Sent via e-mail

Date: 4th April 2005

To Waste PFI Project Directors
   Waste PFI Senior Responsible Officers
   Heads of Waste in prospective PFI LAs

Payment Start Date for PFI Grant and Other PFI Issues

1. This letter is intended for all local authorities (LAs) that are currently in procurement of, preparing an outline business case (OBC) for or have expressed an interest in PFI projects. Defra have recently been working with a stakeholder group facilitated by the Institute of Civil Engineers, which has been considering the case for derogations from SoPC3 guidance and required drafting for the key bidder and funder issues that arise in waste PFI negotiations. During this process a number of issues were identified upon which it was agreed Defra could give general guidance. At the same time ODPM have been consulting with LAs on a revised PFI grant regime and this has identified the need to address a specific issue on the trigger for grant payments to commence. This letter addresses these issues.

Grant Payment Trigger

2. Taking this issue first, it has been the case historically that in waste and to a lesser extent in other sectors, grant became payable on the commencement of the contract. However, this was never in keeping with the spirit of PFI which was based on the premise of an asset being built and grant payments starting in the month that the service starts to be delivered using that asset. ODPM are addressing this point in the new grant determination correspondence shortly due to be issued. Therefore all LAs in the process of preparing to submit an OBC or at the earlier stage of discussion with members need to base their affordability assumptions on the grant payment trigger being at the point of service delivery from the relevant asset(s). The ODPM will clarify the approach to be taken in projects with phased build, or with transfer of assets which require refurbishment. This may mitigate the impact of the above for some projects.
3. Defra is in discussion with ODPM over transitional arrangements for those projects already endorsed by PRG and in procurement. So far I can confirm that projects where ITN documents have been issued will not be affected as ODPM have agreed that it would be unreasonable at that stage to change the arrangements upon which the project has been predicated. However, the position is not yet settled for those projects that have not yet reached the ITN stage. I hope to write to those authorities very soon on the outcome.

4. ODPM plan to include further guidance for LAs on their web site around early to mid April.

SoPC and Other Issues

5. Drafting Changes: In starting to look at the detailed changes in drafting sought by bidders and their funders, it has become apparent that many of the proposed changes have no basis of substance and are simply about preferred styles of drafting. This leads to unnecessary costs being incurred by bidders and the LAs.

6. Where there is no issue of substance, LAs should insist on the required SoPC drafting being applied. Drafting changes on the basis of style will not be accepted derogations at the final business case (FBC) stage.

7. Insurance Advisors: Whilst LAs do get in financial, legal and technical advisors fairly early on in the PFI process, it has become apparent that insurance issues are addressed very much later on. It is important that LAs are considering insurance issues earlier in the process and that, in doing so, they avail themselves of professional advice. LAs should therefore appoint professional insurance advisors from the point at which bidder’s ITN returns are received.

8. Sub-contractor Agreements: One issue identified in the stakeholder work is that of risk transfer to sub-contractors. The emphasis for the main contractor and, where applicable, the special purpose vehicle (SPV) is to pass on as much risk as they can through sub-contract agreements. There is a risk however that if the level of risk transfer is too great and possibly inappropriate, it will not be sustainable for the sub-contractor. It is therefore important that LAs satisfy themselves that the level of risk which is passed to sub-contractors is no more than is reasonable and sustainable for the sub-contractor to bear, with the balance being retained by the main contractor and SPV. In order to do this, LAs should ensure they have sight of the sub-contractor agreement(s).

9. Transfer Pricing/Thin Capitalisation Rules: Inland Revenue recently announced that with effect from 4 March 2005 certain transfer pricing and loan relationship rules will be amended. A copy of the Inland Revenue announcement is attached at appendix 1. The legislation will form part of the Finance Bill 2005.
10. There is a possibility that this may affect the PFI market and deals LAs are currently procuring. HMT have been approached by some institutional investors expressing concerns about how this legislation may affect them. The legal firms in the city are also issuing news letters to their clients warning them of the changes. HMT have advised of one PFI project at preferred bidder stage where the bidder wishes to increase its price by approximately £250,000 p.a. due to the proposed change.

