# BSF GUIDANCE NOTE

# Economics of the LEP

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This Guidance Note is provided to Local Authorities as a summary of the business structure and economics of the LEP.

This Guidance Note does not purport to be a comprehensive assessment of all issues that might be of concern to parties, and Local Authorities should ensure that they take appropriate professional advice in relation to matters raised in this Guidance Note.

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# Contents

# Economics of the LEP

## Purpose of this Guidance Note

Since the original Economics of the LEP Guidance note was issued in August 2005, a number of BSF schemes have now reached financial close and a significant number of other schemes are in the later stages of procurement.

The original Guidance Note has therefore been updated to ensure it fully reflects the lessons learnt from these schemes in respect of the financial aspects of the LEP structure and the likely monetary investment that local authorities and others will need to make.

This updated Guidance Note seeks to:

- summarise the business of the LEP and its contractual structure;
- provide clarity to Authorities at SfC/OBC stage of the PfS requirements in respect of local authority investment in the LEP and PFI SPVs;
- provide guidance on the estimated quantum and timing of investments required by local authorities in the LEP and PFI SPVs and the likely contribution towards working capital that might be required; and
- provide local authorities and the private sector with a summary of the cost and revenue streams of the LEP in the context of its business cycle.

## Glossary of Terms

**BSFI** – Building Schools for the Future Investments LLP, the central investment vehicle established by DCSF (formerly DfES) and PUK that will invest in each of the LEPs and any PFI SPVs.

**Design and Build (D&B) Contract** – A form of contract in which a single contractor is responsible for both the design and the construction of a building project. In BSF this contractor will usually be the LEP, but the contract will then effectively be passed on to a construction company sub-contractor, which forms part of the LEP supply chain. There are two types of D&B contract – Lump Sum and Target Cost.

**Local Education Partnership (LEP) -** The joint venture company for local delivery of the BSF programme, formed by a local authority, BSFI and a Private Sector Partner (PSP) which is usually a consortium. The standard model anticipates the PSP owning 80% of the shares, BSFI 10% and the local authority 10%.

**Lump Sum D&B Contract** – A form of contract which in BSF is normally used for new build non-PFI schools. The contractor agrees a fixed price (the "Lump Sum") for building the new school, and takes all of the risks and rewards should the actual cost turn out to be different.

**Phase** – A local authority will receive BSF funding for a number of schools within a wave. DCSF funds a number of local authorities within each wave of investment. There are fifteen waves and a local authority may receive funding as part of more than one wave. For practical reasons the schools will not all be built at the same time. There will typically be two or three schools built as part of the Sample Scheme which is developed as part of the procurement process, followed by a phase or phases which each contain a number of schools. The number of phases will depend on the number of schools funded in the wave and the practical considerations specific to the project.

**Private Finance Initiative (PFI)** – PFI Credits represent a commitment on the part of the Government to provide a certain level of revenue support to a local authority, under the Local Government (Capital Finance) Regulations 1997. The government makes an annual payment to the local authority (which contracts with the private sector to provide facilities) for that element of the contract price that relates to the repayment and servicing of funds borrowed to provide the facilities. The revenue support acts as a contribution to the unitary charge that the local authority will be contractually committed to paying to its PFI contractor.

**Project Agreement** – The legal agreement reached between the local authority and the PSP for PFI projects. For BSF projects the PfS standard form of Project Agreement is used.

**Risk Capital** – That element of funding made up by Subordinated Debt and Share Capital

**Sample Schemes** – Two schools, usually one PFI and one D&B, chosen by the local authority as a cross-section of the type of schools the LEP will be likely to deliver over time. Designs for these schools are developed during the procurement process and form a significant part of the evaluation process to select the PSP.

**Senior Debt** – Long term bank loans taken out by the PFI SPVs to fund most of the development costs. This debt is the least risky funding from the investor's (i.e. lender's) point of view, and is therefore the cheapest form of funding to the PFI SPV.

**Share Capital** – The element of Risk Capital that represents the stake its owners have in a company. In a liquidation the investors will receive funds only after preferred creditors, Senior Debt, ordinary creditors and Subordinated Debt have been paid out in full; it is therefore the most risky form of investment in companies. It has no fixed return payment, and the return will depend upon the performance of the company. Note that Share Capital is sometimes called "true equity" or, if it forms a very small part of the total finance required, "pinpoint equity".

**Shareholders Agreement** – The agreement between the shareholders in the LEP (the local authority, BSFI and the PSP) which provides the basis for joint working within the LEP, including the shareholders' individual rights and obligations.

**Special Purpose Vehicle (PFI SPV)** – The company that will be established by the LEP to operate and manage individual schools or phases of the PFI project. Its sole purpose will be the delivery of the school(s) or phase. It will deliver the services using PFI funding.

**Strategic Partnering Agreement (SPA)** – The contractual agreement between the local authority and the LEP which sets out the details of the partnership working arrangements between them and defines key terms such as exclusivity and the new project approval process.

**Strategy for Change** – The first formal component of the BSF approvals process. It is designed to capture both the local authority's strategy for secondary education and the requirements placed upon the physical school estate by that strategy.

**Subordinated Debt** – Subordinated debt (also called junior debt or sub debt) is debt that takes a lower priority than other debt. It is generally unsecured, i.e. not protected by a mortgage or debenture, and in a liquidation the subordinated debt holders will only be paid after preferred creditors and senior debt have been fully paid. This makes subordinated debt more risky than senior debt (but less risky than Share Capital), which is reflected in the fact that it should have a higher return than senior debt (but lower than Share Capital).

**Target Cost D&B Contract** – A form of contract which in BSF is normally used for schools which are being refurbished and which are not being financed by PFI. The contractor agrees a Target Cost for refurbishing the school, and shares the risks and rewards with the client (the local authority) if the actual costs turn out to be different.

