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Report by the
Comptroller and Auditor General

The Prison Service

The refinancing of the Fazakerley PFI prison contract

HC 584 Session 1999-2000
29 June 2000

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Comptroller and Auditor General

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John Bourn
Comptroller and Auditor General

National Audit Office
20 June 2000

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Executive summary

Paragraphs 1.2 and 1.15

1 In November 1999, Fazakerley Prison Services Limited (FPSL), a project company formed by Group4 and Tarmac[1], refinanced the project it had been awarded by the Prison Service in 1995 to build, maintain and operate Fazakerley prison, the first prison under the Private Finance Initiative (PFI)[2]. The terms of the refinancing included:

- an extension to the period over which FPSL's bank loan would be repaid;
- a reduction in the lending margin for the loan;
- the arrangement of a fixed rate of interest covering the full period of the loan; and
- early repayment of the subordinated debt invested by the shareholders of FPSL.

Paragraphs 1.3 to 1.5, 1.10, 3.7, Figure 1

2 FPSL was able to refinance the Fazakerley project firstly because of its success in constructing the prison and establishing a track record in its operation, and secondly because of increasing confidence in the financial markets towards PFI projects generally. The refinancing has improved the expected returns to FPSL's shareholders both through the early repayment of their original investment and by generating a more favourable flow of dividends. These expected returns have increased by £10.7 million (61 per cent) as a result of the refinancing, as compared to their originally projected level of £17.5 million[3] at the time the contract was awarded.

Paragraphs 1.3 and 1.4, Figure 2

3 The refinancing has been a major factor - but not the only one - in increasing shareholder returns. FPSL had already been rewarded financially by completing the prison ahead of schedule and by achieving savings on construction and commissioning costs. These factors, in combination with the refinancing,

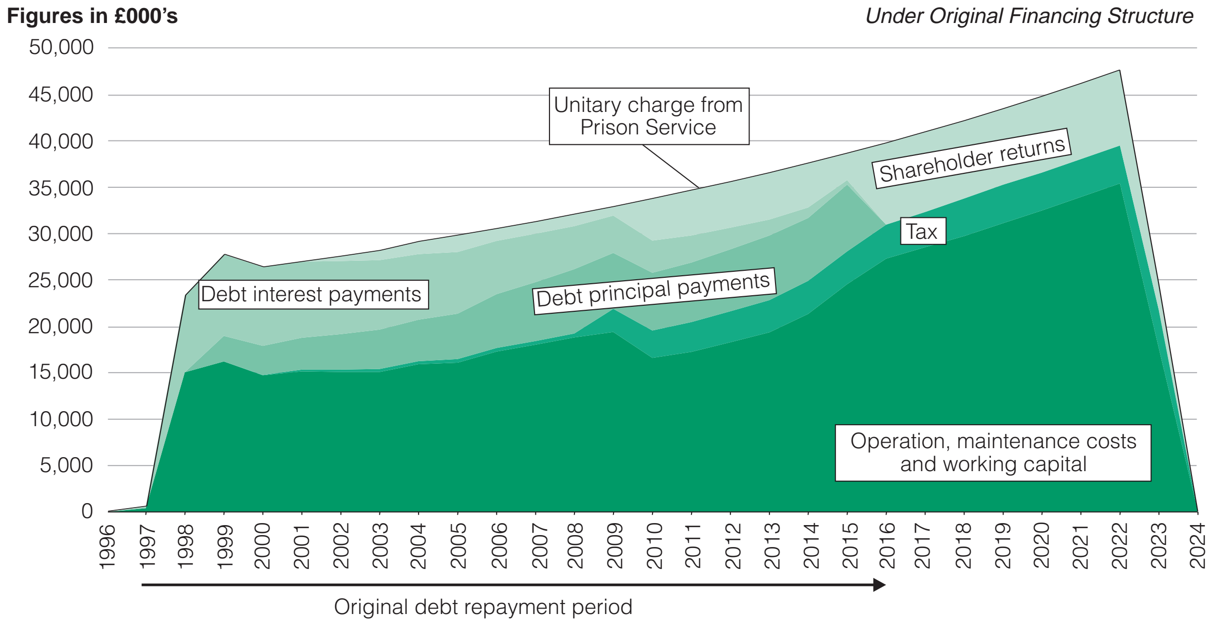
1 The interests of Tarmac in this project have since been taken over by Carillion plc which operates the former construction business of Tarmac.

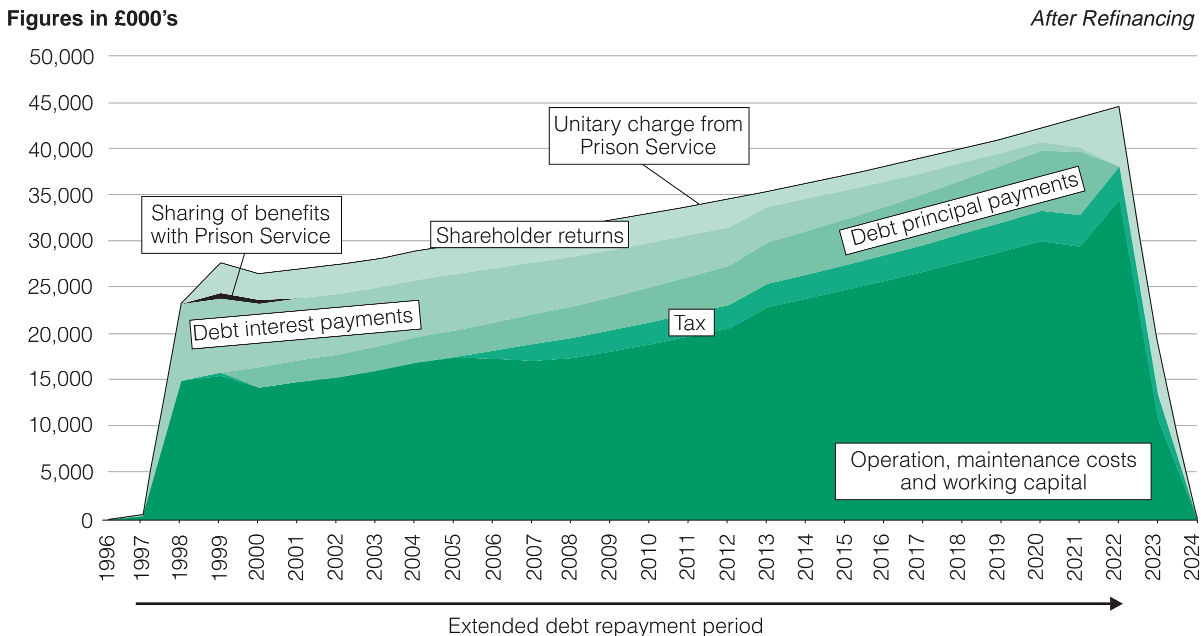
2 The prison is now known as HMP Altcourse.

3 Unless otherwise stated, all figures shown in this report relating to the value of benefits to shareholders are quoted in present value terms as at 30 November 1999 – the date of the refinancing – using a real discount rate of 6 per cent.

Figure 1

How the Fazakerley Prison refinancing increases, and brings forward, the returns to the shareholders of the consortium





The figures above show how the Fazakerley Prison refinancing affects the costs of funding to the FPSL consortium. The reduction in the interest rate means that annual interest charges are lower throughout the life of the loan. The extension in the repayment term of the loan means that annual debt repayment costs are lower in the next 13 years. The total debt service costs are therefore reduced after the refinancing has taken place and until 2013. Thereafter, FPSL will face additional costs because the loan will not have been repaid in full by this time. As the unitary charge payable by the Prison Service remains the same as under the original contract, before any sharing of the refinancing gains, the refinancing therefore creates earlier and larger dividends for the equity investors in the consortium.

The Fazakerley prison was actually completed ahead of schedule, so the operating revenues in 1998 were higher than originally expected. This is the reason for the slight kink in the early years.

Source: National Audit Office

have increased shareholders' expected returns by a total of £14.1 million, some 81 per cent higher than when the contract was awarded.[4] The Prison Service has also benefited from the early completion of Fazakerley through the earlier availability of prisoner places which has helped it cope with prison overcrowding in the North West of England. The Service regards the ability to operate Fazakerley at a higher than planned prison population during the first year of operations as commendable for a newly opened local prison.

The Prison Service's position

Paragraphs 1.6, 1.13, 1.14

4 Although the PFI contract with FPSL did not give the Prison Service any contractual rights to share in the benefits of the refinancing directly, it did require the Prison Service's consent for arrangements which could increase termination liabilities (the payment the Prison Service would have to make if the contract was terminated prematurely[5]). There was, however, uncertainty initially as to whether the proposed terms of FPSL's refinancing would require such consent.

Paragraphs 1.21 and 1.22

5 The Prison Service's position strengthened when FPSL's lenders decided that it would be prudent for FPSL to seek consent anyway. The lenders were concerned that the Prison Service might in the future decline to pay them termination liabilities on the grounds that FPSL had proceeded with the refinancing without explicit consent. Without consent, FPSL considered that it would have been able to pursue a different refinancing strategy which would have secured only £5.2 million of benefits.

Paragraphs 1.19 and 1.20, Figure 3

6 The Prison Service's advisers, NM Rothschild & Sons (Rothschild), calculated that the Service's maximum termination liabilities, which were approximately £90 million before the refinancing in 1999, would reduce over time more slowly as a result of the refinancing. Rothschild showed that the maximum termination liabilities would be between £8 million and £47 million higher than previously anticipated depending on when termination of the contract occurred. In

4 After a payment of £1 million from FPSL to the Prison Service (paragraph 9), the expected net returns to FPSL's shareholders are £13.1 million higher (75% higher) than when the PFI contract was awarded (Figure 2, page 4).

5 A premature termination could arise if FPSL's standard of service delivery is very poor such that it becomes a matter deemed by the contract to be an event of contractor default. In this situation, the Prison Service can appoint a new contractor (which can be the Prison Service itself) and the contract will only be terminated if this is not possible. Alternatively, the contract could be terminated by the Prison Service if it considers there are other compelling reasons to do so. The basis of the termination payments which arise in these different circumstances is described in paragraphs 2.21 to 2.22.

present value terms, the increase in termination liabilities would be up to £13.5 million. The Prison Service formed the view that it was justified in seeking compensation from FPSL for accepting this extra risk.

Summary of increase in expected returns to FPSL's shareholders

Figure 2

	£m	£m	% increase since 1995
Expected shareholders' returns when the PFI contract was let in December 1995		17.5	
Increase from early delivery of the prison and lower costs	3.4		20
Increase from refinancing before payment to the Prison Service [1,2]	10.7		61
	14.1		**81**
Payment to the Prison Service from the refinancing [1]	(1.0)		(6)
		13.1	**75**
Expected shareholders' returns in November 1999 after the refinancing		**30.6**	

Source: National Audit Office from information supplied by PricewaterhouseCoopers, FPSL's advisers

Notes: 1. FPSL paid £1 million to the Prison Service as compensation for increased termination liabilities.