11. You will need to get professional advice if you are approached. However, in layman’s terms the thrust seems to be that investors may be affected if:

- their financing arrangements are not on arms length terms and
- the shareholders act together (e.g. through a shareholders agreement) and are capable of collectively controlling the SPV.

12. Our understanding of the risk to the shareholders/SPV is that the interest paid by the SPV may not be deductible in the SPV’s accounts for tax purposes. It also seems that the shareholders may be affected by this law in their own companies/partnerships (i.e. outside the SPV structure).

13. LAs should contact Simon Mander on 0207 082 8846 or Oluwole Ajibola on 020 7082 8100 if approached for variations or price increases arising from these new rules. In the mean time the line should be that this is a risk to be borne by the private sector and no variations/increases should be agreed. I will advise LAs if that line changes.

14. *Detailed Mark-up of Contracts at ITN Stage:* I wrote to LAs on this issue last May (copy attached at appendix 2). In the meantime, LAs are still looking for detailed mark-up of contracts at ITN. The work currently in train to expedite greater standardisation in this sector will reduce the need for this. However, for those LAs not yet at ITN stage, the following approach should be taken:

15. Taking SoPC3 and the current waste management procurement pack as the starting point, when issuing the ITN, LAs should require bidders to include in their return a list of issues on which they will seek to derogate. It will be worth advising potential bidders, using the ITN, that only derogations of substance will be entertained (i.e. advising them of the line set out in paragraphs 5 and 6 above). For each proposed area of derogation, bidders should be asked to demonstrate in their return the substance of the case for a derogation. Experience and the work of the stakeholder group suggests that there will not be more than 5 or 6 key issues that will prove material, with many others able to be managed out through the competitive process. Taking a hard line on drafting changes on the basis of style should also help to greatly reduce the level of mark-ups submitted later in the process.
16. **Use of M-BEAM Model in OBCs:** All LAs will by now have access to the recently launched Mass Balance Estimator Allowance Manager (M-BEAM) model. It is available on the Defra web site at:


17. This is currently being modified to extend the number of years for which the landfill target of an LA can be shown. This does not imply that there is any intention at this time to extend LATS beyond 2020, but is rather for internal, PFI related modeling purposes. The revised model is expected to be on the above web site by mid April.

18. **2nd Stage PRG Review of PFI Projects:** The 2nd stage review is designed to evaluate project affordability and compliance with standardised contract terms and conditions at a later stage in the procurement process than achieved by the existing PRG review at OBC stage (to be referred to as the 1st stage review). It will be completed at the point just prior to the procuring authority appointing its preferred bidder. The intention of the 2nd stage review is to highlight any issues that may have an adverse impact on the success of the project in reaching financial close at a time when the procuring authority can still enter into negotiations with bidders in a competitive environment. The introduction of the 2nd stage review does not impact in any way upon the level of scrutiny applied in the 1st stage review.

19. Only those projects that have gone through the 1st stage PRG review (seeking approval for PFI credits) will be considered to undergo the 2nd stage review. However, only a proportion of these projects will actually undertake the 2nd stage review. It is anticipated that this proportion will be approximately 40% of all projects that come to the PRG. This will be subject to periodic review.

20. All PFI projects, whether undergoing a 2nd stage review or not, are strongly encouraged to achieve compliance with standardised contract terms and conditions prior to appointing a preferred bidder. In addition, participation in a 2nd stage review does not alter a project's obligation to seek Treasury approval for any new or modified derogations that arise after the review has taken place.

