

HM Treasury

Application Note – PPP Projects In Current Market Conditions

1. Introduction and Scope of this Application Note

The dislocation in the financial markets and adverse economic conditions continue to affect the procurement of PPP projects and this note is intended to aid authorities in addressing the issues that have arisen specifically from these circumstances. Conceptually, the note is organised to give advice in respect of stages of procurement from the pre-OJEU phase through preferred bidder. Clearly, many activities are not confined to a single stage of a procurement, and authorities should be aware that advice given under one stage may be useful in other stages as well.

Some of the advice in this note will require authorities to work closely with their financial advisers in areas that might not have called for special attention in the past. Appendix 1 contains details of these and is referenced where applicable in the note.

This Application Note is intended to address current market conditions and consequently will expire, unless renewed, on 31 August 2010.

28th August 2009

2. Pre-OJEU phase

- ***When preparing an Outline Business Case authorities should not rely on a return to “normality” in the funding markets by the time the project needs financing***
- ***Authorities should draft the OJEU notice and other tender documents as widely as possible to ensure that alternative financing solutions can be accommodated***

2.1. Overall timing and context

This Application Note is intended to address the situation as it exists in summer 2009. An authority might take the view that markets will return towards “normality” over a period similar to that experienced after previous economic downturns.

This is not a robust approach, for several reasons:

- it is not clear what will represent stability in the next business cycle;
- the timeframe for any change in market conditions is not clear; and
- if authorities are to engage with the market effectively during the bidding process it is necessary to make it clear that they have taken an appropriately prudent view of market developments and that they have a robust strategy for accommodating changes in market conditions.

The key requirement for any authority is therefore to determine a strategy for running their procurement which is robust and which will be seen as such by the market.

2.2. Flexibility, affordability and value for money

Current economic circumstances offer less certainty for authorities than has previously been the case. Given this lack of certainty, when preparing their Outline Business Cases (OBC) authorities need to plan for flexibility with regard to:

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

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

In relation to the detail of contract design and risk allocation, for many areas there is standard drafting set out in departmental standard forms and SoPC4. Authorities should assume as a default that these positions will not change but if there are particular areas where an authority may want to derogate from these

standard positions they should seek input from their sponsor department, Partnerships UK or HM Treasury as early as possible.

Authorities should be wary of trying to address the current lack of long-term funding by shortening the contract length. It may be that shorter contracts are more attractive for bidders or funders, but authorities should be careful not to undermine the risk transfer inherent to the PFI model, which relies on project life being adequate to incentivise contractors to design a sustainable construction and service model.

Where an authority is considering making a capital contribution to a project, this should be considered as part of the OBC in both the affordability and value for money assessments. Capital contributions by authorities are discussed further at section 4.3.

As with the affordability assessment, constructing a robust quantitative value for money assessment will require particular attention to be paid to the following points:

- financing costs / terms such as gearing, maturity, swap rate, swap credit spread and bank margins;
- underlying construction and service costs; and
- inflation assumptions.

Authorities should seek professional advice on suitable assumptions to use for financing inputs. Authorities should ensure that financial advisers have access to information on comparable assumptions over a suitable timeframe including recent transactions as well as terms achieved on older transactions to inform the sensitivity analysis. Similarly, suitable advice should be sought from technical advisors in relation to the underlying contract costs and the appropriate sensitivities to be applied.

In terms of inflation, the Bank of England's target remains 2% annual inflation based on the Consumer Prices Index. Customarily in PPP projects, inflation has been assumed to be 2.5% per annum based on the Retail Prices Index, the difference between the two figures largely reflecting the differing construction of the indices. Authorities may wish to make a case for a different figure, but should not use the inflation assumption to address affordability concerns. Regardless of the figure used, it should be standardised across bidders and be acceptable to potential funders.

Although financing matters are frequently seen as quantitative, the qualitative assessment should consider these issues also. For example, alternative financing solutions may have an impact on project robustness, the nature of the commercial relationship or the detail of risk transfer.¹

The overall business case should be presented and understood on the basis of sensitivity analysis run against assumptions rather than on single point

¹ SoPC4 chapters 35 and 37 provide further relevant guidance on financial robustness and the approach to be taken to proposals for corporate finance, respectively.

assumptions alone. Assumptions should incorporate an appropriate but not excessive level of optimism bias.²

2.3. Procurement plan and OJEU notice

The OBC procurement plan will need to incorporate the flexibility required to deal with a changing market and uncertainty about the most appropriate financing solution. Whilst the expectation may be that the project is wholly privately financed, procuring bodies may need to retain the option to provide or procure capital contributions or access The Infrastructure Finance Unit (TIFU). Project managers should therefore consider whether the OJEU notice, descriptive document and other tender documentation are sufficiently flexible to facilitate capital contributions or TIFU participation. Capital contributions are discussed further in section 4.3 below and TIFU participation in section 4.2 below.

