

# CGF TECHNICAL NOTE 1

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## 1. INTRODUCTION

**1.1** In “PFI - Meeting the Investment Challenge” (“MTIC”) the Government set out its approach to the Private Finance Initiative (“PFI”) and the role of private finance in PFI.<sup>1</sup> MTIC set out, among other initiatives, the Government’s plan to test the use of a new way to finance certain PFI projects. This CGF Technical Note sets out in more detail how a Credit Guarantee Finance (“CGF”) scheme is intended to work in practice. Any policy proposals contained in the CGF technical note have direct effect only in England, as policy on PFI is the responsibility of the devolved administrations.

## 2. BACKGROUND

**2.1** MTIC makes clear that the involvement of private finance in taking performance and other risks in PFI projects is crucial to the benefits offered to the public sector by PFI. It incentivises the private sector to complete on time and to budget, and requires the private sector to take into account the whole-of-life costs of an asset. Because of these benefits, private finance can represent good value for money, even taking account of the risk premium paid to the private sector compared to the risk-free rate of interest associated with Government gilts.

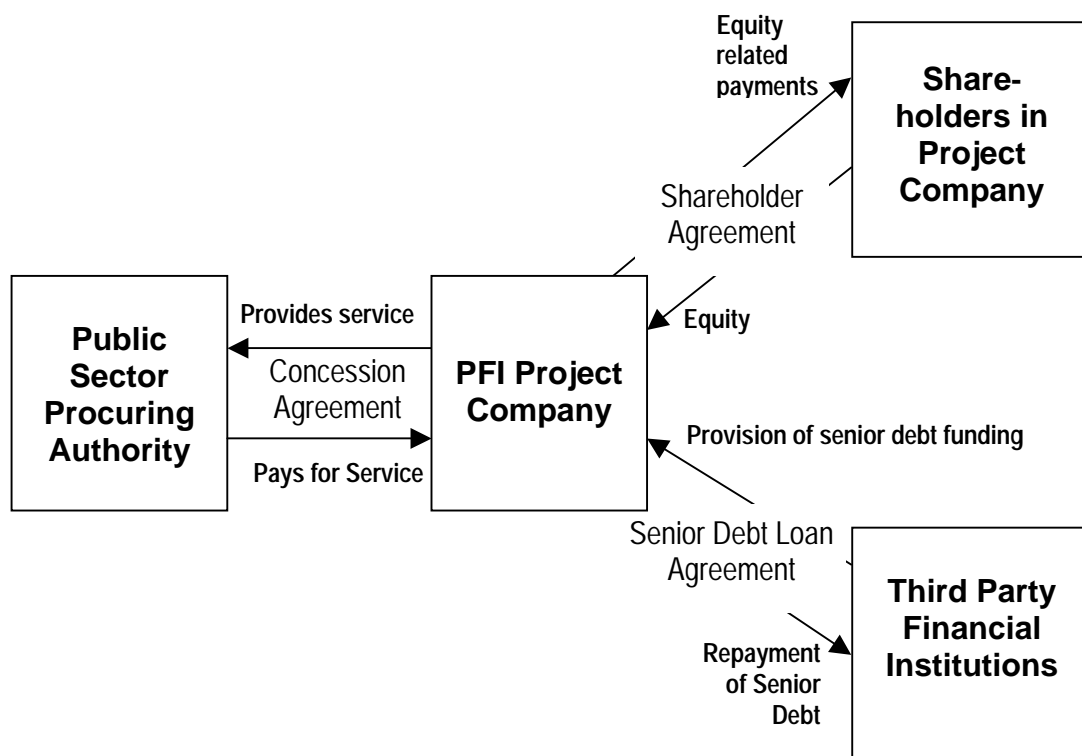
**2.2** Private finance in PFI comprises both equity and senior debt and can also involve providers of mezzanine and/or subordinated debt. CGF Technical Note 1, however, addresses the role of senior debt only. The Government recognises the importance and value which equity providers, including commercial sponsors and specialised financial investors, bring to PFI and their important contribution in achieving value for money.

