Re:fit Guide to Financing

Guidance for Framework Users

Glossary of terms used in this guidance note

Term	Definition
Contracting Authority (CA)	public sector organisation accessing services under the new Re:fit programme
Combined Heat and Power (CHP)	the use of a heat engine or power station to generate electricity and useful heat at the same time
Debt Covenant (or Loan Covenant)	a condition of a loan to control risk of future default (for example, financial ratios such as interest cost to income)
ECM	Energy Conservation Measure
EIB	European Investment Bank
ESA 2010 (ESA 10)	the accounting standards for National Accounts issued by Eurostat
Eurostat	European body responsible for setting accounting standards for National Accounts
FITs	Feed-in Tariffs. A subsidy paid to owners of certain renewable generation assets, including solar photo voltaics (PV)
Framework Agreement	agreement between (1) the GLA and Local Partnerships (joint contracting authorities) and (2) Framework Providers
Framework Providers	parties listed at Appendix •••••• , being those providers appointed to the new Re:fit programme
Green Investment Bank (GIB)	bank set up by government to provide finance to the energy sector, supplemental to commercial finance, with strict environmental criteria
GLA	Greater London Authority
HLA	High Level Appraisal
Heat Offtake Agreement (HOA)	a contract for the purchase of heat, which may be associated with a PPA where heat and electricity is supplied by a Combined Heat and Power plant (CHP)
International Financial Reporting Standards (IFRS)	the accounting standards used by national and local government (and the bodies they control) in the UK for their annual accounts, which are consolidated in Whole Government Accounts
IGP	Investment Grade Proposal
Internal Rate of Return (IRR)	a key measure of the financial efficiency of an investment used in investment appraisal
ITT (Mini-Competition)	invitation to tender for a Mini-Competition under the new Re:fit Framework Agreement
Local Partnerships	Local Partnerships LLP
M&V	measurement and verification

Term	Definition
National Accounts	the accounts produced by the UK government in accordance with ESA 2010 and used to measure the national debt (see also WGA)
Net Present Value (NPV)	the financial value of a project taking account of investment and operating costs and savings/revenues taking account of the time value of money (usually based on a public sector organisation's appraisal discount rate)
Payback	the period (usually measured in years) required for the savings and/or income to cover the investment cost (note that a "simple" Payback does not include financing costs and a "financed" Payback does include financing costs)
Power Purchase Agreement (PPA)	a contract for the purchase of electrical power
Private Finance Initiative (PFI)	a form of finance, usually a service concession, where the private sector funds public investment
Public Works and Loans Board (PWLB)	the provider of finance to local government (and certain other public sector bodies) at published rates based on UK gilts plus a margin
Renewable Heat Incentive (RHI)	a subsidy payable where heat is produced such that it creates energy and carbon savings
Service Provider	a Framework Provider as selected by a Contracting Authority (through Mini-Competition) to deliver a Re:fit project
Services	term used in Template Call-Off to describe potential Re:fit services
Template Call-Off	terms and conditions for any call-off contract under the new Re:fit programme as set out in the Framework Agreement
UK GAAP	the accounting standards applied by those bodies not using IFRS, notably universities
Whole Government Accounts (WGA)	the accounts produced under IFRS, which consolidate the accounts of national and local government and the bodies they control

Preface

Re:fit is a procurement initiative for public bodies wishing to implement energy-efficiency and local energy-generation measures to their buildings or estate and support services. These measures improve the energy performance of buildings, thereby reducing carbon emissions and achieving substantial guaranteed annual cost savings.

In addition, Re:fit can allow for significant income-generation opportunities through the introduction of energy-generation measures. Many of the Re:fit services require upfront and sometimes ongoing investment. However, with capital budgets also being constrained, any investment must be well justified and cost effective. In some cases external financing may be required. This guide is intended to support securing the optimal financing arrangements to support the business case for investment.

The appropriate financing approach will differ depending on the specific circumstances of the organisation, including which part of the public sector it sits in, the type of project and the measures installed. Sectors include local government, central government organisations, universities, heritage organisations, further education institutions, schools and the NHS, all of whom have differing funding regimes.

The types of project also range from more service-oriented building efficiency measures to more capital-intensive CHP (Combined Heat and Power). Investments such as PV (Solar Photovoltaic Power Generation) can generate income from energy sales and incentive regimes, such as Feed-in Tariffs[1] (FITs), Renewable Heat Incentives [2] (RHIs), etc.

The financing options, which may in some cases be used in combination, include:

- internal funds and prudential borrowing
- third-party finance
    - project loans
    - grant funding
    - service provider[3] financing (service agreement or leasing agreements).

Practical advice to help decision-makers identify the most appropriate financing options to support the decision to proceed with an energy-efficiency/energy-generation project and subsequent procurement is included in the guide, comprising:

- key considerations, such as borrowing rules, existing loan covenants, accounting treatment, VAT, etc, which can differ by sector and are subject to policy change
- a description of the key features of each type of financing
- key elements required to analyse projects to support the business case and, specifically, the financing decision
- procurement considerations for the finance element of a project, including setting requirements and evaluation of proposals
- references alternate forms of guidance where appropriate.

The main body of this guide sets out an overview of the best financing route that might be determined and incorporated into procurement. It can be used by the project sponsor and senior responsible officers to agree the overall approach. It identifies the issues that need to be addressed in preparation for the tailoring of the template Invitation To Tender (ITT)

[1] gov.uk/feed-in-tariffs/overview

[2] gov.uk/government/publications/2010-to-2015-government-policy-low-carbon-technologies/2010-to-2015-government-policy-low-carbon-technologies

[3] Re:fit Service Providers are often also referred to as ESCos.

documents that are available for carrying out procurement under Re:fit. It is not intended to replace appropriate professional advice but should facilitate the specification and commissioning of such advice where required.

The appendices provide more practical, detailed guidance and include sector-specific information as well as references to funding sources and further information.

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Contents

1. Purpose and intended use/readership

1.1 The purpose of this guidance note is to help public sector organisations wishing to access services under the new Re:fit programme (launched in April 2016) to identify, specify and secure the most appropriate financing approach. The focus is on situations where the Contracting Authority (CA) is considering using external finance, particularly where it is arranged by the Service Provider. This is generally referred to under the Framework and Call-off Contracts as Alternative Financing and where this forms part of a Call-off Contract the arrangements will be set out in Schedule 12 (Alternative Financing).

1.2 This guidance note is part of a body of similar related guidance and other supporting materials published by Local Partnerships for use with the new framework and should be read in conjunction with other relevant guidance. As this guidance note focusses principally on financial matters, we suggest that potential Users share it with their finance team. However, as alternative financing arrangements will impact on the preparation of the business case, the approach to procurement and key contractual provisions, it is recommended that the guidance is made available to other colleagues involved in any potential Re:fit project (for example, legal, technical, procurement) in order to maximise its benefits. In particular, we consider it essential that your financial colleagues are actively involved in the detailed work on finance and accounting matters, including developing the financial bid requirements and evaluating the financial bid responses.

1.3 Note that only those bodies listed or otherwise classified in contract notice reference 2015/S 214-391299 as placed in the Official Journal of the European Union and dated 5 November 2015 are entitled to access services under the new Re:fit programme.

2. Executive summary

2.1 Background

2.1.1 External finance is generally more expensive than self-funding. Balance sheet treatment of loans and capital budgeting are often seen as a driver for seeking particular forms of funding but the rules and regulations for these continue to become more restrictive. So ensuring that any financing approach has demonstrable practical benefits and delivers value for money is of fundamental importance in any case. Generally, there will be a minimum value of project that justifies external finance. That limit will depend on the type of project and finance. Service Provider working-capital funding will always be welcome whereas a Special Purpose Vehicle (SPV) would be unusual for projects less than £5-10 million[4].

2.1.2 The issues considered include the following:

- developing a financing strategy/strategies relevant to the required measures
- identifying potential sources of funding
- assessing the accounting implications
- ensuring a sound commercial approach is taken to the contractual and procurement approach
- assessing projects, including financing in the business case and for bid evaluation.

2.1.3 There will be different sectoral considerations and these are generally identified. The technical aspects of finance and accounting issues are complex and subject to change so it is important that the right expertise within an organisation, supplemented by external advice in some cases including from auditors, is sought. This guidance seeks to outline the issues but is not a substitute for detailed project-specific advice (internally or externally as required).

2.2 Funding and financing strategy

2.2.1 Energy efficiency and carbon reduction are usually core strategic objectives both as a corporate policy objective for social and environmental reasons and as a means to make financial savings. Each organisation will have its own specific objectives, but finance will always be a constraint and, where investment is required, the savings are generally expected to provide the funding to cover the initial outlay and service any finance charges. The tools to measure this should be established at the outset as a means to assess alternative approaches.

2.2.2 Entering into a Re:fit contract can also enable public sector organisations to manage risk. Financial risk is reduced both by reducing exposure to market energy-cost variations and to the delivery and performance risk associated with investment in energy efficiency. Externally financed projects are usually accompanied by tighter contractual terms around risk transfer, especially where third-party funders are involved, because they will need to be confident about a contractor's ability to deliver. Additional due diligence and reporting may be put in place. While this can increase transaction costs, it significantly enhances risk transfer. It can also support an organisation in demonstrating it is meeting sustainability objectives, reducing reputational risk.

[4] The minimum size for PFI of £20 million was established many years ago but some providers have SPV models that they can offer for lower capital values where the project is relatively standardised.

2.2.3 Financial strategy across the public sector is subject to different opportunities, constraints and regulations (for example, capital budget allocations for central government, prudential borrowing in local government, debt covenants for independent public sector bodies). The assessment of financing requires separate consideration in the business case at each stage from business-case options appraisal to procurement. This should be factored in to resourcing and timetabling.

2.2.4 External debt finance will almost always have a higher cost than internal funds but there are often other reasons for using alternative finance. Some arise from constraints, others are driven by creating capacity for a more holistic approach.

2.2.5 The constraints that may be addressed include:

- not increasing balance sheet debt where there are borrowing constraints
- not utilising core capital budgets (subject to budget treatment of expenditure)
- increasing liquidity and diversifying financing sources (many funders may be prepared only to fund a capped proportion of a public sector organisation's financing needs to control credit exposure).

2.2.6 The strategic drivers associated with a more holistic approach to financing energy efficiency include:

- providing funding capacity for a Service Provider to bring forward solutions that generate net savings rather than simply work to a capital budget
- providing more flexibility in calling down funds as required.

2.2.7 The time and cost required to put in place external financing needs to be offset against these benefits. However, the related processes can provide more rigour around the due diligence and cost/savings monitoring process based on funder requirements.

2.2.8 External financing may often be more appropriate to investment in assets with a longer life and higher investment cost.

2.3 Types and sources of finance

2.3.1 Re:fit projects have often been self-funded without the involvement of Service Provider finance. The main sources of self-funding include:

- capital budget allocations
- reserves
- prudential borrowing via Public Works Loan Board (PWLB) for local authorities
- commercial borrowing facilities (including EIB and the Green Investment Bank)
- programme loans, such as Salix.

2.3.2 There are also other funding mechanisms which may support or work alongside finance arrangements, such as:

- FITs, RHI, etc
- European grants and loans.

2.3.3 The main types of borrowing that could be facilitated by Service Providers are:

- corporate finance from the Service Provider/Service Provider group
- project loans raised by the Service Provider/Service Provider group (possibly using an SPV structure)
- leasing
- bespoke Service Provider arranged financing, notably sale of receivables
- Service Provider controlled and financed assets for the provision of energy (for example, heat and power under a PPA/Heat Offtake Agreement) or other services (for example, energy management).

