

# Interface

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The newsletter of Manches Projects Group



## AFTER THE 'WHAT', A BIT MORE OF THE 'HOW'.....

In this edition of Interface we look at HMT's latest publications on the procurement process for PPP projects.

After October's excitement of the comprehensive Spending Review, and the flurry of announcements about winners and losers in the decisions as to what infrastructure sectors and projects would be the target of investment over the next five years, November saw the publication of two significant documents addressing some of the detail of how the delivery of PPP projects will be different under the Coalition regime: the Public Private Partnerships Technical Update 2010 ([http://www.hm-treasury.gov.uk/d/ppp\\_technical\\_update.pdf](http://www.hm-treasury.gov.uk/d/ppp_technical_update.pdf)) and the HM Treasury Review of Competitive Dialogue ([http://www.hm-treasury.gov.uk/d/ppp\\_competitive\\_dialogue.pdf](http://www.hm-treasury.gov.uk/d/ppp_competitive_dialogue.pdf))

### Public Private Partnerships Technical Update 2010

A fairly short document at only 26 pages, the Public Private Partnerships Technical Update 2010 contains as its first section a useful roundup of changes made and to be implemented in specific areas of PPP and PFI process. Through its footnotes and cross-referencing it serves as an aide-memoire to much of the published guidance on the PPP process.

The update defines PPP projects as joint working between the public and private sectors, whether by contract or joint venture, to deliver infrastructure assets and services; and PFI projects as a subset of the PPP, being long term contractual arrangements for the design build financing and operation of infrastructure services.

The second section of the Technical Update consists of a summary of the ongoing framework for PFI and PPP project scrutiny, documentation and approval. Most specifically it contains two annexes: Annex A on Financing, to replace the 2009 HMT Application Note – 'PPP Projects in Current Market Conditions'; Annex B comprising an update on the approval of

sector specific PFI contracts and of derogations from SoPC4.

#### Key points identified are:

**The end of the PFI Credit system.** With effect from April 2011, the distribution of PFI credits via the local government Revenue Support Grant system will be ended, and in its place central government departments will have to provide funding to support local authority delivery of their projects. Revised guidance is to be published by Infrastructure UK.

**The end of the HMT Infrastructure Finance Unit (TIFU).** TIFU will no longer have capacity to make new loans to projects, and will seek in due course to sell the loan that it made to the Greater Manchester Waste Disposal Authority.

The effect of increased central government transparency commitments on PPPs. HMT now lists on its website all signed PFI contracts as of February 2010, with key details such as term, date of close, balance sheet treatment, actual and anticipated unitary charge. It also lists equity investors in projects that have reached financial close, and gives details of projects in procurement, although to date the delivery of this information has clearly been slow and publication runs several months behind events.

Using a contract value threshold of just £10,000, publication commitments have been made for all ICT contracts (from July 2010), all new central government tender documents (from September 2010) and all new central government contracts (from January 2011).

Although SoPC4 has always anticipated the possibility of publication, the new regime now works on the basis that publication will be the norm. Limited redaction of commercially sensitive information will be permitted on the FOIA basis. Sponsoring departments are charged with the administration of that process, so those with concerns should address them promptly to the relevant department.

Although the supply of information through these sources may well continue to be somewhat behind the curve, these sources may become a helpful source of intelligence, and avoid the need for use of a specific Freedom of Information request in many cases.

**The initiative to achieve costs savings on operational contracts.** Infrastructure UK is developing options for cost reduction on existing contracts, with a view to achieving long-term value

for money, rather than a short term gain for the public sector. Guidance for Infrastructure UK will be published shortly through the HM Treasury website.

In addition to these annexes, the second section of the document contains a number of statements of a procedural nature:

**Scrutiny and approval of PPP projects.** All PPP projects receiving direct central government funding (whether delivered centrally or locally) will require HMT approval. The PRG will continue in existence and its processes will be integrated more closely with other HMT processes.

As a broader range of PPPs continues to develop, HMT stresses the significance of the SoPC4 guide. SoPC4 creates a well understood risk allocation, that is capable of delivering value for money, and the commercial aspects of projects using its terms can be assessed relatively rapidly. Although reiterating that it is not mandatory for non-PFI projects, HMT stresses that the familiarity of SoPC4, and the fact that it reflects the lessons already learnt from the PFI process, mean that it is one of the key standard contracts that public bodies should look to where they are developing non-standard PPP projects.

