technical advisers and other organisations, during the contract negotiation, will assist the association and its co-sponsors in ensuring that risk is apportioned appropriately between the contracting parties, and that this is reflected in the project documentation.

Whilst not conclusive or exhaustive, Table 3 provides an example of a risk register for an association acting as both sponsor and a housing management sub-contractor on a housing PFI project. It should be emphasised that Table 3 is an example only and that the actual risks will vary on each individual transaction and must be separately identified on a project by project basis. The value of recording and monitoring risks cannot be understated in a project as complex as PFI. A project risk register will enable the board to understand the key project risks, the exposure of the association and the way in which risks are to be managed and mitigated. Associations must ensure that effective and quantified risk management across all activities is central to their governance and operations and be embedded in the culture of the association.

RISK	OUTLINE DESCRIPTION OF RISK	ASSOCIATION ROLE (AS CO-SPONSOR, SUB-CONTRACTOR OR BOTH)	LIKELIHOOD		IMPACT	MITIGATION APPROACH	DESIRED OUTCOME
			HIGH (H) MEDIUM (M) LOW (L)				
1 Level of equity investment	Exposure to unlimited equity contributions	Co-sponsor	L		H	<ul style="list-style-type: none"> Shareholder Agreement 	<ul style="list-style-type: none"> SPV will not be able to demand further contributions from project sponsors
2 Risk sharing in SPV	Association is inappropriately penalised for failure of other contractors	Sub-contractor	M		H	<ul style="list-style-type: none"> Clear risks and responsibilities Co-sponsors have access to independent legal advice 	<ul style="list-style-type: none"> All risks flow to appropriate contractors. Any shared risks, such as voids, are separated out by sub-contractor
3 Accountability within SPV	Inadequate mechanism for holding SPV partners to account	Co-sponsor	L		M	<ul style="list-style-type: none"> Independent legal advice for association when negotiating Shareholder Agreement 	<ul style="list-style-type: none"> Contract performance reported regularly and frequently at Board meetings
4 Financial model assumptions	Third party revenues (income from sources other than unitary charge e.g. private house sales) do not materialise	Co-sponsor	M		H	<ul style="list-style-type: none"> Developer underwrites value of contribution from disposable asset 	<ul style="list-style-type: none"> Third party revenue risk passed to developer No residual risk with SPV
5 Impact of Right to Buy (RTB) on financial model	Dwelling loss through RTB sales reduces SPV revenues and returns	Co-sponsor	L		H	<ul style="list-style-type: none"> Negotiations with authority to ensure no net revenue loss to SPV 	<ul style="list-style-type: none"> RTB compensation methodology in place to ensure no net loss to SPV or sub-contractors

TABLE 3 RISK REGISTER

RISK	OUTLINE DESCRIPTION OF RISK	ASSOCIATION ROLE (AS CO-SPONSOR, SUB-CONTRACTOR OR BOTH)	LIKELIHOOD HIGH (H) MEDIUM (M) LOW (L)	IMPACT	MITIGATION APPROACH	DESIRED OUTCOME	
6	Increasing procurement costs	Both	M	M	<ul style="list-style-type: none"> SPV agrees capped budget with association and other co-sponsors and consultants. Budget monitored and reported to co-sponsors collectively and individually through agreed mechanisms 	<ul style="list-style-type: none"> Costs within budget [consultants often on success fees i.e. the payment of the main element of their fees being contingent on the success of the bid.] 	
7	Sub-contractor delivery 1	Sub-contractor	M	H	<ul style="list-style-type: none"> SPV demands collateral warranties Capacity of sub-contractors assessed during sub-contractor selection 	<ul style="list-style-type: none"> Risk of financial loss by SPV due to sub-contractor failing is mitigated. Risk of sub-contractor failing is minimised through rigorous selection assessment 	
8	Sub-contractor delivery 2	Performance triggers payment deductions	Co-sponsor	L	M	<ul style="list-style-type: none"> Process and frequency by which sub-contractors performance is monitored by SPV is pre-defined and followed Sub-contractor is liable for deductions for their poor performance 	<ul style="list-style-type: none"> Deviations in performance identified and rectified in time
9	Sub-contractor delivery 3	Insufficient set up period	Sub-contractor	M	M	<ul style="list-style-type: none"> Set up requirements clearly identified and suitable period or allowance negotiated with authority 	<ul style="list-style-type: none"> Timetable agreed to enable set up and/ or agreement to reduced targets in the first three months

TABLE 3 RISK REGISTER (CONTINUED)

TABLE 3 RISK REGISTER (CONTINUED)

RISK	OUTLINE DESCRIPTION OF RISK	ASSOCIATION ROLE (AS CO-SPONSOR, SUB-CONTRACTOR OR BOTH)	LIKELIHOOD	IMPACT	MITIGATION APPROACH	DESIRED OUTCOME
10	Output specification/ Payment mechanism open to interpretation	Deductions triggered or more severe than understood during procurement	Co-sponsor	M	H	<ul style="list-style-type: none"> Procurement negotiations with authority ensure agreed understanding, monitoring and impact of variations in performance Penalties now clearer and detailed risk assessment of breach of each one is being undertaken
11	Information & Communication Technology (ICT)	SPV's IT system not meeting specification	Co-sponsor	M	H	<ul style="list-style-type: none"> Performance assessment on defined outcomes rather than adherence to method statements No deductions or deductions do not exceed forecast Value of deductions passed on to appropriate sub-contractor Specification and implementation timetable agreed and confirmed as viable during procurement and reflected in set up negotiations with authority SPV have reviewed ICT systems and capacity with ICT provider and it meets the specification SPV demands collateral warranties from ICT provider
12	Housing benefit	Delays impact on rent collection performance	Sub-contractor	L	L	<ul style="list-style-type: none"> Clear demarcation of responsibilities negotiated with authority during procurement Authority bears risk of HB service delivery but role of SPV is clear

TABLE 3 RISK REGISTER (CONTINUED)

RISK	OUTLINE DESCRIPTION OF RISK	ASSOCIATION ROLE (AS CO-SPONSOR, SUB-CONTRACTOR OR BOTH)	LIKELIHOOD HIGH (H) MEDIUM (M) LOW (L)	IMPACT	MITIGATION APPROACH	DESIRED OUTCOME
13 Decanting/ Rehousing	Risk transfer is not transparent association/ SPV incurs penalties	Sub-contractor	M	H	<ul style="list-style-type: none"> • Clear demarcation of responsibilities negotiated with authority during procurement 	<ul style="list-style-type: none"> • Authority's decanting/ rehousing policy, processes and monitoring is clear and agreed during procurement
14 Allocations	Risk of higher housing management input per tenant as allocations managed by LA not association	Sub-contractor	M	M	<ul style="list-style-type: none"> • Clear demarcation of responsibilities negotiated with authority during procurement • Lettings Policy negotiated with authority during procurement • Variations subject to change mechanism 	<ul style="list-style-type: none"> • Authority's letting policy, processes and monitoring is clear and agreed during procurement

CASE STUDIES FINANCIAL ASSESSMENT

CASE STUDY 1

For one Association (bidding as part of a consortium), the key decision was whether to invest directly or to be a sub-contractor. As housing PFI would be a key Association activity, it decided to invest. It assessed the risks using a sophisticated risk matrix and developed its pricing principles independently of the activities undertaken elsewhere by the group. The conclusions of the assessment were reported to an Executive Board of the Group.