# Section 1 - The Business of the LEP

As set out in the Shareholders Agreement, the business of the LEP is to:

- provide (or procure) the “Partnering Services” and “Project Services” as set out in the Strategic Partnering Agreement (which will in turn be based on the Strategy for Change documents of each local authority);

- provide any additional services agreed; and

- work with the supply chain to achieve partnering consistent with that envisaged under the Strategic Partnering Agreement, leading to efficiency savings.

These will be undertaken in accordance with the LEP’s Business Plan which will also cover income, costs and capital requirements for the LEP as well as setting out corporate business objectives and targets.

***LEP Business Cycle***

There are broadly two states of operation for the LEP once established:.

- an initial development period, being the period of exclusivity, where the LEP is working with the local authority under the terms of the Strategic Partnering Agreement to exclusively develop and deliver new projects in combination with managing a growing portfolio of operational projects; and

- an operating period following financial close on the final set of schools or other capital investment delivered through the LEP where there are no new projects to develop and the LEP becomes a vehicle purely to manage a portfolio of operational projects.

During the initial development period for a standard LEP it is expected that there will be a number of phases of work to deliver new school facilities and other agreed capital investment. Typically the work to develop each phase to a point where financial close can occur will last between 9 and 15 months. This initial development period may include a period of time during which the first phase is (or early phases are) operational.

The development work for each phase will involve the following stages:

- initial development work (Stage 0) taking 2 to 3 months to scope the work, price it and carry out initial due diligence, in addition to assembling the information required by the LEP. The work carried out should be sufficient to be reasonably certain that the subsequent stages run smoothly. The Stage 0 work can be carried out by the local authority itself or the local authority can pay the LEP to do it;

- initial development work to Stage 1 Approval (expected to take approximately three months). This work involves undertaking initial design work to allow confirmation that the affordability assessment made in Stage 0 was materially correct, and to inform local authority sign off before proceeding onto detailed design work; and

- detailed development work to Stage 2 Approval and Financial close (expected to take approximately 6 to 9 months). Authorities will submit a Final Business Case to PfS prior to financial close. It is not currently expected that there will be a significant gap between Stage 2 approval and Financial close;

This is illustrated in Figure 1 below (ignoring the informal Stage 0), which covers a LEP through the development of the Sample Schemes and Phase 1 (which has a mixture of PFI and conventional projects) and assumes that there is a six month period between reaching financial close on one phase, and starting development work on the subsequent phase.

*Figure 1: Illustrative Development Business Cycle of the LEP*

| | Value | Financial Close / Completion Date | 2009 Q1 | 2009 Q2 | 2009 Q3 | 2009 Q4 | 2010 Q1 | 2010 Q2 | 2010 Q3 | 2010 Q4 | 2011 Q1 | 2011 Q2 | 2011 Q3 | 2011 Q4 | 2012 Q1 | 2012 Q2 | 2012 Q3 | 2012 Q4 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Sample Schemes: 2 schools** | 0 | 1Q 2009 | 3 | | | | | | | | | | | | | | | |
| 1 First PFI School | 25,000 | 3Q 2010 | 4 | 4 | 4 | 4 | 4 | 4 | | | | | | | | | | |
| 2 First Conventional School | 12,500 | 3Q 2010 | 5 | 5 | 5 | 5 | 5 | 5 | | | | | | | | | | |
| **Development of Phase 1: 5 schools** | 3,500 | 3Q 2010 | | | 0 | 1 | 2 | 2 | 3 | | | | | | | | | |
| 3 Second PFI School | 25,000 | 1Q 2012 | | | | | | | 4 | 4 | 4 | 4 | 4 | 4 | | | | |
| 4 Third PFI School | 25,000 | 3Q 2012 | | | | | | | | | 4 | 4 | 4 | 4 | 4 | 4 | | |
| 5 Second Conventional School | 12,500 | 1Q 2012 | | | | | | | 5 | 5 | 5 | 5 | 5 | 5 | | | | |
| 6 Third Conventional School | 12,500 | 3Q 2012 | | | | | | | | | 5 | 5 | 5 | 5 | 5 | 5 | | |
| 7 Fourth Conventional School | 12,500 | 1Q 2013 | | | | | | | | | | | 5 | 5 | 5 | 5 | 5 | 5 |

**Legend**

| | |
|---|---|
| Stage 0 | 0 |
| Stage 1 Approval | 1 |
| Stage 2 Approval | 2 |
| Financial Close | 3 |
| PFI Construction | 4 |
| Conventional Construction | 5 |

### *LEP Relationships with Supply Chain*

A critical factor in determining the success of the BSF programme will be the extent to which the LEP can develop effective partnering relationships with its supply chain and the local authority to develop project proposals under the Strategic Partnering Agreement and deliver projects. The three main areas in which the LEP must develop these supply chain relationships are determined by the involvement of the LEP in the following types of works / contracts:

- PFI contracts;
- D&B contracts; and

- ICT contracts.