2. FPSL considered that it would not have required Prison Service consent to obtain £5.2 million of these refinancing benefits.

Scope of the study

Appendix 1

7 We examined to what extent the Prison Service achieved its objectives in the negotiations on the refinancing of Fazakerley prison, and whether there are any general lessons for departments who are involved in such negotiations in the future.

The Prison Service received £1 million from FPSL as compensation for increased termination liabilities

Paragraph 1.25

8 The Prison Service did not seek to place a cap on the level of increased termination liabilities that it was prepared to accept, though it did discuss with FPSL other refinancing options which would avoid creating extra risk for the Service. In the event, FPSL decided not to pursue these alternatives, and instead negotiated a sharing of the benefits on the basis of its original refinancing proposals.

Paragraphs 1.24 and 1.28, Figure 5

9 Rothschild estimated that the potential financial consequences for the Prison Service of accepting the additional termination liabilities could, based on a cautious assumption of a 10 per cent probability of the contract being terminated early, amount to between £0.9 million and £1 million. On the basis of this calculation and a consideration of other options open to FPSL, the Prison Service accepted compensation in the form of a £1 million share of refinancing benefits, having initially rejected lower offers from FPSL of £100,000 and £300,000. This level of compensation represented approximately one fifth of the refinancing benefits for which FPSL had sought the Prison Service's consent.

Paragraph 1.9

10 The Prison Service acknowledged that, in other respects, the refinancing benefits were a reward to FPSL for taking risks in managing this first PFI prison project successfully. This has helped the Prison Service to progress the PFI prison programme which has produced over five thousand new prisoner places more quickly than would have been achieved under conventional public procurement.

Paragraph 1.12

11 The Treasury proposes to issue expanded guidance on refinancings because of the complex issues involved. The Treasury expects the guidance to continue to recognise the private sector's rights to receive refinancing benefits as a reward for the successful management of risks where these are appropriately priced. It will also describe the circumstances where the public sector may be justified in seeking a share of refinancing benefits along with appropriate sharing mechanisms.

Further refinancings of PFI contracts are likely to occur

Paragraph 2.1

12 The refinancing of the Fazakerley prison contract is one example of how shareholders can extract financial benefits both earlier and in greater quantity than the expected benefits originally disclosed in their consortium's bid for a PFI contract. There are likely to be similar opportunities in other PFI contracts, particularly those signed in the early stages of the development of this new form of procurement and where the required service has been successfully provided by the private sector consortium. There can be, however, important consequences for departments arising from refinancings, and departments should consider what provisions they should make to share in some of the financial gains and whether their consent should be required before a refinancing can proceed.

There are general principles which departments can apply to refinancings

Paragraphs 3.1 and 3.2

13 Refinancings are complex financial arrangements. Departments will need to consider the implications of refinancings on a project by project basis. There are, however, principles which should guide departments and strategies which can help departments apply the principles. They are that:

- appropriate benefits should go to those bearing risks;
- benefits from reducing costs in a developing market should be shared if they have not already been reflected in the contract price;
- it is reasonable for departments to seek compensation for any increased exposure to termination liabilities arising from a refinancing;
- substantial refinancing gains to the private sector may threaten the perceived value for money of the project;
- a refinancing should not jeopardise the stability and success of the long term contractual relationship between a consortium and a department; and
- if the private sector seeks to improve its returns by renegotiating parts of a PFI contract it is reasonable for departments to seek a share of refinancing benefits.

Other learning points

14 As a result of this examination we have identified the following points for future projects which are either covered by existing Treasury guidance or are expected to receive expanded coverage in the next update to this guidance (paragraph 11). They are that:

Paragraphs 1.16, 3.26, 3.27

1) early on in the procurement process, when preparing an Invitation to Tender and when developing the PFI contract, departments should give careful consideration to refinancing issues. They should address whether they should establish within the PFI contract the right for them to share in refinancing benefits;

Paragraphs 1.13 to 1.21, 3.24, 3.25

2) departments should set out unambiguously in their PFI contracts the circumstances in which they would be required to consent to part, or all, of a proposed refinancing. These should include any situation which may have adverse consequences for departments, for example by increasing their termination liabilities;

Paragraph 1.18

3) as in the case of Fazakerley, when faced with the refinancing of an existing project, departments should enlist the help of experienced legal and financial advisers. This can assist departments in understanding the full implications of the refinancing proposals and in establishing the best way to approach any negotiations;

Paragraph 1.25

4) where departments are likely to be exposed to increased termination liabilities as a result of a refinancing, in the absence of reaching an acceptable agreement on the sharing of refinancing benefits, they should consider whether to limit their risk. They may be able to achieve this by placing a cap on the level of termination liabilities they are prepared to accept, or by requiring the private sector to underwrite the risk themselves or through a third party;

Paragraph 1.22

5) where a department has the flexibility to negotiate over refinancing benefits, it should ensure that it prepares a robust but reasonable negotiating strategy. This should be grounded on sound principles and should contemplate the alternative, for both the public and private sector parties, in the event that a negotiated agreement cannot be reached; and

Paragraph 3.36

6) departments should consider linking at least part of their advisers' remuneration to the outcome of any negotiations to which the advisers contribute. This will create an incentive for the advisers to help departments achieve the best possible outcome.

Part 1: The Prison Service achieved its objective for this refinancing

1.1 Although the Prison Service had no contractual rights to share in the benefits of the refinancing, the lenders to FPSL considered it prudent for Prison Service consent to be obtained as the refinancing proposals would create additional liabilities for the Service. The Service decided that it should be compensated for agreeing to accept these additional liabilities and negotiated an upfront payment from FPSL of £1 million. This sum was consistent with the Service's estimate of the extra financial risk it was taking on.

Expected total returns to FPSL's shareholders had increased by £14.1 million since the PFI contract was let

1.2 In December 1995 the Prison Service awarded FPSL the contract to build a new prison at Fazakerley, near Liverpool, and to operate and maintain it for a period of 25 years. The Prison Service estimated that the discounted cost of the contract over this period would be £247 million in 1995 prices. The finance for this project comprised bank borrowings and a mixture of subordinated debt[6] and equity capital invested by Group4 and Tarmac who were shareholders in FPSL and the main contractors on the project. Group4 and Tarmac expected to receive a total of £17.5 million in discounted values in interest and dividends on their investment in the project.

1.3 The Fazakerley prison opened in December 1997, five months ahead of schedule. While, as with all new prisons on opening, not everything went to plan, Prison Service confidence in the prison was such that during the first year of operations the prison was requested to hold more inmates than its designed capacity, to help the Service manage overcrowding in the North West of England. The Service regards the prison's ability to operate with a higher than planned prison population during the first year of operations as commendable for a newly opened local prison.

6 Subordinated debt is a loan which will rank behind the principal borrowings of a company for repayment on the occurrence of certain events (such as insolvency).

1.4 By December 1999, the expected returns to the shareholders of FPSL had increased by £14.1 million (Figure 2, page 4). £3.4 million of these increased benefits arose primarily because the Fazakerley prison came into operation five months ahead of schedule and because FPSL has achieved savings on its expected construction and commissioning costs.

£10.7 million of the increase arose as a result of a refinancing

1.5 The remaining increase in the expected returns for the shareholders in FPSL of £10.7 million, arose from a refinancing of the project in November 1999. The refinancing was possible following the successful construction and first two years of operation of Fazakerley prison. The refinancing benefits are analysed further in Part 2 of this report.

The Prison Service had no explicit contractual rights to share in the gains

The original PFI contract was silent on the issue of sharing refinancing benefits

1.6 The contract which the Prison Service awarded to FPSL was the first PFI prison contract under the PFI. It made no reference to the sharing of refinancing benefits, by way of a benefit sharing formula or otherwise. As a result, there was no explicit contractual right to a share of the refinancing benefits which FPSL secured in 1999. During the original contract negotiations in 1995, FPSL had not offered the Prison Service any such rights. FPSL considered that there was no certainty that a refinancing opportunity would arise and, if it did, this would be because the project had been successful and any refinancing benefits would therefore be a reward to FPSL for developing the market for PFI prisons. Lazard Brothers & Co. Limited, the then Prison Service's financial adviser, had advised the Service that, if FPSL was able to get benefits from a refinancing, then this was a matter for it and its shareholders so long as there was no increase in liabilities for the Prison Service as a result.[7]

7 Paragraphs 2.20 to 2.22 and 2.24 describe how these liabilities arise and how they might be affected by a refinancing.

Treasury guidance on refinancings was only available as the Service and FPSL concluded the refinancing

1.7 When this early PFI contract was awarded, Treasury guidance focused on the way that departments should approach PFI procurements. An awareness of what would be acceptable PFI contract terms for the public and private sectors emerged over a number of years as the first generation of PFI deals were concluded. Then, in July 1999, the Treasury issued guidance on standard contract terms which included advice on how departments should address refinancing issues.[8] By the time this guidance was issued, the Prison Service had, in April 1999, already accepted an offer from FPSL of a share of the refinancing benefits as compensation for some additional liabilities that the refinancing created for the Service. The Prison Service was, therefore, in the process of finalising the contractual arrangements for this deal. These arrangements were finally agreed at the end of November 1999, at which point FPSL was able to proceed with the refinancing.

The guidance says that refinancing benefits generally reward private sector risk taking, but may be shared

1.8 The Treasury guidance issued in July 1999 generally puts forward a view that refinancing benefits are gains which should accrue to the private sector, but states that in limited circumstances it may be appropriate for refinancing benefits to be shared with departments. The guidance says, inter alia, that:

Treasury guidance reference

Paragraph 14.6.4

- the limited circumstances for sharing refinancing benefits include novel projects, because there is a likelihood that more favourable financing terms will emerge as the market develops. The Fazakerley PFI prison contract, being the first prison contract to be awarded under the PFI, would have been a novel contract at the time it was let;

Paragraph 14.6.4

- but contractors' arguments (such as those put forward by FPSL) that the benefits are their reward for taking the risk of entering a new market are entirely justified in certain cases;

8 The guidance on refinancings is set out in section 14.6 of Standardisation of PFI Contracts (HM Treasury July 1999).

Paragraph 14.6.4

- other circumstances where sharing refinancing benefits may be appropriate include those where competition has been poor with the result that the original bid may either have been based on higher than necessary financing costs, or based on a price which did not anticipate the benefits of a future refinancing;

Paragraph 14.6.8

- except where a refinancing removes comforts which a department has relied upon, departments should not seek a share of refinancing benefits if the rights to share in such benefits have not been incorporated in the PFI contract; and

Paragraphs 14.6.8 and 21.3, Footnote 3

- care must be exercised to ensure that a refinancing does not disturb a pattern of projected returns on the consortium shareholders' equity, or the consortium's contingency reserves that are essential for a stable and successful long term relationship. A refinancing should also not increase debt levels to the point where they could prejudice the contractor's ability to perform over the term of the contract.