CASE STUDY 2

One Association, acting as a sub-contractor to a SPV, has managed and mitigated its risk by:

- Raising and investing 10% of the equity required by the SPV. This was sufficient investment to secure a seat on its board and establish an interest in the overall operation of the SPV.
- Taking on the role of bid manager including project managing the development of the financial model and taking on a role as “interpreter” – advising the SPV Board on the management and operation of social housing.
- Providing staffing resources to the SPV thus enhancing individual experience and collective skills.

CASE STUDY 3

Prior to its involvement in the consortium which was successful in winning a Housing PFI contract, one Association formed a specialist team of five senior managers (with stock transfer and contract management experience) in order to develop its expertise in PFI. They identified the requirement for significant delegation of responsibility for the landlord function and understood the complexities and risks of doing so.

The Association’s Board created a Special Executive Committee to consider carefully the Group’s entry into the PFI market. This Executive was chaired by the Association’s Chairman and included representatives from the key central sub-committees and the relevant regional committee. It considered the proposals from the project team in detail and concluded PFI was something that the Association wanted to be involved in. The reasons “why we would pursue this form of activity” were discussed at length and the principles for bidding and “how we would work in partnership” were agreed.

Housing PFI was seen by the Association as a route for growing the business in an environment it understood and with which it was familiar.

The decision was made early on to approach PFI on a commercial basis - to deliver the best service possible for a reasonable return. A sophisticated risk matrix was produced that identified; a complex array of risks, the probability of these risks arising and which party (SPV or sub-contractor) would be responsible for them. The combination of this detailed risk analysis and the Association’s social housing expertise enabled it to take a lead role on number of complex issues including negotiations on the output specification and its impact on the payment mechanism.

04 FINANCING AND GOVERNANCE

4.1 THE SPV – THE TYPICAL PFI DELIVERY VEHICLE

The typical delivery vehicle for a PFI project is a SPV. A SPV is a limited company that is established for the sole purpose of delivering the PFI project. The SPV is granted a concession to build or refurbish the assets in question and to operate them for a fixed period of time (the life of the project or the “concession”).

At the end of the concession period, in most cases, assets are passed back to the authority. Indeed this is exactly what happens with the dwellings in the case of HRA housing PFI projects. It is the SPV that contracts with the authority. The SPV will not (in most cases) own assets in its own right and will not directly construct or refurbish the houses or deliver the ongoing housing management or maintenance services.

The SPV is in essence a vehicle for:

- financing the PFI project as it acts as the “borrower”, and
- managing the delivery of the project in its role as “concessionaire”.

The SPV will raise the financing needed to deliver the project and, in the case of housing projects, engage sub-contractors to deliver the refurbishment and its ongoing service obligations. The revenues paid by the authority by way of the unitary payment will be used by the SPV to meet its obligations to its funders and its sub-contractors.

SPVs used in PFI transactions are usually highly geared, limited recourse vehicles. The majority of funding (typically 90%) is sourced from a bank or other debt provider such as bond holders in the case of bond financing. Typically bank (or senior) debt is priced at the London Inter-Bank Offered Rate (“LIBOR” – the base rate at which commercial banks fund) to which a margin is added to reflect the risk profile of the project borrower. Such a rate is usually fixed (hedged) at financial close thus negating the risk of interest rate movements affecting the SPV during the life of the project.

PFI or project finance-related debt is generally more expensive than traditional association funding. This is because traditional association funding is normally secured against the association’s assets (dwellings).

This is not the case in most PFI deals because the SPV does not own the assets. In typical PFI deals the debt funding is not asset backed but secured against the revenues to be earned by the SPV by way of the unitary charge it levies on the purchasing authority.

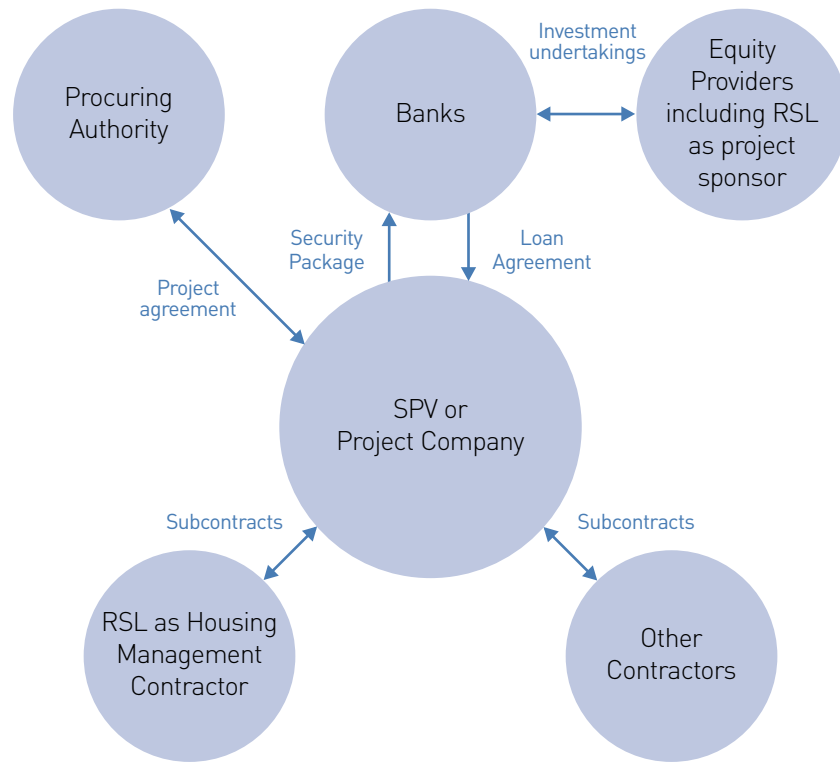
Equity is by definition risk financing and equity returns will only be earned if the SPV delivers sufficient net revenues to permit the payment of dividends. The high gearing (typically 90% debt, 10% equity) used in PFI deals means that the weighted cost of capital is less than is typically the case for more uncertain or speculative investments. This means the returns that are needed by the SPV in order to repay debt and meet the targeted shareholder returns, are lower than they are in more commercially based ventures and the cost of a project to the public sector is consequently lower.

The limited recourse nature of the SPV financing means that if the project were to suffer financial difficulties or to fail, the lenders to the project have limited or no recourse to the general funds or assets of the project sponsors (those parties injecting equity). Because the SPV does not typically own assets, and because of its limited recourse nature, lenders are dependent on the project revenues being sufficient to repay the senior debt. Lenders will therefore attach a series of security documents, covenants and conditions precedent to the provision of its lending.

Lenders will also require the SPV to demonstrate that it is able to meet its debt obligations in each and every year of the project. It does this through the use of financial ratios. The most commonly used ratios are the “Annual debt service cover ratio” (ADSCR) and the “Loan Life Cover Ratio (LLCR). The ADSCR measures the level of project revenues that are available to service principal and interest on the debt. The LLCR compares the present value of future cashflows to the SPV, with the balance of debt outstanding. There are also triggers for preventing payment of shareholder distribution as lenders will want to make sure that they are adequately protected before they allow shareholders to start to make a return through the payment of dividends.

Diagram 4 shows a typical structure chart for a PFI Scheme.

DIAGRAM 4 A TYPICAL STRUCTURE FOR A PFI SPV



A Non-SPV (“on balance sheet”) Approach

In a number of instances, associations have considered and/or submitted proposals for the delivery of PFI schemes without the establishment of a limited recourse SPV. Indeed in the case of non-HRA projects it is usual for associations to lead or act as a sole bidder, although future non-HRA projects may be delivered through an SPV due to the size of the project or specialist nature of the assets/services. As the new housing assets in these deals are to be owned by the operator, associations can use these assets as security when raising external debt.