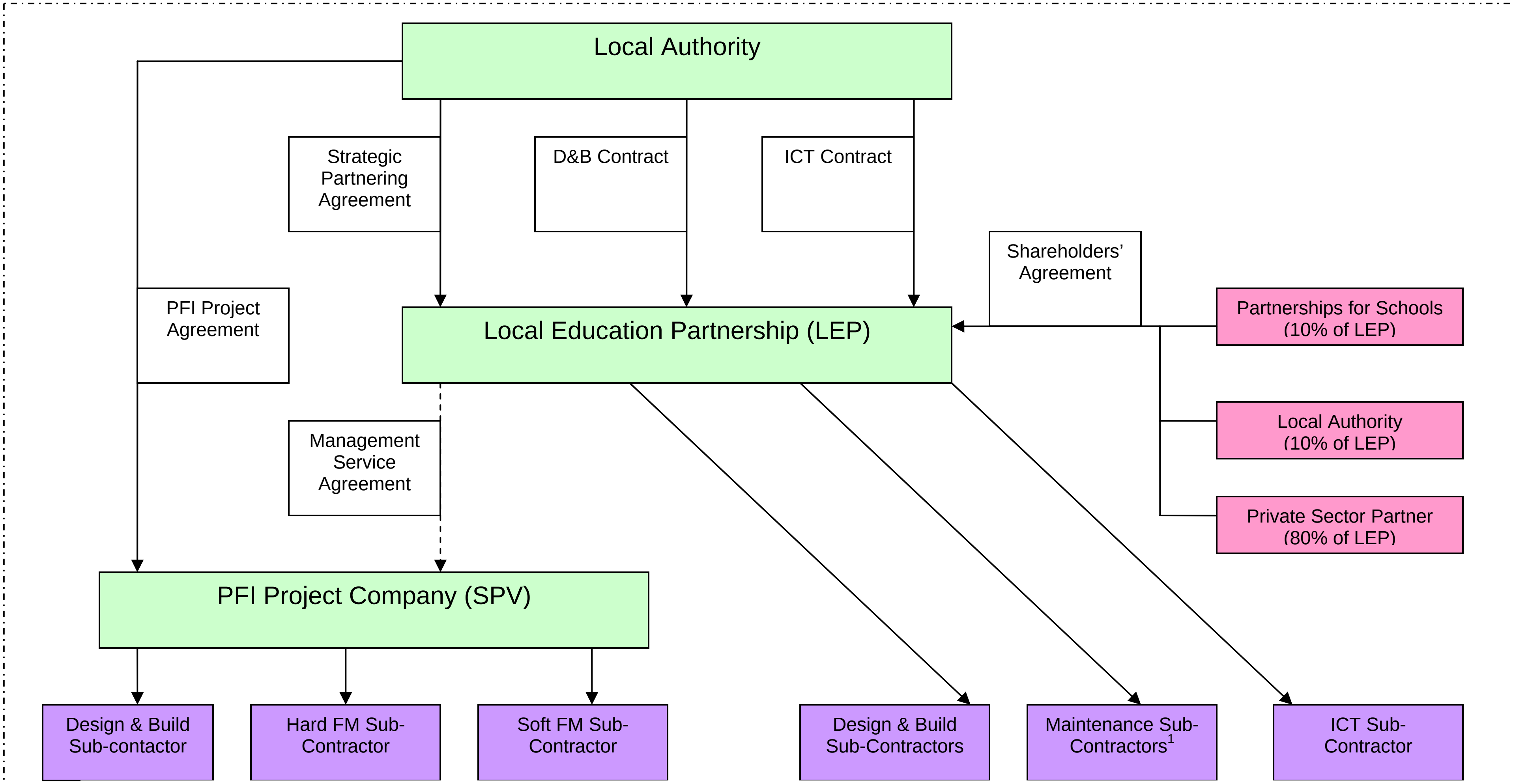
These contracts will include capital works (e.g. building schools, providing ICT equipment) and providing services (e.g. facilities management and ICT management services) and could relate to projects other than secondary schools.

For each of these work areas, there will be a cost, delivery and risk relationship between the LEP and the supply chain which will be defined by the contractual parameters within which these works are undertaken (the respective PFI Project Agreements, D&B contracts, ICT contracts and Strategic Partnering Agreement).

Each of these contracts will specify a level of risk transfer to the LEP which will then be passed to the supply chain in the relevant sub-contracts or may be retained and managed by the shareholders of the LEP.

The overall structure of the LEP and its supply chain is set out in diagrammatical form below. Appendices 1 to 3 provide a brief summary of the contractual structure together with cost and risk relationships for each of the three main contract structures noted above.

*Figure 2: The Contractual Structure of the LEP*




[1] Note: Where the LEP is responsible for overseeing the contract for the maintenance of D&B schools and retains some residual risk it will require a margin.

# Section 2 - PfS Requirements in the LEP Investment Structure

PfS has the following requirements in respect of the LEP Investment Structure.

***LEP Investors***

The following parties will be shareholders in the LEP:

- Private Sector Partner (80% of Risk Capital);
- BSFI (10% of Risk Capital); and
- Local Authority (10% of Risk Capital).

Each local authority should carry out its own due diligence on its investment in the LEP.

***LEP Investment in PFI Schemes***

Under the standard model at inception the LEP will have a controlling stake in the PFI SPV, i.e. it will own 51% of the Share Capital and associated voting rights in the PFI SPV. Under the BSF contractual documents this controlling shareholding can be reduced over time, to a minimum of 10% of the Share Capital, no earlier than one year after construction is completed, subject to the agreement of all parties. Alternatively, the LEP could control 10% of the Share Capital and 51% of the voting rights, with the voting rights reducing over time as above.

The other requirement is that the LEP will provide a minimum of 10% of the total Risk Capital investment in the PFI SPV .

The above investments in PFI schemes flow through the LEP rather than a wholly owned subsidiary of the LEP, and will give the LEP:

- a true economic interest in the PFI SPVs;
- the ability to influence the impact of SPA KPIs; and
- greater partnership with the public sector through the shareholder / boardroom transparency.

It also is also intended to drive behavioural change in all of the parties involved in the LEP.

Note that some early BSF projects have had these investments flowing through a separate finance company (or FinCo) which is a subsidiary of the LEP. Other projects have not had a separate FinCo but instead direct security has been given to investors in the LEP over the investments made by the LEP in the PFI SPVs. Neither of these structures is now acceptable as they do not achieve the aim of ensuring that the risk capital invested in the SPVs through the LEP is exposed to the risks that form part of the LEP's business of investing in projects and developing new ones.

***Direct Investment in the PFI Schemes***

As it is likely that not all the Risk Capital required in the PFI SPVs will be invested by the LEP, the remaining amount will be invested directly into the PFI SPVs by the investors in the LEP and third party investors.

The preferred approach is that both BSFI and the local authority will each take up their respective rights to a 10% stake in this direct risk capital investment. In the event that the LA chooses not to invest directly in the PFI schemes, BSFI reserves the right to take up the forgone local authority share. As with the LEP investment, a local authority should carry out its own due diligence on any investment made in the PFI SPVs.