The Service accepts that refinancing benefits are FPSL's reward for a project which has benefited the public sector

1.9 The Prison Service considers that the Fazakerley PFI prison has been a success because the prison opened five months ahead of schedule and, although some payment deductions have been made where FPSL has not fully met its contractual obligations, the Prison Service has generally been satisfied with FPSL's operational performance. The Service thinks that the success of this contract has helped the wider PFI prison programme which has provided over five thousand new prisoner places more quickly than would have been achieved under conventional procurement.

1.10 The Prison Service acknowledges that the success of the project contributed to the opportunity for a refinancing to take place and that, therefore, it is reasonable for FPSL to benefit from the refinancing as a reward for taking risks in successfully developing this first PFI prison project. The Service also did not wish to deter FPSL or other consortia from bidding in future PFI prison competitions by removing opportunities for them to benefit from this type of project.

1.11 The Service has continued to explore with bidders how contract prices and overall value for money will be affected by different approaches to the sharing of refinancing benefits. These issues include whether contractors will be encouraged in a competitive market to take greater risk in pricing a PFI contract in return for retaining refinancing benefits in the future.

The Treasury expects to issue expanded guidance on refinancing

1.12 The Treasury considers that because of the complex issues raised by refinancings, and in the light of market trends, more extensive guidance is required. It proposes to issue expanded guidance on refinancings during 2000. This guidance is expected to reflect a number of the principles which departments may wish to bear in mind when faced with a refinancing, and which are set out in Part 3 of this report. The Treasury expects the guidance to continue to recognise the private sector's rights to receive refinancing benefits as a reward for the successful management of risks where these are appropriately priced. It will also describe the circumstances where the public sector may be justified in seeking a share of refinancing benefits along with appropriate sharing mechanisms.

The contract left uncertain the need for the Prison Service's approval for the refinancing

1.13 The contract for Fazakerley did not give the Prison Service explicit rights to share the benefits of a refinancing by FPSL. It did, however, require the Prison Service to approve any arrangements which resulted either in an increase in the aggregate loan principal of FPSL's borrowings, or which had the primary intention of increasing the termination liabilities of the Prison Service. Termination liabilities are payments which the Prison Service would be required to make to FPSL in the event that the contract was terminated prematurely by either party. They are intended to provide some level of reimbursement to FPSL's lenders in return for surrendering their ownership of the prison to the Service, but at a level which is projected to leave the Service no worse off than if the contract had been fulfilled.[9]

9 See the National Audit Office report, "The PFI contracts for Bridgend and Fazakerley Prisons" paragraphs 2.43-2.49 (HC253 1997-98)

1.14 There was, however, uncertainty as to what extent the Prison Service needed to approve different aspects of FPSL's refinancing proposals. This uncertainty arose because:

- although FPSL's initial refinancing proposals suggested that FPSL would not be taking on any new borrowings as part of the refinancing, it was unclear whether the Prison Service's approval would be required to the proposed extension of the loan repayment period. The proposed extension meant that the amount of borrowings outstanding at particular points in time would be higher than had been envisaged in the financing plan FPSL had submitted to the Prison Service when bidding for the contract;

- as a consequence of extending the loan repayment period (although not necessarily a primary intention), the Prison Service's termination liabilities - which are related to the amounts FPSL owes its lenders - could be viewed as having increased; and

- the amount to be repaid to FPSL's lenders in the event of termination could increase as a result of costs incurred in breaking the fixed interest rate arrangement which FPSL was planning to include within the terms of the refinancing.

The Prison Service agreed that its consent was not required for FPSL's initial refinancing proposals

1.15 FPSL told the Prison Service in 1998 that the refinancing would involve:

a) an extension to the repayment period of its bank loan;

b) a lower lending margin on that loan; and

c) a reduction in the level of cash held in reserve accounts.[10]

At this stage, FPSL did not mention a further feature of the eventual deal,

d) that it would put in place a new fixed interest rate on its bank loan covering the extended life.

10 Reserve accounts are funds which FPSL is required to maintain, and not to pay out as dividends, as part of its agreement with its lenders.

FPSL provided the Prison Service with legal advice to the effect that the refinancing would not require the Service's consent, but this advice did not cover the potential increase in the Service's termination liabilities resulting from the new fixed interest rate (d).

1.16 Based on the limited information provided by FPSL, the Prison Service's legal adviser, Freshfields, agreed that the Prison Service's consent was not required for the refinancing. The Prison Service had not, at this stage, fully appreciated the impact of the refinancing on its termination liabilities. It told FPSL in October 1998 that, subject to Freshfields reviewing the final details of the refinancing, it would permit FPSL to proceed.

1.17 FPSL subsequently asked the Prison Service to consent to its plans to put in place the new fixed interest rate covering the extended life of the bank loan. The Prison Service asked Freshfields whether Prison Service consent was required to this aspect of the refinancing. Freshfields advised the Prison Service that, under the terms of the PFI contract, it was uncertain whether such consent was required but that given there was uncertainty, FPSL's financiers were likely to require consent from the Prison Service before proceeding with the refinancing. Our legal advisers, Theodore Goddard, agree with Freshfield's advice that the position was unclear.

The Prison Service rightly decided to seek further advice on the refinancing proposals

1.18 The Prison Service realised that, even if its consent was not contractually required for FPSL to proceed, the refinancing might increase the amount which it would be required to pay to FPSL in the event that the contract was terminated prematurely. Given that it was not familiar with refinancing issues, the Service rightly decided to seek further advice from both Rothschild and Freshfields.

Rothschild advised the Prison Service that it would face higher termination liabilities as a result of the refinancing

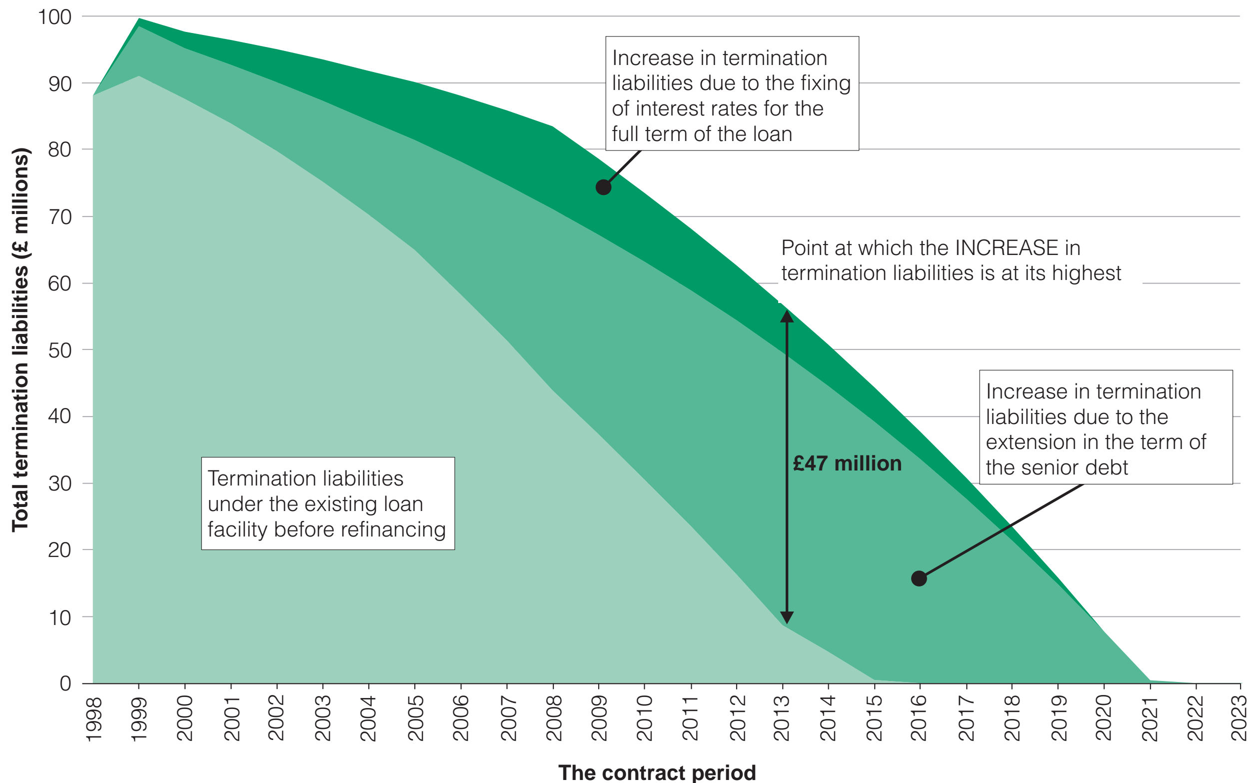
1.19 On the recommendation of its advisers, the Prison Service sought more detailed information from FPSL about the refinancing. Rothschild then analysed the effect of the proposed refinancing on the Prison Service's termination liabilities and gave the Prison Service some preliminary advice as to how they could approach the refinancing situation. Rothschild's advice took into account further

information from FPSL, that the amounts which FPSL would owe to its lenders in the event of premature contract termination might include additional costs in breaking the fixed interest rate arrangement.

1.20 Rothschild calculated that the Prison Service's maximum termination liabilities would reduce over time more slowly following the refinancing. They showed that the maximum termination liabilities would be between £8 million and £47 million higher than previously anticipated, depending on when termination of the contract occurred (Figure 3). In present value terms, the increase in termination liabilities would be up to £13.5 million.

Figure 3

How the Prison Service's maximum termination liabilities have increased since the refinancing



This figure shows that the maximum termination liabilities, in cash terms, vary depending on what point in the contract period termination takes place. As a result of the refinancing, termination liabilities have increased. The point at which this increase is at its maximum occurs in 2013 when there is an additional £47 million of liabilities.

Source: National Audit Office from information supplied by Rothschild

FPSL's lenders then sought confirmation from the Service that it was content with new financing arrangements

1.21 FPSL's lenders decided that it would be prudent for FPSL to seek the consent of the Prison Service to the refinancing in view of the uncertainty as to whether or not such consent was actually required. They were concerned that the Prison Service might in the future decline to pay termination liabilities on the grounds that FPSL had proceeded with the refinancing without explicit consent. FPSL therefore told the Prison Service early in 1999 that its lenders would require the Prison Service's explicit approval given the increase in termination liabilities that would arise from the refinancing.

The Prison Service considered what proportion of the refinancing benefits would be dependent on its consent

1.22 Based on advice from Rothschild and Freshfields, the Prison Service formed the view that it was justified in seeking a share of the refinancing benefits from FPSL as compensation for accepting increased termination liabilities. Rothschild advised the Prison Service that £5.5 million of the refinancing benefits that FPSL expected to receive, depended on the Prison Service agreeing to accept these additional liabilities. The Prison Service took this into account in negotiating a level of compensation consistent with its estimate of the extra financial risk it was being asked to accept (Figure 4).