2.3.4 The Service Provider can draw on a range of sector-specialist external providers of finance, who can provide both debt and equity.

2.4 Accounting and budgetary issues

2.4.1 A common objective in private financing of public projects is to secure the required services and benefits without eroding borrowing capacity and capital budgets. The relevant accounting and budgeting rules are complex and subject to change. Recent and impending changes are generally making it more difficult to achieve off balance sheet solutions.

2.4.2 Central government capital expenditure can under certain limited circumstances be treated differently for capital budgeting and financial accounting purposes. Under the guidance on National Accounts, known as ESA 2010 (or ESA 10), expenditure on assets that are on balance sheet for the normal financial statements may nevertheless be treated as revenue. Many private finance initiative (PFI) contracts are examples of this.

2.4.3 The determination of accounting and budgeting treatment depends on the nature of the asset (for example, whether it is moveable or immoveable) and the contractual arrangements in terms of risk transfer, operational control and economic benefit. The specific rules that apply are complex and vary by sector but generally look to economic substance rather than simply contractual form. So improvements to the fabric of a building are unlikely to be off balance sheet whereas more commercial energy schemes with alternative users are more likely to be off balance sheet (for example, a Power Purchase Agreement (PPA) meeting the requirements of IFRIC 4 – see Section 5).

2.4.4 If such considerations are critical to the ability to enter into a Re:fit Call-off Contract, the issues need to be substantially resolved before the Mini-Competition commences. (Further guidance on this process can be found at local.gov.uk/abc.)

2.4.5 This will require early involvement of senior finance officers, probably including the accounting officer/finance director and possibly external auditors. For instance, where changes to accounting rules are expected, the impact of these need to be considered and the auditors may be best placed to advise on how these might be implemented. The involvement of external auditors also reduces the risk of the accounting treatment not being accepted.

2.5 Contractual and procurement issues

2.5.1 The Re:fit programme and Call-off Contract documents make provision for financing. However, they are not prescriptive on the financing arrangements and contractual terms (there are no standard-form financing documents, although sample drafting may be available). It is expected that at the Mini-Competition stage the Contracting Authority will set out its requirements in more detail. But in order to ensure innovation, bidders may be allowed to offer their own approach to financing, which best suits their solution and access to finance.

2.5.2 There will, nevertheless, be certain contractual provisions that are normal where external finance is being provided. These are generally intended to define the lenders' and authorities' rights in relation to key matters, especially events of change under the contract that might impact on financing and include:

- direct agreement between the Contracting Authority and a third-party lender
- step-in rights for external funders where the Service Provider is failing to perform
- early termination arrangement
- refinancing provisions
- variations.

2.6 Procurement

2.6.1 A Service Provider financed solution also brings additional procurement considerations, which will vary to some extent according to the type of Re:fit procurement approach selected [5]. The key points in procuring the finance element are:

- meeting procurement regulations and avoiding challenge
- economic evaluation of the bid having regard to financing given that, while
- a fully priced proposal may be required – in some cases there may not be a fully priced project and financial model at the time the preferred bidder is selected.

2.6.2 Given the potential range of funding solutions and the likely importance of financial issues, such as accounting treatment, finance should be a critical consideration during soft market testing with Service Providers.

2.6.3 The procurement regulations require fair dealing between contractors and the evaluation process should, therefore, demonstrably test the transparency, robustness and value for money of all aspects of bids, including financing.

2.6.4 Due to their complexity, and in some cases the changeability of financial markets, there is a risk of funding terms being subject to change up to contract signature and after in respect of multi-stage projects. This can be particularly challenging for a partner bid. However, by pinning down during the bid process the criteria for any changes post-appointment, sufficient certainty can be secured. Changes to financing terms based on pre-agreed principles can be acceptable while "renegotiation" is not.

2.7 Business case and assessment of value for money

2.7.1 Financing increases the complexity of the business-case assessment and bid evaluation. The appropriate financial expertise will be required both to develop the business case, tender requirements and evaluation criteria and to assess bids.

[5] This is discussed further in Section 7, with further details available in the Re:fit procurement guidance note. Broadly, there are three main procurement options: (1) Partner Bid, where the bidder outlines its proposals and approach but more detail is developed subsequently with the Contracting Authority; (2) Target bid, where the Contracting Authority can specify its requirements more precisely and the bidder can define its proposals (including price and finance) with some certainty but subject to further verification; and (3) Investment Grade Proposal bid, where a fully priced bid is provided including financing.

2.7.2 Self-funded bids are typically capable of being assessed for procurement purposes based on capital, services costs and payback. The key difference where financing is introduced is the profiling of payments by the Contracting Authority over an extended period (rather than milestone payments during construction). The profiled payments include the additional cost of finance (including interest and investor returns). The financial implications of ongoing liability for future payments still outstanding in the case of variations and/or early termination will also need to be evaluated. The Contracting Authority's metrics in relation to these financing issues need to be approved in principle as part of the business case and assessed in detail during the procurement.

2.7.3 In terms of the financial evaluation, the key elements will be affordability, value for money and financial risk. The metrics of simple payback, which are commonly used in self-funded procurements, will not be sufficient and both assessment of the financed payback (the duration of the period debt that is outstanding) and Net Present Values (NPVs) are likely to be more appropriate. The financial metrics in the business case and procurement should be aligned as far as possible and requirements for the relevant information included in the Invitation to Tender (ITT).

3. Funding and financing strategy

3.1 Introduction

3.1.1 This section describes some of the main considerations in developing a funding and financing strategy for a Re:fit project. This will normally be set out in the business case. Energy-efficiency projects are typically driven by estates teams. Ongoing energy costs, while important, can often represent a relatively small proportion of total revenue budgets and therefore be subject to more limited attention in overall financial strategy. However, energy-efficiency projects, especially as part of a wider estates strategy, can be more significant to capital budgets. It will, therefore, be important to validate existing cost bases/asset values, etc, and energy and related operational budgets to get the right baseline for assessing value for money of capital expenditure, including finance costs.

3.1.2 It is worth noting that the financing considerations may differ according to whether energy savings are to be secured through reduced consumption (efficiency in use) or securing energy supplies more efficiently. This might be either more efficiently than previously, where for instance Combined Heat and Power (CHP) is being upgraded, or as a result of substituting market supplies of energy with, for example, CHP or solar photo voltaic (PV) generation. Energy production, where an energy offtake agreement in some form can be agreed, can sometimes offer more simply financeable projects with greater off balance sheet potential.

3.1.3 Given that generally external finance is likely to be more expensive and complex than self-funding, the basis for adopting the strategy and how it will be implemented need to be clearly understood and articulated.

3.1.4 When considering financing, it is sometimes useful to have in mind that, although the terms funding and financing are often used interchangeably, a distinction may usefully be made. The cost of an investment has ultimately to be funded from the financial reserves or surplus income of an organisation but, where these are not sufficient at the time the investment is made, the expenditure needs to be *financed*. This is precisely the situation that often applies to Re:fit projects where the savings that fund the investment accrue over a period of years while existing financial resources are already allocated to capital budgets for frontline service investment.

3.2 Strategic drivers – public sector finance regimes

3.2.1 Finance and funding strategy for a Re:fit project will be shaped by a combination of institutional strategy and policy, the economic climate and the relevant public sector financial rules. Each organisation will have a detailed understanding of the rules under which it operates. Broadly, bodies falling under central government budgeting are constrained by cash-limited annual capital budgets, while many other parts of the public sector are constrained by prudential financial-planning considerations and borrowing covenants more akin to a commercial organisation (albeit subject to wider public sector budgetary pressures).

3.2.2 An intrinsic part of market engagement (NB soft market testing) should be to ensure that there is a clear and common understanding of how the applicable finance rules impact on a Contracting Authority's financial requirements. Framework Providers may only have a limited understanding of sector-specific finance rules within the public sector; and such rules may not be a normal matter of concern to the Contracting Authority delivery team leading a Re:fit project, where their experience is limited to self-funded projects. Annex A provides a high-level summary of some of the different regimes applicable to different parts of the public sector.

3.3 Strategic drivers – commercial, accounting and budgeting

3.3.1 The reasons (which are not mutually exclusive) for a Contracting Authority to use alternative finance might include:

- not increasing balance sheet debt where there are borrowing constraints (subject to accounting rules)
- not utilising capital budgets (subject to budget treatment of expenditure)
- increasing liquidity and diversifying financing sources, recognising that different lenders have different appetites for risk or, indeed, may not as a matter of policy lend for the purposes of projects such as those arising from the Re:fit programme (where they may not have the expertise)
- providing funding capacity for a Service Provider to bring forward solutions that generate net savings rather than simply work to a capital budget
- providing more flexibility in calling down funds as required for phased works
- accessing sector financing expertise by using specialist funders (see Annex B).

3.3.2 There should always be senior management buy-in, especially from the Director of Finance, and regard, of course, should be taken of any other specific Contracting Authority governance requirements. This will give confidence to potential bidders and enhance their willingness to bid. Soft market testing can provide evidence to input to the approval process and support the development of a tender that is attractive to the market.

3.4 Developing financial analysis to underpin financing strategy

3.4.1 The Re:fit process allows for the Service Providers to carry out detailed work to assess project requirements. However, in order to develop a business case (see Section 8), public sector organisations will normally need to carry out some feasibility assessment and financial-options appraisal as part of the project approval process. This will differ between types of project but some key considerations affecting the relevance of external finance will be:

- what is the potential realistic level/range of energy savings that might be achieved?
- what is the impact on ongoing operational and maintenance budgets and life-cycle programmes?
- what is the potential level of capital expenditure? Can it be efficiently incorporated with other capital programmes?
- are there third-party income opportunities to sell heat/power?
- how does the project fit into current financial plans and budgets?
- what is the potential impact on income and expenditure and financial ratios?

3.4.2 For some organisations, internal financial management issues should be considered. For instance, if energy costs are allocated between departments or sites on a usage basis, there may need to be a mechanism to claw back savings secured through investment to finance the investment by recharges. This does not need to be too complicated and could, for instance, be based on, say, a 75p charge for every £1 saved for a specified period to be allocated to pay the element of the service charge related to investment finance costs.

3.5 Strategy and potential bidders

3.5.1 Under the Re:fit Framework, Contracting Authorities have the opportunity to access Service Providers with the experience and relationships to deliver financed projects. The Contracting Authority will secure the best bids by developing at the outset a clear definition of its financial objectives to go with the technical/energy-efficiency objectives. These may be informed by soft market testing to gain market intelligence and understand the potential-bidder financing offers.

3.5.2 Key considerations that bidders for Service Provider projects will wish to understand include:

- if accounting treatment is a key driver, does the type of project infrastructure have the potential for off balance sheet/budget treatment? And, if so, is this commercially desirable?
- has the Contracting Authority confirmed the likely affordability of the project, including a realistic appreciation of potential finance costs?
- is the Contracting Authority prepared to operationally agree to the ownership, contractual and operational/technical requirements of the risk transfer required?
- is the Contracting Authority resourced to negotiate the finance arrangements?
- the Contracting Authority's financial standing (creditworthiness) and its ability to demonstrate this. Some authorities secure credit ratings to facilitate finance, for instance, although this may not be cost effective for many. The approach will differ between sectors and is more of an issue for more autonomous arm's-length bodies.

3.6 Summary

3.6.1 The financing strategy for a Re:fit project should be developed out of the wider corporate financial strategy, which will be driven by the relevant public sector financial regime and commercial, accounting and budgetary drivers.

3.6.2 It will be important to carry out financial analysis to select the appropriate financing approach. Bidders will wish to know and understand a Contracting Authority's financial strategy. The analysis can help to inform bidders and, when supplemented by soft market testing, can be used to further refine the strategy prior to procurement.