# Section 3 - Local Authority Investments and Working Capital Requirements

As detailed in Section 2, local authorities are required to make a minimum Risk Capital commitment into the LEP and PFI SPVs. This quantum but not the percentage will vary with the number and sizes of the schools falling within the PFI scheme(s) and the structure established, but this section sets out what these investments might be for a local authority with a scheme involving a PFI SPV requiring £25 million of funding. Such a scheme would typically involve about £2.5 million of Risk Capital, of which £250,000 (10%) will be invested through the LEP. The local authority share will be 10% of this, i.e. £25,000. The local authority would then make further investments if there were later phases or waves.

The remaining Risk Capital of £2,250,000 will be invested directly into the PFI SPV. There is therefore a further investment for the local authority of 10% of this amount, i.e. £225,000, to be made direct into the PFI SPV should the local authority choose to do so.

Additionally there may be a requirement for the local authority to contribute to the working capital requirement of the LEP. Most LEPs need in the region of £250,000 to £1,000,000 for working capital, with amounts varying as a function of:

- the resourcing arrangements of the LEP;
- the timing and size of future schemes; and
- the proposal bid by the PSP (in respect of the financial contribution that the PSP will make to the LEP for its development activities and/or the management services that it will provide to any new SPV).

***LEP Investment***

The LEP is a legal entity with its own Risk Capital (typically both Share Capital and Subordinated Debt). The amount of Risk Capital invested in the LEP is generally the same as that which is required for investment in the PFI SPV(s), and is therefore not additional to the amounts considered below.

***LEP Investment in the PFI SPVs***

Typically PFI SPVs operate on a debt to equity ratio of at least 90:10.

The Risk Capital investment will consist of two elements:

- a nominal amount of Share Capital (often referred to as pin point equity) typically in the order of £10,000 to £100,000; and
- Subordinated Debt – the quantum will depend on the capital value of the PFI scheme, but could be in the region of £2.5 million to £10 million (please note however that this is not a definitive range as it will depend on the gearing and the capital values of schemes, which will vary widely).

The requirements detailed in Section 2 therefore result in the following investments by the LEP in the PFI SPV:

- 51% of the Share Capital (e.g, in the order of £5,100 to £51,000); and
- 10% of the Subordinated Debt (e.g, in the order of £250,000 to £1,000,000).

Since the local authority will own 10% of the LEP, this has the following financial consequences for authorities:

- 10% of the LEP's Share Capital investment in the PFI SPV (e.g. 10% of £5,100 to £51,000 = £510 to £5,100); and
- 10% of the LEP's Subordinated Debt investment in the PFI SPV (e.g. 10% of £250,000 to £1,000,000 = £25,000 to £100,000).

As an example, assuming that a PFI SPV requires £25 million of investment and is 90% geared; a bank provides £22.5 million as senior debt; the remaining sum (£2.5 million) will be invested as Risk Capital as follows. The table at the end of this section summarises the amounts set out below.

- The total Risk Capital of the PFI SPV is £2.5 million and the LEP will invest 10% of this (i.e. £250,000);
- the PFI SPV Share Capital is £10,000. The LEP will purchase 51% of the Share Capital ie £5,100 of which the local authority will purchase 10% (£510);
- the Subordinated Debt requirement in the PFI SPV is the difference between the £2.5 million Risk Capital and the £10,000 equity, i.e. £2,490,000;
- The LEP investment in PFI SPV Subordinated Debt will be £244,900. This is the difference between its total Risk Capital investment of £250,000 and its Share Capital investment of £5,100. The LEP therefore holds 9.84% of Subordinated Debt;
- The direct Risk Capital investment in the PFI SPV will be £2,250,000 (£4,900 of Share Capital and £2,245,100 of Subordinated Debt. The local authority is recommended to take its 10% share of this investment; if it chooses to do so it will result in an additional investment requirement of £225,000 (£490 in equity and £224,510 in Subordinated Debt.

*Table 1: – Summary of a Local Authority's Risk Capital Investment*

| | **PFI SPV** | **LEP Investment in each PFI SPV** | | **Local Authority Share of each LEP Investment** | | **Direct Investment in each PFI SPV** | **Local Authority Share of each Direct Investment (optional)** | |
|---|---|---|---|---|---|---|---|---|
| Share Capital | 10,000 | 51.00% = | 5,100 | 10% = | 510 | 4,900 | 10% = | 490 |
| Sub Debt | 2,490,000 | 9.84% = | 244,900 | 10% = | 24,490 | 2,245,100 | 10% = | 224,510 |
| Risk Capital | 2,500,000 | 10.00% = | 250,000 | | 25,000 | 2,250,000 | | 225,000 |

# Section 4 - Revenues and Costs

***LEP Revenue Streams***

The LEP has three main sources of income:

- the LEP Management Fee paid by a PFI SPV or D&B scheme to the LEP upon reaching financial close for a new project.

  In the case of PFI the PFI SPV will then include this in its cost structure, and the local authority will pay for it over the life of the PFI project through the unitary charge.

  In the case of D&B schemes the cost will be included in the first payment due under the D&B contract.

  The LEP Management Fee, which is bid during the procurement phase covers the following costs:

  - Recovery of all or part of the LEP set up costs (applying to those schemes completing within a five year period from financial close of the sample scheme);

  - Recovery of entire scheme-related LEP development costs incurred in developing the New Project;

  - Recovery of LEP running costs incurred relating to scheme development and charged to New Projects; and

  - The LEP Margin, currently assumed to be of the order of 5-15%, applied to the LEP development and running costs above.