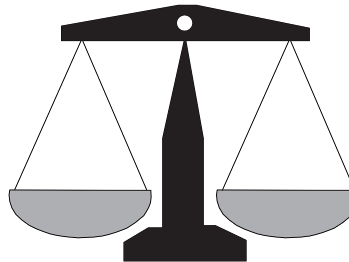
The Prison Service has made its approval rights clearer in other contracts

1.23 In the case of the contract for the Fazakerley prison, there was uncertainty as to the need for the consent of the Prison Service to aspects of the refinancing. The contract for the Bridgend prison (which was contemporaneous with Fazakerley) appears to have been rather clearer on the issue, and the Prison Service now ensures that all contracts unambiguously require its approval to any refinancing proposals which increase its termination liabilities.

Figure 4

Factors influencing the Prison Service in its negotiations

Reasons for refinancing benefits to go to Prison Service



Reasons for refinancing benefits to go to FPSL

- the Prison Service faced substantially higher termination liabilities should the contract be terminated
- it was seeking reasonable compensation for its increased liabilities
- the Prison Service knew that £5.5 million of the refinancing benefits were conditional upon its consent
- the Prison Service could be criticised if it did not negotiate a share of what might appear to be substantial benefits to FPSL

- FPSL had taken risks in developing this novel project from which a refinancing was a potential source of reward
- the Prison Service had no explicit contractual right to share the refinancing benefits
- the Service accepted the benefits arose partly from successful management of the construction and operation to date
- the Service taking a large share of the refinancing benefits might deter bidders on future PFI prisons contracts

This figure shows that the Prison Service identified a number of reasons why the refinancing benefits should go to the Prison Service and also reasons why the benefits should go to FPSL.

Source: National Audit Office

The Service sought compensation for its risk of increased termination liabilities

Advisers estimated the cost of additional termination liabilities

1.24 Rothschild estimated the possible financial consequences for the Prison Service of accepting the additional termination liabilities arising from the refinancing. They tested a range of assumptions about the probability of the contract being terminated prematurely, and the reasons for such termination, to determine what would be an appropriate level of compensation. The Prison Service then took this calculation into account in its negotiations with FPSL, along with a consideration of the overall level of benefits expected by FPSL and what alternatives FPSL could pursue without consent.

The Prison Service accepted £1 million having rejected lower offers

1.25 The Prison Service did not seek to place a cap on the level of increased termination liabilities that it was prepared to accept as a result of the refinancing. It did, however, discuss with FPSL the option of having the increased termination liabilities underwritten not by the Prison Service but instead by FPSL's shareholders or a third party insurer. Another suggested approach was for FPSL to simplify the refinancing proposals so that they would not cause an increase in termination liabilities per se. In the event, FPSL decided not to pursue alternatives, and instead negotiated a sharing of the benefits on the basis of its original refinancing proposals.

1.26 The Prison Service initially rejected offers of compensation from FPSL of £100,000 and £300,000. Although the Service judged that there was only a low percentage probability of a premature termination of the contract, these offers of compensation were not commensurate with Rothschild's calculation of the Prison Service's likely increased costs (Figure 5, page 19).

1.27 The Prison Service asked FPSL for a significantly greater share of the refinancing benefits without disclosing its calculations on how the risk of increased termination liabilities had been valued. FPSL, which was by then seeking to close the refinancing negotiations, increased its offer to £1 million, which the Prison Service accepted.

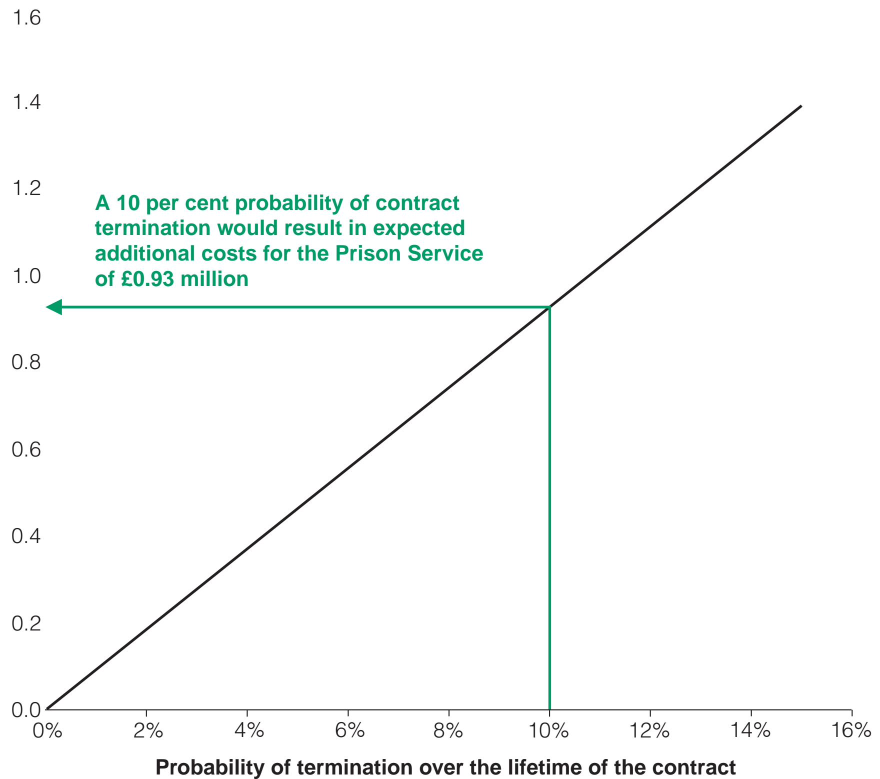
The compensation was consistent with the Service's estimate of the extra financial risk it was bearing

1.28 The calculations which Rothschild had prepared for the Prison Service showed that the £1 million compensation offered by FPSL would, on average, be acceptable if the probability of an event which could trigger a contract termination during the contract period was 10 per cent or less (Figure 5). The Prison Service considered that the £1 million offer from FPSL would be acceptable because it would be satisfactory compensation even based on cautious assumptions about the likelihood of contract termination. In reaching this conclusion the Prison Service took into account that:

- Rothschild's calculations assumed that any event of contractor default would lead to the termination of the contract, whereas the Prison Service would expect many such cases to be remedied without termination occurring. The Fazakerley contract allows, for example, either FPSL's lenders to appoint a replacement operator acceptable to the Prison

Rothschilds' calculation of the possible financial consequences for the Prison Service of accepting the additional termination liabilities arising from the refinancing

Figure 5



Rothschilds estimated the expected value of the increase in termination costs resulting from the refinancing, by multiplying the increase in termination liabilities in each remaining year of the contract by the probability of the contract being terminated prematurely in that year, and then discounting the result. An equal probability of default was assumed for each year of the contract.

This figure shows that, assuming a 10% probability of termination over the remaining contract life, adequate compensation for the Prison Service for accepting additional termination liabilities would be between £0.9 million and £1.0 million.

Source: National Audit Office from information supplied by Rothschilds

Service, or for the Prison Service to step in and appoint another contractor or itself as the operator of the prison. After taking account of this, the Prison Service judged that it was very unlikely that the probability of contract termination would be as high as 10 per cent; and

- Rothschild's calculations also assumed that, in the event of contractor default leading to termination, the Prison Service would be liable, as a result of the refinancing, for the full increase in FPSL's liabilities to its lenders. Based on the formula for calculating termination liabilities set out

in the PFI contract, in certain cases the termination payment would not have to reflect the full increase in lender liabilities, but only the remaining value of the contract if this was a lower figure.[11]

The Service recognises that £1 million of compensation represented approximately one fifth of the refinancing benefits for which FPSL considered it was necessary to obtain the Prison Service's consent (Figure 7, page 25):

1.29 Figure 3 (page 15) shows that, if the Fazakerley contract is terminated at any time before 2021, then the actual payment due from the Prison Service to FPSL could be a maximum of nearly £100 million, reducing gradually to zero depending on when termination occurs. The Service recognises that in such an event, £1 million is very unlikely to cover termination costs in full. It therefore regards the £1 million not as a fund for meeting future termination costs should they arise, but as compensation for accepting a risk which it is prepared to shoulder. This approach is consistent with the government's general approach to insurable risks which, on value for money grounds, departments themselves bear.

The Prison Service decided to take the £1 million as an immediate payment

1.30 The Prison Service considered the options of either spreading the £1 million due from FPSL over the contract period through a reduction in the annual contract price, or receiving it immediately following the refinancing. It agreed with FPSL to receive the £1 million in two instalments, the first on 30 November 1999 when the refinancing was completed, and the second on 31 March 2000. In receiving the payment up front, the Prison Service could be certain of receiving it in full; had the Service decided to take payment by way of a reduction in the contract price and the contract had indeed been terminated prematurely, then an element of the payment would remain outstanding.

11 In the event of contractor default, the termination liabilities would be the lesser of: (a) FPSL's lender liabilities; and (b) the net present value of the unexpired part of the contract, less any rectification costs which would be required to return the prison to an acceptable standard, less the additional cost (if any) of providing alternative accommodation for prisoners while rectification takes place, less any projected additional operating costs incurred in fulfilling the remainder of the services required under the contract up to the date when the contract would have otherwise expired.

The Prison Service also negotiated amendments to the PFI contract at the same time as the refinancing

1.31 The Prison Service was engaged in negotiations with FPSL over other matters relating to the PFI contract at the same time as it was negotiating the refinancing arrangements. These negotiations concerned the amounts which the Prison Service had, in accordance with the contract, deducted from the service payments to FPSL because FPSL had not met its contractual obligations in respect of the required service delivery. In addition, the Prison Service and FPSL were in discussions about the role of the prison and the impact this had on the payment deductions which the Service had made. As a result of these discussions, both parties agreed amendments to the contract covering the payment deduction criteria, the service specification and the sharing of occupancy risk.[12]

1.32 In finalising the discussions over the service payment deductions, the Service took account of the additional occupancy risk taken on by FPSL and agreed to waive £500,000 of the deductions. The Prison Service allowed FPSL to offset this refund against the £1 million payment FPSL was due to make to the Service following the refinancing.

1.33 At the end of November 1999, the Prison Service and FPSL entered into one new legal agreement which dealt with both the refinancing and the other contractual matters. This new agreement makes reference to the other contractual changes being in consideration of the Prison Service accepting increased termination liabilities arising from the refinancing. Both the Prison Service and FPSL say, however, that they agreed to deal with all these matters together in one agreement for convenience, but in all other respects the negotiations on the refinancing were kept separate from the other contractual negotiations.

12 By sharing occupancy risk, FPSL will not be paid in full should the Service not make use of certain prisoner places.

Part 2: Further refinancings of PFI contracts are likely to occur

2.1 The refinancing of the Fazakerley prison contract is one example of how shareholders can extract financial benefits both earlier and in greater quantity than the expected benefits originally disclosed in their consortium's bid for a PFI contract. There are likely to be similar opportunities in other PFI contracts, particularly those signed in the early stages of the development of this new form of procurement, and where the required service has subsequently been successfully provided by the private sector consortium. There can be, however, important consequences for departments arising from refinancings, and departments should consider what provisions they should make to share in some of the financial gains and whether their consent should be required before a refinancing can proceed.