HMT also points readers at the new HMT guidance on joint ventures, published in March this year ([http://www.hm-treasury.gov.uk/d/joint\\_venture\\_guidance.pdf](http://www.hm-treasury.gov.uk/d/joint_venture_guidance.pdf))

**Value for Money.** VfM will continue to be assessed using the HMT Green Book and PFI Value for Money Assessment Guidance, although the quantitative VfM assessment model and associated guidance will be updated to reflect recommendations made by the NAO and other lessons and developments taking place since the guidance was last updated in 2006. Public bodies will have to keep an eye on the development of this guidance, to make sure that they are applying the correct regime for VfM assessment.

**Refinancing support.** There is no change to the required contractual position on refinancing gain, which remains as in the April 2009 SoPC4 addendum. Infrastructure UK will continue to provide the support for the public sector on refinancing that has to date been provided by the Partnerships UK refinancing taskforce.

**Annex A : Revised Financing Guidance.** Annex A, which deals with this subject, comprises almost half of the Technical Update. The Annex replaces (and to a large extent restates) the HMT Application Note of August 2009 which addressed the impact of financial market dislocation on the procurement of PPP projects. Although most specifically directed at PFI projects, the guidance is stated also to be 'broadly applicable' to PPP projects.

Annex A is organised according to the stages of a competitive dialogue process. Clearly any active participant on this market will need to review its text in full, but some of the key points made are as follows:

#### a) Pre-OJEU phase

Foresight in procurement planning. Public bodies must provide in their procurements for the risk of a future change in market conditions, which might make private financing difficult. They must therefore ensure that public sector financing and funding, including capital contributions, are left open as possible options in the OJEU notice and tender documents.

Authorities must plan in their OBCs for flexibility in relation to underlying costs (including finance); inflation; and the financial resources of the Authority over the lifetime of the project.

Capital contributions. There is some detailed guidance on public sector capital contributions, which includes a reiteration of the SoPC4 guidance that they should not be paid until the works have been completed and accepted (or even later if there is not a substantial diminution of project risk at that date); that all public sector capital contributions will be subject to Infrastructure UK's sign-off; and that it is unlikely that contributions exceeding 30% of the capital cost of the works will be appropriate.

Authorities are instructed to work on the basis that sponsors and private sector debt should bear all losses expected through default, and all losses shown by stress testing or caused by construction delay. In addition, authorities are required to ensure that the effectiveness of payment mechanisms is not diluted by the reduced finance cost resulting from a capital contribution, nor that the operational gearing of the project is skewed by it.

Capital contributions must always be open to set-off in respect of amounts owing to the Authority, and the Authority's interest in any public land which is to be contributed must be protected until the completion of construction.

Debt funding competitions. The Annex outlines some of the key issues for the Authority to bear in mind when deciding whether or not to run a debt funding competition, pointing out the challenges in doing so in the context of novel, complex or very large projects. Authorities will also need to consider the impact of a funding competition on timing, and to ensure that the procurement timetable makes adequate allowance for it.

Although stating that the decision as to whether or not to run a preferred bidder-stage debt funding competition is one for the Authority, and that the Authority must explain its proposals and rationale in this respect at OBC, the Annex does require that the Authority should always reserve the right to require the preferred bidder to run such a competition.

#### b) Dialogue stage

Financing issues during dialogue. The Annex guidance aims at ensuring that the Authority keeps itself informed about the state of the finance markets and plays an intelligent role in respect of this element of the procurement. It stresses, for example, that

the Authority should seek to understand the issues in the project that affect financeability; to ask the bidders' funders for their views on the same; and to understand which areas of the project documentation the proposed funders have considered. It leaves to the Authority the degree of funder involvement that is to be required before preferred bidder selection, and suggests that in cases where a funding competition is required, shadow lenders' advisers should be appointed by the Authority to identify the issues that are likely to be raised by funders.

Possible EIB involvement should be considered at this stage, and the validity and duration of pricing offers in bids and subcontracts tested.

Where appropriate for the project, the Authority is to encourage bidders to identify variant financing solutions such as capital markets, where these offer robust and deliverable solutions that give VfM.

Authorities are encouraged to make use of standard financing assumptions in cases where terms proposed by bidders appear off-market, or where there is a prolonged period to financial close.