  PfS funds LEP set up costs only once for each local authority, in the form of an increased PFI credit multiplier which is applied to the capital costs of schools in the first phase of the first wave in which a local authority receives funding. If the local authority pays the PFI SPV or LEP later than this (for example where the LEP defers some of the set up costs to a later phase or wave) then it is for the local authority to manage the timing and affordability issues involved;

- the LEP Management Services Fee is charged by the LEP to PFI SPVs (see paragraph below on schemes with no PFI). It is assumed that this is paid to the LEP on a monthly basis thereby reducing the working capital requirement of the LEP. The Management Services Fee covers:

  - Running costs incurred by the LEP in administering and providing management services to active PFI SPVs. This covers office space and may include staff costs for PFI SPVs, which would otherwise be included in the cost base at PFI SPV level. Where the LEP operates a number of PFI SPVs, then these costs may be charged on a marginal cost basis thereby offering significant efficiency savings over the standard approach to PFI contracts, though this will depend upon the model bid by the PSP; and

  - A margin charged on the LEP running costs, currently assumed to be of the order of 5%; and

- sponsor returns from being an investor in the equity and sub debt of the underlying PFI SPVs (these are likely to be mainly or wholly paid out to the investors in the LEP).

Note that schemes with no PFI will still need to charge a LEP Management Services Fee to cover the LEP running costs. This can be funded through up-front capital or through revenue charges:

- This is likely to be lower than that incurred in a scheme with PFI because there will be no costs associated with monitoring and managing the PFI SPVs themselves. However there will be costs to cover the general overheads such as office space and the costs of the LEP managing service contracts such as FM and ICT managed services;

- One option is for the LEP to charge this directly to the local authority on a regular basis over the life of the SPA or Managed Service Contracts.

These are the main sources of income for the LEP, which may be supplemented by payments made for additional services and interest income on cash balances held within the LEP.

***LEP Costs***

The LEP will be resourced according to the workload to be placed upon it, and this will depend on the local authority's requirements – if the local authority requires the LEP to have a degree of independence from the supply chain, and actively monitor the supply chain's activities, than it will require more resources than if this were not the case. The cost structure in place for each LEP will also be influenced by the perceived pipeline of investment opportunity, the preferred delivery structure of the PSP, the extent to which portfolio investment monitoring is undertaken at LEP level and the relationship between LEP and PFI SPV running costs.

The types of costs incurred by the LEP are similar to those typically seen in a PFI SPV. The overall costs incurred in the LEP will be greater than for a typical PFI SPV, but the average level of costs charged to each of the PFI SPVs (and therefore to local authorities) should be lower under the LEP structure to reflect procurement and delivery efficiencies including:

- the sharing of fixed costs (such as accounting and office support costs) between the LEP and a number of PFI SPVs;

- the recharging of running costs to new PFI SPVs on a marginal basis. It is expected that there will be, depending on the size of the LEP's operations, only one or two employees responsible for directly managing and monitoring the performance of a number of PFI SPVs; and

- the efficiency of operations given the procurement model which stresses the importance of standardisation and establishment of long-term relationships with the supply chain and the local authority.

The additional costs incurred by local authorities under the LEP model are the pro-rated time of a general manager overseeing the operation of the LEP, the cost and time of meeting the performance monitoring and reporting requirements of the LEP as set out in the SPA, accommodation costs and the initial LEP set-up costs (together with the costs resulting from any additional work that the local authority requires the LEP to carry out). However these additional costs are expected to be more than offset by the cost efficiencies mentioned above, continuous improvement savings and savings resulting from the reduced procurement times.

The four broad categories of costs within the LEP are as follows:

- LEP Set-Up Costs

These should cover the advisory costs to establish the LEP company. Experience on early schemes has indicated that the LEP set up costs are in the range of £400,000 to £1,200,000 depending on the size and scope of the LEP. Where the LEP is not expected to carry out much work itself, it is likely to be "thin" with low set up costs and running costs. Where deal flow is expected to be substantial, or the supply chain is not bearing many of the costs, or the LEP is undertaking additional activities (such as actively monitoring and challenging supply chain members) the LEP will be "thick", with more substantial set up costs and running costs. For academies which are brought forward from a later wave of investment, the Academy's new project protocol will set out areas where the LEP will be working at-risk.

These set up costs are funded by PfS up to a maximum of £500,000; this has been achieved by increasing the PFI credit multiplier applied to the funded capital costs of the first school(s). In accordance with Clause 9.2 of the SPA, it is expected that these costs will be recovered across a number of phases. This avoids burdening the sample schemes with all of the development costs, from which subsequent schemes will also benefit.

However the local authority has the choice as to the proportion charged against each phase, and may decide for them to be fully charged to the Sample Schemes. If, due to delays or other factors, the LEP Set Up costs are not recovered fully through the new projects, the obligation for these to be paid falls to the local authority after five years.

If it is decided to defer set up costs an alternative source of funding must be found as the actual costs will have to be paid out at the Financial Close of the Sample

Schemes. This facility may be provided, inter alia, by the senior debt provider or by the PSP – since these costs are guaranteed to be recovered from the local authority as long as there is no LEP default, the cost of this facility should be low. The interest costs will be accumulated and recovered along with the capital across the agreed phases. These interest costs will ultimately be paid by the local authority, so there will be a cost associated with deferring some of the set up costs. Alternatively, the cost of deferring the set up costs may be borne by the PSP LEP investors;

- LEP Running Costs

LEP running costs include the fixed overheads of running the company, the costs of managing the supply chain(s) for the D&B and ICT contracts, the costs of managing the PFI SPVs and the costs of developing new work in conjunction with the local authority.

It is expected that the staffing element of running costs will comprise the time (either full or part time, and employed by the LEP or seconded from the supply chain) of a General Manager, Project Development Manager, Supply Chain Manager, Finance Manager and Project Director. There may also be an SPV General Manager, the ProjectCo Representative.

The LEP running costs comprise two elements:

- o Costs associated with the development and management of conventional projects; and

- o Costs associated with running the LEP and PFI SPVs.