To allow for the return of a more competitive funding environment, projects prior to OJEU should allow time and resource for such a preferred bidder debt funding competition (PBDFC) in the procurement plan (see section 4.1 below).

²See paragraph A.28 of the Quantitative Assessment User Guide (March 2007).

3. Dialogue phase

- ***Authorities should keep themselves well informed about market funding terms. This does not, however, diminish bidders' responsibility for submitting financeable bids***
- ***Authorities should keep funding options open at this stage***
- ***Authorities' financial advisers should begin to review funders' terms against the market***
- ***Authorities should consider funding variants to encourage bidders to explore options that may be developing in the market***
- ***Authorities should work with their financial advisers to understand the use and limitations of standardised funding assumptions***
- ***Authorities should generally not seek firm funder commitment or pricing at this stage***
- ***Authorities should be aware of and manage new sources of risk to bidders' prices***
- ***Authorities should work with their financial advisers to understand the counterparty risk they are taking***

3.1. Bidders remain responsible for financing

Throughout the dialogue period, authorities should be well-informed about the state of the funding market to enable them to make independent judgements about the deliverability of funding terms submitted by bidders; however, this guidance in no way diminishes the requirement for bidders to obtain support from funders and to submit financeable bids. It is important to recognise that bidders need to engage with funders to the extent that they judge necessary to have confidence that their proposals are financeable, but that authorities do not need to engage directly with funders early in the dialogue phase in normal circumstances.

3.2. Clarifying funding arrangements

In the past authorities would have expected:

- bidders to be in discussion with potential funders even if formal due diligence is conducted after the appointment of preferred bidder;
- terms from funders to be reflected in bid models with a credible statement from funders that terms are likely to be maintained until financial close;
- bidders to offer significant certainty about the availability and terms (including pricing) of debt; and

- bidders to manage the relationship with funders (including satisfaction with key contractual positions adopted such as subcontracts) so that this is not a significant interface for authorities.

However, in the current market bidders have found that it is difficult to offer certainty about the availability and terms of funding, or – where they have felt able to offer such certainty – problems have nonetheless arisen. The overall effect is that funding remains less certain until later in the procurement and the authority's risk of adverse affordability and/or contractual changes increases.

It is the responsibility of the authority and its advisers to determine how much funder involvement is required prior to selecting the preferred bidder. Authorities should work with their financial advisers to realistically assess their projects so as to strike a balance between unnecessarily making demands on funders where the risk profile does not merit it and failing to identify aspects that may cause delay later due to funder concerns. Project factors to consider include complexity and, potentially, size:

- for smaller, straightforward projects (e.g. those without demand risk, significant retained estate, challenging construction requirements, unproven technology or high operational gearing or non-standard capital contributions), funder engagement should generally remain limited at this stage. Instead, authorities and their advisers should therefore focus on ensuring bids are financeable prior to selecting the preferred bidder;
- for complex projects, authorities should satisfy themselves that funders are aware of the complexities and have not raised any issues that affect financeability; and
- for large projects where the banking club involves a significant proportion of the available funders, more involvement is likely to be appropriate and authorities should satisfy themselves that the terms assumed represent an appropriately conformed position for this stage of dialogue.

Once authorities have determined the appropriate level of funder engagement, they should apply the chosen approach consistently for all bidders.

Where authorities do seek funder involvement prior to the selection of the preferred bidder, funders should be asked to identify any aspects of the project that they believe would materially adversely affect their ability to obtain credit approval. Authorities should understand exactly what areas of the documents, financial modelling, contractual risk allocation (including subcontracts), and technical aspects of the project the funders have considered in reaching their conclusion. Vague support letters stating that the project documents, preliminary technical report and financial model have been made available to funders should be discouraged in favour of disclosure of specific work undertaken by funders. As such, funders should explicitly acknowledge in their support letters the subcontract flow down inherent in the bid price and disclose any side letters or other conditions that have been communicated to sponsors. Sponsors should have a parallel obligation to disclose such side letters or conditions as part of their bid. Where funders have supported the bid, these representations should be repeated in the preferred bidder appointment letter by the selected bidder and the funders.