**2.3** The private sector has typically financed the senior debt element of PFI projects with a combination of all or some of the following: bank finance; debt raised in the capital markets, with or without a credit guarantee; and finance provided by the European Investment Bank, which usually benefits for part or all of the project’s life from a bank guarantee. A small number of projects have been financed by the private sector without the involvement of third-party finance.

**2.4** A typical financing arrangement is illustrated in Figure 1. This involves the private sector creating a limited liability company, created specifically for the project, which will act as the borrower of funds to finance completion of the project.

<sup>1</sup> This document is available on the HM Treasury website at:  
[http://www.hm-treasury.gov.uk/documents/public\\_private\\_partnerships/ppp\\_index.cfm](http://www.hm-treasury.gov.uk/documents/public_private_partnerships/ppp_index.cfm)

**Figure 1:  
Illustrative  
PFI financing  
framework**



### 3. GOVERNMENT POLICY ON FINANCING PFI

**3.1** The Government wishes to ensure that all the traditional means of funding PFI will remain available to the private sector. The Government’s overall aim in finance provision is to maintain a mixed economy, with three key objectives:

- healthy competition between different sources of finance, ensuring value for money;
- risks associated with the major investment programmes undertaken through PFI spread in a sustainable fashion across a number of sources of credit; and
- that the Government is not overly exposed to systemic market risk on one particular source of finance.

**3.2** The Government continues to be committed to working with the private sector and their funders to identify new approaches to financing PFI projects which may offer value for money benefits. In assessing any new financing schemes, the Government will seek to ensure:

- that it retains the benefits of risk sharing with the private sector;
- that it avoids any Government guarantee of the funding raised; and
- that the terms of credit support for the private sector are included as part of the tender process.

**3.3** In its value for money assessment of financing schemes, the Government will consider the impact of any new financing scheme on the private sector's ability to raise funds for their project and on the procurement timetable.

**3.4** Within this framework the Government has stated its willingness to investigate proposals which reduce the cost of private finance, but which do not compromise its desire to ensure that the benefits of risk sharing and private sector technical and commercial discipline which drive value for money in PFI are retained.

## **4. CURRENT STATUS**

**4.1** In MTIC, the Government stated that a small number of pilot projects would be chosen to develop more fully the CGF scheme and to assess the full implications for Government and the private sector of the use of CGF. The potential pilots are likely to:

- be projects which have reached preferred bidder stage;
- be distributed across a range of sectors;
- be expected to reach financial close before Autumn 2004; and
- include projects intended to be financed through both bank and bond routes.

**4.2** The Government is in discussions with three potential pilot project teams. The CGF pilot process will shadow the conventional financing routes for these projects, but with the intention of funding the projects through CGF where appropriate and possible. This 'twin-track' approach is intended to minimise any potential delays to the procurement process. These pilots will be announced shortly.

**4.3** To facilitate the CGF Pilots, and the broader consultation on the implementation of CGF, HM Treasury has appointed Linklaters as legal advisers to HM Treasury to prepare the documentation for CGF. This documentation will provide a framework for any future implementation of the policy and it is intended that this documentation will become standardised in a manner similar to the Standardisation of PFI Contracts ("SoPC"). (See also section 9 below). Draft terms sheets for this documentation are available on the HM Treasury website.

**4.4** Based on the ongoing experience of the CGF Pilots and the development of standardised documentation, HM Treasury will be consulting with all key stakeholders over the next four months to assess the full implications for both public and private sectors of adopting CGF more widely.

**4.5** Following this consultation and the completion of Spending Review 2004, the Government will decide whether or not to proceed with CGF. If it chooses to proceed with CGF, the Government will set out the guidelines and scope of its use by departments ("the Guidelines").

## 5. SCOPE OF CGF

**5.1** The Government will use its experience with the CGF pilots and broader consultation to determine which projects could be the best candidates for CGF. From this process the Government intends to prescribe the criteria it will apply to future project selection for CGF.

**5.2** As stated above and in MTIC, the Government will not use CGF for more than a limited proportion of its PFI programme, and is committed to maintaining a mixed economy in PFI financing. It is highly unlikely that the Government will decide to use CGF for more than a minority of PFI financing in any year.

