



## LOCAL AUTHORITY PFI GRANT REFORM CONSULTATION PAPER

### **Summary**

1. This paper is addressed to local authorities and other parties involved or considering becoming involved in the Private Finance Initiative (PFI). Their views are sought on proposals for a revised grant regime to support local authority PFI. But the views of those with an interest in the wider debate on whether there is a level playing field between PFI and conventional procurement are also being sought.
2. The basic framework of a new system has been agreed as part of discussions during the 2004 Spending Review. This is to move to an annuity based system, ie a constant grant payment over the period of the PFI contract; and to introduce a scaling factor broadly similar to that used for conventional support. However, decisions have yet to be taken on the details of several areas and views are sought on the options presented.
3. Authorities which are already being paid PFI support for operational projects and those with projects in procurement are asked to inform this Office whether they would wish to switch support to the new proposed annuity system, and why - what would the impact be on their particular projects and financing structures? The implications of switching are discussed in paras 37-41. The charts in this paper are included as embedded spreadsheets which have been designed so that they can be manipulated to see the results based on authority's own position.
4. Other issues where views are particularly sought are:
  - How the scaling factor should be set (para 27)
  - When to set interest rates and scaling factor (para 30)
  - Transitional arrangements, should these prove necessary (para 42)

### **Background**

5. When considering how to address needs which involve new assets, local authorities need to make a decision on whether to purchase (usually funded through borrowing) or lease the asset directly, or to contract for use of the asset through the PFI route. It is important that they take such decisions as much as possible on value for money grounds. This was a central theme of the recent Treasury document *PFI: meeting the investment challenge*. A number of changes are being pursued as a result

of that document to ensure that this is achieved as far as possible - for example, a new value for money assessment procedure is being introduced. During the 2004 Spending Review (SR04) interested departments and other parties, including the LGA and the 4ps, considered whether the local authority PFI support system should be revised as part of this objective.

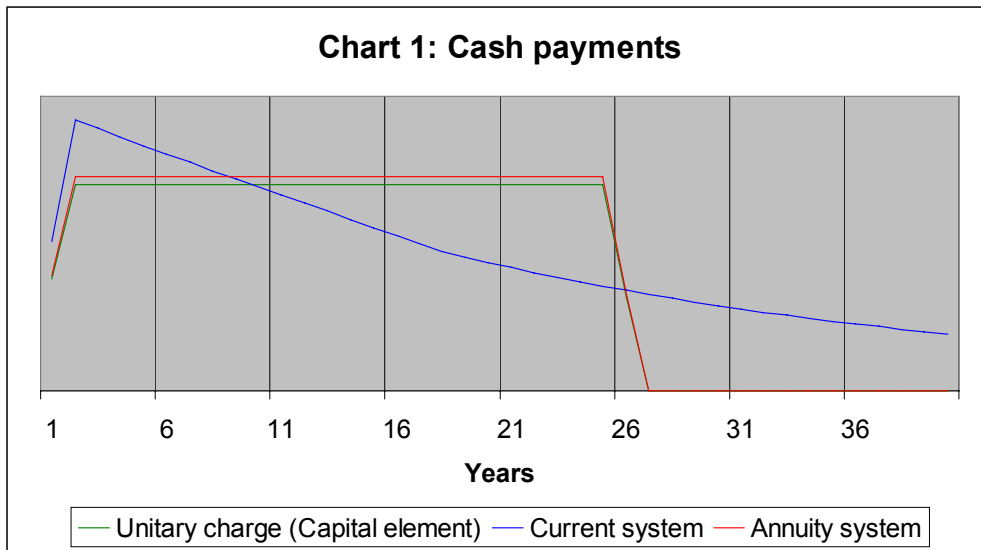
6. Various aspects were examined and it was concluded that the 'playing field' was not as level as it could be. There are some features which could be seen as constituting an artificial bias towards either PFI or conventional procurement. As a result it is the intention of the government to introduce a number of changes which should remove or lessen areas of bias. These are set out in this consultation paper.
7. We are consulting with a view to introduce these reforms from 1 April 2005.