In a limited number of HRA deals, it has also been the case that some associations have sought to use the additional debt capacity within their balance sheets to secure lower cost debt funding. This is proposed on the basis of the commercial advantage it provides. There have been some cases where asset backed funding has reduced lending margins by up to 50 basis points (0.5%).

The case for and against, sole sponsorship and balance sheet funding is complex. Sole sponsorship and balance sheet funding inevitably place more risk on an association than the typical limited recourse approach and consortia model that is favoured by other private sector bidders. Before proceeding with such an approach an association should consider:

- Whether or not it understands the project risks in full and has the skills, expertise and resources necessary to manage the risks and deliver a PFI project as a sole sponsor;
- The opportunity cost of using its corporate assets as security for PFI;
- Whether or not the lower funding costs are material in determining the overall project price and whether the benefit of lower cost funding is likely to be lost if there are relatively small movements in the price of construction, refurbishment and operating costs;
- Whether such an undertaking would affect an association’s debt raising capacity in the future;
- Whether or not the additional risk falling on the organisation, particularly in terms of its security obligations to its lenders (which should be quantified), outweighs the potential benefits of lower funding costs; and
- The extent to which the arms length role of lenders will reduce the rigour of lender due diligence and place an additional risk burden on the association, which can only be mitigated by increasing association bid costs.

4.2 ASSOCIATION GOVERNANCE AND HOUSING PFI

Associations now operate in an increasingly complex and dynamic business environment which by its nature requires more sophisticated solutions. Associations should ensure that the necessary corporate approvals have been obtained before:

- any new activity is entered into; or
- additional costs are incurred; or
- it is exposed to additional risks.

Associations need to ensure they have the skills, or are obtaining the professional advice necessary, for them to consider all the issues in relation to a PFI procurement. The issues facing an association engaged in a PFI deal will change as the PFI procurement process proceeds. Good governance during this process is important and can be secured through the board being properly positioned to:

- consider the fit of the project with the association's business development strategy and the requirements of any future management and governance arrangements;
- understand the key procurement stages;
- understand the association's role and the risks involved;
- have confidence in the quality and comprehensiveness of the information analysis provided to it;
- make clear decisions on the basis of the information provided by the executive and the association's advisers; and
- confirm the powers (vires) of the association to invest in such a project under its constitution. (This is a key issue for charitable associations.)

The board and executive have a responsibility to ensure that procurement and service delivery is embarked upon and delivered in an efficient manner that does not result in resources being diverted from other core activities.

In addition there is a danger that the demands and complexity of a PFI bid may lead to key risks being overlooked or not properly addressed. Experienced advisers should be appointed by any SPV or association leading a PFI bid. Advisers can advise on and assist in identifying any key shortfalls or flaws in the underlying details of the proposed transaction so as to limit costs and risks falling on an association. Typically there is a need for input from three types of adviser:

Legal adviser – appointed to advise on the drafting of the key contractual terms set out in the project agreement. Legal advice is typically required on commercial matters (to assist with the project agreement and sub-contracts) and to assist with the negotiation of the package of financing contracts with the lenders.

Financial adviser – appointed to advise and assist with the financial aspects of the bid. This will include developing the structure and mechanics of the financial model and assistance with the commercial aspects of the transaction including the allocation of risk, the raising of finance and the payment mechanism. Generally speaking, the financial adviser should be independent from the actual sources of funding. Bidders will also need to meet the cost of the bank's financial model auditors.

Technical adviser – appointed to advise and assist with the technical aspects of the project. Depending on the transaction, this may include design, costing and programming advice.

Sub-contractors to the SPV would normally appoint their own legal advisers to represent their interests on contractual matters.

It should be noted that configuration and negotiation of PFI insurances can be complex and it is now common for specialist insurance advisers to be appointed by bidders.

Not all decisions related to a bid necessarily have to be considered by the board but all material decisions should have auditable board authorisation. Any decisions taken by executive officers should be consistent with the association's standing orders and procedures and, where necessary, explicit authority should be passed to appropriate senior staff. This could be achieved through the establishment of a project board, chaired by a board member or senior member of staff. There is therefore a need for clear and demonstrable board sponsorship and levels of delegation.

As a project progresses through the procurement process, so the number of bidders will diminish through the means of selection, managed by the procurement authority, and conducted under EU procurement regulations. The authority should employ defined (although not necessarily externally disclosed) objective evaluation criteria in their pursuit of identifying the best overall submission. Associations are advised to plan early and seek board guidance before embarking on a specific scheme.

The delivery of housing PFI projects will not, in most cases, be possible without the participation of associations. However, for an association there is a risk that they may bid for the wrong scheme with inappropriate partners. At the same time, a decision not to participate in a project may adversely impact on the association's business development.

Board monitoring post project operations

By the time that the relevant project contracts are signed and the project becomes operational, the board should have considered how it intends to manage and monitor this activity effectively. If the responsibility is to be delegated to a sub-committee, then the terms of reference should be amended to reflect this additional responsibility.

Given the complexities of monitoring contract performance, the board must ensure that the sub-committee has the required skills and expertise amongst its members to effectively discharge this responsibility.

Should the board decide that the responsibilities of monitoring this project should rest with the board as a whole then the board must take into full consideration the regularity of its meetings and whether this is sufficient to appropriately manage and oversee this activity.

The board must ensure that reports provide sufficient detail and continuously monitor and report on the risk exposure faced by the organisation. The risk register should be maintained and updated should any of the risk profiles change over the life of the project. Reports should not only contain information in regard to the association's own performance, it should also give account of how its partners are performing and fulfilling their contractual obligations.

4.3 THE PAYMENT MECHANISM

The payment mechanism will determine whether and how much the operator is paid at the end of every payment period designated in the Contract. The payment mechanism is fundamental to the PFI Contract, as it puts into financial effect the allocation of risk and responsibility between the authority and the operator.

Since the essence of a PFI arrangement is the procurement of a service, sub-standard performance will result in reduced payment by the authority or, in certain circumstances, no payment at all. The key objectives and principles of the payment mechanism are that it should:

- provide a framework of realistic, challenging, but achievable performance standards for the operator to meet in order to secure the full unitary charge;
- provide an incentive to meet the performance standards set out in the output specification by placing payment of the unitary charge at risk if performance falls below the agreed standard;
- provide an incentive for the operator to rectify problems by escalating deductions for failing or worsening performance; and
- provide an incentive for the operator to innovate and secure efficiency gains and deliver Value for Money throughout the period of the contract.

From a practical point of view, it is important to remember that the payment mechanism should be objective, transparent and easy to operate.

The payment mechanism will provide for deductions from the gross unitary charge, based on:

- unavailability – where dwellings are deemed to have become unavailable for all or part of a payment period, measured on a per dwelling/per day basis; and
- performance – where performance targets have not been met for all or part of a payment period, measured in aggregate across the portfolio on a per month/per annum basis.

The availability standards for each dwelling will be defined within the output specification. The operator will be evaluated against the adherence of the availability standards for all the dwellings which remain within the project. For work to existing dwellings, there will be an initial period when the dwelling is below full availability standard but is occupied. During this period an "interim" availability standard usually applies.

Any breach of the availability standard (unavailability) during the interim or full service period will lead to payment deductions based on the number of dwellings and length of time that they were unavailable. Even though a dwelling is technically unavailable (e.g. through lifts being out of action in upper floors of a tower block), it is still possible that it will still be occupied. In this event the operator will be subject to a reduced deduction.