Refinancing opportunities are inherent in all PFI deals

2.2 There are many different ways that the funding arrangements for a PFI project may be changed to increase or bring forward the financial benefits for shareholders. All PFI deals may therefore be subject to refinancing, the exact details of which will depend on the terms and nature of the project in question.

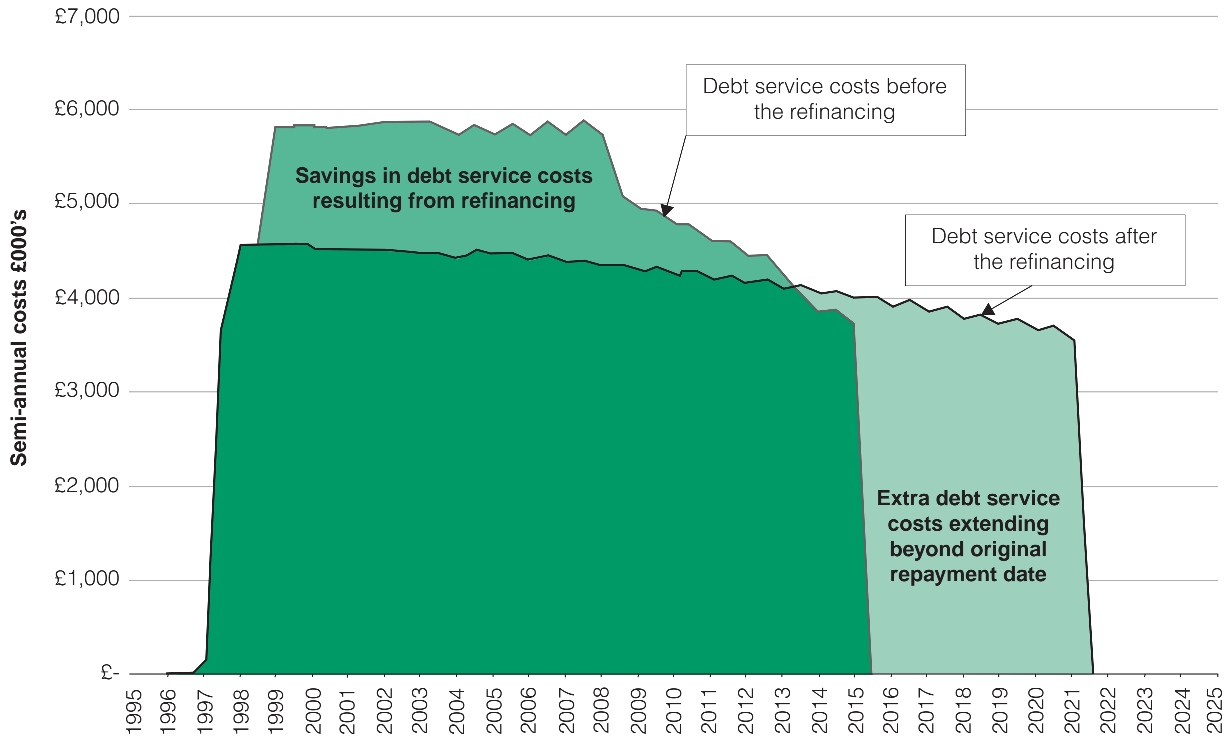
Benefits to shareholders may be improved by extending the term of the funding

2.3 A key element of the funding for many PFI projects is senior debt, so called because the lenders of senior debt have the highest ranking claim over the assets of the project company compared to all other funders and investors. The arrangements for repaying senior debt in many respects resemble a domestic repayment mortgage, whereby the project company makes regular instalments of principal and interest. A shorter term of loan will therefore require larger instalments to repay it in full than will a longer term loan of equal amount.

2.4 In the case of Fazakerley prison, one aspect of the refinancing involved extending the term of the senior debt from 20 to 26 years. This in turn reduces the level of instalments payable by the project company in the first 20 years leaving more free cash with which to pay dividends to shareholders, albeit at the expense of less free cash in years 21 to 26 (Figure 6). The additional value that this creates for shareholders, in present value terms, is £5.2 million.

Figure 6

How increasing the maturity of the senior debt facility for the Fazakerley project created £5.2 million of additional value for shareholders



The graph above compares the half-yearly instalments of principal and interest payable by FPSL under the original loan, with those payable after the refinancing. Due to the extension in the term of the loan, the proportion of principal payable in each period is reduced, creating savings for the company over the next 13 years. Thereafter, the company will face additional costs because the loan will not have been repaid in full by this time. However, because of the time value of money, the savings in the early years outweigh the costs in the final years, providing a net benefit to shareholders of £5.2 million.

Source: National Audit Office from information supplied by PricewaterhouseCoopers, FPSL's advisers

The cost of funding may be reduced where the construction or implementation phase is complete

2.5 One of the primary risks for the private sector in undertaking a PFI project is the construction of new assets required to deliver the specified service. Once the construction or implementation phase has been completed successfully, and the private sector has established a track record in the delivery of the service, the perceived risk of the project is lower.

2.6 A lending margin is added to the banks' own cost of providing a loan for a project, and serves both to provide the banks with a profit and to compensate them against the risk of non-payment. Once the service is up and running and the service provider has proved its ability to deliver the service, there is a reduction in project risk. As a result, the project company may be able to obtain a reduced lending margin either from its existing lenders, or by moving its debt to other lenders. This has the effect of lowering the total level of interest charged to the project company, leaving more free cash with which to pay dividends.

2.7 In the case of Fazakerley prison, one of the existing banks agreed as part of the refinancing to underwrite the full amount of the loan whilst reducing its lending margin from 1.5 per cent to 0.7 per cent (rising to 0.9 per cent in June 2005). Part of this reduction may be attributed to the lender's perception of reduced project risk, and the balance to the general downwards market trend in lending margins for PFI projects. The additional value created for FPSL's shareholders as a result is £2.6 million.

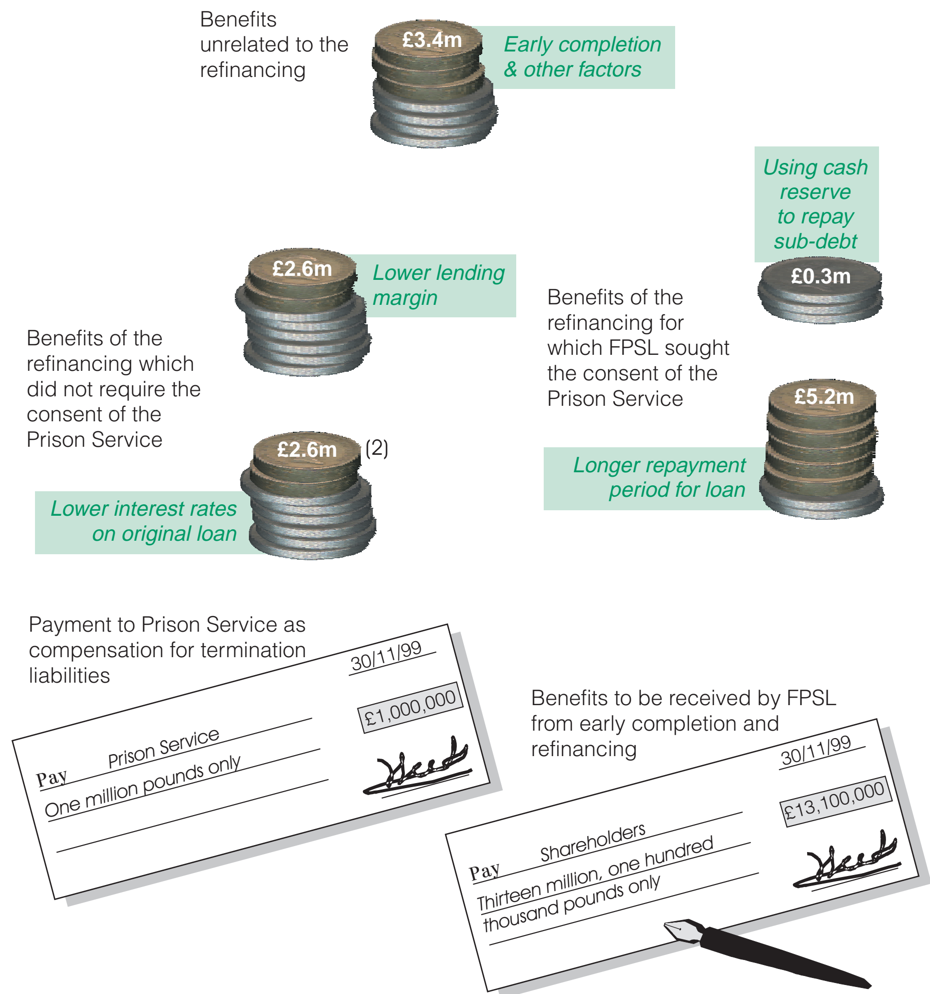
Shareholders may benefit from the early repayment of subordinated debt or equity capital

2.8 A common condition of banks lending to a PFI project is that the companies within the consortium provide a proportion of the total funding required on a basis subordinated to the banks. Shareholders, and on occasions external investors, usually provide such funding in the form of subordinated debt and equity. Its purpose is to provide the project company with adequate capital to absorb any adverse financial consequences arising from construction risks or poor performance in delivering the service specified. At the same time, this reduces the risks shouldered by the banks providing the senior debt.

2.9 Once the construction or implementation phase of a project is finished and the service is being delivered satisfactorily, banks may agree to relax their requirements for subordinated debt or equity because the project risks have reduced significantly.

The source of additional benefits that have been accrued by shareholders in FPSL since the inception of the contract

Figure 7



Notes: 1. Benefits are quoted as net present values as at 30th November 1999, based on a real discount rate of 6%.

2. It is unclear from the legal contract as to whether FPSL needed to seek Prison Service consent to extend the interest rate hedging arrangements to cover the remaining term of the existing loan facility and, therefore, whether the £2.6 million of refinancing benefits from lower interest rates on the original loan also depended on the Prison Service's agreement. FPSL's analysis of the benefits reflects its lenders' opinion that such consent was not required.

Source: National Audit Office from information supplied by PricewaterhouseCoopers, FPSL's advisers

This figure shows the different factors which contributed to the increase of £13.1 million in expected shareholder returns on the Fazakerley prison PFI contract. The shareholders made a payment of £1 million to the Prison Service to compensate the Service for the increase in termination liabilities arising from certain aspects of the refinancing.