### ***Annuity basis***

8. PFI support is currently based on that element of the Revenue Support Grant system used to provide support for borrowing (with some differences of detail). Grant for the latter is provided to support repayment of a proportion of the principal of the loan each year, plus interest. This results in a declining balance profile of payments over time, with no limit on the period over which payments are made.
9. The profile of payments the authority will be making to the private sector contractor is likely to be closer to a constant rate - particularly for that part which relates to capital work - and limited to the life of the contract (usually 20-30 years). It is therefore intended that that the basis of PFI support will change so that each project is paid a set level of grant each year for the life of the contract. This annuity payment will be worked out using the PMT function in Microsoft Excel.
10. PFI support on a declining balance basis thus produces a mismatch in both the profile of expenditure against support, and the period much over which support is paid. This has caused difficulties for local authorities who have often had to set up sinking funds to invest the excess payments in early years so that funds will be available in later years. An annuity system will provide a better fit and should be warmly welcomed by local authorities and contractors.
11. Support for HRA PFI projects, which is paid via a different grant system, has already moved to an annuity basis because of the difficulties set out above.

*Illustrative effects of an annuity system*

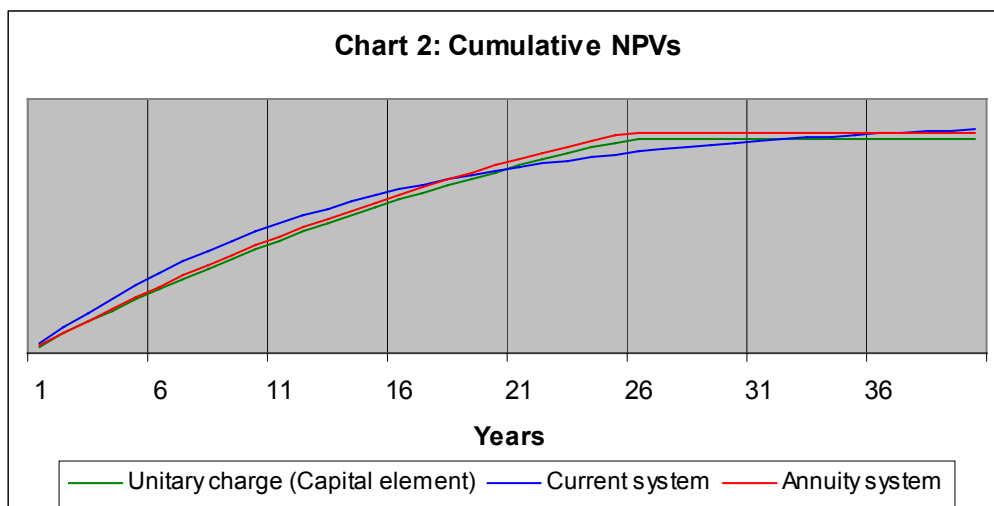
12. The differing grant profiles of the current declining balance system and the proposed annuity system are shown below in Chart 1.



1. The chart is based on a simple project involving a 25 year building project. Discount and interest rates are the same, and the PFI credits cover the whole capital element. Services commence and therefore support starts in September.
2. The unitary charge line assumes that the capital element (that part which PFI credits support) is constant during the life of the contract. The overall unitary charge will usually increase.
3. Interest which the authority can be assumed to have earned in early years is included in the 'current system' line.
4. Scaling (see below) is 100% for the annuity line.

13. As can be seen, the grant paid will be less for the first 8 to 9 years, but more over the remainder of the contract. In the first full year of payment the current system provides 30% more grant than an annuity system. However by the end of the contract it is paying 50% less.

14. Because the profiles differ it is most appropriate to compare the cumulative payments in NPV terms. This is shown in Chart 2.



Details as for Chart 1.  
All lines are discounted at 3.5% (the standard Treasury rate).

15. It can be seen that even in NPV terms (where early high payments will be more valuable than in cash terms) the annuity system shows a higher payment over the life of an average contract.

### ***Length of grant payments***

16. For the majority of projects, which involve buildings, the grant will be paid over a standard length of 25 years. This is the average for existing projects. Although some building projects, and others such as transport infrastructure may have 30 year projects, it is proposed that these still be paid over 25 years. The only sector where this is significantly different is ICT and it is proposed that these be paid over 10 years (although this will only apply if it is concluded that existing projects should be switched - see later - since it has been separately announced that there will be no more ICT PFI projects). Should, however, there be any project types which emerge which have significantly different contract lengths further standard lengths would need to be agreed when that became known.
17. The possibility of paying grant over the actual contract length was considered, it was decided not to pursue this option. The principle reason was that it could provide an artificial incentive to agree to a contract length on grounds other than value for money.