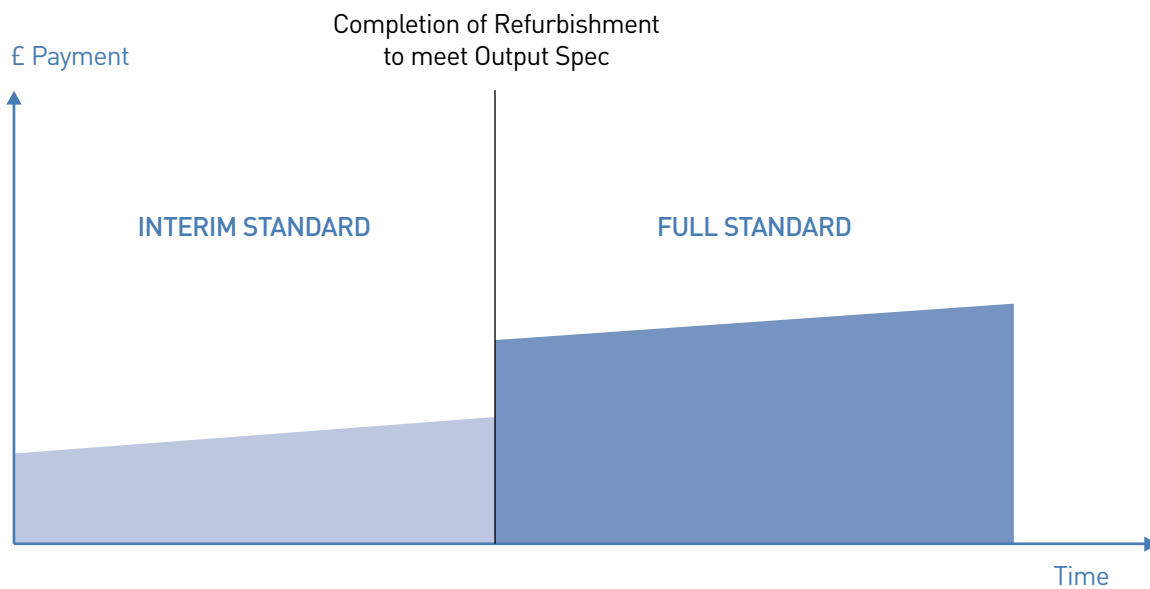
Housing management performance standards will be set out in the output specification. Failure to meet these

standards could result in a deduction for sub-standard performance. The calculation of the level of performance deductions will be based on actual performance compared to target performance for an agreed list of performance indicators. Target performance and the calculation of deductions should be set up to give the operator a realistic prospect of having no performance deductions. The potential level of performance deductions for poor performance should be commensurate with the cost of delivering the underlying services. Repeated unavailability or poor performance may lead to a ratchet mechanism which will increase the level of deductions made against the operator.

Within housing PFI projects, the unitary charge is typically built up on a dwelling by dwelling basis. For schemes involving works to existing dwellings the “interim availability standard” will apply for the period between project commencement and the point in time at which the dwellings are brought up to the (full) availability standard. During this interim period, dwellings attract a lower unitary charge.

Diagram 5 illustrates how the unitary charge (the payment) for a dwelling in a HRA scheme might increase as it is refurbished and moves from the interim to the refurbished or full availability standard.

DIAGRAM 5 INCOME PROFILE FROM A DWELLING FOR HRA PFI SCHEMES



CASE STUDIES GOVERNANCE

CASE STUDY 1

Corporate commitment to involvement in a project must be demonstrated throughout the procurement process. For example, the Group Board of one Association had agreed, as part of its business planning, to expand its involvement in regeneration and new business opportunities, including the provision of housing management services. When the opportunity to become involved in a housing PFI deal arose, staff saw this as an opportunity for achieving these objectives. The Association was able to respond positively and confidently to initial overtures from both the client Council and prospective consortium Partners.

CASE STUDY 2

The importance of continued Board involvement during procurement is demonstrated by the experience of one particular Association. The Association's Board (and its sub-committees) received over 20 reports during the 4-year procurement period with the aim of "ensuring the Board was comfortable with the key decisions it had to make". The key decisions are set out below.

The Board was informed of the initial approaches from potential consortia Partners when the sponsoring authority was undertaking soft market testing. The Board was asked for formal but in principle endorsement of involvement when the Group was invited to submit an expression of interest to the authority.

A complete assessment of the implications and risks of involvement in the PFI scheme was presented to the Board when the consortium (of which the Association was a member) was appointed as preferred bidder. This consisted of an assessment of the risks, costs and benefits of the project.

On selection as the preferred bidder, the Group Board unanimously endorsed continued involvement in the consortium. It also established key criteria (liability limits, minimum returns on investment, contingency reserves) against which continued involvement could be assessed. Review and re-assessment were reported to the Board up to financial close

Before financial close a formal review of the implications of the project (on the Association) were presented to the Board to ensure that "all factors which the Board considered to be relevant" had been "taken into account" and the Association's involvement was formally endorsed.

PART B

In this part of the Guide, the PFI procurement process will be set out to identify the primary actions a participating association needs to undertake at each stage of the procurement process. The various phases of the procurement process have been grouped under the following headings:

05 OUTLINE BUSINESS CASE TO EXPRESSION OF INTEREST/PRE-QUALIFICATION QUESTIONNAIRE

06 PRE-QUALIFICATION TO INVITATION TO NEGOTIATE

07 SUBMISSION OF THE INVITATION TO NEGOTIATE

08 BEST AND FINAL OFFER AND NEGOTIATIONS TO FINANCIAL CLOSE

09 DELIVERING THE CONTRACT

At the end of each chapter there is a checklist detailing the key events or milestones in the procurement process and the activities that need to be undertaken by an association.

05 OUTLINE BUSINESS CASE TO EXPRESSION OF INTEREST AND PRE-QUALIFICATION

5.1 ROLE OF AN AUTHORITY'S OUTLINE BUSINESS CASE AND ASSOCIATION INVOLVEMENT

In an outline business case (OBC), an authority sets out its case for using PFI as a procurement route and the justification for Government support in the form of PFI credits. During the development of the OBC, an authority may consult associations and others operating in the PFI market on both the scope and content of the project and whether or not they would be interested in bidding, if it were to go to market.

Information on the structure and content of an OBC can be found in guidance on the 4ps website. In summary, an OBC sets out the rationale for the project and seeks to demonstrate that PFI is the most appropriate and preferred investment option. It also needs to demonstrate that there is support for the scheme, in principle, by the market. An authority does this through "Soft Market Testing" (SMT) which can take a range of forms from collective meeting with all potential bidders to telephone and face-to-face discussions.

If invited to participate in SMT, the association will need to consider the attractiveness of the opportunity, make comments on the way it can be made more attractive and identify further information needs to assist it in its later decision making. It can only contribute effectively to SMT discussions if it understands the PFI process and is able to make an initial informed assessment of project viability.

It follows that initial discussion at board level should precede, or coincide, with this invitation to any SMT

discussion on an authority's PFI project. A board level discussion should take place if an authority in the association's area of activity announces it has, or is going to, submit an OBC to the ODPM. The board needs to:

- make a judgement on the association's possible involvement and role in the project and make some budgetary provision to investigate these. This should include the strategic implications and context of the project;
- establish clear criteria of success, based on its objectives and business strategy, and identify the benefits it expects to gain from any involvement. These should be stated as a benchmark against which subsequent progress can be assessed and evaluated objectively;
- authorise senior staff to register interest informally with an authority that is actively considering a scheme;
- authorise senior staff to engage in initial market sounding. This may include direct discussions with the authority as well as participation in any events or surveys; and
- consider making informal approaches to potential partners/operators and advisers.

These board considerations should be sufficiently advanced to be able to prepare an EoI and PQQ on behalf of a bidding consortium.