4. Types and sources of finance

4.1 Introduction

4.1.1 The focus of this guide is external finance through a Service Provider, but the decision-making requires consideration of all options, including self-funding. In practice, particularly where the scope of works and projects is wider, a combination of types and sources of finance may be used.

4.2 Overview

4.2.1 Financing can be distinguished between self-funded and Service Provider funded solutions. Many of the finance providers will be prepared to provide finance to the public sector or private sector. There are examples of energy projects where this has been determined during the course of development of the scheme but early consideration of all sources, ideally prior to procurement, can ensure that the optimal financing route is determined at the outset. It should also be noted that the Service Provider may be able to facilitate a Contracting Authority's being able to access finance directly.

4.2.2 The main sources of self-funding include:

- capital budget allocations
- reserves
- prudential borrowing via PWLB for local authorities
- commercial borrowing facilities (including EIB and the Green Investment Bank)
- programme loans, such as Salix
- incentives, such as FITs, RHI where relevant, and EU grants and loans.

4.2.3 The main types of borrowing potentially facilitated by Service Providers are:

- corporate finance from the Service Provider/Service Provider group
- project finance raised by the Service Provider/Service Provider group (possibly using an SPV structure)
- leasing
- bespoke Service Provider arranged financing, notably sale of receivables
- Service Provider controlled and financed assets for the provision of energy (for example, heat and power under a PPA/Heat Offtake Agreement) or other services (for example, energy-management centres).

4.3 Public sector borrowing

4.3.1 The main sources of on balance sheet direct public sector borrowing vary between sectors as illustrated below:

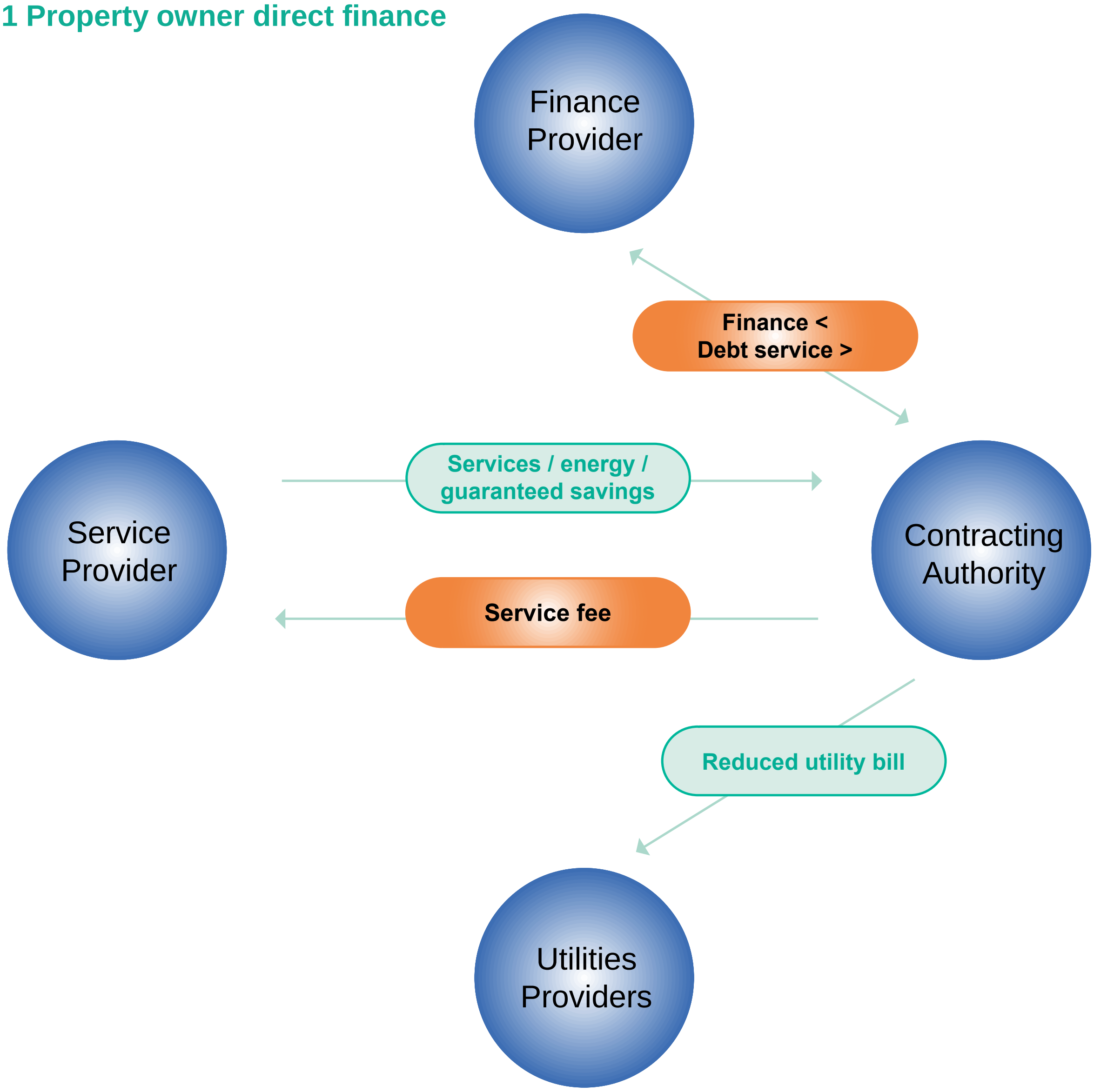
- for local authorities, PWLB is well established as the default low-cost borrowing facility with well-defined terms. The availability is determined by prudential borrowing tests, which essentially consider whether an investment has a positive financial impact and whether it leads to borrowing or debt-service pressures above limits the authority has determined it can manage. Each local authority will normally have a process, including a financial model, to check whether a particular investment meets its tests
- NHS Foundation Trusts can borrow from commercial lenders based on their own prudential borrowing tests. The NHS regulator, Monitor, no longer formally sets detailed prudential borrowing limits. However, one of the tests under its Risk Assessment Framework is liquidity and capital service capacity (ie the ability to service capital commitments)
- NHS Hospital Trusts can take out interest-bearing capital loans through the NHS Trust Development Authority (TDA), with final approval being required by the Department of Health (DH). These loans need to be identified in the NHS Trust's financial plans and

agreed with the NHS TDA, who will subsequently agree them with the DH. The interest rates are based on National Loans Fund rates[6]. The loans are subject to prudential borrowing rules

- universities in England may borrow subject to their own prudential borrowing policies, Higher Education Funding Council for England (HEFCE) limits and the covenants agreed with their lenders. The HEFCE limits are formally set out in a memorandum of agreement with an institution. (Note: these limits are currently under review in the light of the introduction of new UK GAAP accounting rules)
- universities in Wales are subject to similar provisions as English Universities
- schools:
  - local authority maintained schools operate under delegated budgets. Community schools cannot borrow without the permission of the Secretary of State. Permission has been given to use Salix loans. Where a school has foundation or trust status, it has greater ability to borrow
  - academy trust schools may borrow, but the Education Funding Agency (EFA) will need to be consulted in respect of a material borrowing and the accounting treatment may need EFA review.

4.3.2 The commercial structure associated with a direct loan is illustrated in figure 3.1 below.

Fig 3.1 Property owner direct finance



[6] Details of rates can be found at dmo.gov.uk/index.aspx?page=PWLB/PWLB_Interest_Rates

4.3.3 Commercial lenders will consider the financial strength of the public sector counterparty. Their lending margins are driven by the credit risk of their counterparties, which in turn determines the amount of regulatory capital the financial institution needs to set aside for the relevant loan and, thus, the cost of lending.

4.3.4 Each sector benefits from being seen as public sector and, thus, a good credit risk with relatively low margins. However, while central and local government are generally rated to be almost risk free (sovereign risk), independent bodies, such as NHS Trusts and universities, will at least be subject to greater financial due diligence and credit assessment and may in some cases attract higher lending margins due to the risk perceived to arise from their greater autonomy.

4.3.5 Salix provides interest-free loans for certain closely defined kinds of energy-efficiency projects. Eligibility criteria include payback (this varies between sectors) and additionality (ie that is not already going ahead and financed)[7].

4.3.6 In London the London Energy Efficiency Fund can provide loans (and equity), sourced from European-funding programmes, to public sector bodies at low interest rates[8]. The Fund has limited duration. There is currently a process to implement a second wave.

4.3.7 Absent other strategic considerations discussed above, direct borrowing by the public sector will (apart from Salix) usually be the preferred source of finance, being cheaper in terms both of borrowing costs (perhaps by 2.5 to >4 per cent and more depending on the specific project and financing arrangements) and in most cases having materially lower transaction costs.

4.4 Provider finance

4.4.1 How a provider sources finance for a Re:fit project will be determined by its own financial strategy and the nature of the project and required investment.

4.4.2 Some providers use their own entity/group balance sheets and can access funds from their own corporate finance functions. This can simplify contractual arrangements and reduces the due diligence process, but the provider may wish to have the same contractual arrangements. The arrangements will vary and range from financing a project on the basis of a project's internal rate of return (Project IRR), possibly taking account of overall profit generated, to internal arrangements under which internal treasury/investment arms provide funds in a similar way to external funders. This may be required to permit subsequent external refinancing (ie seeking external borrowing after contract close and usually once a project is operational).

4.4.3 It is perhaps more common for providers to access finance from third-party finance providers. Both debt and equity are available as well as leasing arrangements. In practice, finance is provided by certain banks and energy-efficiency funds with co-funding arrangements common. There is a range of finance providers in the energy-efficiency market and further details are provided in Annex B.

[7] Further details can be found at salixfinance.co.uk/loans

[8] Further details of the investment process can be found at leef.co.uk/investment/index.html

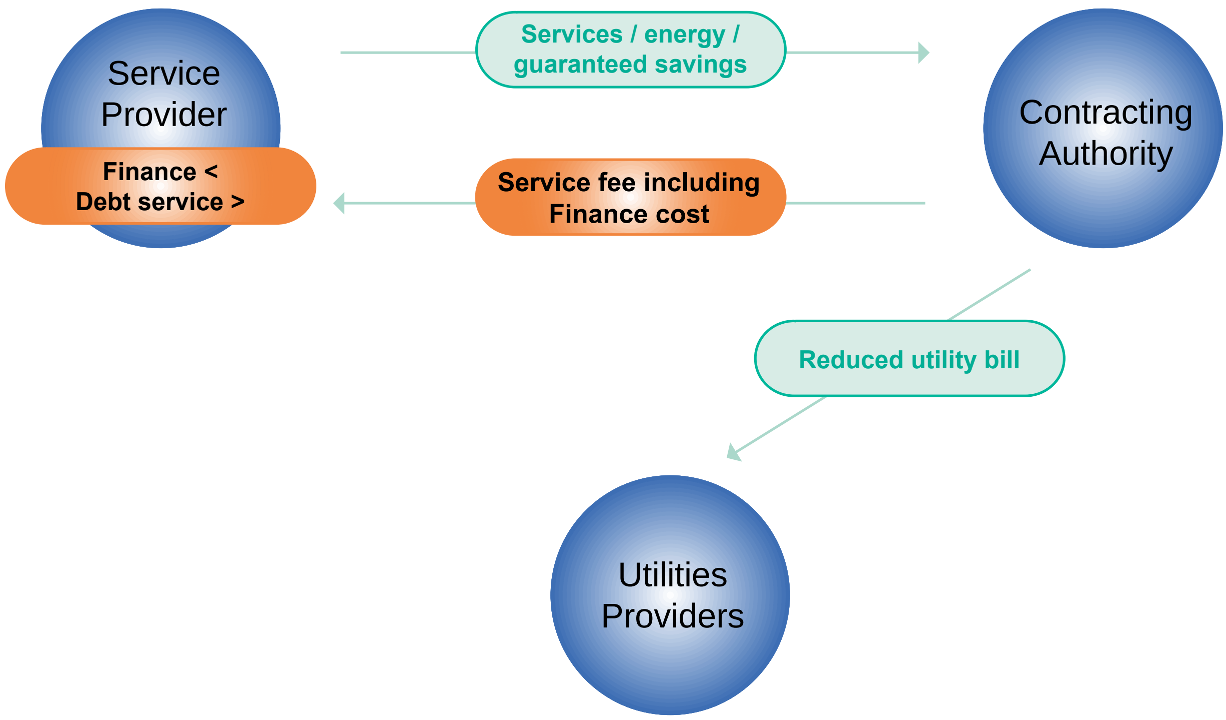
4.5 Potential financing contract structures

4.5.1 The main Service Provider financing structures are set out below. Further contractual considerations are set out in more detail in Section 6.