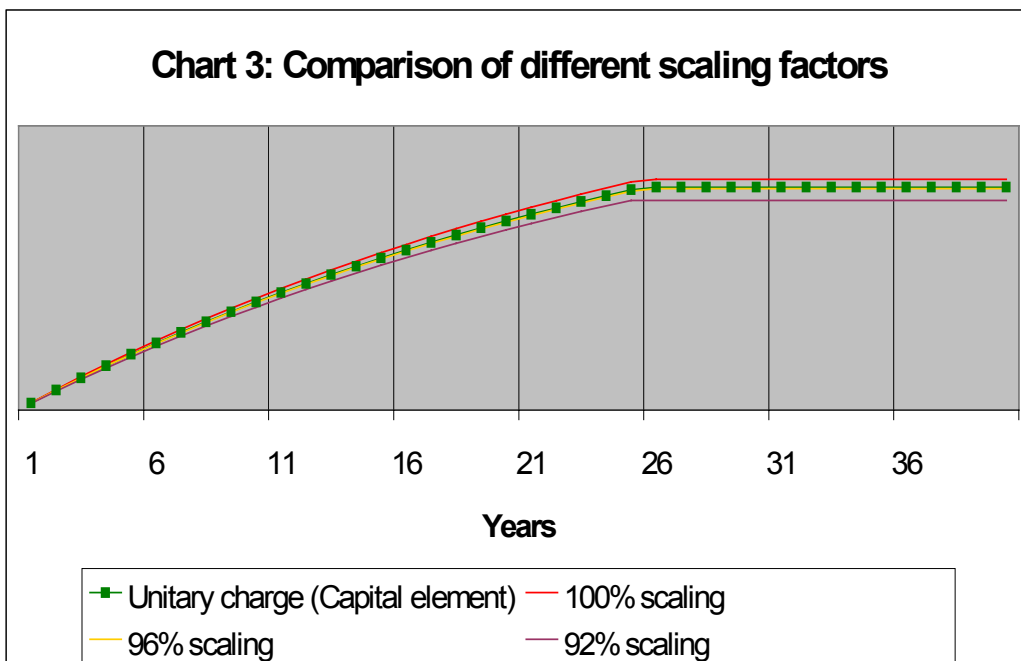
### ***Scaling factor***

18. Support for borrowing is based on the debt charges element of the Formula Spending Share (FSS). This is subject to a 'scaling factor', which is a measure of the difference between the sum of local authorities' notional loan charge requirements and the national total set in the Spending Review process for the relevant financial year. Currently no similar scaling factor applies to PFI grant. The proposal is to introduce a broadly similar factor to PFI. This is important to eliminate an area where it is currently argued that PFI is being given an unfair advantage.
19. It is important to note that this change is neutral in overall terms of support for local government capital investment. Any reduction in PFI grant payments in the SR2004 period will mean that less of the overall resources available are used for PFI. More will therefore be available to support conventional borrowing, and the scaling factor will rise.
20. The scaling factor will be set for the life of a project. This is important in allowing the local authority predictability as to its contribution. It mirrors the existing way in which the interest rate is set for the life of a contract and for the same reasons. If the rates were to fluctuate throughout the life of the contract local authorities would be faced with significant funding

uncertainties. Although this means that PFI grant varies from conventional support it is felt that the need for predictability - and the much simpler administrative arrangements - argue strongly for adopting this approach. It should also be noted that an authority has somewhat greater flexibility in repaying and refinancing loans than it has in paying the contractor under a PFI contract.

21. It has also been agreed that the scaling factor should be set at the same time as the interest rate is set (see later).
22. It should be noted that the scaling factor will be applied to the grant after the level of PFI credits is agreed, rather than to the PFI credits.

*Illustrative effects of a scaling factor*



The unitary charge and 100% scaling lines follow those in Chart 2.

23. As can be seen the annuity system results in annuity payments almost exactly matching the capital element of the unitary charge being paid by the local authority when a scaling factor of 96% is applied.
24. As was shown in Chart 2 an annuity based grant provides more support after 25 years than the existing system, and the following table shows that this is true even if a scaling factor is applied, down to a level of 91% when considered in NPV terms and 85% in cash terms.

Contract as used for the charts above	Cash	NPV
Annuity style grant with scaling @ 100%	+18%	+10%
Annuity style grant with scaling @ 96%	+13%	+5%

Annuity style grant with scaling @ 91%	+7%	=
Annuity style grant with scaling @ 85%	=	-6%

25. The scaling factor for the debt charges FSS element has in the last three years been around 96%. However it has varied considerably on a longer timescale and was 83% in 2000-01.