**5.3** The Government is also committed to using CGF with banks, monoline insurance/assurance companies, and any other suitable guarantors (see section 11, below). The CGF pilots are planned to include both bank and monoline transactions, and the Guidelines to be issued following a decision to proceed with implementation of the CGF Programme will also ensure continued participation of both monolines and banks in each year's CGF programme.

**5.4** At present, the Government expects that CGF could be used in any sector where PFI is currently employed.

**5.5** Upon implementation of the CGF programme, the specific projects to be financed by CGF will be identified prior to their procurement, although there will be a need for transition arrangements to permit the use of CGF for some PFI projects currently in procurement expecting to reach financial close in 2004-5.

**5.6** At present it is possible to anticipate certain limitations to the application of CGF, depending on the type of project:

- the cost-savings involved with CGF arise only where unitary charges are being paid by the public sector to cover project costs, including debt service costs. In projects with significant third-party revenue, this may reduce the potential attractiveness of CGF;
- where there is a need for multiple sources of finance, and CGF would be one of these sources of funding, the Government may be reluctant to be involved in inter-creditor arrangements, although it may be willing to fund a project with more than one guarantor (see also paragraph 11.3).
- CGF may not be appropriate where the risk profile of the project is untested in the financial markets. It may be best applied to PFI programmes that are well established with well-recognised commercial and financial arrangements.

**5.7** Application of CGF funding will be concentrated on those projects where it is judged to offer the best value for money saving for the public sector.

## 6. AIMS OF CGF

**6.1** In using CGF, the Government's first aim is to retain all the benefits to the public sector of involving the banks and monoline insurance/assurance companies' risk taking in PFI projects. This will be achieved by requiring the private sector sponsors to arrange for a financial guarantee to be provided by credit-worthy financial institutions to support loans made to the project by the Government. This approach continues to give the public sector the benefit of private sector risk taking, with private financiers taking, allocating and managing private risk.

**6.2** The second aim of CGF is to reduce the overall cost to the Government of PFI schemes where CGF is used.

**6.3** The Government's third aim is to reduce to a minimum any transaction costs associated with CGF, prevent any delays to the procurement of the project as a result of the application of CGF and avoid the need for any extra due diligence over and above that required by private sector risk takers to the scheme.

**6.4** The fourth aim is to ensure in the application of CGF that a "mixed economy" of funding sources for PFI is maintained and that any credit exposures which Government may enter into as a result of CGF are limited and regularly monitored.