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

Authorities should reject a funding proposal that relies upon the use of TIFU at this stage of procurement. Bidders should not submit bids including TIFU funding and authorities should not assume that TIFU funding will be available at the projected financial close date.

3.3. Managing the implications of financing arrangement uncertainty in bid evaluation

Authorities should:

- work closely with their financial advisers to identify and monitor the development of project-specific issues that may affect the terms of finance;
- where the senior debt terms suggested by bidders are – in the view of the authority and its financial adviser – not supported by market evidence, provide all bidders with standard funding assumptions (see section 3.2) to enable dialogue to proceed;
- monitor the funding market and update both their affordability analyses and standard assumptions provided to bidders as required;
- evaluate dialogue responses with consideration of senior funder sensitivities on project risk, so as to understand the relative implications for alternative bids (for example where some bids are capital-intensive and others service-intensive); and
- seek guidance from their parent or sponsoring department on assumptions which might be appropriate for the project. Authorities may also consult with HM Treasury and Partnerships UK.

3.4. Standardisation of funding assumptions

Given the length of time before financial close, authorities should consider using standardised financing assumptions to assess bids. These terms should be set by reference to financing terms available in the market for similar projects at the time of the bid assessment.

Standardised assumptions should include the underlying gilt or swap rates, swap credit margin, debt margins and debt tenor. Debt service coverage ratios may also be standardised unless there is a wide variation in such ratios due to different business models underpinning different bids³. Care should also be taken in standardising assumptions such as maintenance and handback reserving requirements which may be highly dependent on the technical solutions of individual bidders. Once the preferred bidder is announced, funding terms for that bidder may be subjected to a competition if market conditions warrant (see section 4.1 below).

³ The waste sector is the principal example.

Authorities may consider making an exception from standardised assumptions for bids funded on a corporate finance basis but only if the authority considers that the offer of finance is robust.

3.5. Potential role of EIB in funding

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

The EIB is considering widening the scope of its financial offerings. While avoiding requiring any particular funding solution, authorities should ensure that bidders are aware of what products exist and that they have contemplated them in the preparation of their funding plans.

3.6. Price validity periods in respect of lending and subcontracts

Although it would be unrealistic in the current market to expect funding terms at this stage to be held until financial close, authorities should have a clear understanding of the period for which all pricing elements of each bid submission are valid. In respect of subcontracts, authorities should continue to require prices to be held for a period standardised across all bidders and may wish to make an extension of the minimum price validity period an element of competition.

In projects with a significant content of materials sourced from outside the UK, authorities need to be aware that the sterling contract price may be subject to foreign exchange fluctuations. Foreign exchange rate volatility can increase the risk of a sterling price adjustment in the final stages of contract negotiation. In such projects, authorities should require that bidders explain their strategies to mitigate this risk, or, in cases in which this is a particularly important factor, consider requiring a bidder to enter into a hedging arrangement as a condition of being named preferred bidder.

These factors, as well as financing costs, will have implications for the overall affordability of the project. Working with technical and financial advisers, authorities need to understand the drivers of project costs, and to model sensitivities in key areas to assess the possible impact on affordability of changes in these costs. Authorities should manage cost changes during dialogue by maintaining competitive tension among bidders, but they should also understand what possibilities there may for re-scoping of the project should affordability constraints be breached.

3.7. Variant funding options

There are a number of alternatives to traditional bank and bond funding that are being discussed in the market and authorities should encourage bidders to identify variant funding solutions. The Private Finance Initiative has never been predicated on any particular funding model. The objective on the public sector side might be summarised as being to have a robust delivery arrangement which represents value for money in terms of the overall price. This does not necessarily imply a

90:10 geared project-finance structure and in some sectors corporate finance has been used as an alternative. Authorities entertaining funding structures outside of the historical project finance model should consider how they will be evaluated and consult with their Private Finance / Commercial Unit or HM Treasury at an early stage.