2.10 There are benefits to the investors or shareholders from having subordinated debt or other investment repaid early on in the life of the contract, because they can generally find a more profitable use for these funds either by using them in other parts of their businesses or by making other investments. Repayment of these investments does not normally affect the ownership of the project company. The companies within the consortium will continue to be shareholders in the project company by virtue of nominal holdings of the project company's ordinary shares, and they will therefore continue to be entitled to receive dividends paid from profits on the project.

2.11 In the case of the Fazakerley prison, the shareholders put up some £7 million of subordinated debt for the project, the proceeds of which were placed on deposit and acted as a contingency reserve during the construction of the prison. Now that construction has been completed and the prison is operating satisfactorily, the banks agreed as part of the refinancing that a much lower level of reserve would be required and that most of the cash released could be used to repay the shareholders' original investment of subordinated debt. The total value created for the shareholders as a result is £0.3 million in present value terms.[13]

There may also be opportunities to take advantage of any general fall in interest rates

2.12 In most cases, departments will transfer the risk of future movements in interest rates after contract letting to the private sector. When pricing the contract, the private sector therefore builds into its bid the expected cost of financing the project based on the market's pricing at that time of what future interest rates will be. On signing the contract, the project company will, in most circumstances, then choose to mitigate interest rate risk by locking into a fixed rate of interest for the full term of the funding. This gives it assurance about what its future financing costs will be over the life of the contract so it can be sure that there will be sufficient revenue from the contract to meet these costs. It also relieves the department from concerns that the consortium may seek to pass on costs from rising interest rates even though this is a risk the consortium should bear.

13 The value created for shareholders from the repayment of the subordinated debt has been calculated using a public sector real discount rate of 6%. Shareholders would have evaluated aspects of the refinancing using their own discount rate which is higher than that of government and which would have made a more compelling case for the repayment of the subordinated debt.

2.13 Alternatively, the project company may, in exceptional circumstances, opt to leave itself exposed to future movements in interest rates so long as the procuring department does not perceive that this would put the company's viability in doubt should interest rates move upwards. If, over the life of the contract interest rates prove to be lower than the private sector had expected when it priced its bid, then its financing costs will also be lower than envisaged leading to higher profits and higher dividends for shareholders. Conversely, however, should interest rates prove to be higher than expected, then the returns to shareholders will be depleted and the project company may even become insolvent.

2.14 In the Fazakerley prison project, FPSL found it difficult to fix the interest rate for the full period of its bank loans on competitive terms because the financing market for PFI deals was in its early stages. FPSL therefore decided to lock into a fixed rate of interest only for the first ten years of its bank loan to 2005. This left the company potentially exposed to adverse movements in interest rates for the remaining ten years of the loan, unless it was able to pass this cost back to the Service through variations in the unitary charge.[14] At the time of the refinancing, two things had changed in favour of the company from which the shareholders have been able to derive a significant benefit. They are that:

- the market's pricing of future interest rates for the remaining term of the loan is lower than that assumed at the time the contract was originally priced; and

- the market in interest rate hedging instruments for longer periods has become more competitive. The benefit to the shareholders of being able, therefore, to lock into lower interest rates for the remaining term of the original loan is £2.6 million in present value terms.[15]

2.15 Having left itself open to changes in interest rate movements after 2005, the movement in the market's pricing of future interest rates has worked in FPSL's favour. If the consortium had been able to, and had chosen to, fix its rate of borrowing on competitive terms for the later years of the loans at the start of the contract, the potential for it now to profit from a fall in interest rates would have been reduced or eliminated. This is because the costs of unwinding an existing

14 Although the Prison Service and its legal advisers Freshfields consider FPSL would bear this risk, in our view the PFI contract was ambiguous about this (see paragraph 3.5).

15 FPSL actually chose to fix the interest rate for the full term of the new 26 year loan as part of the refinancing. It is uncertain whether FPSL required the Prison Service's consent for this. The banks were, however, willing to allow FPSL to fix the interest rate for the remaining term of the original 20 year facility without the need for consent.

fixed rate arrangement would normally equate to the benefits of entering into any new arrangement when interest rates change. Although in late 1995, it was generally more difficult and expensive to fix interest rates for longer than ten years because the PFI financing market was not fully developed, the financing arrangements for the Bridgend PFI prison project, which was developed in parallel with Fazakerley prison, did, nevertheless, include fixed interest rates for the full 18 years of the senior debt loan which matures in 2013.[16]

The type of funding used for the project may affect the ability to refinance

2.16 In the refinancing of the Fazakerley prison project, FPSL approached its original arrangers, (ABN Amro and Bank of America) along with other providers of finance (including an existing lender, new banks and bond arrangers). FPSL asked them to bid either to renegotiate the terms of the existing loan facility on a more advantageous basis, or to arrange a bond issue as a competitive alternative. One of the original lenders, ABN Amro, was successful in this bidding process and underwrote the whole new loan on improved terms. Any of the other original lenders that were not prepared to continue lending on these new terms received a small payment to compensate them for being repaid earlier than expected.

2.17 Where other PFI projects have been funded through the issue of bonds to a wide variety of investors, opportunities for refinancings are less likely. This is mainly because there are often penalties for making an early repayment on a bond issue.[17] These penalties may serve to reduce or eliminate any benefits from refinancing therefore rendering the whole exercise of limited value. In addition, the project company may find it more difficult to renegotiate the terms of finance. This is because, rather than dealing with a small number of banks, it would need to approach all the investors who hold the bonds. This presents practical problems, particularly if the bonds are bearer instruments meaning that the holders can remain anonymous. Moreover, investors in bonds tend not to be as close to the project as a lending bank, and may not therefore appreciate the reasons why they are being asked for improved terms.

16 See the National Audit Office report, “The PFI contracts for Bridgend and Fazakerley Prisons” Figure 7, page 42 (HC253 1997-98)

17 The penalties compensate investors for loss of future interest. The basis for calculating the penalties is set out in the listing prospectus for the bond issue.

2.18 If the bonds have been sold instead to one or a limited number of select investors through a mechanism known as a private placement, there may be more scope for a refinancing because there are fewer logistical problems in negotiating with investors.

Refinancing opportunities apply especially to early PFI deals

2.19 Early PFI deals, in particular, are subject to refinancing opportunities. This is due to a number of factors:

- **The prospect of a future refinancing was not reflected in the price of early PFI contracts.** When bidding for the initial tranche of PFI projects many consortia, including FPSL, say that they did not reduce their bid price for the contracts on the expectation of being able to refinance on improved terms and reduce their costs. The procuring authority will have had, therefore, to rely on competitive pressures to drive the best price from the bidders. Consortia took into account that the first PFI projects were not guaranteed to be a success and that, if the projects were subsequently successful, they considered any refinancing benefits would be a reward for bearing the risk of these early projects failing. There is therefore a strong incentive for companies involved in successful early PFI deals to refinance now, where the benefits of doing so largely accrue to them alone.

- **The cost of funding has reduced because more lenders are willing to take the risks of PFI projects and margins are therefore reducing.** There is growing confidence within the financial markets that PFI projects are a good investment. A result of this confidence is that more banks and investors have entered the market and reduced their required rates of return from projects.

- **Borrowing rates generally have fallen in recent years.** Due to prevailing economic conditions and the competitiveness within the banking industry, rates for all types of borrower have fallen as reflected in lower lending margins charged by banks.

- **Funding is more widely available for longer periods which improves the cashflow for the company undertaking a project.** Refinancing now can enable the project company to extend the period over which loans

need to be repaid. This reduces the level of instalments payable and the resultant savings can be passed on to shareholders through earlier dividends than would otherwise have been available.

Refinancings can lead to increased termination liabilities for departments

2.20 The rationale for termination payments in the case of the Fazakerley prison project is explained in paragraph 1.13. Such provisions are common in PFI contracts for similar reasons. These payments remain as contingent liabilities for a department when a refinancing takes place, but the potential level of liabilities can increase as a result.

Termination liabilities crystallise when a PFI contract is terminated prematurely

2.21 Termination payments are intended to ensure, in the event of a PFI contract being prematurely terminated: firstly that the lenders are repaid in part or in full including any interest due, depending on the circumstances leading to the termination; and in certain cases[18] to compensate the investors for the loss of future profit which would otherwise have been derived from the remaining contract period. In the event of contractor default the lenders and investors may not recover all of their investment in the project, but in all termination situations the termination payments are in respect of the surrender of assets which usually return to the public sector.[19] The level of payments made by a department depends, therefore, on the reason for the termination and on which party elected to terminate the contract.

2.22 Under the terms of some of the early PFI deals, one method of calculating termination payments is to relate them to the level of the outstanding borrowings of the consortium and any interest which is due and payable. The termination payments may also include the costs of unwinding any arrangement used to fix the applicable interest rate. In certain circumstances, as with the Fazakerley prison contract, the payments may instead be based on the residual value of the contract to the private sector with a cap of no more than the amounts owed by the consortium to its lenders.

18 This may include voluntary termination by a department.

19 In this case the prison would revert to the Prison Service, but this asset is unlikely to have a realisable cash value which the Service could offset against the termination payments.

2.23 The Treasury guidance on PFI contractual terms which was published in July 1999 advises that termination payments for contractor default should instead be based on the market value of the remaining contract.[20] This is intended to make lenders bear a greater amount of risk where termination is due to contractor default.

Termination liabilities may increase as a result of a refinancing in a number of ways

2.24 Termination payments are only contingent liabilities for a department upon the event of a refinancing, but the level of those liabilities may increase if:

- the refinancing includes an extension in the period over which loans are repaid, which results in a higher level of debt outstanding for a longer period of the contract;
- the refinancing involves the consortium borrowing more money, for example, to repay the shareholders' subordinated loans or other investments;
- the refinancing involves the release of cash reserves which would otherwise have been used to reduce the level of outstanding debt upon a termination occurring; or
- the refinancing involves the use of additional financial instruments to manage interest rate risk on which there are potential penalties to pay if these are broken early.

2.25 The July 1999 Treasury guidance cautions against financial arrangements by a consortium which increase a department's termination liabilities and either:

Treasury guidance reference
Paragraph 14.6.8

- change the consortium's returns from the project in a way which undermines the stability and sustainability of a successful long term relationship between the department and the consortium; or

Paragraph 21.3.5

- result in levels of debt within the consortium in excess of the capital value of the project.

20 The Standardisation of PFI Contracts paragraph 20.2.6 (HM Treasury July 1999).

Part 3: There are general principles which departments can apply to refinancings

3.1 Refinancings are complex financial arrangements. Departments will need to consider the implications of refinancings on a project by project basis. There are, however, principles which should guide departments and strategies which can help departments apply the principles.