*Setting the scaling factor*

26. There are two options for how the PFI scaling factor could be calculated for a particular PFI project:
- (a). To use the same scaling factor as that in force for conventional capital at the time that the rate is determined.
  - (b). To calculate the scaling factor as a rolling average of the conventional rate over a number of years - 3 years has been suggested. The factor used for projects in 2005-06 would then be the average of the conventional factors in 2003-04, 2004-05 and 2005-06; that used for projects in 2006-07 would be the average of the conventional factors in 2004-05, 2005-06 and 2006-07, etc.
27. The advantage of (a) is that it is closer to the position of conventional support and so best avoids the claim that PFI is being given unnecessary preferential treatment. It thus best meets the aim of a better level playing field. It is also more straightforward. The advantage of (b) is that it would "damp" annual fluctuations. In times when the rate was decreasing this would result in a higher rate than for conventional support; when increasing a lower rate. This should even out over time, but would provide more predictability. This could be important for an authority when considering the financial implications of a project at an early stage; or should the likely rate for a project change, eg if there is slippage in contract signature (though in both cases the significance will depend on when the rate is set – see later).
28. Overall, it is suggested that the advantages of (a) slightly outweigh those of (b), but we would be interested in views.

***Setting interest rate and scaling factor***

29. There are two options proposed on when to set both rates:
- (a) To do as now and set at contract signature.
  - (b) To set at an earlier stage, possibly endorsement. This could be taken to be the date of the Project Review Group (PRG) meeting when the project was agreed. The rate would be revised if the project

had to be re-submitted to PRG as a result of a request for additional PFI credits.

30. For option (a) the arrangements are known and understood. It also most closely mirrors the position for conventional borrowing, since borrowing would occur around construction period., ie soon after contract signature.
31. However, there are a number of real problems which result:
  - It can lead to affordability problems late in the day if the rate decreases from that assumed when the project was endorsed, which may be as a result of slippage in the date of contract signature. That can lead to either requests for additional support or to the local authority trying to change the project and/or contract to keep the project affordable and within the agreed level of support.
  - At least in the current circumstances when the interest rate is falling, local authorities can find themselves under pressure to sign before they are really ready, and possibly not on the best terms.
  - There is an incentive to state that commercial close has been reached before that is really the case.
32. Option (b) has significant advantages in addressing most of these difficulties in the current system. It would provide predictability as to the level of grant which can be anticipated from an earlier stage, when an authority starts its procurement process. This would lead to far fewer requirements for additional support. It would also greatly help to remove the pressures to sign on less than best terms.
33. There are, though, some possible disadvantages to option (b):
  - It could incentivise perverse behaviour, eg delaying submitting OBCs if the rate appeared to be rising, or submitting before really ready if declining (although the same can be said now in relation to the contract signature date, and PRG should not endorse a project if it is not ready).
  - It would result in the loss of a 'real' deadline for contract signature, which might result in even longer procurement periods than already exist. Views are sought on whether alternative means of agreeing and enforcing a deadline for contract signature could be agreed. It is noted that deadlines could be set at a time of year other than 31 March, which is probably the least convenient date.
  - The resulting rates for a project would be different to those which would have been in force if the project had been pursued using conventional borrowing (even though this could be an advantage or disadvantage depending on which way the rates moved).
34. Views are sought on whether the advantages noted in para 32 are sufficient to outweigh the disadvantages in para 33.