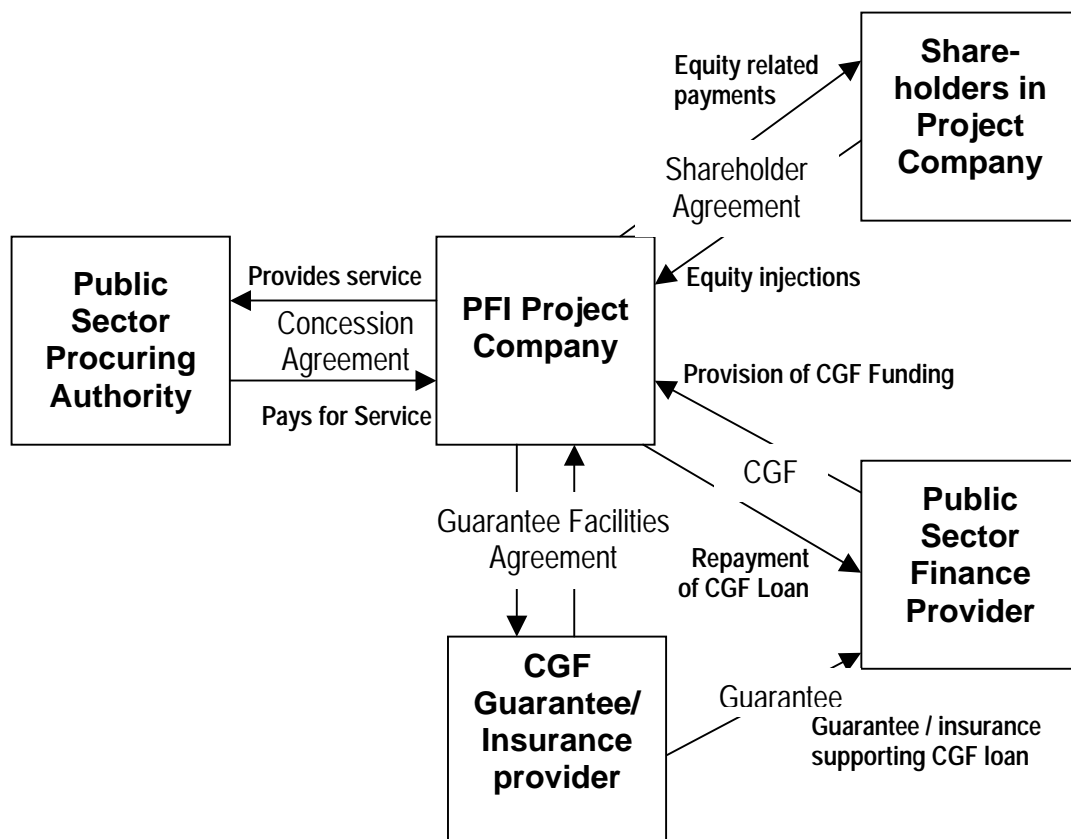
## 7. HOW IT WORKS

**7.1** The key elements of a CGF transaction will be as follows:

- the Government will provide funds to the PFI project by means of cash advances under the terms of a loan agreement to be entered into between the Government and the private sector;
- these loans will be repaid after completion of the project, in accordance with a loan repayment schedule and financial model as agreed with the project company, procuring authority and Guarantor; and
- in consideration for providing this loan facility, the Government will receive an unconditional repayment guarantee from the Guarantor, and will issue a letter of awareness (see section 9, below) to the shareholders of the PFI project, the guarantors and the public sector counterparty to the PFI project.

7.2 These arrangements, as they would be applied to a typical project, are illustrated below, in figure 2.

Figure 2:  
Illustrative  
CGF  
financing  
framework



7.3 The Government loan facility will be provided by either the relevant Department of State or by HM Treasury. The intended approach for the pilots is for the relevant Department of State to be the Public Sector Finance Provider. However, if the Government decides to proceed with the CGF programme, consideration would be given, to the possibility of HM Treasury’s participation in CGF as a public sector lending entity. A final decision on the Government’s preferred approach will be made following its decision to proceed with CGF.

7.4 The Government is currently considering two approaches to setting the interest rate for a CGF project:

- a fixed rate of interest, calculated as a spread over the relevant gilt rate established at the time of financial close, with the spread being determined based on appropriate market benchmarks.
- an inflation-linked rate of interest, calculated as a spread over the relevant index-linked gilt rate established at the time of financial close, with the spread being determined based on appropriate market benchmarks.

7.5 The Government, in establishing its approach to setting interest rates for CGF loans, will seek to ensure that concerns regarding State Aid have been taken into account. This is further discussed in Section 12.

**7.6** Provision of funds could either be:

- an up-front sum sufficient to fund construction of the project, such a sum to be calculated as the amount which when invested pursuant to a Guaranteed Investment Contract (“GIC”) would meet the sums required;
- provided on the basis of a draw-down schedule, subject to the guarantor’s prior authorisation and satisfaction of conditions prior to each drawdown.