Departments should consider a range of principles when they assess a refinancing

3.2 There are a number of principles which departments should keep in mind when they assess issues relating to refinancing. These principles will be relevant when a PFI project is being developed and also if a department is faced with a possible refinancing during the contract period. The key principles are that:

- appropriate benefits should go to those bearing risks;
- benefits from reducing costs in a developing market should be shared if they have not already been reflected in the contract price;
- it is reasonable for departments to seek compensation for any increased exposure to termination liabilities arising from a refinancing;
- substantial refinancing gains to the private sector may threaten the perceived value for money of the project;
- a refinancing should not jeopardise the stability and success of the long term relationship between a consortium and a department; and
- if the private sector seeks to improve its returns by renegotiating parts of a PFI contract it is reasonable for departments to seek a share of refinancing benefits.

Appropriate benefits should go to those bearing risks

The private sector will be entitled to benefits from favourable movements in interest rates where it bears the related risk

3.3 Provided that the risk of both favourable and adverse movements in interest rates has been properly priced in competition in the original contract and is borne fully by the private sector, then it is reasonable that the private sector should receive the full benefit, or adverse consequences, of subsequent interest rate movements. This is a normal business risk which the private sector is used to managing. If, however, it is clear that the public sector is paying too much for the transfer of this risk, or if the payment mechanism does not transfer this risk fully to the private sector, then it is reasonable for the public sector to negotiate a share of refinancing benefits arising from favourable interest rate movements.

Favourable movements in projected future interest rates produced a £2.6 million benefit for FPSL shareholders

3.4 Projected future interest rates had fallen between December 1995 when the Fazakerley PFI prison contract was let, and November 1999 when the refinancing was completed. During this period, FPSL had been exposed to the possibility of variations in its interest costs after December 2005. As a consequence of the reduction in projected future interest rates since the inception of the contract, a £2.6 million benefit has accrued to shareholders (paragraph 2.14).

Ambiguity in the PFI contract would have allowed the Prison Service to seek a share of these benefits

3.5 In our view the Fazakerley PFI prison contract was ambiguous about whether costs arising from adverse interest rate movements could be included by FPSL in any permitted claim which it submits for price variations at five yearly intervals.[21] If, as the Prison Service and Freshfields considered, FPSL had clearly been bearing the risk of adverse interest rate movements, it would have been reasonable for FPSL to receive the £2.6 million benefit from favourable interest rate movements. On the basis of our view, however, the Prison Service could have sought to negotiate a share of the £2.6 million benefits as a reward for the risk it had borne through the ambiguity in the contract.

21 See paragraph 2.42 of the National Audit Office report on The PFI Contracts for Bridgend and Fazakerley prisons (HC253 1997-98). The contract did not explicitly exclude financing costs from the costs which FPSL could include in such a claim.

Benchmarking can help identify where there is scope to share in refinancing benefits

As a new market develops, contract prices may reduce or increase

3.6 In a developing market, the private sector should become better at pricing contracts correctly. Prices on later deals may therefore be lower or higher in comparison with similar, earlier deals but are unlikely to be the same. In the context of the PFI, because the public sector pays predetermined, fixed charges over the term of the contract, it is protected against these charges increasing if the contract was originally under-priced by the supplier. Alternatively, where the contract was over-priced originally, if the public sector has no provision to share in any benefit of cost reductions, then it may become locked into long term contract prices which are out of line with lower prices on subsequent PFI contracts.[22]

Cost reductions have been achieved on PFI projects as the experience of operating PFI contracts has grown

3.7 The prices of early PFI contracts reflected the private sector's caution about predicting costs over a prolonged contractual period in the absence of experience. Since then, contractors have become more confident about pricing contracts as their experience of PFI has grown. Banks were similarly cautious in their approach to funding early PFI deals because of their perception of the risks involved in long term projects under a new form of procurement. Since the early projects, financing costs (as reflected by lending margins) too have reduced as the PFI market has developed and contractors have demonstrated their ability to manage these projects successfully.

On early PFI deals, the benefit of such cost reductions should be shared between the private and public sectors

3.8 Early PFI deals, such as the Fazakerley PFI prison contract, were priced in the absence of the increased confidence and lower costs which now prevail in the PFI market. Both the private and public sectors may have a justifiable claim for sharing in the benefits arising from these cost reductions. In the context of refinancings, Treasury guidance recognises that, for novel projects, financing rates are likely to reduce as market familiarity develops, and this is one of the limited situations where the sharing of refinancing benefits may be justified. The

22 Benchmarking, in this case, would apply to on-going costs and would assist the public sector customer in achieving cost reductions in line with prevailing market prices.

guidance also says the same principles should apply where competition for the underlying services has been poor and, therefore, the future benefits of refinancing may not have been priced in the original bid.[23]

Benchmarking can help to identify cost reductions

3.9 Benchmarking is a technique whereby a contractor's prices for certain services are compared with prices charged by other contractors for similar services. As Treasury guidance recognises, if the contractor's prices are higher than the prevailing market prices, then they should be adjusted on an agreed basis to reflect the differential.[24] In including such provisions in a contract, departments need to balance the potential benefits with the impact this may have on the opening price of the contract. Also, alongside the possibility of benefiting from reducing market prices, departments may need to permit upwards adjustments to the contract price in the event of increasing market prices.

3.10 The public sector has tended to use benchmarking to assess the price for facilities management, information on which can be obtained easily from alternative suppliers. This technique could also be used to compare the terms of finance on an existing PFI project with those pertaining to more recently signed deals of a suitably similar nature. This will provide departments with a better platform from which to discuss the sharing of any refinancing benefits where this is justified. The Treasury intends to give further consideration to these and other issues related to benchmarking in its forthcoming review of guidance on PFI financing issues.

Benchmarking techniques would have given the Service important information about the source of refinancing benefits for FPSL

3.11 The shareholders in FPSL derived £2.6 million of refinancing benefits from the reduction in the lending margin (paragraph 2.7). This reduction was the result of two factors. First, it reflected the fact that FPSL had successfully overcome the construction risks of the project and had established a track record of operation. Secondly, it reflected the keener pricing of finance for PFI prison deals generally available by late 1999, and therefore brought the cost of finance for the Fazakerley project into line with more recent PFI prison contracts. For example, financial savings, together with construction and operational savings, contributed to the

23 Paragraph 14.6.4 of the aforementioned Treasury guidance on refinancing.

24 The Standardisation of PFI contracts paragraph 14.4.1 (HM Treasury July 1999).

lower pricing of the Lowdham Grange PFI prison contract let in November 1996. This contract price was 36 per cent cheaper per prisoner place than Fazakerley[25]. The Prison Service notes that the lower price on the Lowdham Grange contract was also attributable to the prison having a lower security classification than the Fazakerley prison. The price per prisoner place of the Agecroft prison, which is similar to the Fazakerley prison and was let in July 1998, was also 36 per cent cheaper than Fazakerley. The Prison Service considers that, in addition to general improvements in financing terms, the price reductions on later PFI prisons reflect the success of its procurement strategy which has developed from the original Fazakerley and Bridgend competitions.

3.12 There were no provisions in the original contract for the Prison Service to use benchmarking to align FPSL's price with market rates.[26] Benchmarking principles may, nevertheless, have helped the Prison Service identify how much of the reduction in the lending margin on the Fazakerley project was attributable to the improvement in financing terms for PFI prisons generally. In the absence of other negotiating stances, it could then have pressed for a share of the refinancing benefits on the grounds that some of these benefits were extraneous to FPSL's success with the Fazakerley contract. This would have rewarded the Service for the risks it had borne during the early stages of the PFI prison programme, although FPSL could argue that its success with Fazakerley brought knock-on benefits for the Prison Service by increasing lenders' confidence in subsequent contracts.

It is reasonable for departments to seek compensation for any increased exposure to termination liabilities

The Prison Service used this approach to secure £1 million from the Fazakerley refinancing

3.13 If a department accepts any adverse consequences from a refinancing then it is reasonable for it to seek compensation for this by sharing in the refinancing benefits. The situation which the Prison Service faced in the case of Fazakerley, which will arise on many refinancings, is that its liabilities in the event of contract termination increased as a result of the refinancing. The Service was correct in

25 The National Audit Office report on the PFI Contracts for Bridgend and Fazakerley prisons paragraph 1.27 (HC 253 1997-98).

26 The National Audit Office report on the PFI Contracts for Bridgend and Fazakerley prisons paragraph 2.42 (HC 253 1997-98)

negotiating compensation arrangements before agreeing to accept these higher termination liabilities and, as described in Part 1, secured a £1 million payment from FPSL.

Future refinancings should not increase termination liabilities arising from contractor default

3.14 The July 1999 Treasury guidance recommends that, in the event of contractor default, a department's termination liabilities should be determined by reference to the market value of the contract (paragraph 2.23). If this basis is adopted, the termination liabilities in the event of contractor default should not be affected by any changes in the capital structure of the defaulting contractor whether through refinancing or otherwise. In respect of other termination scenarios, such as through the fault or volition of the department where compensation payments refer directly to senior debt, termination liabilities may still increase as a result of refinancing.

Substantial refinancing gains to the private sector may threaten the perceived value for money of the project

Large private sector gains in the early years of a project may attract criticism

3.15 Experience on privatisations has shown that if the private sector makes large windfall gains in the early years after taking over a public sector activity, there is a perception that the original deal was wrongly priced and represented poor value for money for the public sector.

It is important, however, to assess value for money by reference to the whole life costs and benefits of the project

3.16 Departments should always take into account the costs and benefits which are expected over the full life of a PFI project when assessing whether the contract represents value for money. This approach should be adopted when assessing the value for money of contractors' original bids and the final contractual terms, and in any subsequent assessments of value for money during the contract period. It is equally appropriate, therefore, for departments to reassess the value for money of a PFI project when faced with a possible refinancing. Where, as a result, a department has concerns about the value for money assessment, it should consider using the benchmarking principles outlined at paragraphs 3.6 to 3.12 as a basis for negotiating a share of refinancing benefits.

The Fazakerley refinancing has yielded substantial gains for FPSL but the project has brought rewards for the Prison Service

3.17 When the Prison Service awarded the Fazakerley PFI prison contract in 1995, it estimated that the contract, worth £247 million, would only deliver marginal financial savings of £1 million (less than one per cent) compared with a similar project under traditional procurement[27]. Our analysis shows that the total expected payments to FPSL shareholders increase from £17.5 million to £30.6 million as a result of the early delivery of the prison, lower costs and the refinancing (Figure 2, page 4). As a result, the shareholders' projected rate of return has increased from 16 per cent[28] to 39 per cent. Although the £1 million compensation which the Prison Service has secured is consistent with its estimate, based on cautious assumptions, of the extra financial risk it will bear in respect of increased termination liabilities, FPSL's shareholders will receive the balance of £9.7 million (91 per cent) of the benefits arising directly from the refinancing. The refinancing could, therefore, be perceived as having provided FPSL with substantial rewards from a contract which only offered marginal value for money at the time it was awarded. The award of the Fazakerley and Bridgend contracts has, however, enabled the Prison Service to stimulate competition for subsequent PFI prisons in turn leading to greater savings.