4.5.2 Figure 3.2 shows the arrangement where the Service Provider uses its own balance sheet to fund investment. This can be relatively simple to negotiate because the arrangement only involves two parties, although Service Provider's using these arrangements may have investment arms that operate internally but that have many of the requirements of external finance providers.

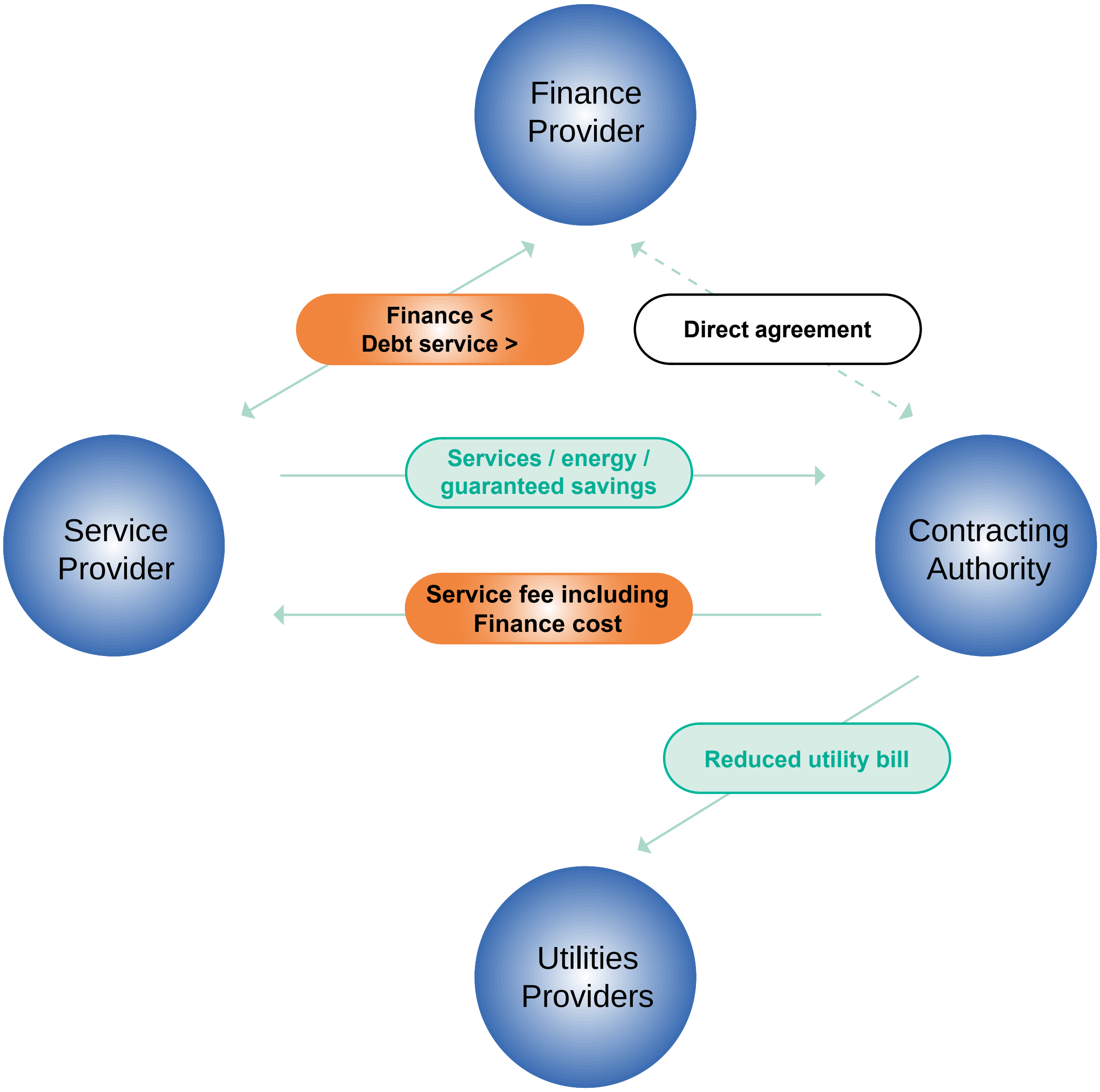
4.5.3 The financing cost may be determined in some cases by reference to an internal rate of return (IRR) requirement, which provides greater simplicity and can be more stable and predictable (ie it is less subject to market movements in interest rates).

Fig 3.2 Service uses corporate finance



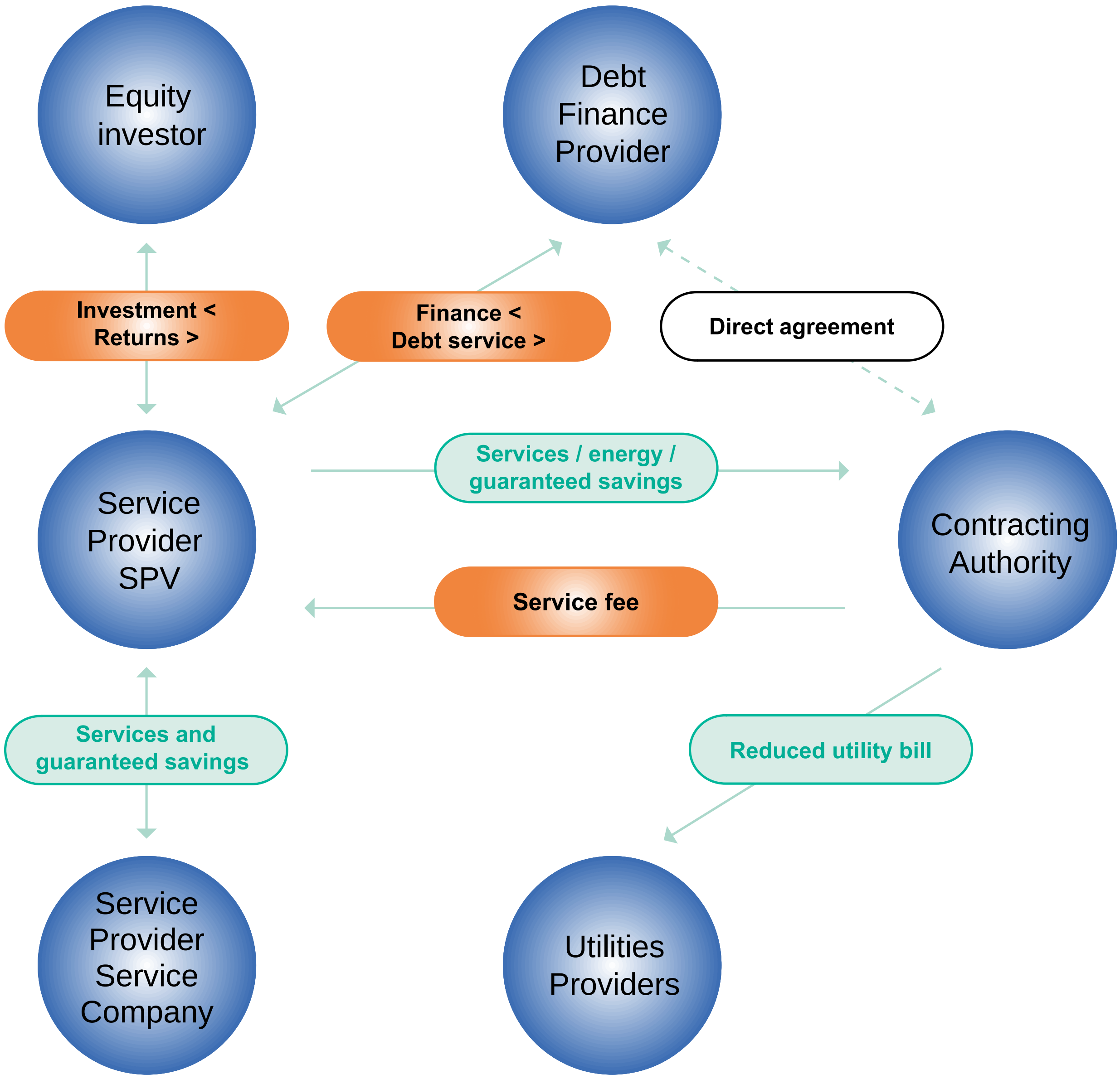
4.5.4 Figure 3.3 shows the arrangements where the Service Provider secures external financing. The finance provider and the Contracting Authority will wish to put in place arrangements to deal with a situation where the Service Provider is in default (or there is a risk of default) and there is usually a Direct Agreement made (see below).

Fig 3.3 Service uses external finance



4.5.5 Figure 3.4 shows the arrangement where a separate company usually referred to as an SPV (Special Purpose Vehicle) is set up to enter into the service contract and financing contracts. This can allow the Service Provider to secure additional risk capital and is often used to keep the project off Service Provider balance sheet. Due to the additional complexity, it would only be suitable for much larger projects.

Fig 3.4 Service sets up SPV for contract



4.5.6 The detailed financing arrangements within these generic structures can differ and the following points of understanding are relevant.

4.6 Leasing

4.6.1 Leasing arrangements are a specific form of contract granting the use of an asset to another party. So, a Service Provider may use lease finance for assets it uses to deliver services to its public sector customer. It can be an effective means of financing with tax advantages reducing the cost of finance and balance sheet treatment advantages for the Service Provider.

4.6.2 As the arrangement generally entails the lessor financial institution owning the asset, procuring authorities will need to ensure this does not put at risk continuity of service under certain circumstances.

4.6.3 It should be noted that, even where the Service Provider enters into the lease, for accounting purposes the asset and related finance may have to be accounted for as a lease by the end user.

4.7 Sale of receivables

4.7.1 A structure that has become relatively common is sale and purchase of receivables (sometimes referred to as sale of receivables). In effect, the Service Provider sells and the lender/lessor purchases the right to the payments by the public sector end user. The payments will usually then be made into an account maintained by a third party. Payments will be made from that account to the lender to service finance obligations and, subject to performance, to the Service Provider for services. This arrangement protects the lender, who is assured that the Contracting Authority will make payments, and the Authority, who is sure the Service Provider will only get paid based on performance.

4.7.2 The assets will be leased to the Service Provider (or a loan made for the Service Provider to purchase the assets). For redress over performance issues, the Contracting Authority must turn to the Service Provider but continue to make payments that flow to the lender/lessor.

4.7.3 There are various nuances to the arrangement but essentially it allows the lender/lessor to be able to rely to a more significant extent on the cash flow from the public sector end user. This reduces the cost of funds because the credit risk is assessed on the basis of the public sector financial covenant, meaning the cost of finance is closer to the direct public-borrowing rate.