Financial health of project parties. The Annex requires that, as the PQQ responses will provide only a snapshot, the Authority continues to monitor the financial health of the project parties throughout the procurement process, and consider how to respond to any adverse movement in a party's financial health. Disqualification of the affected bidder is an option, but other methods, such as a reallocation of supply chain responsibilities, are also identified. All of this advice is subject to the overriding requirement to comply with EU procurement law.

#### c) Preferred Bidder phase

Hedging. The May 2006 HMT Application Note on Interest-rate and Inflation Risks in PFI Contracts ([http://www.hm-treasury.gov.uk/ppp\\_finance\\_guidance.htm](http://www.hm-treasury.gov.uk/ppp_finance_guidance.htm)) remains in place, although the Annex adds some further notes on items to be taken into account, all subject to the overriding statement that these matters are complex and Authorities should seek guidance from their financial advisers and/or Infrastructure UK.

**Annex B: Updated Guidance on SoPC4 Derogations.** The guidance on derogations reiterates the principle that derogations from SoPC4 should only be made in exceptional, project-specific cases. Sponsoring departments are the first line of defence in ensuring this approach, and are charged with challenging any requests from projects for derogations, and filtering these before submission to Infrastructure UK which will not expect to receive requests for approval of derogations on a competitive dialogue after the close of dialogue, as by that point the form of contract should not be open to revision. The ultimate sanction for unapproved derogations is that the project will not gain Final Business Case approval.

## HM Treasury Review of Competitive Dialogue

In November, following a series of questionnaires and roundtable discussions with the public and private sector, HMT published a review of the competitive dialogue procedure and delivered its verdict on key areas for improvement.

The Competitive Dialogue procedure was introduced into UK law in January 2006. Its aim was to replace the negotiated procedure as the procedure of choice for use in complex procurements and to reduce the opportunities for protracted post-preferred bidder discussions and the incidence of late changes accepted during preferred bidder stage.

Guidance issued by HMT in 2008 which aimed to discourage the use of the negotiated procedure, favouring instead the use of competitive dialogue, may, this HMT review suggests, have been interpreted as "complete ban on everything but competitive dialogue". As a consequence, the competitive dialogue procedure has become the 'default' procedure for all complex procedures, when open and restricted procedures are likely to be more appropriate.

The review identifies the main problems with the procedure as follows:

- A public sector skills gap; lack of experience and inconsistent approach to delivery, with too much reliance being placed on the private sector to support contracting authorities.
- The procedure has been used on projects that are not sufficiently complex to warrant it – for instance purchasing annual, insurance policies, printing a local government newsletter and obtaining cleaning services for a single school.
- Perception that the public sector use the dialogue phase as an opportunity to take advantage of "free consultancy" from the market, using this phase to tailor and often redefine their requirements.
- Compared to the negotiated procedure, 86% of respondents to the review's general survey believe that the competitive dialogue procedure has significantly increased bid costs, with 55% of the public sector being of the same opinion.
- Advice from the legal sector is inconsistent – particularly in relation to the post dialogue phase – leading to uncertainty and confusion.
- SMEs lack the skills and depth of resource to engage in competitive dialogue, effectively excluding them from a large swathe of public contracts, which is unfair and eliminates healthy competition.

Key recommendations are as follows:

- Projects should be led by a well briefed "Senior Responsible Owner" – it is important to have strong leadership.
- Contracting authorities should document clearly their rationale for using the competitive dialogue procedure before initiating a procurement exercise. All future projects should justify why they intend to use the competitive dialogue

procedure instead of the open or restricted procedures.

- Contracting authorities should engage in more pre-procurement activity, including soft market testing, bidders days and OJEU Prior Information Notices.
- The public sector should be given more training in the use of the competitive dialogue procedure and there should be more sharing between contracting authorities of best practice.
- The public sector should produce cost estimates of their own procurement spend and resource plans.
- Procurement timetables should be developed allowing for a realistic schedule of meetings, anticipating the time required for internal "sign offs".
- Projects should establish procedures for closing the dialogue before commencement of the procurement.
- The public sector should bear in mind bid costs when determining the level of detail genuinely required for bid submissions.

The HMT review indicates that step by step guides on use of the open, restricted and negotiated procedures are due to be published to aid the public sector and improve the decision making process. The HMT review recommends that a short suppliers' guide to the competitive dialogue process should also be developed, outlining how bidders can get the best out of the procurement as well as information and behaviours they are entitled to expect from procuring authorities.

The overarching conclusion of the review is that, when used appropriately, the competitive dialogue procedure "has been a positive addition to the procurement spectrum".

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