5.2 CHECKLIST 1 PRE-EXPRESSION OF INTEREST TO PREPARATION OF PRE-QUALIFICATION QUESTIONNAIRE

PROCUREMENT PHASE/EVENT	ASSOCIATION CHECKLIST
AUTHORITY EoI APPROVED BY ODPM	
1 Pre-procurement to PQQ request	<ul style="list-style-type: none"> ○ After becoming aware of a specific opportunity, determine association's interest in the scheme, its potential role (as either sub-contractor and/or project sponsor) if the OBC is approved ○ Consider, up to board level, the association's in principle involvement in the PFI project ○ Establish engagement criteria ○ Establish any vires issues ○ Board approval of initial bid funding budget ○ Begin sounding out potential bid partners ○ As project sponsor, identify potential partners to improve bankability and sub-contractors with necessary experience ○ As the majority project sponsor, assess the likely value of the sub-contracts to assess whether they need to be advertised in the OJEU ○ Agree heads of terms for joint venture and consortium modus operandi ○ Undertake initial risk assessment ○ Determine the association's role as a sub-contractor (housing management and/or repairs subcontractor) ○ Create provisional internal list of external financial, legal and technical advisers ○ Participate positively in soft market testing
EXPRESSIONS OF INTEREST/PRE-QUALIFICATION QUESTIONNAIRES REQUESTED	

06 PRE-QUALIFICATION TO INVITATION TO NEGOTIATE

6.1 PRE-QUALIFICATION, SHORT-LISTING AND INVITATION TO NEGOTIATE

The board should receive a report when EoI from potential operators are requested by the authority and respondents are invited to complete a PQQ.

The EoI request will be advertised formally by a notice in the OJEU although the authority may also draw it to the attention of organisations that have informally registered their interest with them.

A PQQ and some basic description of the scope, content and key features of the scheme, usually in the form of a prospectus, will be sent to respondents of the OJEU notice. The aim of the PQQ is to assess potential bidders for ItN. The capacity, capability and financial standing of the bidder to deliver the schemes outputs is the primary consideration of a PQQ although the breadth and depth of relevant experience may also be important. For a bidding consortium, the PQQ will need to be completed collectively on behalf of the consortium and individually for sponsoring companies and organisations.

Completion of the PQQ is the first substantive action in the procurement stage and should not proceed without an appreciation of the consequences and provision for possible costs of being shortlisted and being asked to submit priced bids at ItN. The board will need to consider and confirm:

- approval of the completed PQQ;
- service delivery proposals;
- an initial assessment of risk;
- the establishment of a procurement budget;
- criteria regarding the suitability of partners and advisers;
- consideration of possible bid partners and potential external advisers;
- plans for the appointment of a project board, project team and a project manager; and
- an initial assessment of the materiality of the transaction, including the association's obligations, and the potential impact on its core business.

The authority may introduce an ISOP stage. An ISOP is used if shortlisting of bidders from PQQ is required and/or the authority wants to understand better how bidders might deliver the project outcomes (although this phase has not been widely used in housing PFI to date).

Submissions are likely to be assessed on a mixture of quantitative and qualitative criteria which should be made known to bidders before the ISOP submission.

If an ISOP stage is necessary, the association board will need to consider:

- the cost of submitting an ISOP;
- the proposals for delivering the project; and
- the process for approving the final submission.

The commitment, cost and risk of bidding for a PFI project rise significantly when an association, whether in the capacity of a project sponsor or sub-contractor, becomes a shortlisted bidder following a PQQ or an ISOP. The shortlisting of an association will initiate an intensive period of discussion and clarification with the authority to confirm the services required and the condition of the stock in relation to the proposed service standard. The association should use this opportunity to understand better the project requirements and costs, and therefore the risks involved, in the project. Shortlisting to bid invitation may take four to six months for a HRA PFI contract.

The board should:

- be notified that the association has been shortlisted;
- be notified of the details of its partners and co-sponsors;
- review the costs of procurement to date;
- have signed up to the risk register and its high level allocation between consortium members;
- confirm the procurement budget;
- give delegated permission to the senior officers to negotiate with the authority, advisers and partners;
- confirm the association's role (sub-contractor and/or project sponsor); and
- set limits on procurement expenditure.

Before the ItN documents are issued, the authority will begin to share with shortlisted bidders details of their requirements in the form of an output specification.

During the period between shortlisting and the release of ItN documentation, the association will need to ensure that it has all the information and data it needs to price

the tender. This means being clear about the authority's requirements in relation to the services the association is delivering, and the robustness of the information on the condition of the existing housing stock and the land on which any new dwellings are to be constructed. This will entail identifying the information and data the association needs. There will be an element of shared investigation and co-operation with rival bidders to ensure all information requirements are met. The latter typically relate to site and stock condition surveys.

Completion and submission of the ItN documentation by the bidding consortium is typically required within 10 to 12 weeks after the documents have been issued.

6.2 CHECKLIST 2 PRE-QUALIFICATION TO INVITATION TO NEGOTIATE

PROCUREMENT PHASE/EVENT	ASSOCIATION CHECKLIST
2 Eol/PQQ preparation and submission	<ul style="list-style-type: none"> ○ Preparation and completion of the Eol and PQQ ○ Initial planning of service delivery proposals including capacity to deliver ○ Establishing a provisional budget for the PQQ and ItN submission ○ Ensure criteria are established for determining the suitability of partners and advisers ○ Confirming and securing partners ○ Provisional appointment of advisers, having assessed if the contract's annual value is likely to exceed £150,000 and have to be advertised in the OJEU ○ Create a project board, a procurement project team, develop project plan and appoint project manager ○ Revised risk assessment ○ Financial appraisal of project ○ Board approval of: <ul style="list-style-type: none"> • the completed PQQ • service delivery proposals • initial risk assessment and high level allocation between consortium members • the procurement budget • criteria for the suitability of partners and advisers and selected partners • appointed advisers • project management arrangements ○ If ISOP required: <ul style="list-style-type: none"> ○ Complete formation of consortia and confirm roles ○ Prepare outline proposals ○ Board approval of the submission of outline proposals and the cost of submitting an ISOP

6.2 CHECKLIST 2 PRE-QUALIFICATION TO INVITATION TO NEGOTIATE (CONTINUED)

PROCUREMENT PHASE/EVENT	ASSOCIATION CHECKLIST
SHORT LISTED PARTIES ANNOUNCED	
<p>3 From shortlisting to issue of ItN by authority</p>	<ul style="list-style-type: none"> ○ Review the costs incurred to date ○ Confirm appointment of advisers ○ Confirm the procurement budget and set limits on procurement expenditure ○ Revisit risk analysis ○ Give delegated permission to the senior officers to clarify scheme parameters and negotiate with the authority, advisers and partners ○ Confirm that the information and clarification gained during the post-shortlisting phase has not compromised the achievement of the objectives and criteria established by the board at the outset ○ Agree risk register and allocation between consortium members or mitigation schemes such as insurance ○ Confirm association's role ○ Initial pricing of association's services as an operator or sub-contractor on confirmation of scope of contract ○ Board approval of: <ul style="list-style-type: none"> • delegated powers to specified senior officers to negotiate with the authority, advisers and partners • appointed financial, legal and technical advisers and funders • initial pricing of association's services ○ Prepare and sign shareholder agreements (if association is a project sponsor) ○ Establish how tenant consultation will be undertaken and participate in any forum as requested. Start to develop association's consultation strategy for the project ○ Assess project area for additional and added value regeneration opportunities and assess potential risks ○ Update association risk register as project data emerges
ITN DOCUMENTATION ISSUED BY THE AUTHORITY	

07 SUBMISSION OF THE INVITATION TO NEGOTIATE

7.1 INVITATION TO NEGOTIATE

The ItN issued by the sponsoring authority requires the bidders to:

- set out their approach to service delivery;
- determine their response to the proposed contractual terms, output specification and payment mechanism; and
- provide a financial model which is the basis of the formulation of the annual unitary charge to price for the required services.