Authorities may be asked to consider proposals to change risk allocations to elicit more attractive financing terms, in particular in respect of margin and maturity. Any variant requiring risk allocation that differs from SoPC4 (March 2007) will require Treasury approval and authorities should be clear in their instructions to bidders that, while they wish to receive innovative proposals that will lower the cost of financing, a variant that may require derogations from SoPC4 will not necessarily be approved. Authorities should consult with HM Treasury before progressing with a bid that is affordable only with a derogation from SoPC4.

3.8. Due diligence by authorities on financial health of project parties

Authorities will typically include questions within the PQQ to elicit information on the financial robustness of bidders. In the current economic environment, it is essential that authorities and their financial advisers continue to monitor the financial health of critical members of each bidder's supply chain, including sponsors, key sub-contractors and lenders, throughout the procurement period (see Appendix 1).

Authorities should consider:

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

In terms of responses to potential problems with the financial robustness of relevant organisations, authorities should consider whether the most suitable response is to disqualify the bidder, amend the procurement plan or seek to remedy the potential problem, perhaps by encouraging a change to the risk allocation within the supply chain or by encouraging some form of financial support. Funders' interests are aligned with those of the authority in this area, and authorities may find it useful to examine credit-enhancing features that funders have required within the supply chain of bidders about which they have concerns. Authorities may require legal advice in responding to potential problems in this area.

4. Preferred bidder phase

- ***Authorities should understand when a preferred bidder funding competition is appropriate***
- ***Authorities should be aware of TIFU and its role***
- ***Authorities should understand the appropriate use of capital contributions as a solution to a funding shortfall***
- ***Authorities should be aware of issues around hedging in the current market***
- ***Authorities should know their options if there is a funding shortfall***

4.1. Applicability of preferred bidder debt funding competitions or competitive book building

Historically, PBDFCs have enabled the authority to obtain the most favourable funding terms. The use of a PBDFC however presumes that there are sufficient funders in the market to create competitive tension to the benefit of authorities. In recognition of current market conditions, a balance needs to be struck between the preferred bidder's desire to close quickly and the authority's desire to minimise funding costs.

With its financial adviser, the authority should realistically assess the potential for improvement in the terms (taking into account recently closed projects of a similar nature to its own) to be gained from a PBDFC. Several factors could influence this assessment including:

- **Value for money & deliverability of existing terms.** Where funders have supported a bid, the authority should consider whether the existing funding package is deliverable and represents value for money before deciding to run a PBDFC. Authorities should be aware that the same banks may have supported several bidders prior to the selection of the preferred bidder with the result that lenders' interest in a particular project may not be as deep as would have appeared to have been the case. The authority should therefore satisfy itself that it is fully aware of the existing funders' positions and this may involve direct interaction with the funders;
- **Funder appetite.** Authorities should be aware that apparent sufficiency of funding as evidenced by funders' support letters is not necessarily reflective of the commitment or ability of those funders to reach financial close on the authority's timetable. In addition, funders that supported only the unsuccessful bidder(s) may not necessarily be able or willing to support the winning bidder due to differences in risk appetite, client relationship or for other reasons;
- **Funding shortfall.** The larger the project, the less likely a PBDFC will be effective; and
- **Adverse impact on timetable to close.** Authorities should be mindful of the potential for delays to close associated with PBDFCs.

4.2. Guidance on using The Infrastructure Finance Unit

As set out in HM Treasury's letter dated 5th May 2009 "Treasury lending to PFI projects and the Treasury's Infrastructure Finance Unit", TIFU will consider lending to PFI projects where insufficient private sector or EIB funding is available on acceptable terms to allow the project to reach financial close on a timely basis.

In summary, TIFU will consider lending on a market basis, generally alongside other funders, where:

- a project cannot secure sufficient finance to reach financial close on a timely basis;
- proposed private sector funding is not representative of terms and conditions generally available in the market; or
- a project is at risk of delay due to lack of genuine funder engagement.

TIFU will not engage before the preferred bidder stage of a project. Any approach to TIFU should be made via the procuring authority and any relevant Private Finance Unit.

The fact that funding offered to a project is on terms which may create affordability difficulties will not, on its own, be grounds for TIFU to consider lending.

For further information, authorities should refer to the TIFU section of HM Treasury's website.

4.3. Use of authority capital contributions

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

Timing

Whether the capital contribution is made during construction or at / after completion will, in most cases, make relatively little difference to affordability. Either will reduce the unitary charge because, for the bulk of the life of the project (i.e. its operational phase – typically much longer than the initial construction period), the level of private funding is reduced; however, the timing of the authority's contribution has a significant effect on risk transfer.