4.7.4 The Contracting Authority will wish to scrutinise these arrangements closely to ensure its interests are protected, for instance through its guaranteed payments being ring-fenced. A number of finance providers support such arrangements.

4.7.5 This arrangement is often associated in the market with off balance sheet operating leases (see Section 5). However, the sale of receivables' arrangement does not itself generate an off balance sheet treatment but the contingent nature of the payment to the contractor supports such a treatment. Clearly, this is a complex area where professional advice may be advisable.

4.8 Service concessions

4.8.1 A service concession is an arrangement whereby the provider receives a "unitary" service payment, which covers financing of infrastructure, its maintenance and operational costs. Typically, the grantor (the public sector in this case) controls what services are required and the standards, but the operator (the Service Provider in this case) has overall responsibility for procuring the assets and delivering the service.

4.8.2 This arrangement has specific consequences in accounting terms for bodies accounting under International Financial Reporting Standards (IFRS), which are set out in Section 5.

4.8.3 While not strictly necessary, such arrangements often lead to the establishment of an SPV.

4.8.4 It should be noted that a service concession will usually be distinguished from a service contract (see below) by the degree of control and the current or future ownership interest that is envisaged in the contract. Under a service concession, the Contracting Authority controls the services provided (even if the Service Provider delivers them) and the assets used to deliver the service usually revert to the Contracting Authority at the end of the contract. Neither of these are formally the case under service contracts and this forms the basis of the different accounting treatment discussed in Section 5.

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4.9 Offtake agreements and service contracts

4.9.1 Where the Re:fit contract is purely for the supply of services or energy and the Service Provider controls the relevant assets, this may be treated as a service contract, which does not contain a lease and is, therefore, off balance sheet.

4.9.2 Examples include:

- appropriately structured Power Purchase Agreements (PPAs) and Heat Offtake Agreements. Where the project involves energy generation (power or heat and power), the contract may involve the provider investing in the assets and supplying the output to the Contracting Authority (for example, under a PPA or Heat Offtake Agreement). Under such arrangements, the Service Provider would control and take the risk on the performance of the assets. The plant may be sized so as to generate, at least at certain times, more energy than the Contracting Authority requires, which can be sold to third parties (depending on technical feasibility, such as location of third party and grid connections). The existence of financing incentives, such as RHI and FITs, can reduce the risk and enhance financeability by reducing credit risk
- remote energy-management centres
- control equipment that is operated by and can be swapped/substituted at the Service Provider's discretion.

4.9.3 The accounting basis for these arrangements potentially being treated as off balance sheet is set out in Section 5, but the key considerations for the Contracting Authority are:

- it needs to be comfortable that, although the outputs of the contract can be specified at procurement, the contract provides no ongoing control of the assets used to provide the services or rights to the assets when the contract expires. There would, for instance, be no contractual step-in rights in the case of Service Provider failure
- the greater risk transfer to the Service Provider is likely to translate into a higher cost (due to direct risk provisions and to higher cost of funds).

4.9.4 While these arrangements may well be off balance sheet for the Contracting Authority, demand risk will probably be the most difficult aspect because an investor would be concerned if there was a possibility that in the future there might be no customer for a plant's output. This has both cost implication, because finance providers will price in additional risk, and may lead to the Service Provider seeking assurances that may challenge the accounting treatment. These issues should be identified with potential Service Providers at an early stage during procurement.

4.10 Summary

4.10.1 Direct borrowing by the public sector is clearly simpler and generally cheaper than Service Provider sourced finance, so there will need to be wider strategic drivers if the latter route is chosen. This is clearly complex, even as set out in the simplified description here, and needs senior and expert financial input at an early stage to avoid abortive effort and to secure a solution that meets strategic objectives and provides value for money.

5. Accounting and budget treatment issues

5.1 Introduction

5.1.1 Whether the assets used to deliver energy-efficiency services, and any related borrowing, need to be accounted for on the balance sheet of the Contracting Authority will be a critical consideration where external finance is used. It should be noted that the rules are complex and are generally changing, increasingly to limit the circumstances when an off balance sheet treatment can be achieved.

5.2 What rules apply by sector?

5.2.1 Most public sector bodies now produce financing accounts based on International Financial Reporting Standards (IFRS). However, a different accounting regime – UK GAAP[9] – is used by some of the public sector organisations, such as universities. The relevant standards are often supplemented by sector-specific guidance and, therefore, there may be in practice some nuances in their application. The differences are generally very small but can sometimes be important to particular issues (for example, lease accounting) and, where changes are implemented, the timing of application can differ.

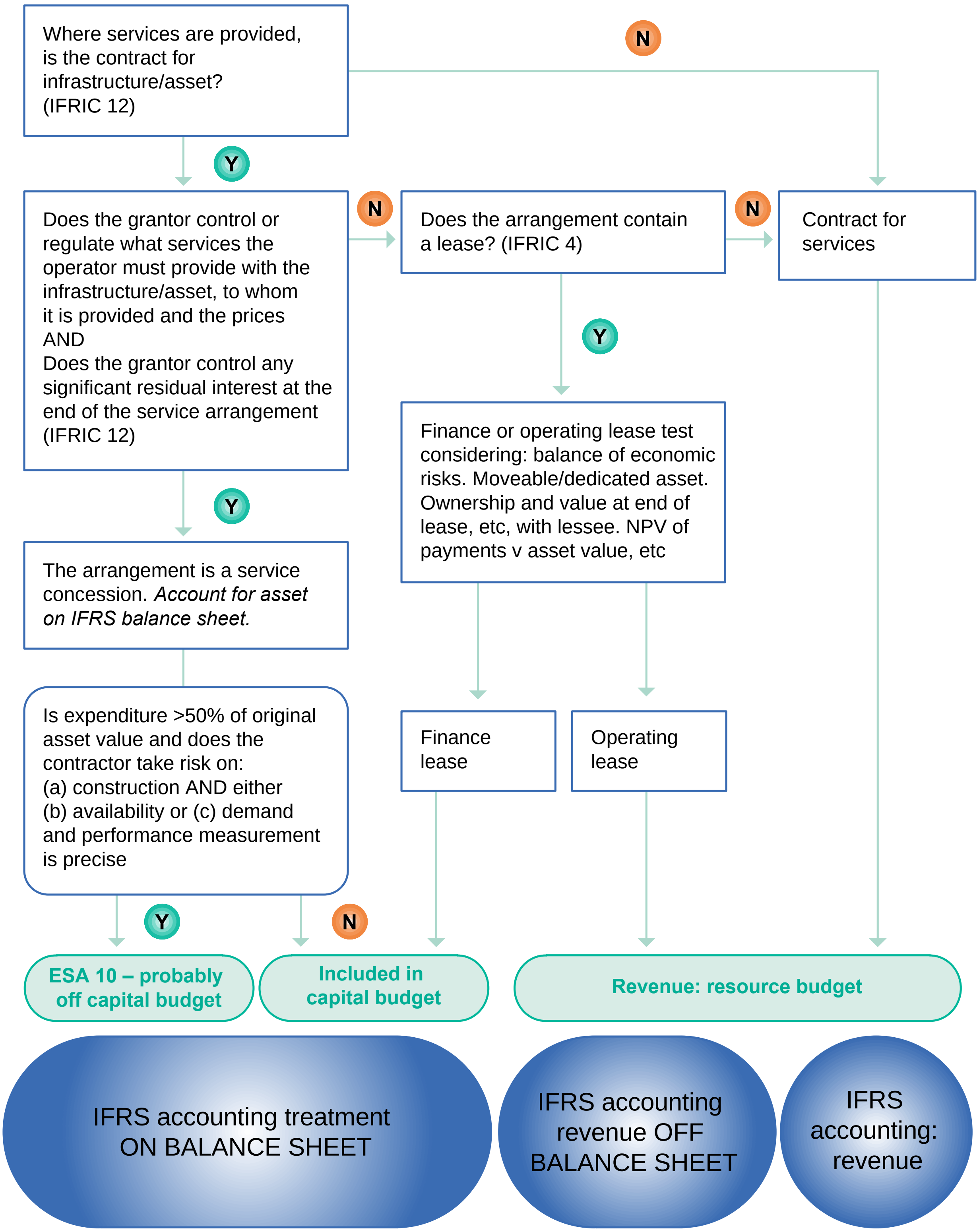
5.2.2 For central government organisations, it can sometimes be the case that, whereas the assets used to deliver services under a service concession may be capitalised for the purposes of the Whole Government Accounts, for the National Accounts, and therefore for budgetary purposes, the same expenditure is treated differently, ie as revenue. Whole Government Accounts are produced under IFRS, while the National Accounts (which measure national debt) are produced under ESA 2010 rules, determined by Eurostat. Where there is a difference, the description is often that the assets and liabilities are "on balance sheet" but "off capital budget".

5.2.3 This distinction can be important for organisations where capital budgets have to be agreed as part of the government's annual expenditure process.

[9] Generally Accepted Accounting Principle (GAAP). Further details of the recent revisions to UK GAAP that are being implemented can be found at frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/New-UK-GAAP.aspx

5.3 Balance sheet v capital budget treatment of service contracts

5.3.1 For organisations where central government accounting rules apply, there is a process to determine the accounting and/or budgetary treatment. This is summarised at a high level in the figure below. Where an organisation is not experienced in carrying out the analysis, it is usually advisable to consult with external auditors at an early stage in the process.



5.3.2 It should be noted that the interpretation of ESA 2010 has generally become more restrictive. For instance, when considering risk transfer, where the public sector has an equity stake or there is a profit-sharing arrangement, it will be deemed that the public sector has a share of the project risk. If this is material, the asset may be required to be treated (irrespective of other factors) as capital for ESA 2010 purposes. This is a developing area with limited formal guidance.

5.3.3 Supplementary guidance, however, was issued by Eurostat in August 2015 (Impact of Energy Efficiency Contracts on Government Accounts) specifically considering expenditure on assets supporting energy efficiency[10]. The key points in the guidance are as follows:

- a contract for energy purchase where the output of a plant is bought would (as long as the Service Provider owned and took the risk on the assets) essentially follow the same path in the diagram above as a service contract, with the energy purchased being a revenue cost
- for energy systems and generating capacity, consideration may be given to whether the contract may be accounted for as an operating lease in respect of the assets and liabilities (see below) or, indeed, as a service contract where just the outputs are contracted for
- for energy-efficiency measures to existing assets, the expenditure would have to represent at least 50 per cent of the upgraded value of the existing asset (ie after retrofit expenditure). This would rule out the majority of retrofit energy-efficiency measures to the fabric of the building. So, fitting insulation that represented 10 per cent of the current value would fail the test, whereas stripping back a building with a current value of £1 million and applying retrofit measures including a renewed roof, windows, energy systems and plant such that it was worth £2 million afterwards would potentially pass the test[11]
- the performance of the private sector in delivery must be precisely measured. This is likely to be the case under any EPC.

5.4 Service contracts and offtake agreements

5.4.1 Where the contract is for services or energy outputs and the Contracting Authority does not control the assets used, then under IFRIC 4 (and similar UK GAAP provisions) there is deemed to be no lease and the payments are accounted for as revenue. Examples were set out in Section 4. The key tests, in summary, are that there would be a lease if:

- the contract identified the asset to be used (ie there could be no substitution), and
- the Contracting Authority controlled how it was operated
- controlled physical access
- the price was not fixed.

Where the contract does not include these requirements, then there may be considered to be no lease and the contract would be off balance sheet.

5.4.2 A contract for energy outputs at a fixed unit price provided from plant fully controlled by the Service Provider will generally meet these tests: the services provided by assets are controlled and capable of substitution by the Service Provider.

5.4.3 However, as noted previously, Contracting Authorities will need to be both satisfied strategically and comfortable from a risk management point of view with the lack of control and its ability to provide continuity (if required) at the end of the contract.