It is at this stage that resource implications on associations increase significantly. The ItN sets out in significant detail the authority's requirements for the project in terms of both the service delivery parameters that bidders must meet and the contractual framework within which they must operate. The cost of submitting an ITN will vary project by project. Whilst many bid costs are fixed, typically the larger and more complex the scheme, the higher the bid costs. However, financial and legal advisers are usually prepared to work on a contingent or largely contingent basis (the payment of the main element of their fees being contingent on the success of the bid).

The association must confirm its role and responsibilities under the contract as well as its roles, responsibilities and relationships with its consortium partners. Particular importance should be given to the performance and monitoring regime defined by the authority, as failure to meet service delivery parameters will invoke performance deductions as set out in the payment mechanism.

At this, and any subsequent pricing submission, the association must ensure its own internal control processes are adhered to and, if necessary, its involvement and role

in the project should be reconsidered and/or confirmed. Part of the submission requirement of an authority may well be to see board minutes and resolutions that demonstrate the association's commitment to the project.

Whilst the length of time for the ItN submission stage should be more predictable than earlier stages, costs associated with its development need to be monitored and reported back to the board if the procurement budget is likely to be exceeded. Withdrawal after ItN bid submission will damage the association's standing with the authority and its partners.

The ItN is a set of bid documentation, typically comprising:

- instructions and guidance to the short-listed bidders on the process to be followed;
- the project timetable;
- the criteria for evaluation of bids;
- details of the services required (the output specification);
- the proposed contractual terms governing the project (project agreement), including any preferred contract length;
- draft payment mechanism;
- form and content of financial models;
- format of funder support letters; and
- the extent to which bidders are able to submit variant bids.

7.2 CHECKLIST 3 INVITATION TO NEGOTIATE (ITN)

PROCUREMENT PHASE/EVENT	ASSOCIATION CHECKLIST
<p>4 Bid Preparation</p>	<ul style="list-style-type: none"> ○ Prepare for board approval a report on potential costs, risks and benefits to the organisation whether sponsor or sub-contractor and ensure these have been fully and appropriately evaluated ○ Confirm the core business of the association will not be undermined or compromised by participation in the PFI contract ○ Confirm, for final board approval, anticipated final contractual relationships with partners and sub-contractors ○ Confirm for final board approval that pricing of services to be delivered by the association as sub-contractor have been properly risk assessed ○ Check availability of resources for implementation in the event of a successful bid ○ Reappraise risk and financial appraisal of the project from the perspective of the association ○ Confirm that the contractual terms offered by the authority are acceptable and have been assessed by suitably qualified and experienced legal, financial and technical advisers ○ Evidence that the proposals are affordable to the authority ○ Finalise pricing and specify caveats and any contingency pricing ○ Agree risk register and allocation between consortium members including methods of mitigation schemes ○ Secure letters of support from funders ○ Obtain sponsor sign-off on the key assumptions underpinning the financial model ○ Approve ItN bid submission and sign-off of financial models ○ Update and maintain association's risk register ○ Ensure advisers are available to assist with answering any detailed questions
<p>ANNOUNCEMENT OF BIDDERS TO BE INVITED TO NEGOTIATE</p>	
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08 BEST AND FINAL OFFER AND NEGOTIATIONS TO FINANCIAL CLOSE

8.1 BEST AND FINAL OFFER TO PREFERRED BIDDER

An authority selects bidders for further negotiation on the basis of its evaluation of the ItN submission. Before “preferred bidder status” can be conferred, further clarification and negotiation is usually necessary and there may be a requirement for a BAFO process before a preferred bidder is selected. The BAFO process may be used by the authority as a means of finessing bid prices whilst there is still competition between bidders.

At the preferred bidder stage the focus of work is likely to be in respect of:

- the payment mechanism;
- finalising the output specification;
- resolving specific contractual matters (RTB formulae, hand back requirements etc.);
- further iterations of the financial model (taking account of any input changes arising from final stock survey work and matters arising from tax and accounting reviews);
- agreement of the sub-contracts; and
- confirmation that the project is affordable for the authority.

The finalisation of project documentation is dependent on the satisfactory completion of due diligence by the senior lenders. Due diligence takes three key forms, technical, legal and the financial model:

Technical Due Diligence – a detailed review of the costs underlying the project to ensure that they are sufficient to deliver the project requirements. This will include an assessment of all construction and service related costs and a detailed analysis of the payment mechanism. It is necessary to ensure that all sub-contractors are able to

bear any deductions without undermining their ability to perform. It is also necessary to consider whether, if the SPV and the bank were to elect to terminate a sub-contract, it would be possible to find a replacement sub-contractor who would be comfortable with the existing project terms.

Legal Due Diligence – focuses on the contractual risk that the bank as senior lender is exposed to through the contract, and focuses on issues such as termination provisions, payment and indexation terms and ensuring all obligations contractually placed upon the SPV are passed through to the sub-contractors. This work will also assess the authority’s legal ability to embark upon such a contract and the legality of the contract terms.

Financial Due Diligence – the price offered to the authority by the SPV is based upon the output of a financial model which takes account of all the cashflows required to deliver the project. The bank employs advisers to ascertain the robustness of the financial model, testing its construction, and the formula within it. It includes sensitivity testing of assumptions (increases in cost base, changes in inflation, reduced revenues due to poor performance etc.). All of this is set against the funding covenants set by the bank.

Contractual Close of a project is the point at which the project agreement between the authority and the SPV is signed and all the sub-contracts existing between the SPV have been signed.

Financial Close is the point at which senior debt funding is in place and priced (usually via an interest rate swap). Funders will only allow an interest rate swap to be put in place once all its condition precedents are met. Financial close allows the senior debt to be drawn down. Senior debt is used to fund the construction and refurbishment works, thus allowing project work to commence.

CHECKLIST 4 BEST AND FINAL OFFER, FINAL NEGOTIATIONS AND CONTRACT SIGNATURE

PROCUREMENT PHASE/EVENT	ASSOCIATION CHECKLIST
5 BAFO Preparation	<ul style="list-style-type: none">○ See checklist for “Bid preparation” above and○ Ensure that association’s board is available to take any material decisions relating to the bid○ Update risk assessment○ Ensure advisers are available to assist with BAFO○ Ensure that potential lenders are kept abreast of proceedings and if necessary request revised letters of support
BAFO SUBMISSION AND SELECTION OF PREFERRED BIDDER	
6 Detailed Negotiations	<ul style="list-style-type: none">○ Ensure that potential lenders are kept abreast of proceedings and if necessary request revised letters of support and Term Sheets as the process continues○ Revisit risk assessment○ Ensure association’s board is kept up to date with changes to the output specification, pricing and risk allocation and the financial model○ Approve final contract documentation○ Instruct separate legal advisers to advise association as sub-contractor○ Negotiate and finalise all caveats and contingency pricing○ Ensure authority has confirmed price is affordable and “off balance sheet” for public sector account purposes○ Update and maintain risk register○ Keep implementation team on board and ready to start contract○ Ensure resources are in place or are earmarked to meet immediate or ongoing funding obligations of the association
FINANCIAL AND COMMERCIAL CLOSE	