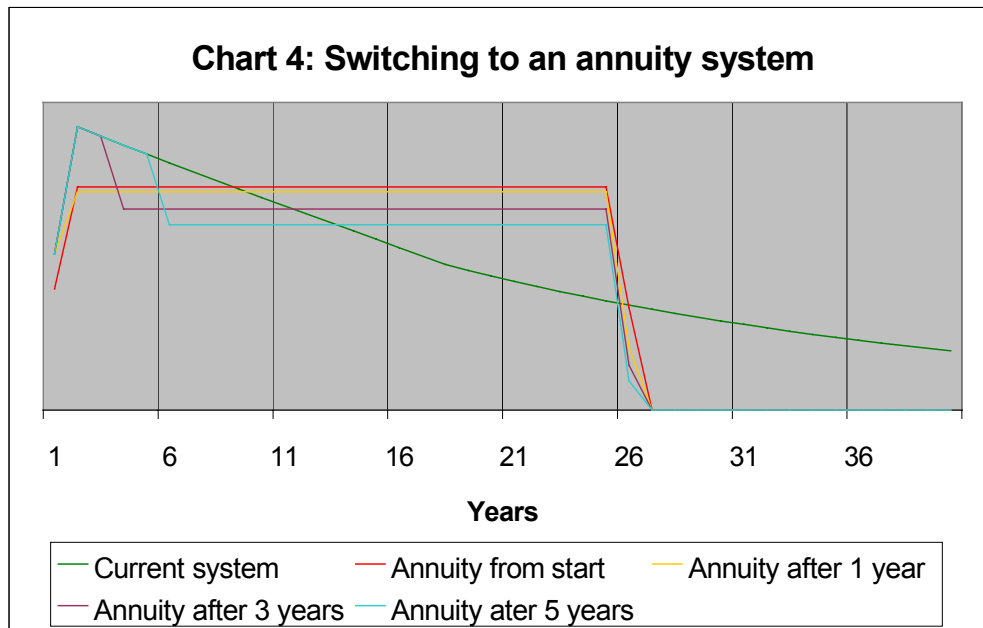
### ***Meaning of contract signature***

35. Whatever the decisions on when to set the interest rate and scaling factor there are good reasons to clarify what that meant by 'contract signature'. This has always been a vague term despite some attempts to clarify it as meaning commercial close. There have been a number of recent cases where the period between commercial and financial close has been unacceptably long – sometimes more than a year. This is clearly unsatisfactory as the financial terms will have changed, despite initial indications at commercial close that this would not happen.
36. The proposal is that contract signature should in future be taken to mean financial close. Although it might appear as if procurement times were longer there would be no real change. It is a clear date and should remove the current uncertainty. Taking judicial review periods into account that would mean setting the deadline at least 9 months after the project expects to select a preferred bidder.

### ***Existing projects***

37. Views are sought on whether projects which are already receiving support should be switched to the new system or whether they should continue to receive grant under the current system. Both central government and local authority representatives consulted thus far have concluded that the best outcome would be for projects to switch.
38. However, it is recognised that this could not happen if it would cause significant problems for the authorities involved. There is limited detailed knowledge of the real impact and we are therefore very interested in whether authorities already receiving PFI grant would wish to switch support to the new proposed annuity system, and why - what would the impact be on their particular projects and financing structures?
39. The calculation of the annuity for a project switching from the current system would simply use the 2005-06 opening balance - as would have been used under the current system - as the starting figure. The period would be reduced by the number of years over which grant had already been paid. It is proposed that a scaling factor of 1.0 should be applied to existing projects. To try to retrospectively apply a scaling factor is very likely to create affordability pressures without any balancing benefit.
40. Projects already receiving grant will have been paid more grant in respect of interest than they would have received in those years under an annuity system. There is no proposal to reduce future grant to try to recover this.
41. The effects of switching are illustrated in Chart 4. It can be seen that the period before grant becomes higher under the annuity system stays

constant. The total grant received is still significantly more over the life of an average project which has already been paid grant for 6 years.



### ***Transitional arrangements***

42. If, as a result of views received on the issue above, it is decided that there should be an option of existing projects continuing to receive grant on a declining balance basis, then a decision will need to be made on whether any other projects could also follow that pattern. If all existing projects switch it will clearly be unnecessary. The options are:

(a) All projects not yet receiving grant would be paid under the annuity system.

(b) Those projects which have reached contract signature, but which are not yet operational would be paid under the declining balance system, those which have not reached contract signature would be paid under the annuity system.

(c) Those projects which have reached ITN would be paid under the declining balance system, those which have not would be paid under the annuity system. It was suggested that it could be difficult to

structure tender documents properly without knowing the payments mechanism (particularly where sculpted payments are used).

(d) Those projects which have been endorsed by the Project review Group would be paid under the declining balance system, those which have not would be paid under the annuity system.

Central government's preference is for option (c), since that it is reasonable to take that as a point at which major financial decisions will have been made which cannot easily be reversed.

### ***Issues not changing***

43. No change is proposed to the following features of the PFI grant system:

- The interest rate will continue to be based on that used for conventional support and is derived from a weighted average of interest rates (pool rate) existing on loans taken out by local authorities. The continued application of the pool rate ensures equitable treatment between PFI and conventional procurement.
- Projects will continue to become eligible for grant when services commence.
- Grant in the first year will continue to be pro rata to the number of months for which services are received in that year. A balancing amount will be paid in the final year.