[10] ec.europa.eu/eurostat/web/government-finance-statistics/methodology/guidance-on-accounting-rules

[11] The guidance does not provide detailed interpretation notes but states that there should be consultation with the national body responsible for ESA10.

5.5 Lease accounting

5.5.1 Leases are currently distinguished for accounting purposes between finance leases and operating leases. Finance leases treat the relevant assets and the related liabilities as belonging to a Contracting Authority for accounting purposes and therefore on balance sheet. The related payments are distinguished between repayment of debt and finance charges (along with any service payment that may form part of the contract). In contrast, under an operating lease the assets and liabilities are not considered to belong to the Contracting Authority and are thus not required to be accounted for on balance sheet. The payments are treated as expenses.

5.5.2 It should be noted that a lease may be a stand-alone contract or may be “embedded” in a wider contract. This will be examined by auditors for all major contracts and needs to be considered early in the planning process.

5.5.3 A Service Provider financed asset may be accounted for under an operating lease where certain conditions are met in relation to the nature of the asset and the economic arrangements and how those are expressed in the contract.

5.5.4 The first test is whether the asset is “moveable” or an intrinsic part of a building. Measures to improve a building’s fabric will generally be intrinsic, so the asset and any financing will, therefore, be on balance sheet. Equipment associated with heating systems and for the generation of energy may depend on whether the configuration could be considered moveable.

5.5.5 The economic test relates to which party bears the most significant part of the risk. So a lease is a finance lease where it transfers substantially all of the risks and rewards of ownership to the lessee and conversely an operating lease is where it does not.

5.5.6 The specific tests will consider how risks and rewards are allocated in the lease contract:

- does ownership pass to the lessee at the end of the lease term?
- can the lessee buy the asset at less than its market value?
- is the lease term for the major part of the asset’s economic life?
- do the lease payments represent most of the value of the asset at the commencement of the lease?
- are the assets so specialised that only the lessee could use them?

Where the answer to one or more of these is yes, then the lease would be deemed a finance lease. There is generally an overriding substance over form test, which might consider factors such as technological obsolescence and the ongoing requirement for the asset. These are challenging tests.

5.5.7 Clearly, where an asset can be used to provide services to third parties, these tests can be more easily met as in the case of energy generation. Also, where equipment is deployed as determined by the Service Provider, with the right to remove and substitute, they may be considered as the operator’s assets for service delivery. This may be the case with some control equipment and for some CHP assets and PV generation assets.

5.5.8 The specific drafting of the contract provisions will be critical in determining the accounting treatment and there are examples of what appear to be very similar arrangements being on and off balance sheet. As noted, early involvement of auditors is often advisable.

5.6 Changes to accounting rule

5.6.1 This commentary reflects the position at the time of writing. For organisations accounting under International Financial Reporting Standards (IFRS), it was confirmed in January 2016 that the leasing standard IAS 17 will be replaced by IFRS 16 with effect from 1 January 2019. The main impact is that the distinction between operating and finance leases will be removed from that date. The IFRIC 4 guidance is also replaced by IFRS 16 but the changes are more limited, providing a clearer, amended but fairly similar set of tests to those currently in force, and will not have such a significant impact (ie this route to off balance sheet treatment essentially remains).

5.6.2 There is no formal confirmation in respect of UK GAAP, but it might be reasonable to assume that similar changes will be implemented and similar considerations apply.

5.6.3 The operating lease route remains available under IAS 17 until IFRS 16 is implemented. A change in accounting standard does not generally lead to a breach (for example, of loan covenants), but there will be a need to look closely at the risks when IFRS 16 is required to be applied if this option is to be followed due to balance sheet treatment considerations.

5.7 Summary

5.7.1 The developments in accounting continue to move increasingly in a direction that limits off balance sheet finance. This will have an impact on the financing of the kind of assets used for energy-efficiency services and procured under Re:fit. Where balance sheet treatment is a critical objective, it is important early on to determine the key contractual and commercial arrangements that might be required to achieve this. This should be included in the approach to engaging with potential bidders and in the procurement requirements. Appropriate members of the legal and financial teams should be involved from the outset. The early involvement of external auditors may also be advisable.

6. Commercial contractual considerations

6.1 Introduction

6.1.1 The inclusion of finance brings additional complexity to the contractual arrangements, which makes the procurement and contract management processes more onerous. Within the Re:fit Call-off Contract, Schedule 12 (Alternative Financing) will contain the financing arrangements and the draft Call-off Contract highlights in drafting notes where additional drafting may be required in respect of the financing arrangement. The other key Schedules that will interact with Schedule 12 are:

- Schedule 6, which will contain the payment requirements, including charges to recover finance costs
- Schedule 3, which will include payments relating to Savings Guarantees.

6.1.2 Reference should also be made to the Re:fit Contract Guidance document.

6.1.3 In terms of drafting, it should be noted that there are likely to be a number of financing documents that will form part of Schedule 12. It is common for these to be drafted by the legal advisers of the Service Provider or their funders, with agreement of the Authority and its lawyers.

6.1.4 There will usually be a number of finance-specific requirements that arise both in respect of the payment regime and to protect the interest of finance providers. The detailed arrangements will differ according to the funding structure.

6.1.5 Section 4 sets out at a high level the potential contract and financing structures. Further consideration is given in the remainder of this section to some of the wider commercial terms impacted by or specifically associated with externally financed projects. It is not intended to be comprehensive but identifies key areas for early consideration. They should not be left for final negotiations because they are of fundamental importance and will be matters that the accounting officer would usually be concerned to ensure are dealt with correctly.

6.2 Energy performance contracts – performance and service

6.2.1 The procuring body will specify the outputs required (for example, energy savings required, payback period required, maximum capital spend) rather than the inputs (for example, insulation measures or voltage optimisation). This allows the Service Provider to innovate through designs in order to produce the best value-for-money solution for the client.

6.2.2 The Service Provider will typically provide an integrated solution, either subcontracting with technology suppliers or performing all the work itself as required. The scope of the contract may vary; most include design and installation, but contracts can be structured to include operation and maintenance of systems. Integration of EPC contracts with existing operation and maintenance regimes is an important aspect of managing integration risk.

6.2.3 The performance element of the contract will be important to the financing arrangements. The payment to the Service Provider will be designed to cover both operational costs and debt service/lease payment costs with an allowance for risk and profit. The Re:fit Savings Guarantee regime will allow for rebates to the Contracting Authority for failure to deliver savings (which, in the case of CHP, will be failure to deliver the agreed amount and supply profile – ie date and time – of energy). Where the payment is reduced, this will impinge on the Service Provider's resources to make finance payments.

6.2.4 The extent to which payments can be reduced for failure to perform will be a key matter in setting up the contract. It is a critical risk for finance providers and will be an important part of their due diligence, both technically and in terms of their assessment of the financial standing of the contractor. The financier will wish to be able to take action to address poor performance to ensure that payments will be made and this is usually addressed through step-in rights (see 6.5).

6.2.5 The payment and performance regime is critical to the contractual risk transfer. Where relevant, it will be an important consideration in determining accounting treatment. The ESA 2010 rules (see 5.3) require that the contractor takes either demand or availability risk. Also, if the contract payment is contingent on energy savings as part of the service, that may underpin the determination of where the risks and rewards of ownership substantially lie in order to determine whether there is a finance or operating lease.

6.3 Direct Agreement

6.3.1 The Direct Agreement is used to ensure that, in the case of the failure of the contractor who has taken out a loan, the repayment of which depends on a contract with an end user, the lender and the Contracting Authority have a contractual basis for exercising their respective rights. This may regulate such matters as step-in, ongoing use of assets, insurance proceeds and other matters.

6.4 Asset ownership

6.4.1 The ownership of assets provides a degree of control to the owning party in the case of contract-change events. Under leasing arrangements, the lessor will generally have title to the assets. Where the lessor is the Service Provider, the Contracting Authority is one step further removed from title, whatever the substance of the matter.

6.4.2 It will be important, therefore, to ensure that consideration is given to under what circumstances this might be a risk to the Contracting Authority – generally where the Service Provider is failing to perform financially. The protections required include step-in arrangements and the ability to acquire assets without material loss to ensure operational continuity.

6.5 Step-in rights

6.5.1 Step-in rights might allow either the Contracting Authority or the finance provider to step in and manage the contract or replace the provider temporarily to correct failures or permanently, for instance where the Service Provider fails financially. While there is a mutual interest in service continuity, the Contracting Authority will wish to have some control over how step-in rights are exercised by a lender, for instance by having some degree of agreement in advance about the identity/characteristics of a suitable substitute provider. If such advance arrangements are not developed, there may be procurement issues to consider.

6.5.2 There may also be circumstances where it is most appropriate for the Contracting Authority to step in. In this case, a lender or lessor may have rights over assets that it wishes to protect. The Contracting Authority will need to acknowledge such interests but not be put in a position where it cannot protect its own interests.

6.5.3 It is advisable that the requirement to fully develop step-in provisions with protection for the Contracting Authority is included in the Invitation to Tender (ITT) (see Section 7).

6.6 Early termination provisions

6.6.1 Early termination can occur for a variety of reasons and, where the Contracting Authority has a number of properties or the contract contains a range of services, a partial termination may be most appropriate. Reasons for early termination include:

- disposal/change in use of one or more properties
- changes in Contracting Authority requirements
- Service Provider default
- Contracting Authority default (usually only for non-payment – unlikely)
- force majeure.

6.6.2 Finance providers do not take risk on Contracting Authority termination for convenience and will require provisions that ensure they do not make losses as a result. Typically, this “compensation on termination” entails the Contracting Authority paying a lump sum, which prevents the loss. While lenders would usually simply require compensation for any costs arising from early repayment of fixed interest debt, if equity has been provided then the provisions may be proposed to secure the loss of future returns. The Service Provider may also seek compensation for the cost of redundancies and breakage of any subcontracts.

6.6.3 It should be noted that, even in the case of Service Provider default, there can be some material payment required where the assets transfer to the Contracting Authority.

6.6.4 This is a potentially complex area that should be considered in advance. It should also be noted that the protections for both Contracting Authority and Service Provider are more limited under a service contract or PPA where assets remain in the ownership and control of the Service Provider unless a new agreement (for which the original contract will not provide) is reached.

6.7 Dedicated project companies

6.7.1 An SPV (Special Purpose Vehicle) is a company set up with the sole purpose of performing a contract. For legal purposes, it enters into the Service Contract and generally subcontracts certain activities to other businesses, usually including the SPV’s own sponsor. The SPV can then seek external finance (debt and equity). Its delivery obligations are generally supported by parent company guarantees and supplier guarantees because it has no financial resources other than the contract itself.

6.7.2 SPVs are, therefore, the most complex arrangements that are likely to arise. While the economics of an SPV mean that it will only arise for larger projects (the actual threshold will vary according to the nature of the services), some authorities may wish to rule such arrangements out from the outset. Careful consideration of the impact on costs and resources of procurement should be considered. Also, the cost of unwinding an SPV, should circumstances change, can be significant and there may be a management case for not wishing to enter into such arrangements.

6.8 Refinancing

6.8.1 It is sometimes possible and desirable to refinance a project to increase the return to the investor by taking advantage of more favourable financing terms and/or enhancing the cash-flow profile. However, in some cases refinancing can change the risks to the Contracting Authority, in which case the Contracting Authority should have to provide consent and, normally, share in any gain. The basis for refinancing generally arises out of one of two factors:

- once a project enters operational phase and if it is performing well, the risks are lower, which can make available lower margins and financial covenants
- market rates can move advantageously. Rates are currently low, which has meant that this has been less common in recent years. It should be noted that, where a rate has been fixed, there can be either costs or gains from "breaking" the fixed-rate contract before term.