The majority of these costs, roughly 65%, are assumed to be akin to PFI SPV running costs under a normal PFI transaction. These will therefore be associated with running and managing the PFI SPVs and these costs will be reimbursed by the PFI SPVs to the LEP. These costs will be charged to the local authority through the Unitary Charge, replacing (at a lower level for the reasons highlighted above) the PFI SPV running costs seen in normal PFI transactions.

It is assumed that around 35% of running costs (ignoring at-risk costs carried by the supply chain) will be associated with development work and these are reimbursed by the local authority in the LEP Management Fee paid at financial close of each New Project.

It is assumed that the combined LEP and PFI SPV running costs (including overheads) are between £100,000 to £300,000 per annum, for a standard LEP during the period of exclusivity with a flow of new projects. This estimate does not include development costs being borne by the supply chain, such as design, though the higher figure will include some element of development costs. (For those authorities with no immediate new projects it should be assumed that running costs are reduced to levels typically seen for PFI SPVs . The LEP is therefore assumed to be managing a portfolio of schools until a development opportunity arises);

- LEP Development Costs

These costs are equivalent to private sector bid costs on a normal PFI, D&B or ICT transaction. The costs of developing a new project to financial close are paid to the LEP as part of the LEP Management Fee upon financial close.

This assumption on the extent to which the supply chain can bear the majority of development costs until financial close on new projects is a key determinant of the level of working capital and risk capital required in the LEP.

The greater the extent to which the LEP passes down this risk to the supply chain, the more economical the LEP becomes in terms of calling on capital. Early BSF schemes have indicated that the LEP can minimise its working capital requirements by working closely with its supply chain and encouraging them to carry development costs at risk to financial close. The local authority may, however, decide that the LEP should have an increased role in development of new projects, and will then need to provide funding accordingly.

With respect to the quantum of these LEP development costs, it is expected that as a result of the standardisation of documents, reduced procurement time, exclusivity granted and the continuous improvement plan, the LEP development costs to financial close for new PFI projects will reduce over the life of the LEP from a range of circa £1.5 million to £3 million on the first phase to a range of around £1 million to £2 million by the second and third phases, if some of the initial costs are deferred to later phases of the wave. For subsequent waves of the programme the costs for each phase should be at the lower end of this range.

PfS will be monitoring and benchmarking LEP set-up costs bid, with funding for LEP set-up costs being based on the updated national benchmark.

On a similar scale to a PFI scheme the equivalent costs for a non PFI (Conventional D&B only) scheme will be of the order of £1 million to £2 million, which largely comprises design and other consultancy fees with a small amount assumed for legal and financial advice.

- LEP returns payable to investors

Dividends paid to shareholders in the LEP and interest paid to providers of sub debt and working capital. Some of these dividends and interest payments will be made to the local authority by virtue of its investments in the LEP.

***LEP Revenues and Costs for non PFI schemes***

As noted above the LEP will also receive a LEP Management Fee from non PFI schemes, and if there is no PFI at all within the LEP then it is likely that a separate LEP Management Services Fee will also be charged to the local authority.
The LEP will incur costs and recover these costs from non PFI contracts, as follows:

- milestone payments for the construction costs of each non PFI scheme. These payments will be made by the local authority to the LEP as and when construction work is certified and completed to specified milestones. The LEP will pay the contractor directly for the work as it is completed;

- milestone payments on the installation of ICT equipment;

- payments for on-going services under the ICT Managed Service Contract; and

- (possibly) FM payments on traditionally funded D&B schemes – the LEP will then need to make a margin on these payments as it is exposed to certain risks.

The timing of these payments has the potential to cause some working capital issues for the LEP if, for instance, the contractor is paid on a monthly basis but the local authority will only reimburse the LEP at two or three key milestone points. The milestone payments in and out of the LEP may therefore need to be synchronised if there are working capital constraints at the LEP level.

The LEP will commonly charge no margin on these costs. [1]

[1] Assuming that all risk is passed to the D&B contractor. If co-ordination risk on design and build contracts is retained by the LEP then this will probably attract a D&B risk margin.

*Table 2: Summary of LEP Costs and Revenues*

| Costs | Revenues to Recover Costs |
|---|---|
| LEP **set-up costs**<br><br>scheme-related LEP **development costs**<br><br>LEP **running costs** relating to project development<br>(roughly 35% of total LEP running costs)<br><br>plus a **margin**, circa 5 to 15% | **LEP Management Fee**<br>charged to PFI and D&B schemes;<br>with PFI the LA will pay through the UC;<br>with D&B this will be as part of the first stage payment;<br>set-up costs may be charged wholly to the first scheme or partly c/fwd to charge against later schemes |
| LEP **running costs** relating to the PFI SPVs<br>(roughly 65% of total LEP running costs)<br><br>plus a **margin**, circa 5% | **LEP Management Services Fee**<br>charged monthly to PFI SPVs;<br>where there is no PFI, these costs will be lower (no SPV management to carry out) but there will be some admin - could be charged direct to LA monthly over life of contract |
| **Costs** | **Revenues to Recover Costs** |
| **Returns** paid to investors<br>(sub debt interest and dividends on equity) | **Returns** received by the LEP as an investor in PFI SPVs<br>(sub debt interest and dividends on equity) |

# Section 5 – Working Capital

The previous section deals with the revenues and costs of the LEP. Whilst the LEP will receive revenues to cover its costs, timing differences may mean that LEP shareholders consider it prudent to establish some form of working capital facility at or after financial close in order that the LEP has a cash buffer. Hence, in addition to the investments required to set up the LEP and establish the PFI SPV, it is likely that within each LEP there will also be a working capital requirement, either payable by all of the shareholders or with the costs covered by the PSP.

The cyclical nature of the development process means that it should be possible to recycle working capital when a phase reaches financial close and the development costs are recovered through the LEP Management Fee (detailed in Section 4).