09 DELIVERING THE CONTRACT

9.1 KEY ISSUES FOR AN ASSOCIATION PRE FINANCIAL CLOSE

The following are key suggestions of good practice in the period between preferred bidder selection and up to financial close:

- ensure that the delivery teams are involved in the negotiation of the contract, particularly around key risks. This is vital to ensure understanding of the project, that the practical aspects of delivery are taken into account by the negotiating team and that all parties are fully aware of the requirements being placed upon them. One way to do this is to involve the delivery team in the negotiation of the sub-contract with the SPV in tandem with the negotiations the SPV is undertaking with the authority;
- ensure that operators are ready to deliver from day one. Associations need to mobilise their resources and be ready to deliver services immediately;
- concentrate on getting the basics right first. Customer care is vital and in housing PFI the association has a key role to play in getting customer care right. PFI contracts often have wider aims than basic service delivery, for example, regeneration of an area, not just essential repairs. Even so, customers will not be won over if the PFI team cannot deliver immediately at least as good a service, and preferably an improved one, as existed previously. Other members of the SPV and sub-contractors may not be as experienced as the association in dealing with customers on a day to day basis. In most cases, customers have been waiting for the PFI project for a considerable period of time and will be keen to see visible change quickly. Managing expectations by providing adequate and reliable information will be a critical part of the association's role;
- establish professional relations immediately with the client. For housing PFI, the client side will include tenants as well as officers of the authority. Elected members will also be taking an interest in an association's service delivery. Ensure the staff are known and available to all the client representatives; and

- focus on building good relationships at operational and senior managerial level between the sub-contractors and the SPV. There will be a great deal of detailed working together and this will be much easier if there are good relationships and clear lines of communication and accountability.

9.2 KEY ISSUES POST-FINANCIAL CLOSE

The completion of a PFI deal is a significant achievement. However, for the delivery teams the hard work is just about to begin. Most PFI projects provide a mobilisation period to enable set up for service delivery. This is a crucial period as the tone set for the operation of the contract in its early days will be vital to its success. The following need to be considered:

- **Mobilisation** – the association should ensure that its services are mobilised from day one to undertake the services specified in the output specification;
- **Get the basics right** – focus on delivery and solid performance of the basics from day one. Any added value element can be introduced more gradually;
- **Focus on relationships** – a new team is in place for delivery. It may contain some of the negotiating team but will certainly have new members of staff, often from different organisations. Take time to build the team;
- **Disseminate information** – make final copies of the documentation available as soon as possible. It is difficult to remember where negotiations ended up on every issue and a great number of versions of the documentation will be discussed in the latter stages of negotiation. Ensure that everyone knows and understands where the final position rests;
- **Read the Project Agreement** – key members of the delivery team should become familiar with the relevant details of the project agreement and its schedules at an early stage. It may be tedious, but it is vital. There will be a significant number of queries in the early stages. There will be a large number of processes and protocols that an association will need to understand. Some associations may find it helpful to develop summaries of the key contractual terms, output specification requirements and payment mechanism in so far as they impact on the obligations and requirements of the association;

- **Expect some 'storming'** – this is the formation of a new team and the usual processes will apply. There will be difficult issues to deal with as the practicalities of the contract are explored. Different interpretations will become apparent as will issues which were never covered in the negotiation. Be prepared to put resources into this period to assist resolution and the establishment of a high performing team at the earliest possible stage;
- **Provide resources within the SPV** – although the SPV passes on its responsibilities to the sub-contractors there is nevertheless a continuing role for the SPV to play in managing the overall performance of the project and the sub-contractors. This is intense and resource hungry in the early stages. Similarly the sub-contractors need to make sure that sufficient resources are made available to deal with the inevitable issues that arise immediately after financial close. Project implementation groups will need to be established in order to manage the effective delivery of the key elements of the output specification;
- **Staffing issues** – the delivery of the project will most likely require the recruitment of new staff and the assimilation of Council staff under the Transfer of Undertaking (Protection of Employment) (TUPE) regulations by the sub-contractors. It will also require new ways of working and staff will need to understand

the disciplines of working with an output based performance regime. This will require appropriate support and training and does not come without a cost;

- **Benchmarking** – PFI contracts typically require services to be subject to benchmarking every five years or so. Benchmarking is a means by which an authority obtains assurances that such services continue to provide value for money. An association will need to ensure that the method and means of benchmarking are clearly understood and comparative data is relevant to the contract and services it is delivering;
- **Variations** – PFI contracts are long term in nature and it is likely that aspects of the output specification will need amendment at some stage. Any variations or changes will need to be processed and priced in accordance with the relevant clauses in the project agreement; and
- **Reporting and monitoring** – The SPV will need to maintain careful watch on its delivery against the output specification and the payment and performance regime. Performance should be reported to the association's board which needs to ensure that appropriate governance structures are in place to ensure the risks and the financial exposure are being managed appropriately.

CASE STUDIES IMPLEMENTATION

CASE STUDY 1

To give a community in the North West confidence that the planned PFI scheme would deliver (negotiations had lasted for some three and a half years), one of the partners in the SPV entered into a contract to refurbish empty properties in the PFI area before the PFI contract was signed. This early win gave the SPV the opportunity to work in the area, get to know tenants and to find out how things worked “on the ground”.

CASE STUDY 2

On one Scheme, it was agreed that there would be a two month grace period for deductions after the newly introduced housing management and repair service commenced. This gave the Operator the opportunity to settle in and get to know the job before the performance monitoring regime was applied in full.

CASE STUDY 3

Flexibility is required in delivering a PFI contract. At a PFI scheme in the North West, it quickly became apparent that the sub-contractors did not have all the resources at hand necessary to resolve a range of complex operational issues. The sub-contractors were rightly focussing on delivering their contracts - they did not have the authority or responsibility to resolve issues affecting the overall performance of the SPV.

The structure within the SPV has now been amended to put in financial and management resources to deal with:

- Client management
- Performance and delivery of the overall service
- The resolution of interface issues between sub-contractors.

CASE STUDY 4

In a PFI scheme in the North West, the housing management provider agreed that some services would start ahead of the main contract:

- The authority contracted separately with the refurbishment contractor to refurbish a number of empty properties so they would be available for residents, whose homes were being demolished.
- Housing management and repairs services started immediately on contractual close, giving the delivery teams a six month period of service delivery before the major capital works started.

Both steps helped to reassure customers that “something was being done” and as a consequence customer relations and client satisfaction improved.

APPENDIX GLOSSARY OF TERMS AND ABBREVIATIONS USED

ABBREVIATION (WHERE USED)	TERM	DEFINITION
	4ps	The Public Private Partnership Programme: the body established by the LGA to provide procurement support to local authorities.
	Affordability	Provision of an acceptable scheme at a price which the local authority can fund within available resources over the whole contract period.
ALMO	Arms Length Management Organisation	Housing management company, guaranteed by the authority which owns the housing stock it manages.
	Assured tenancy	Tenancy defined by 1988 Housing Act. Form of tenancy often prescribed by the Housing Corporation for rented dwellings built or provided with public subsidy.
	Authority	The authority commissioning the PFI contract.
BAFO	Best & Final Offer	The stage during the bid period at which a short-listed bidder submits a final Bid to the procuring authority, in the form of a best and final offer.
	Best Value	The duty of continuous improvement placed on public bodies in the Local Government Act 1999.
	Bid	A Bid submitted by a SPV in response to an Invitation to Negotiate.
CSR	Comprehensive Spending Review	Tri-annual review of public expenditure led by HM Treasury. The last review was completed in July 2004 for 2005/6.
CCT	Compulsory Competitive Tendering	Requirement on local authorities, originally prescribed in 1988 Local Government Act to subject specific services to competition. Housing management services were included in 1991.
	Contract	The Project Agreement - the terms are used interchangeably.
	Contract negotiation	Negotiations between the contracting parties between acceptance as preferred bidder and final agreement of quality, timing and costs of services for inclusion in the contract.
	Contractor	The Party which ultimately enters into the Project Agreement with the authority (see also "Operator");
	Contractual close	Signing of Project Agreement between the authority and the SPV and all the sub-contracts between the SPV.
	Co-sponsors	If a PFI scheme is delivered by a SPV comprising of a consortium of individual members.