6.8.2 This is a complex area, but the financing documents should address refinancing in advance. This should cover both the definition of what constitutes refinancing and how any gains might be shared between the Service Provider and Contracting Authority. In the context of PFI, there is HM Treasury Guidance on this issue which may be referred to.

6.9 Service contracts/offtake agreements

6.9.1 It should be noted that, in the case of certain service agreements and offtake agreements (PPAs/Heat Offtake Agreements), the Contracting Authority will have no control over the assets and the Service Provider will be taking greater risk. Termination provisions and step-in rights will, therefore, not be available in the same way. Also, since the Contracting Authority is not involved in the ownership and control of assets during the contract or (contractually) on expiry and the financing costs are contractually entirely a matter for the Service Provider, Schedule 12 will not have the same function.

6.9.2 It should also be noted that, in respect of offtake agreements, the saving will typically be embedded in the unit price. The Savings Guarantee mechanism will not be relevant in the same way. It might deal with late implementation or the cost to the Contracting Authority of failure to meet obligations that led to savings not being achieved.

6.10 Summary

6.10.1 Some of the commercial provisions associated with externally financed solutions bring additional operational and financial risks. They are complex and should be identified and principles determined as part of the initial business-case approval process. Contracting Authorities should ensure that they exercise sufficient control over the processes to agree these provisions.

7. Procurement

7.1 Introduction

7.1.1 While Contracting Authorities may wish to encourage innovation, it will be important, not least to avoid procurement challenges, to specify the key commercial principles and parameters relating to financing in the ITT document. These will include ensuring that bidders have sufficient knowledge of the financial rules under which the Contracting Authority operates and relevant elements of financial strategy, objectives and policies. There may also be certain contractual positions (for example, as set out in Section 6 Contractual considerations) that the Contracting Authority will require and these should be specified.

7.1.2 This section provides guidance on how developing the finance solution might work within the procurement process. Specific guidance to help public sector organisations wishing to procure services under the new Re:fit programme is available in the Re:fit Procurement Guidance. This guidance document provides supplemental guidance on the financial considerations that should be made during the procurement process.

7.2 Developing Schedule 12 (Alternative Financing) for the ITT

7.2.1 The Framework Agreement provides in Schedule 12 to the Call-off Contract for the contractual arrangements associated with Service Provider provided finance. It sets out key considerations but is not prescriptive and will need to be developed further for the ITT. Contracting Authorities have flexibility to develop the details as part of the procurement to align with their financial strategy and commercial policies.

7.2.2 In order to do this, it is important for the Contracting Authority to plan what aspects it wishes to take a lead on and which it expects the bidder to lead on. It would be appropriate for the Contracting Authority to lead on the payment mechanism that ties the Savings Guarantee to the ongoing payment to the Service Provider. In practice, it is common for the financing documents themselves to be drawn up by the contractors and their legal advisers or by the external finance providers but the Contracting Authority should ensure it controls the process to agree the key provisions.

7.2.3 Under a self-funded solution, there will be milestone payments for investment in infrastructure, with subsequent payments for services and a potential rebate for failure to meet the Savings Guarantee. Where there is financing, typically the payment will comprise a profiled element for debt service/lease payment (to cover capital and interest) and a service payment. The Schedule 3 (Savings Guarantee) contains arrangements for remedies where a Service Provider fails to meet savings targets.

7.2.4 The Service Provider and/or its external finance providers are likely to have template financing agreements. The Contracting Authority should seek drafts/heads of terms as part of the procurement process, specifying in advance any matters where it has specific requirements or limitations on what it will agree to, dealing at least with the matters set out in Section 6.

7.2.5 In the case of a service contract/offtake agreement, where there is essentially a contract for services, although the Service Provider will have to finance the assets it uses, the Contracting Authority will not have rights over the assets and will not generally be party to the financing arrangements. In procurement terms, it will be interested to scrutinise the arrangements but Schedule 12 will not be required in the same way.

7.3 Mini-Competition ITT overview

7.3.1 If the reader is not familiar with the Re:fit tendering process, reference should be made to the Re:fit Procurement Guidance. In simple terms, the Re:fit process generally provides for the full development and pricing of projects in an Investment Grade Proposal (IGP) prior to implementation. The stage at which the IGP is completed can vary between projects. There are three procurement options under Re:fit:

- partner bid (option 1) – essentially this provides for selecting the bidder best able to work with a Contracting Authority to develop a solution. Usually this suits projects where there are particular complexities and detailed proposals are best developed in collaboration. The focus is on approach and objectives rather than final price, although minimum savings and pricing elements may be bid
- target bid (option 2) – the target bid usually includes a price, probably as an output of a High Level Appraisal (HLA). As is implied, this is subject to more detailed analysis. It would be appropriate to seek the price of a financed proposal to be expressed in terms of the payment profile (including financing) as well as simply capital and operating costs where relevant. However, both the prime costs and the financing terms may be subject to a degree of uncertainty where further due diligence on the relevant assets is required
- IGP bid (option 3) – this bid should be capable of providing a firm price, possibly subject only to market interest rates at contract signature/financial close.

7.4 Finalising financing terms

7.4.1 There are three main approaches that may be adopted to securing financing terms where the Service Provider is expected to use third-party finance (ie not its own finance):

- Contracting Authority may consider designating a funder separately (for example, where it has a relationship with a finance provider) to provide consistency but would need to ensure that any procurement issues related to this were addressed
- require the provider to hold a funding competition. This can drive out keener rates but the finance provider may seek to carry out a greater degree of due diligence than it would if it had an existing relationship
- allow the Service Provider to determine at its discretion the funding arrangements. This has advantages – usually benefiting from existing relationships and developed documentation. The Contracting Authority should nevertheless require evidence of value for money perhaps through benchmarking of rates.

7.4.2 However, the element of the cost of finance that relates to interest rates can be subject in any case to market conditions at the time the financing is irrevocably committed, which may be after the preferred Service Provider is appointed. The challenge, therefore, is to get sufficient certainty at the point of evaluation and selection of preferred bidder. This may differ according to the procurement option selected for the reasons set out in 7.4.1 above.

7.4.3 A template for the ITT requirements in respect of finance is available. The main elements of the requirements for the bidder's financial submission are set out below.

- an overview of the financing approach should be provided, including:
  - a description of the key features (including the role of external funders) and rationale for the approach
  - a structure diagram showing the contractual relationships and cash flows
  - key elements of the payment mechanism and how it relates to the Savings Guarantee
- a "term sheet"/heads of terms (and draft documents where available) showing the key terms, including:
  - key contractual provisions (terms of financing, termination provisions, etc)
  - the cost of funds (interest rates, IRRs, etc, as appropriate to the solution) and any conditions associated with them for instance how long rates will be held, what

circumstances might justify updating rates, what market reference rate might be used (eg gilts, Libor etc))

- details of how it is proposed to conclude the financing arrangements (see 7.4.1 above) and any authorisations required (Service Provider or funder credit committees, etc). Requesting letters of commitment for corporate investment or external finance might provide for greater assurance
- details of allocation of key risks
- confirmation of the Service Provider's understanding of the Contracting Authority's own financial and accounting requirements and constraints and its capacity to support these
- details of any relevant tax assumptions and/or opportunities for optimisation to the benefit of the Contracting Authority (VAT, capital allowances, carbon taxes, etc)
- confirmation where relevant that Parent Company Guarantees (PCGs), performance bonds and/or any other form of security will be provided in the prescribed form (see Re:fit Contract Guidance). It is advisable to set out the reasons for requiring a PCG.

7.4.4 There is a challenge in evaluating financial bids based simply on a terms sheet, which will typically be the case under a partner bid and may be the case to some extent under the other procurement options. This difficulty is greater where there are different approaches proposed by different Service Providers and where the interaction of the financing costs and operational proposals may not be immediately obvious (NB in terms of risk transfer, which will be of concern to finance providers and subject to technical due diligence). It can also be difficult to pin down how the commercial terms and conditions impact on pricing and other financial parameters. The devil is often in the detail. Examples include how arrangement fees are treated, how Service Providers calculate investor IRRs, payment terms, early termination liabilities, etc.

7.4.5 In some procurements, a priced bid with a financial model may be available to understand how the overall price, including finance, has been determined. It can also support sensitivity analysis. Financial modelling is a cost to bidders particularly where the model becomes a schedule to the contract and may require auditing. They may want to limit providing a financial model that is contractually binding at bid stage but there may be circumstances where there is merit in requesting that the financing terms are modelled based on the proposed financing terms and a reference set of capital and operating costs[12]. In addition to a clearer understanding of the bidder's approach, a financial model can be used to lock down the approach to modelling possibly prior to, but certainly as part of, the Investment Grade Proposal (IGP).

7.4.6 The Re:fit process allows an opportunity to appoint a reserve bidder that can be selected should the preferred bidder prove unable to deliver their bid offer. In the case of finance, this might arise where the original financing proposals fail to be delivered by the bidder[13].

7.4.7 For pragmatic reasons, this is easier under the target bid and IGP options, where the reserve bidder will have done much of the work that the preferred bidder has done. In the case of a partner bid, there is a risk that the reserve bidder may be faced with the same difficulties the preferred bidder was unable to resolve. The issues associated with appointment of a reserve bidder should be addressed as part of the procurement strategy.

[12] These might be specified by the Contracting Authority as the same for all bidders, so financing impacts only are assessed.

[13] The approach to using reserve bidders should be defined closely in the Mini-Competition ITT.

7.5 Multi-stage projects

7.5.1 The approach may be associated with the procurement of a wider range of energy-efficiency measures, not all of which are to be delivered immediately. It may be that only some of the measures will be financed by the Service Provider. Indeed, financing may be required for follow-on projects rather than the first project. This should not mean that less attention is paid to financing but it may require more emphasis on the Service Provider's approach to develop financing solutions. There will be less certainty about financial conditions and market offerings for future projects, so particular attention should be paid to how a bidder will ensure value for money, and proposals for market testing and benchmarking of finance terms will be relevant.

7.5.2 A further consideration affecting both self-funded and externally financed solutions arises with follow-on projects and variations. Regulation 72 of Public Contract Regulations 2015 limits the extent of variations and additions to initial contracts. It is advisable to identify and provide for such developments, including finance at the Mini-Competition stage even where an initial project phase is self-funded.

7.6 Evaluation

7.6.1 The detailed approach to evaluation of value for money is set out in Section 7, where it is cross-referenced to the business-case quantification. In this section, how the evaluation of the financial proposal sits within the overall evaluation and the broader commercial evaluation is considered.

7.6.2 There are some key financial assessment criteria that it may be useful to use in developing the evaluation scoring:

- transparency: have full details been provided that enable a full understanding of the proposed approach and how it will be developed? Where funding costs might vary with market conditions, the approach to varying them should be explained (for example, a reference rate, such as gilts of a particular maturity, base rate, etc)
- robustness: what evidence and/or guarantees have been provided that the proposals, including the cost of finance, are deliverable? Margins and fees might be guaranteed, for instance, and evidence of deliverability might include commitment letters from funders and board approvals
- value for money: while the overall price (and risk), which is largely driven by capital and operating costs, is the ultimate measure of value for money of a proposal, finance margins and required IRRs will need to be assessed, along with the level of fees and the basis for compensation on early termination. Some aspects of this will require legal commercial input.