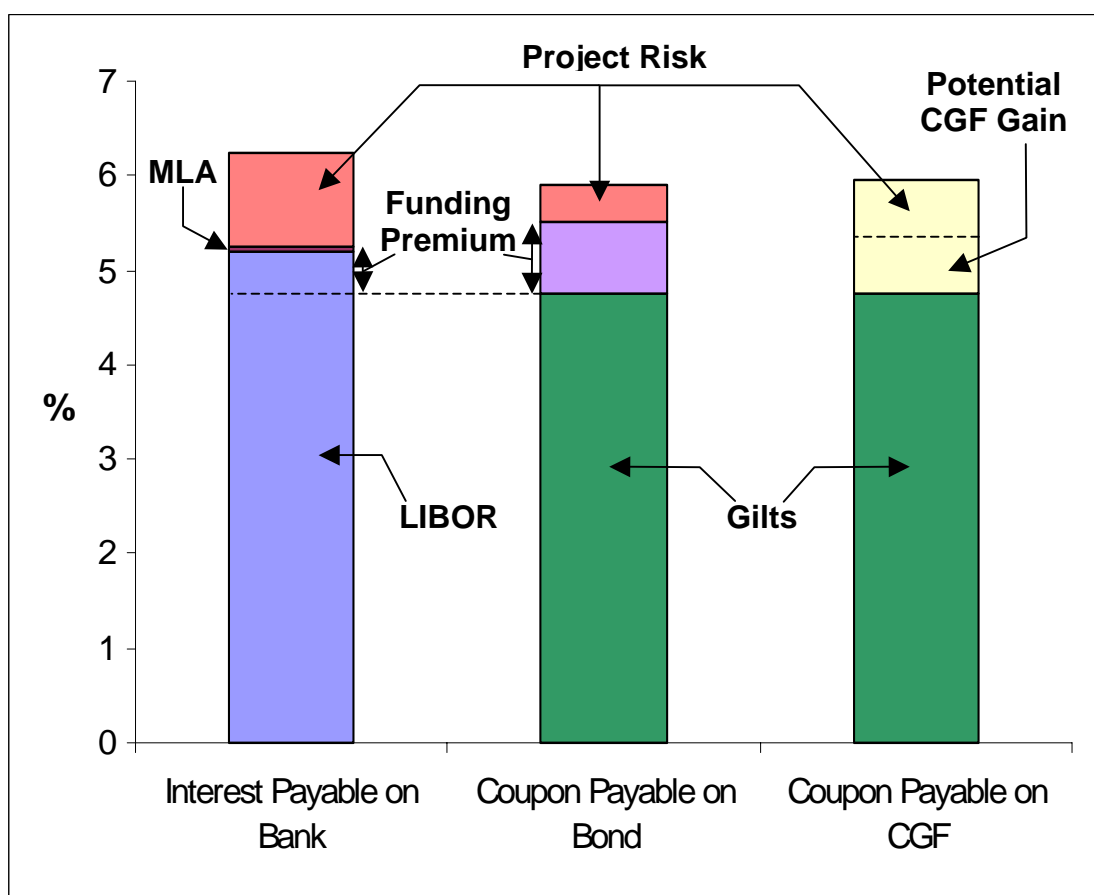
**7.7** Any risk associated with a Guaranteed Investment Contract would be borne by the private sector, although the Government may seek to impose certain criteria upon the investment activities to be undertaken under the GIC.

**8. BENEFITS**

**8.1** The benefits of the CGF programme are intended to accrue to the public sector as a whole and not to the private sector or the procuring authority.

**8.2** The primary financial benefit of CGF to the public sector arises from the fact that the component of the unitary charge that relates to the private sector funding premium will now accrue to the public sector under the CGF loan. The potential savings are illustrated in Figure 3, below.

**Figure 3:**  
Illustrative  
CGF benefits



**8.3** Under CGF the PFI scheme may also benefit from lower transactions costs, for example the up-front issuing fees, and increased flexibility in accessing the financial markets.

**8.4** Public sector appraisal of value for money is undertaken on a whole of government basis. Consequently, the potential benefits of CGF to the public sector as a whole will be taken into account in the overall value for money appraisal of a PFI scheme.

## 9. DOCUMENTATION

**9.1** The Government intends to produce documentation for use in the implementation of CGF schemes, which will be standardised following the CGF pilot scheme process (see paragraph 4.3, above). All CGF schemes will, additionally, require contract documentation which complies with Standardisation of PFI Contracts (“SOPC”).

**9.2** Linklaters, on behalf of HM Treasury, is in the process of developing such documentation, which will comprise:

- a loan agreement between project company and the Government;
- a guarantee provided by the guarantor to the Public Sector Finance Provider;
- an outline guarantee facility to be provided by the guarantor to the project company; and
- a letter of awareness (see below).