For straightforward accommodation projects, attaining completion generally marks a point of diminished risk for an authority making a capital contribution. In the ordinary course of events, no public sector capital contributions should be made to the project, and no unitary charge should be payable, until the works have been completed and accepted (SoPC4 3.9.1).

However, for some complex projects (including those with unproven technology or high operational gearing), construction completion does not always mark a point of diminished risk. In such circumstances, authorities should justify to HM Treasury

the timing of capital contributions in the context of construction and operational risk posed to the authority.

Authorities wishing to make capital contributions earlier must obtain approval from HM Treasury through the derogations procedure.

Funders, equity and subcontractors should not seek to have authorities provide date certainty for payments linked to completion.

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

Amount

The size of capital contributions appropriate will depend, *inter alia*, on the risk characteristics of the project. The overriding principle should be that sponsor equity and private sector debt should absorb all of the expected losses in the project as determined through stress testing of cash flows and construction period delay and default scenarios. It is possible that the risk characteristics of some projects, in particular those with challenging construction techniques or volatile cash flows associated with demand risk, will make them unsuitable for funding by authority capital contributions.

It is unlikely that capital contributions in excess of 20% of the capital works value of a project will be appropriate. Any capital contribution over this amount must be discussed with and approved by HM Treasury as part of the derogation process.

Other implications of capital contributions

- Payment mechanism. The inclusion of a capital contribution will lower the total unitary charge by reducing the amount required to service finance; however, the unitary charge attributable to service providers will remain the same. The effect of this is to change the relative amount of unitary charge at risk to project sponsors. Where a capital contribution is introduced into a project once the payment mechanism is relatively mature, the authority will need to review the payment mechanism to ensure it remains appropriately calibrated and appropriate incentives exist to ensure delivery of the contracted services.
- Operational gearing. As noted above, the reduction in finance costs relative to service costs raises the operational gearing of the project⁴. In turn, this may give rise to a lender requirement for higher debt service coverage ratios thereby increasing the unitary charge. Authorities should therefore consider related financial impacts when analysing capital contributions.
- State aid and procurement procedures. Any capital contribution must be consistent with laws relating to state aid. Additionally, to reduce the risk of infringing procurement procedures, the OJEU notice and tender documents should be drafted sufficiently broadly to allow for the possibility of public sector financing, including capital contributions.

4.4. Hedging matters

⁴ By increasing the ratio of the service cost to the total costs of the project company.

HM Treasury's May 2006 Application Note "Interest-rate & Inflation Risks in PFI Contracts" (Interest-Rate & Inflation Application Note) contains guidance on hedging issues for projects at various stages in procurement through to financial close. In particular, it includes guidance on the execution process for interest rate swaps that are common to most PFI projects (see section 2.7 of such Application Note). The interest-rate swap is sometimes regarded as a minor technical area within the overall funding arrangement but it is important that authorities are aware of the issues which arise and able to manage the process so as to protect their interests.

In the current environment authorities should note the following points in addition to those set out in the Interest-Rate & Inflation Application Note:

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

Funders are motivated by the swap economics as well as the loan economics, often via separate departments of the same organisation. For example, funders committing to a loan on a take and hold basis typically amortise the upfront fee over the loan life. However, in some cases the value of the swap credit spread is recognised upfront. As a result, many funders will seek to have a role in arranging swaps. This has a number of implications:

- deciding which funders will arrange the swap(s) and whether or not they can be removed from the funding / swap provider group should be a key part of the funding competition / book-build process rather than an afterthought. In some cases, a separate swap competition may be appropriate. This is primarily a matter for the bidder but the public sector should understand and agree the key aspects of the process given they take the risk on swap rates;
- not all funders in a club are equally positioned when it comes to providing hedging. For example, building societies are generally unable to provide swaps but may provide other solutions. The authority and its advisers should seek to understand the bidder's overall hedging strategy early on and in particular whether it requires any derogations from SoPC4; and

- particularly for larger transactions, there is a balance to be struck between too many swap participants and too few. If every funder in the club is given the right to participate there may be a large number of participants seeking to execute trades at the same time which may lead to market confusion. Alternatively, if there are too few swap participants, the authority may lose the option of removing a swap provider / lender from the transaction should they no longer offer value for money.