ABBREVIATION (WHERE USED)	TERM	DEFINITION
DBFO	Design, Build, Finance and Operate	An approach by which schemes are procured in partnership with the private sector as an alternative to traditional procurement mechanisms.
	Due diligence	An assessment by funders of the robustness of anticipated costs and appropriateness of risk allocation before final contract close. Usually takes the form of technical, legal and financial due diligence.
	Equity stake	Investment by project sponsor(s) in project company or SPV.
Eol	Expression of Interest	An initial registration of interest by a potential operator.
	Facilities management	Services associated with the maintenance of an asset provided through PFI.
	Financial close	Point at which senior debt is priced and secured allowing funding to be drawn down for the construction and refurbishment works.
	Funder	A bank or other financial institution from which a Bidder proposes to obtain senior debt funding for the Project.
	Hedged interest rates	The interest rate fixed at financial close negating the risk of future interest rate movements affecting the project price.
Corporation (the)	Housing Corporation	Non-departmental Public Body which regulates and invests in Registered Social Landlords (RSLs).
	Housing Corporation's scheme development standards	The minimum building standards prescribed for new developments undertaken by RSLs with public subsidy. Applied to new build housing PFI schemes. See " www.housingcorplibrary.org.uk/housingcorp.nsf " for details.
	Housing Investment Programme	An authority's plans for capital investment in its stock.
HRA PFI	Housing Revenue Account Private Finance Initiative	PFI schemes benefiting existing housing stock owned by a local authority and held in its HRA.
HRA	Housing Revenue Account	An authority's housing landlord account as required under 1989 Local Government & Housing Act.
	Interest rate swap	A Hedging instrument that fixes (typically for the life of the PFI contract) the interest rate payable on the Senior debt.
	Interim Services Period	The period during which Properties are being brought up to the standard required in the Full Services Period.

ABBREVIATION (WHERE USED)	TERM	DEFINITION
ItN	Invitation to Negotiate	Invitation to short-listed Bidders to provide and negotiate bids.
ISOP	Invitation to Submit Outline Proposals	Invitation to interested bidders to prepare and submit their proposals for meeting the authority's requirements.
LGA	Local Government Association	The body representing local authorities in England and Wales.
LIFT	Local Improvement Finance Trust	Form of PFI scheme developed by NHS and PUK to provide primary and social care facilities and services but enabling the public sponsors to retain a stake in the asset. RSLs have been the private sector partner in a number of schemes.
LIBOR	London Interbank Offered Rate	The rate at which banks will offer funds on the London interbank market. It is often used as a reference rate for payments on floating rate instruments.
	Method Statements	The method statements to be prepared by the Contractor as part of its Bid.
Non-HRA PFI	Non-Housing Revenue Account Housing Private Finance Initiative	PFI schemes benefiting a local authority through the provision of new or improved housing owned by an association.
	Off balance sheet	For an authority the transaction needs to be off balance sheet by reference to Financial Reporting Standard 5 (FRS 5).
ODPM	Office of Deputy Prime Minister	Government department responsible for approving and funding housing PFI schemes.
OGC	Office of Government Commerce	HM Treasury department overseeing procurement by public bodies.
OJEU	Official Journal of the European Union	The publication in which tender opportunities from public bodies are publicised within the European Union.
	OJEU notice	The advertisement of a tender in the OJEU.
	Operator	An organisation or consortium, usually constituted into a Special Purpose Vehicle, providing services under a PFI contract.
OBC	Outline Business Case	An outline of the proposed PFI scheme submitted by an Authority to the Policy Review Group (PRG).
	Output Specification	The document, usually an appendix to the Project Agreement, which sets out the required availability and service standards.

ABBREVIATION (WHERE USED)	TERM	DEFINITION
PUK	Partnerships UK	A Public Private Partnership (PPP) with the public sector owning a minority interest. Its mission is to help the public sector to deliver fast and efficient procurement of PPPs.
	Pathfinder scheme	One of the eight HRA PFI schemes in the initial round of the housing PFIs announced in 1999.
	Payment Mechanism	The basis on which payments and deductions are made with regard to the PFI contracts.
	Performance Standards	The service standards set out in the Output Specification;
	PFI Procurement process	The process by which a successful contractor/operator is selected following the process outlined in this Guide.
PRG	Policy Review Group	Bi-monthly Inter-departmental meeting led by HM Treasury to consider and approve bids for PFI credits.
	Preferred Bid	The Bid submitted which, in the opinion of the authority, offers the most advantageous terms.
	Preferred Bidder	A Bidder that the Authority has selected as its preferred partner for the Project.
PQQ	Pre-Qualification Questionnaire	Process by which the procuring authority shortlists Bidders following EoI.
	Procurement Process	The competitive process used to appoint a contractor to undertake the Project.
	Project	The basis of the contract - the assets being included in the contract and the expected outputs.
	Project Agreement	The formal contractual agreement between the authority and the successful bidders (see also "Contract" above).
	Project board	The committee created by the RSL board to oversee the procurement of the PFI contract. A project board is usually also established by the authority.
	Project sponsor	An organisation taking a stake in the body delivering and attracting funding for a scheme, in this case a PFI scheme. If the scheme is delivered by a consortium, individual members of the consortium are "co-sponsors".
	PPP	Public Private Partnership
PSC	Public Sector Comparator	The cost to the authority of procuring an equivalent scheme by traditional methods.
RSL	Registered Social Landlord;	A social landlord which is registered with the Housing Corporation,

ABBREVIATION (WHERE USED)	TERM	DEFINITION
	Reserve Bidder	An alternative operator held in reserve in case the authority cannot reach agreement with the original preferred bidder.
	Resource and Financial Cost Comparison Model	The pro-forma financial model which the authority is required to complete for ODPM and PRG.
RTB	Right to Buy	Process by which tenants of local authorities and some tenants of non-charitable RSLs can acquire their homes.
	Risk scenarios	Calculations of the impact and probabilities of different risks occurring.
	Service Delivery Plan	A document prepared by the Contractor which sets out the manner in which it or each Operator proposes to provide the Services and satisfy the Service Specification.
SMT	Soft market testing	Process of identifying whether a project is attractive to the market.
SPV	Special Purpose Vehicle	A limited Company that is established for the sole purpose of delivering the PFI project.
	Step-in	A funder will reserve the right to intercede if a contract is not delivering the required services and termination is in prospect.
	Stock Condition Survey	An assessment of the works required to the assets to bring them up to the availability standard and maintain them there for the duration of the contract.
	Stock transfer	The transfer of a local authority's housing stock to an association.
	Third party revenues	Income from sources other than unitary charge e.g. private house sales.
	Unitary Charge	The fee payable monthly over the life of the contract by the authority in respect of works and services provided by the Contractor
VfM	Value for Money	The relative cost of delivering the same service through different procurement methods.
	Variant Bid	A bid submitted at ItN to price for variations to the output specification.

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Good Practice Guide – Private Finance Initiative (the “Guidance”)

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