21. We will provide further guidance to those LAs that are selected for the 2nd stage review.
22. Value for Money in Refinancing: HMT recently issued a guidance note on this issue. Early feedback from the private sector is that this points to an HMT line of no refinancing. This is simply to relay to LAs who may get similar messages through their bidders, that the application note was not intended to be taken in this way. As such, LAs should continue to negotiate on the basis of including refinancing and should apply the application note both in terms of agreeing provisions in their negotiations and when any such refinancing actually takes place.

23. A copy of this letter is available on our website and can be found at:

http://defraweb/environment/waste/localauth/funding/pfi/index.htm

Yours Sincerely,

By e-mail

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C.c. Neil Thornton
   John Burns
   Mark Filly
   Suzie Daykin
   David Wood
   Simon Mander
   Wole Ajibola
   Alan Burnett (4Ps)
## List of Addressees

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FINANCING OF BUSINESSES BY RELATED PARTIES - CHANGES TO TRANSFER PRICING AND LOAN RELATIONSHIP RULES

Transfer pricing rules

Transfer pricing rules in Schedule 28AA, Income and Corporation Taxes Act 1988 prevent businesses obtaining a tax advantage from non-arm’s length transactions with a person who controls the business.

Currently, these rules apply to certain particular control relationships (set out in Paragraphs 1(1)(b) and 4 of Schedule 28AA). In other circumstances the self-interest of the parties would normally operate to ensure transactions take place on an arm’s length basis. But this may not be the case if a number of persons (eg participants in a business) act in concert, or if a person is going to have a control relationship with the business in the future.

We are aware, for example, of co-ordinated action by investors who share control of companies to put in place debt finance in excess of an arms length amount.

To ensure that transfer pricing rules remain effective in the light of these developments, the scope of the rules will be extended. From 4 March 2005 the rules will apply to the financing arrangements of a business (a company or a partnership) in two additional circumstances:

1) If the following two conditions are satisfied:
   (i) a number of persons (who may be companies, partnerships or individuals) act together in relation to the financing arrangements of a business, and;
   (ii) collectively those persons would be capable of controlling the company, if all their actual or potential rights and powers were aggregated.

This change will apply to the calculation of profits arising on or after 4 March 2005, except in respect of debt financing provided before or after then under pre-existing contracts, which will not be affected until either the contract is changed (see separate section on contract changes further below), or 1 April 2007.

2) If a control relationship that could trigger the application of transfer pricing rules comes into existence up to six months after the provision is made. This change will apply to the calculation of profits arising on or after 4 March 2005 in all cases.

In detail, provisions relating to the financing arrangements of a business – including loans and loan guarantees – will be subject to the basic transfer pricing rule in Paragraph 1 of Schedule 28AA in two new circumstances.
Firstly, if a number of persons act together in relation to the financing arrangements of the business and considered together they would trigger one of the tests in Paragraph 1(1)(b) of Schedule 28AA (ie if those tests were applied to that body of persons rather than to each person individually). This change will apply to the calculation of profits arising on or after 4 March 2005, except in respect to debt financing provisions made before or after then under pre-existing contracts, which will only be affected from 1 April 2007 (or earlier if a change is made to the contract – see separate section on contract changes further below).

Secondly, if a person satisfied one of the tests in Paragraph 1(1)(b) (or the new test above was satisfied) within six months of the transaction occurring. In this case, transfer pricing rules will apply from the date of the financing provision, except that provisions made before 4 March 2005, will only be affected in relation to the calculation of profits arising on or after 4 March 2005. (For example, where a loan was made before 4 March 2005, deductions for interest arising on or after 4 March 2005 could be affected by this change, but earlier deductions would not.)

Where an accounting period (or a period of account) straddles 4 March 2005, profits for the whole period should be calculated as the sum of the profits for two periods, one ending on 3 March 2005, and one starting on 4 March 2005.

**Loan relationship rules**

Special loan relationship anti-avoidance rules apply in certain circumstances to ensure that debtor companies are not allowed to make deductions in computing their taxable profits on an accruals or amortised cost basis for late paid interest or for discounts. These rules apply where the debtor company is a close company, the parties to the loan or security are connected and the creditor is not within the charge to corporation tax. To ensure that these rules did not affect venture capital investment for start-ups and expanding new enterprises, exceptions were made where the debtor is a “CIS-based close company” or the debts are owed to, or to persons acting for, a “CIS limited partnership” (these terms are explained below).