Further to the Interest-Rate & Inflation Application Note, the value-for-money baseline should be a matching of indexation of the service charges to the underlying inflation exposure of the contactor's costs during the service delivery period. Any authority seeking a derogation from this position will require the approval of HM Treasury. In addition, authorities should note that the inflation swap market is smaller and less transparent than the interest rate swap market and therefore more difficult to benchmark. As such, the principles set out herein are particularly important for RPI swaps.

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

4.5. Alternative financing instruments

Authorities should be aware that a number of innovative financing techniques are being discussed in the market. These may not be covered by the existing SoPC4 drafting for *inter alia* calculating compensation on termination or determining if a Refinancing has occurred. If authorities are presented with a new means of financing accompanied by arguments to change SoPC4 risk allocation and drafting to accommodate it, they should ask HM Treasury for guidance on the specific proposal, via their departmental PFU if applicable.

Appendix 1: Areas for public sector financial adviser focus

Dialogue phase

Funder due diligence

In an environment in which bank lending teams are resource constrained, it is preferable that funders are not asked to carry out significant early due diligence on projects that do not present unusual technical, legal or financial risks. However, for more complex projects, authorities should be aware of issues which might affect funder appetite for the project or give rise to higher financing costs, either directly through the credit margin or indirectly through performance bonding, reserve requirements and coverage ratios in excess of those required on plain vanilla projects. Authorities should seek advice from their financial advisers in making this determination. To avoid later difficulties with funders, it is essential that this assessment be made conservatively. Factors that might concern funders include:

- Site with known adverse ground conditions or restricted accessibility;
- High operational gearing;
- Substantial corporate support behind key subcontracts;
- Significant refurbishment works;
- Requirement for novel or unusual construction techniques;
- Construction period of more than three years;
- Construction materials or equipment with a unique supplier;
- Fixed or unusually rigid construction programme delivery dates;
- Assets that will be difficult to insure;
- Demand or volume risk;
- Unproven technology;
- Training/educational outcome risk;
- Unusual maintenance requirements;
- Services requiring a unique supplier or very limited number of suppliers;
- Funding solution that requires novel intercreditor arrangements;
- Timing & conditions of authority capital contributions; and / or
- Project with multiple authorities.

Authorities should be confident that the contractor support package and overall risk allocation will be acceptable to funders.

Due diligence on bidders

The adverse economic environment heightens concerns about the financial health of bidders and their supply chains. The historical PQQ assessment should be updated and monitored throughout the procurement period. Financial advisers should play a key role in this activity which is likely to involve monitoring of credit ratings, balance sheet strength / tangible net worth / market capitalisation, share price volatility, investment research reports and independent financial analysis where third party assessments are not available. Particular attention is required where the supply chain includes scarce resources and authorities should seek to ascertain if the supply chain encompasses any such participants.

Potential funders' involvement in other projects

The reduction in the number of banks participating in the PPP financing market has increased the number of projects for which the remaining lenders are considering

providing funds. Faced with market uncertainty, these institutions may have not significantly increased their staffing numbers with the result that lending teams may be committed to more projects than they can manage within the timetables for those projects.

Later on in the dialogue, authorities should therefore review the capacity of each funder to deliver the transaction. This may include consideration of the following: the number of transactors in the PFI/PPP lending group, the number of projects those transactors are supporting, the projected closing date for each project, any relevant sector exposure limitation and the total amount of funding for which the funder has issued support letters. Financial advisers should help authorities to assess funder capacity and to decide if further commitment should be required from funders that appear to be over-extended.

Funder due diligence – sensitivity analysis

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

Preferred bidder phase

Potential funders' involvement in other projects

Financial advisers should refresh the exercise undertaken in the dialogue phase with an increased emphasis on avoiding delay.

Capital contributions

Financial advisers should assist authorities in assessing the appropriate size and timing of any capital contribution taking into account the matters covered in this note. They should also advise authorities on the VfM aspects of the authorities' capital contribution plans.

TIFU

Financial advisers should be aware of the circumstances in which TIFU can be used and should advise authorities on timing their discussions with TIFU. Although TIFU does not formally engage with a project prior to the selection of the preferred bidder, as soon as the financial adviser concludes that obtaining private finance on a timely basis at acceptable terms may be difficult, the authority should be made aware that an early approach to TIFU is advisable following the process set out in HM Treasury's letter of 5th May 2009.