**9.3** This documentation will be developed further in the light of the experience of the pilots and wider consultation. Term sheets for this documentation are available on the HM Treasury website.

## 10. LETTER OF AWARENESS

**10.1** The Government will seek to ensure that the PFI market explicitly understands that the Government’s interests under the CGF loan are distinct from the interests of the relevant department procuring the services under the concession agreement where a project is financed by CGF.

**10.2** With the implementation of each CGF project, the Government will issue a general clarification letter on the Government’s position as loan provider. The letter will re-emphasise that project participants should expect the Government to act to protect its interests by enforcing its rights as a lender - where it is in its interests to do so – notwithstanding and without prejudice to any wider public sector considerations.

## 11. COUNTERPARTY LIMITS

**11.1** As a result of a CGF project, the Government will be taking credit risk on the ability of the guarantor to meet, *inter alia*, interest payments when due, and repay the loan. In most cases this will be for a term of fifteen to thirty years. The Government also wishes to ensure that it retains a mixed economy in the provision of funding for PFI projects, involving both banks and monoline insurance/ assurance companies in CGF.

**11.2** Consequently, the Government will set counterparty limits to control its credit exposure and maintain a mixed economy. There will also be a fixed annual limit for the amount of business underwritten by monoline insurance companies and by banks as a sector. This will be set out as part of the Guidelines to be issued by HM Treasury following a decision to proceed with a CGF programme. An example of how this would work on a notional amount of business to be underwritten in any year is set out in Table 1, below.

**Table 1:  
Example  
programme  
sector limits**

Type of Investment	Value (£bn)
Total PFI (including CGF)	4.0
Total CGF	1.5
Comprising:	
Monoline Guaranteed	0.75
Banking Guaranteed	0.75

**11.3** In the case of banks the Government may require that a single bank provides a single guarantee, but is itself counterguaranteed by other banks. As Government will be primarily reliant on the guarantee provided by the private sector in providing the CGF loan, the Government recognises that there are a number of issues in incorporating banks into a CGF programme, specifically in setting minimum acceptable guarantor credit criteria. The intention will be to use the bank pilots and regular consultation with the banking community to find a satisfactory basis for bank participation in the CGF programme.

## 12. STATE AIDS

**12.1** The CGF loan will be provided in line with established PFI market rates. Consequently, the CGF loan will not, most likely, be a cheaper source of finance for a project company compared with other traditional means of financing PFI projects.

**12.2** Projects to be financed by CGF will be identified prior to their procurement. As the application of CGF to a project will be known at the outset of the procurement process, the use of CGF is not expected to be a factor in the selection of the preferred bidder.

**12.3** The Government, in line with its stated CGF aims and intended approach to implementing a CGF loan, does not expect that the use of CGF to finance projects will give rise to State Aid implications. The Government will continue to review this position using its experience gained from the pilot process.

## 13. INSTITUTIONAL ARRANGEMENTS

**13.1** If the Government decides to proceed with a CGF programme, the Government intends to fund the CGF programme as part of its ordinary debt issuance programme. Funds will then be made available to the relevant Department once the CGF facilities are in place, using the Government's normal cash management procedures.

**13.2** It is expected that a significant part of typical project finance agency functions will continue to lie with the guarantor. The Government currently expects that any CGF loan administration responsibilities will lie centrally with HM Treasury, in conjunction with the relevant departments providing the loan facility.

**13.3** However, where the Government decides to proceed with CGF, it intends to review the wider institutional arrangements to ensure that adequate capabilities are in place for the administration and monitoring functions of a CGF programme. As part of such a review, the Government may also consider procurement of CGF loan agency functions from external financial institutions on behalf of Government as lender if this is determined to be the appropriate, better value for money and/or more viable option.

**13.4** The Government is committed to ensuring that bid costs for both private and public sectors are kept as low possible, and that the PFI procurement process runs without delay. High costs or long delays in the PFI bidding process, if unchecked, may reduce competition for PFI projects, threatening value for money. Similarly, high bid costs may influence the returns sought by the private sector from PFI projects. The findings set out in Chapter 6 show that the most effective way to reduce bid costs and delays is to increase the public sector's ability to procure PFI projects.