These exceptions will be amended so that they are only available if the debtor company is a small and medium-sized enterprise and the creditor is not resident in certain territories, such as tax havens. This will focus the exceptions on their original purpose.

This change is to be brought into effect for loan relationship debits accruing from 4 March 2005, except for debits arising from pre-existing loan relationship contracts, which will not be affected until the contract is changed or 1 April 2007, whichever is sooner.
In detail, paragraph 2(1B) and paragraph 18(1), Schedule 9, Finance Act 1996 will be amended so that those exclusions from paragraph 2(2) and paragraph 18(2) apply only if:

- the debtor company is (in addition to being a CIS-based close company or a close company with a loan from a CIS limited partnership) a small or medium-sized enterprise (as defined in paragraph 5D, Schedule 28AA, Income and Corporation Taxes Act 1988); and
- the creditor is not resident (within the meaning of paragraph 5B(6), Schedule 28AA) in a non-qualifying territory (within the meaning of paragraph 5E(1), Schedule 28AA).

A “CIS-based close company” is a company which would be treated as a close company under tax law only because of the attribution (under the close company rules in Chapter 1, Part XI, Income and Corporation Taxes Act 1988) of the rights and powers of one or more of the partners in a CIS limited partnership to another of those partners. A “CIS limited partnership” is a limited partnership which is a collective investment scheme or which would be a collective investment scheme if it were not a body corporate.

Further technical changes will be made to loan relationship rules, that will have effect from 4 March 2005 in all cases:

Paragraph 2(1B) and paragraph 18(1)(b), Schedule 9 also define the creditors who are considered to be connected with the debtor company for the purposes of these special loan relationship anti-avoidance rules. From 4 March 2005, these creditors will include persons (and certain other persons connected with them) who control a participator in the company as well as participators themselves (and certain persons connected with participators).

In detail, the list of types of creditor in paragraph 2(1B) and paragraph 18(1)(b), Schedule 9, Finance Act 1996 will be extended to include:

- a person who controls (within the meaning of section 87A, Finance Act 1996) a participator in the debtor company;
- an associate of a person who controls a participator in the debtor company;
- a company which is controlled by a person who controls a participator in the debtor company.

**Contract changes**

Changes to a loan relationship contract will include changes to the parties, to interest rates or repayment terms, or other terms or conditions or formulae used in the contract. An advance made on or after 4 March 2005 in accordance with terms agreed before 4 March 2005 will not be considered a change to the contract. Changes in the applied interest rate in accordance with terms agreed before 4 March 2005 will not be considered a change to the contract.
Contacts

Further advice about the implications of the changes can be obtained from:

*Transfer Pricing rules*: David Hannigan (3C/03, 1 Parliament Street, London SW1A 2BQ; Tel 020 7147 2736; E-mail David.Hannigan@ir.gsi.gov.uk)

*Loan Relationship rules*: David Sly (3C/15, 1 Parliament Street, London SW1A 2BQ; Tel 020 7147 2602; E-mail David.Sly@ir.gsi.gov.uk)
To Waste PFI Project Directors
   Waste PFI Senior Responsible Officers
   Heads of Waste in prospective PFI LAs

Implementation of Standardisation of PFI Contracts (SoPC) 3 in Waste Projects

In addition to the waste specific PFI Procurement Pack which is to be launched this week, you will by now be aware that the Treasury have published the SoPC3 document on their public web site at www.hm-treasury.gov.uk/sopc. I am attaching for reference a copy of the implementation letter sent to government departments. This covering letter does two things:

1) it summarises the main points covered in the Treasury letter;
2) it emphasises the need to take a less stringent approach to the requirement for fully marked up contracts at the Invitation to Negotiate stage of a PFI or other major procurement project.