7.6.3 Another critical issue to determine is weighting. This is not prescribed in absolute terms for Re:fit (but there are ranges set out). However, the following considerations will be relevant at the planning stage:

- financing costs will represent a relatively small proportion of the total payments made under a Re:fit contract and, if they represent a greater proportion, the reasons for this should be clear (for example, the project could not otherwise proceed, risk transfer is enhanced, etc)
- where financing proposals are required to support future projects (as opposed to the initial project), the relative size and likelihood of using financing need to be considered
- where there is a possibility that financing may, after consideration of bidders' proposals, be found not to be the best solution and self-funding takes place, the ITT requirements and evaluation scoring should be able to deal with this (for instance, to address the possibility of challenge from a bidder that might have been appointed but for the financing scores).

7.6.4 The Re:fit approach represents a robust tool to ensure value for money across strategic fit, quality of delivery, risk management, input cost and financial efficiency criteria through the requirements for clear pricing of investment, services and finance in a competitive process. This is backed up by a sound monitoring regime and open-book accounting. External financing can add more rigour to the due diligence process at the investment stage and delivery through robust third-party monitoring arrangements.

8. Business case, value for money and other financial issues

8.1 Introduction

8.1.1 Each public sector organisation will have its own business-case processes that they will apply but it is common for the HM Treasury Green Book approach[14] using the Five Case model to underpin the approach, although usually in a simplified form. This is used to inform the comments in this guide. Guidance notes to support the development of your business case are available in the Re:fit Business Case Guidance document.

8.1.2 It is expected that the outline business case will be developed prior to procurement. The procurement process should require bidders to provide information in a form that allows the business case to be validated and the final business case to be prepared to confirm or revise the original decisions. The approach to financing will be an important aspect of the business case.

8.2 The business case

8.2.1 The Five Cases are set out below, identifying key points relating to an externally financed approach:

- **the strategic case** establishes the need and rationale
- **the economic case** considers options and demonstrates that there is a net benefit, sometimes taking into account non-monetary factors, which in the case of energy efficiency might be "green credentials" (having a value over and above the carbon tax costs)
- **the commercial case**, which concerns procurement, the suitability of the contractual arrangements and the accounting treatment. VAT and tax issues should be considered (see below)
- **the financial case**, which concerns affordability and funding, along with any other financial metrics relevant to the public sector organisation (capital budget limits, debt covenants, etc)
- **the management case**, which considers the implication for the public sector organisation of managing the project. The factors include a more complex contract-management and payments regime, greater complexity for contract changes or termination and potentially more complex financial-reporting requirements.

8.2.2 In practice, the economic, commercial and financial cases may be considered as a package.

8.2.3 Local Partnerships has produced guidance on the developing Green Book compliant business cases, which can be provided on request.

8.3 Financial evaluation metrics (payback, NPVs, etc)

8.3.1 The standard approach used for self-funded projects is payback. This has the advantage of being straightforward. It also aligns with public sector administrative imperatives to secure cash savings out of a fixed-capital budget within relatively short timescales.

[14] gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-governent

8.3.2 However, particularly where financing is involved, it does not always capture all the financial characteristics. For instance, if additional finance can generate additional savings in excess of costs, then in principle the fixed-capital budget is not as relevant and either the Internal Rate of Return (IRR), Net Present Value (NPV) or a solar PV ratio (PV of savings/PV of costs) might be more informative.

8.3.3 Also, for some projects where assets need replacing, payback can fail to capture the impact of costs and benefits falling beyond the payback period. For instance, where maintenance costs are part of the payback calculation, lower maintenance costs will shorten the payback but may reduce future savings and increase future costs. This is more relevant to mechanical and electrical equipment than building fabric, of course. Nevertheless, even for building work, lower upfront investment that reduces the payback period can mean shorter asset lives and/or higher future life-cycle/maintenance costs. The concept of the Persistence Factor (ie how long a measure may continue to deliver savings) is relevant.

8.3.4 Where payback is used in any case as part of the assessment of an externally financed project, there will not be an upfront payment by the Contracting Authority, so an adapted payback will need to be adopted based on the ongoing payments, including finance. This will usually entail comparing the payment profile (including finance costs) to savings to determine when the savings have paid for the measure (including future liabilities). However, it should be noted that it is likely that this point may be reached before the actual liability is paid (ie the contract length) so the date at which there would be no liability on early termination (usually when the Service Provider has repaid its debt) is also relevant.

8.3.5 This is a complex area and further project specific consideration, taking account of a Contracting Authority's own processes, will be required. However, it is usually appropriate to ensure that bidders produce information in the format required to support the Contracting Authority's assessment as part of the bid submission.

8.4 VAT and tax

8.4.1 VAT can be complex and potentially cause unexpected problems. It will be important to take appropriate advice, but points to note include:

- for organisations that generally have irrecoverable VAT (for example, universities), there can be cash-flow advantages where VAT is paid on a series of payments to the Service Provider rather than upfront on capital expenditure. However, VAT may be payable on the overall Service Provider charge including finance, whereas there would be no VAT on interest payments for a direct loan
- when measuring savings, it will be important to make sure that prices are measured on a consistent basis (usually excluding VAT)
- where services currently provided by a Contracting Authority's staff are transferred to a Service Provider, while there might be efficiencies, the costs will also attract VAT, the recoverability of which must be considered.

8.4.2 The Service Provider will pay tax on its profits from services provided. While this is neutral for the public sector as a whole, it does mean that the charges borne by the Contracting Authority will have to allow for tax to be paid.

8.4.3 Under leasing arrangements and where the Service Provider owns equipment, they may benefit from capital allowances. The benefits of this will typically be wrapped up in the financing terms and pricing offered, but the arrangements should be understood.

8.5 Summary

8.5.1 The business case for a project using alternative financing will need to include financial analysis of the costs and benefits including financing. It will also need to consider the other financial risks associated with such arrangements. The metrics used in the business case should flow through as far as possible to the bid's requirements and evaluation of bids (and subsequent financial proposals under the contract). The accounting treatment and tax issues will also be important.

8.5.2 This typically requires expert input from the outset.

Appendix 1 • Finance strategy and sector rules

Central government and related bodies

Central government departments and various related bodies are overseen by HM Treasury. The broad principles for managing public finances are set out in the document Managing Public Money[15].

Capital spending is determined by annual budgetary allocations with capital expenditure generally being defined based on accounting definitions, except in the case of service concessions, where under certain limited circumstances expenditure on infrastructure can be "on balance sheet" for Whole of Government Accounts but "off capital budget" and balance sheet for National Accounts purposes.

Government accounting rules are set out in the Financial Reporting Manual[16], often referred to as "the FReM".

The FReM applies directly to: financial reporting by all entities ("reporting entities") that are prepared on an accruals basis and consolidated within Whole of Government Accounts (except rarely where there is no Accounts Direction).

It does not apply directly to local government, those public corporations that are not trading funds, and NHS Trusts and NHS Foundation Trusts. *However*, The NHS Manual for Accounts, the NHS Foundation Trust Annual Reporting Manual and the CIPFA Code of Practice on Local Authority Accounting in the United Kingdom are compliant with the FReM other than for specifically agreed divergences.

In addition, the Welsh Government and the Department of Health, Social Services and Public Safety in Northern Ireland will apply the principles outlined in this Manual in the accounting guidance that they issue in respect of Local Health Boards in Wales, and Health and Social Services Trusts in Northern Ireland.

Local authorities (including police authorities and fire authorities)[17]

Local authority capital spending is governed by the Prudential Code, which requires councils to assess the most effective way of delivering an outcome, and to take a long-term view of affordability, such that it is prudent, affordable and sustainable. Local authorities also have some revenue generation and trading opportunities.

Health sector

NHS Foundation Trusts are authorised and regulated by Monitor. Borrowing is not formally limited but is constrained by the requirement to meet liquidity and capital service capacity (ie the ability to service debt) requirements under the Risk Assessment Framework[18].

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[15] gov.uk/government/uploads/system/uploads/attachment_data/file/454191/Managing_Public_Money_AA_v2_-jan15.pdf

[16] gov.uk/government/uploads/system/uploads/attachment_data/file/488328/2015-16_FReM__December_2015_.pdf

[17] Local authority corporate finance functions will have detailed information on the code. (It is also available from CIPFA cipfa.org/policy-and-guidance/publications/t/the-prudential-code-for-capital-finance-in-local-authorities-2011-edition-book)

[18] The Monitor Risk Assessment Framework can be found at gov.uk/government/uploads/system/uploads/attachment_data/file/455893/RAF_revised_25_August.pdf

NHS Trust hospitals are subject to centrally allocated Capital Resource Limits. They have some capacity to seek approval for external finance from the NHS Trust Development Authority (NTDA) but this is more limited[19].

Universities

Universities in England are able to set their own Treasury Management Policies. This includes the ability (and requirement) to ensure that there are adequate borrowing arrangements in place. In doing so, they are monitored by the Higher Education Funding Council for England (HEFCE), which has a role to ensure that they are financially healthy and specifies certain financial ratios[20]. It should be noted that these rules are being reviewed as a consequence of the implementation of revised UK GAAP accounting standards.

Universities in Wales are regulated by HEFCW and are subject to a similar regime[21].

More specific constraints arise from the borrowing covenants they agree with their own external lenders.

Further education

Further education colleges are able to borrow within the terms and conditions of the Financial Memorandum with the Skills Funding Agency[22]. The conditions include standard requirements for effective risk-management policies, audited financial statements and fulfilling the purpose of the funding.

Schools

An overview of schools' finance has been published by the EFA[23].

Academies have their own borrowing powers overseen by the Education Funding Agency (EFA).

Maintained schools are subject to oversight by their local authority and generally do not have distinct borrowing powers unless authorised by the Secretary of State (as is the case for Salix loans). The exceptions are foundation and trust schools, which are established as separate legal entities and do have greater financial independence including borrowing.

Housing associations

Housing associations account under UK GAAP (FRS 102) with sector guidance contained in the Housing SORP 2014 (Statement of Recommended Practice for registered social housing providers).

Statements of Recommended Practice (SORPs) relating to registered social housing providers and landlords are issued by the National Housing Federation (NHF)[24], Community Housing Cymru and the Scottish Federation of Housing Associations (SFHA).

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[19] Detailed guidance can be found at ntda.nhs.uk/blog/2014/07/11/capital-regime-and-investment-business-case-approvals-guidance-for-nhs-trusts/

[20] Information on the memorandum of assurance and accountability, which includes rules around borrowing, can be found at hefce.ac.uk/pubs/year/2014/201412/ (See page 12 Sustainability of universities and colleges)

[21] Information on the financial memorandum applying to Welsh universities can be found at hefcw.ac.uk/documents/publications/circulars/circulars_2008/W0836HE_circ.pdf

[22] gov.uk/government/collections/sfa-capital-funding-for-fe-colleges-and-training-organisations

[23] gov.uk/government/uploads/system/uploads/attachment_data/file/486440/Scheme_for_Financing_Schools_Dec_2015.pdf

[24] housing.org.uk/topics/finance/

Housing associations are experienced in borrowing from commercial finance providers, with the borrowing usually secured on assets.

In October 2015 the Office for National Statistics (ONS) reclassified housing associations as public sector bodies meaning that their debt would be included in the national debt. This had the potential to place additional constraints and scrutiny on their borrowing and the Government promptly decided to introduce measures to ensure that this decision was reversed. This is to be effected by reducing Government control over housing associations by further deregulation. This means that there is a degree of change in the rules currently.

Charities and third sector bodies

Charities account under UK GAAP as interpreted by the Charities SORP. Borrowing powers are prescribed by the constitution of the body concerned and governance by Trustees. Many charities have trading subsidiaries set up to carry out commercial and non-core activities and the specific arrangements need to be considered.

Some other third sector bodies, such as community groups, may be small and have less well-developed financial governance arrangements. There may be a need to develop these as the Re:fit project develops.