The actual working capital requirement of the LEP is sensitive to a number of commercial assumptions such as:

- the relationship with the supply chain, and external advisors, in terms of managing risk and payment terms;

- the level of minimum cash reserves required within the LEP (and the level of 'look forward' of these cash reserves) to cover for payment of running costs or additional costs or risks that crystallise;

- the length of time between financial close of the first Sample Schemes and the time at which the LEP begins development of the next new project under the terms of the Strategic Partnering Agreement;

- the cost structure of the LEP and the level of costs recharged from the LEP to the PFI SPVs (the higher the proportion of costs being recharged, the lower the effective working capital requirement at the LEP);

- risks associated with a New Project not obtaining Stage 1 or Stage 2 Approval or cost over-runs as a result of the time delays on reaching financial close on New Projects; and

- the timing of payment for development works.

As noted earlier, the relationship between the LEP and the supply chain in terms of bearing development costs has a significant impact in terms of determining the level of working capital required within the LEP.

Early BSF schemes have identified the need for a working capital reserve on financial close in the range of £250k to £1,000k. The range is wide as a result of the many variables involved such as those set out above.

This is typically provided by shareholders as a loan to the LEP (attracting a specified interest rate) – this may include all shareholders. Alternatively the working capital requirement could be funded by a third party, such as the senior debt funder, on commercial terms secured by shareholders. These commercial terms may vary according to the type of working capital. Working capital to cover cash shortfalls in the steady state business, and working capital provided for development costs prior to Stage 1 approval is relatively risky and so will demand a commensurate interest rate. Working capital to cover development costs incurred following Stage 1 approval is considerably less risky, as by then there will definitely be a project, so the interest rate charged should be correspondingly lower.

Early schemes have taken different approaches and in some cases the PSP has not required a contribution from the local authority. For prudence at OBC stage, and as noted in Section 3, local authorities may wish to budget to make a level of contribution towards a working capital requirement.

## *Appendix 1*
### *Structure of PFI Contracts*

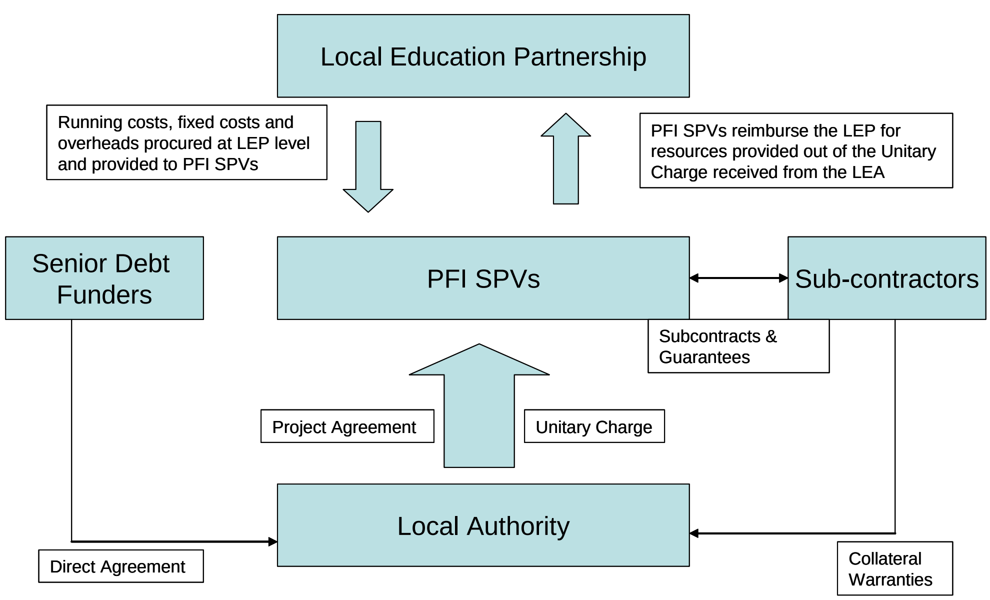
This section of the paper provides a brief summary of the cost and risk relationships between the LEP and the supply chain. The detailed contractual relationships between the LEP and the supply chain are defined within the suite of contract documents issued by PfS and available on the PfS website, and this paper does not seek to replicate those documents.

*PFI projects*

The simplified relationship between the LEP and the PFI SPVs is shown in Figure 3 below. This illustrates that with respect to resources and costs:

- the LEP will procure the resources (staff and office accommodation) for use by the PFI SPVs;
- the PFI SPV pays the LEP for the resources received (mainly for SPV management) via the LEP Management Services Fee (discussed in more detail in Section 4); and
- the PFI SPV receives the Unitary Charge from the local authority, part of which will be used to cover the LEP Management Services Fee (discussed in more detail in Section 4).

*Figure 3: The LEP and the PFI SPVs*



The risks passed to the private sector in a PFI contract are now well-established and set out within the PFI Project Agreement which forms the contractual basis of PFI works under BSF. Sponsors at PFI SPV level typically seek to pass the majority of the risks passed to the SPV directly onto the sub-contractors with typically only insurance and subcontractor replacement risk remaining within the PFI SPV.

The use of the LEP procurement model has not altered this model and as investors into PFI SPVs, LEP sponsors will have the same protections and risks as equity sponsors into existing PFI SPVs.

The exception to this is the contractual provisions within the Strategic Partnering Agreement pertaining to performance of the PFI SPV(s) and the impact of this on either exclusivity provisions or termination of the Strategic Partnering Agreement.

The Project Agreement covering the 25 year operating period of the concession is entered into by the local authority with the PFI SPV direct rather than through the LEP.

## *Appendix 2*

### *Structure of D&B contracts*

The simplified relationship between the LEP and the D&B sub-contractor (assuming for ease of presentation that there is a single D&B subcontractor[2]) is shown in Figure 4 below.