The main points in the letter to note are as follows:

- As of 1 April 2004, all LAs with projects which are still in procurement should ensure that they are SoPC3 compliant ( paras. 4 & 5).
- Any derogations from SoPC3 will have to be cleared through the Treasury (para. 6).
- Treasury encourages procuring bodies’ to develop SoPC compliant sector specific contracts (para. 7)
- Projects that are not SoPC3 compliant and do not have Treasury approved derogations will not receive Full Business Case (FBC) or Project Review Group (PRG) approvals (para. 11).
APPENDIX 2

➢ Treasury now require to receive from procuring bodies electronic copies of all PFI contracts as signed at financial close (para. 12).

It will be worth expanding a little on the above, taking each point in turn. From discussions with Treasury, I can advise that there will be no scope to deviate from these requirements. Starting from this point, it is also worth noting that such standardisation in PFI is something that the private sector has pressed for in all sectors. It will lead to procurement savings for both private and public sector partners and will, especially in the waste sector, start to give the sort of certainty that will be required if we are to address the sort of market constraints we currently see.

Treasury will be robust in challenging proposed derogations, as will Defra. However, where there is a solid case for a derogation to be approved, this will be fed in to a sector specific contract. With regard to that contract, it is intended that further work will take place on the waste PFI procurement pack, in line with Treasury guidelines. This will seek to address some of the issues raised on the first version and to ensure that we do have a waste specific, SoPC3 compliant procurement pack in the future. It is intended to consult widely with LAs, banks, the industry, etc. in undertaking this development work and we recognise that this will not be completed for a number of months. As such, it will be important to advise the Defra team and the 4Ps as early as possible with any likely derogations, if approval and procurement timescales are not to be materially threatened.

There has been much good work with LAs over the last 18 months to ensure that projects that go to Defra ministers and the PRG at Outline Business Case (OBC) stage will be successful in gaining approvals first time. The above requirements make this all the more important. As such, I should like to emphasise that any projects which are not likely to receive approval at the PRG will not be submitted for ministerial approval in the first instance. This is important not only from the perspective of LAs who otherwise risk a lot of abortive and costly work, but also in encouraging the confidence of the market place in waste PFI projects.

The publication of both SoPC3 and the waste PFI procurement pack offers an opportunity to address an issue directly affecting private and public sector procurement costs in PFI; something that continues to be one of the barriers to opening up the market. Currently LAs are insisting on fully marked up contracts at the Invitation to Negotiate stage. This inevitably leads to the appointment of expensive consultants on both sides at a very early stage in procurement. The introduction of the above guidance should minimise the need for variations in contracts from project to project. Therefore, the following approach should be taken by LAs with immediate effect.

As a norm, reference bids should be SoPC3 compliant from the outset. Where variant bids are submitted, it should be sufficient that the private sector partner informs the LA of their major contractual concerns in writing. This stops short of the requirement for a fully marked up contract, but should provide sufficient information on which to assess bids at ITN stage and to provide a basis for ongoing negotiation.
You should ensure that a copy of this letter is passed on to your advisors. There are also no constraints on sharing it with prospective private sector partners. A copy of this letter will also be available at:

[http://defraweb/environment/waste/localauth/funding/pfi/index.htm](http://defraweb/environment/waste/localauth/funding/pfi/index.htm)

Should you wish to discuss this further, please contact either Wole Ajibola on 020 7082 8100, or myself as below. For those Local Authorities already in procurement, I would be grateful if you could contact me on email by Monday, 14 June with confirmation that your contracts will be SoPC3 compliant.

Yours Sincerely,

Ron Bates  
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Fax: 020 7082 8283  
Email: ron.bates@defra.gsi.gov.uk

C.c. Neil Thornton  
John Burns  
Lindsey Cornish  
Mark Filly  
Simon Mander  
Wole Ajibola  
Kevin Bates