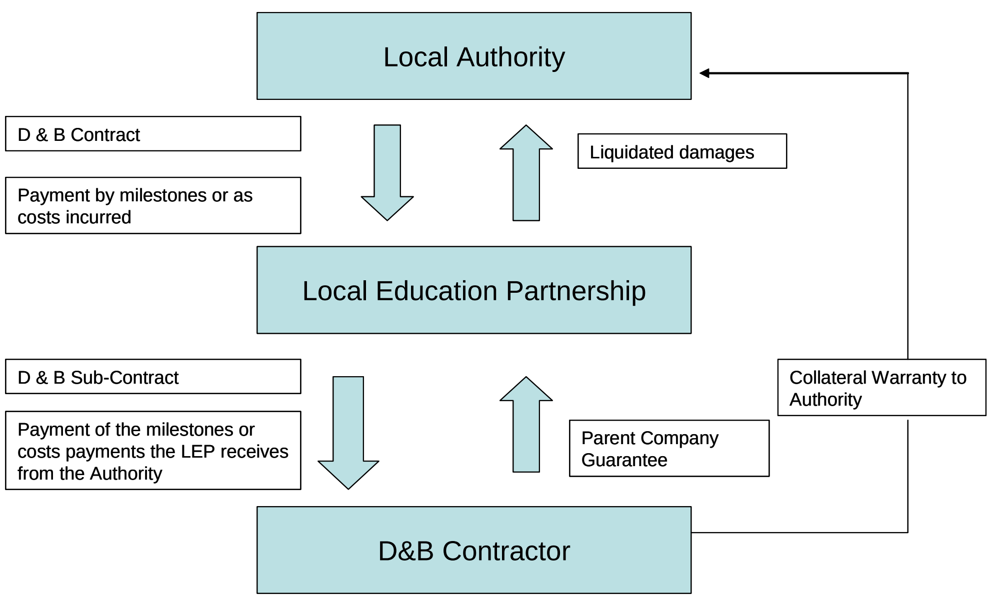
The D&B contract is signed between the local authority and the LEP. There are two types of D&B contract:

- Target Cost Contract in which the local authority pays the contract value according to monthly actual costs up to the target cost with 50:50 sharing once the target is exceeded up to a guaranteed maximum price; and

- Lump Sum Contract in which payments are made by reference to agreed milestones, with the LEP margin payable on practical completion.

Working capital requirements will be fully borne by the LEP and/or its supply chain and the interest cost of this will be priced into the contract sum.

*Figure 4: The LEP and the D&B sub-contractor*




The primary obligations of the LEP under the D&B contract is to carry out or procure the design, construction, completion, commissioning and testing of the works so that each facility, including ICT, is completed on or before its relevant date of completion

[2] Where this is not the case and the LEP separately procures design and construction services then the LEP will bear the risk of commissioning and delivering the work and would then be expected to charge a margin on the D&B contract reflecting this risk retained within the LEP.

complying with the facilities requirements, good industry practice and necessary consents.

There is a twelve month defects liability period post certification by the Independent Certifier as well as provision for liquidated damages in relation to works as a whole and in relation to completion of individual schools.

Key risks passed to the LEP include latent defects, asbestos liability, site conditions and completion as set out in the D&B contract. It is expected that the LEP will seek to pass these risks onto the D&B sub-contractor via the D&B sub-contract supported by either warranties or parent company guarantees provided to the LEP. Where the risk borne by the D&B sub-contractor can be priced, this will then be reflected in the contract sum.

Poor performance or delay under the D&B contract may lead to the loss of exclusivity under the SPA.

## *Appendix 3*

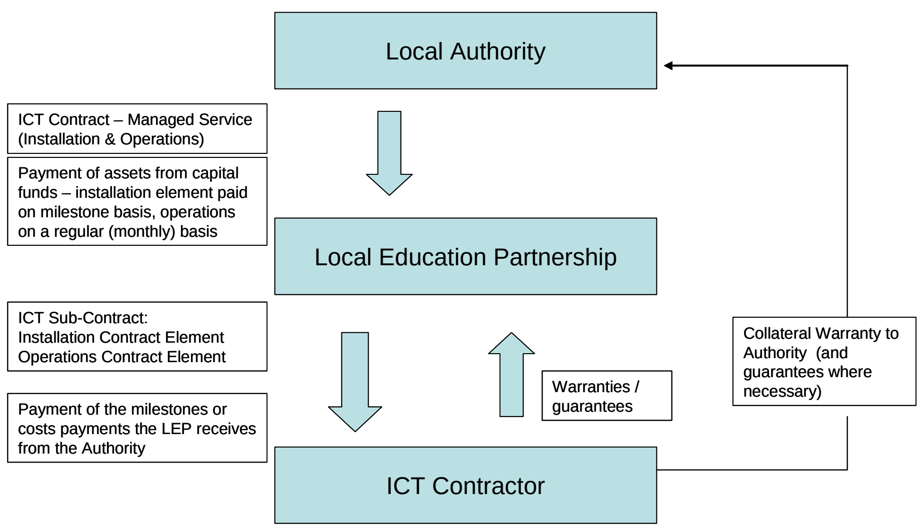
### *Structure of ICT contracts*

The simplified relationship between the LEP and the ICT provider is shown in Figure 5 below whereby:

- the ICT contract is signed between the local authority and the LEP with the local authority paying the installation element of the contract on a milestone basis and the operational services element monthly during the five year managed service term; and

- any working capital requirement on the installation and operations element will be fully borne by the ICT subcontractor.

*Figure 5: The LEP and the ICT sub-contractor*




As set out in the ICT contract, the LEP shall design, install, test and commission the ICT assets in accordance with the ICT requirements, the Implementation Programme and the Implementation Testing Procedure.

The risk of commissioning and operational performance (which is governed by a performance regime applied to the operations element of the contract) which are passed to the LEP, are expected to be passed in full to the ICT sub-contractor.

In addition to those risks the LEP can not pass down in sub-contracts, there will be residual risks which remain with the LEP such as managing the process of replacement of the ICT provider in case of sub-contractor default.

Breach of the ICT contract or late installation of ICT may have an impact on the exclusivity arrangements in the SPA.