3.18 Any assessment of a contract's value for money should also take into account all the costs and benefits that are likely to arise from the contract. The Fazakerley contract has contributed to a range of financial and non-financial benefits that are not reflected in a simple comparison of the contract price with the cost of a traditional publicly funded project.

3.19 The Fazakerley prison was opened five months ahead of schedule, to a timetable that was significantly faster than traditional prison building programmes, and has generally been operating satisfactorily. The success of the Fazakerley prison - the first prison under the PFI - has enabled the Prison Service to take forward its PFI prison programme which currently comprises seven prisons either in the stage of procurement or construction. These prisons should provide much needed additional prisoner places at a cost which should deliver significant savings compared with traditional procurement, and at a time when it

27 The National Audit Office report on The PFI Contracts for Bridgend and Fazakerley Prisons, Figure 10, page 46 (HC 253 1997-98).

28 The projected rate of return to shareholders was 12.8 per cent at the time the contract was awarded (Figure 7, page 42 of the aforementioned National Audit Office report). The projected rate of return had increased to 16 per cent just before the refinancing as a result of cost efficiencies by FPSL.

is unlikely that public finance could have funded such a programme. The Prison Service sees these benefits as rewards which flow from its decision to enter into the Fazakerley contract with FPSL in 1995. FPSL says that its pricing of the contract reflected the risks involved in developing a PFI project in a new sector. In addition, assuming the contract is not terminated prematurely, the refinancing has not increased the cost of the prison for the Service.

A consortium's refinancing should not jeopardise a stable and successful long-term relationship with a department

3.20 In certain cases, for example by accelerating payments to shareholders, a refinancing may change the pattern of risks and rewards for consortium shareholders which is appropriate for a sustainable long term relationship with a department. Departments should, therefore, assess the pattern of expected shareholder returns and how these will be affected by a proposed refinancing, to satisfy themselves that there will continue to be an appropriate incentive for the consortium to maintain the quality of service desired while delivering the project at a price which is value for money. Departments should also be concerned by any refinancing proposal which involves releasing cash reserves tied up in the project company, as these reserves can also act as a continuing incentive to maintain the quality of service as well as provide financial stability to the project company. Departments should seek suitable financial advice in respect of these issues.

If the private sector seeks to renegotiate a contract, it is reasonable for departments to share refinancing benefits

3.21 The terms set out in a PFI contract should generally remain in force throughout the contract period except where both parties agree that particular terms are impractical. Departments should resist any contract variations which may reduce the value for money of the project for the public sector. If, however, a consortium seeks to renegotiate parts of a contract in order to improve its own returns from the project then, as an alternative to rejecting such proposals, departments could reasonably seek a share of any refinancing benefits that may arise. In such circumstances, departments should avoid agreeing to variations to the existing contract before they are certain that the refinancing, and the associated benefits, will definitely be achieved.

3.22 At the time that the Prison Service was negotiating with FPSL over the Fazakerley prison refinancing, it was also involved in parallel negotiations on other contractual issues (paragraphs 1.31 to 1.33). In this case, these other

contractual negotiations did not materially affect the value for money of the deal, and so the Prison Service quite reasonably did not seek trade-offs between the two sets of negotiations.

There are strategies which can help departments apply the principles

The possibility of withholding consent to a refinancing will place a department in a strong negotiating position

In certain circumstances departments should have the right to approve a refinancing

3.23 When departments negotiate PFI contracts, they need to give thought to the implications of any future refinancing and to consider whether, in certain circumstances, they wish to have the right to consent to a refinancing before it proceeds. In the refinancing of Fazakerley, there was some uncertainty as to whether the Prison Service's consent was required, but FPSL's lenders asked for consent because they recognised that their ability to recover their loans in the event of a premature contract termination might otherwise be impaired (paragraph 1.21).

3.24 Departments should ensure that their PFI contracts are quite clear on the circumstances under which their consent to a refinancing proposal is required. There are two situations in particular, namely:

- if the refinancing will produce any adverse outcome for the department (paragraph 3.25); and
- if the department wishes to reserve the right to negotiate a share of the refinancing benefits (paragraph 3.26).

3.25 Departments should ensure that their consent will be needed for any refinancing proposal which could produce an adverse outcome for them. This should include any proposal which could increase the department's termination liabilities. Departments should also have the right to object to any refinancing arrangement which could destabilise the project and threaten the service delivery. If, for example, a consortium significantly increases the gearing of the project (the proportion of the total funding represented by bank borrowings), then this could increase the financial risks for the consortium possibly leading to insolvency or other default under the PFI contract.

3.26 Departments should also consider, on a contract by contract basis, whether they wish to have broader rights to approve refinancing proposals so that they have a strong position from which to negotiate a share of any refinancing benefits. They should bear in mind, however, that such rights may affect the pricing of the contract at the outset, whereas if there is strong competition, contractors may price their bids more keenly in the knowledge that they will keep the benefits from any future refinancing.

3.27 The situations where a department may wish to have the right to negotiate a share of future refinancing benefits include[29]:

- where the PFI contract price does not represent good value for money;
- where it may be difficult to form a view on this because the contract was not priced under competitive conditions (in these circumstances there may be doubts as to whether anticipated future gains from a refinancing are already reflected in the consortium's pricing of the contract);
- where the project is novel and there is a likelihood that the financing charges for similar projects will reduce within a short timescale; or
- where the department is bearing any risk relating to future movements in interest rates during the contract period.

Approval rights will place a department in a strong negotiating position

3.28 Where departments have the right to approve a refinancing proposal, this will place them in a strong negotiating position. They should not, however, unreasonably withhold their consent. If, for example, a department only has the right to approve a refinancing where its termination liabilities increase, it should not use the threat of withholding this consent unreasonably to negotiate on other aspects of the refinancing proposal. An exception to this might be where the consortium has itself attempted to reopen other aspects of the contract.

3.29 Where a department has broader contractual rights to negotiate a share in the benefits of a refinancing, then it should seek to negotiate the best possible deal without jeopardising its long term relationship with the consortium. This should

29 See also paragraph 1.8.

help departments share in a higher proportion of the refinancing benefits than did the Prison Service – who lacked such broad contractual rights and could only negotiate over certain aspects of the refinancing – in the case of Fazakerley.

FPSL's lenders sought Prison Service approval to aspects of the refinancing giving rise to benefits of £5.2 million

3.30 It was not clear from the Fazakerley prison PFI contract whether the Prison Service's approval was required for those parts of FPSL's proposed refinancing which involved extending the period over which the loan would be repaid and fixing the interest charge for the extended period, together worth £5.2 million to FPSL's shareholders. Nevertheless, FPSL's lenders asked for consent because they recognised that their ability to recover their loans in the event of a premature contract termination might otherwise be impaired (paragraph 1.21).

The Prison Service was in a strong negotiating position because it had been asked to consent to the refinancing

3.31 Once FPSL had asked the Prison Service to consent to the refinancing, this placed the Prison Service in a strong position to negotiate over those aspects of the refinancing about which it was concerned. As explained in Part 1 of this report, the Prison Service did not agree to give its consent to the refinancing until it had received an offer from FPSL of compensation consistent with the Service's estimate, based on cautious assumptions, of the extra financial risk it would bear in respect of increased termination liabilities.

Departments should consider what the consortium's alternative is if approval to the refinancing is withheld

3.32 In any negotiating situation, it is good practice to consider what alternatives are open to the parties involved. In the context of refinancing negotiations, departments who have secured a right to approve part or all of a refinancing proposal should consider what would happen if they withhold their consent.

3.33 In the case of Fazakerley, the Prison Service calculated that FPSL would still have been able to secure £5.2 million of the refinancing benefits without consent. This is because some of the terms of the refinancing would still generate benefits for FPSL without increasing concurrently the Prison Service's termination liabilities. This knowledge assisted the Prison Service in its negotiations. In addition, the Service and Rothschild discussed with FPSL and its advisers some possible alternative approaches to the refinancing (paragraph 1.25). We consider,

however, that a fuller assessment of these alternatives and the commercial pressures facing FPSL would have shown that the Prison Service was in a stronger negotiating position than it had realised.

3.34 Firstly, although FPSL considered that it could have secured benefits of £5.2 million[30], at the time of the refinancing, without the Prison Service's consent there was uncertainty about whether £2.6 million of these benefits did, in fact, require the Service's consent.[31] Secondly, although the terms of the refinancing had been agreed in April 1999, in the second half of 1999 FPSL was under great time pressure to complete the refinancing. Tarmac wished to have the subordinated debt it had lent to FPSL repaid so that there would be increased liquidity in Tarmac's year-end balance sheet at 31 December 1999. Thirdly, because of expected uncertainty in the financial markets leading up to the end of the millennium, FPSL wished to complete the refinancing by no later than 30 November 1999. Finally, FPSL's shareholders had been advised of the proposal which, after paying the Prison Service £1 million, would yield benefits of £9.7 million before the end of 1999 and it would have been very difficult for FPSL to put forward revised plans which proposed either deferring or reducing these benefits.

3.35 The Prison Service could have considered making use of the time pressures faced by FPSL to press for a greater share of the refinancing benefits, although this would have meant reopening the agreement it had already reached with FPSL. Although the £1 million share compensated the Prison Service for its increased exposure to termination liabilities, the Service had been possibly exposed to the consequences of adverse movements in interest rates (paragraph 3.5), benchmarking showed that the pricing of the Fazakerley contract was now out of line with other PFI prison contracts (paragraphs 3.11 and 3.12), and the Service had, like FPSL, borne risks when the PFI was being developed as a form of procurement (paragraph 3.12). These are arguments which the Prison Service could have pursued further in negotiations with FPSL given the Service's strong negotiating position. The Prison Service considered, however, that it had agreed a deal with FPSL as its PFI partner and, were the situation reversed, it would not want a contractor to reopen negotiations at a late stage.

30 This relates to the benefits from the lower lending margin (£2.6 million) and the fixing of interest at lower rates for the remaining term of the original loan facility (£2.6 million), see Figure 7 page 25.

31 For the reasons set out in Note 2 to Figure 7, page 25.

Linking advisers' remuneration to the outcome of negotiations may be helpful

3.36 Where departments are seeking to maximise the benefits they secure from financial negotiations with consortia, they should consider linking at least a proportion of their advisers' remuneration to the sum achieved. This will create an incentive for advisers to help departments achieve the best possible outcome.

3.37 The Prison Service did not adopt this strategy. Rothschild told us that, in addition to assessing the impact of the refinancing on the Service's termination liabilities, it gave the Prison Service some initial broad advice on how the Service might approach the negotiations. Rothschild was not, however, asked to lead the negotiations or to attend any negotiation meetings. Nor was it asked to provide any detailed briefing to the Prison Service on how the negotiations should be conducted to achieve the best outcome. The Prison Service's decision to handle the negotiations itself was based on a view that this was the best approach given its experience in negotiating PFI prison contracts and the good working relationship it had developed with FPSL in relation to Fazakerley prison.

3.38 Although the Prison Service was experienced in awarding PFI contracts, it had never before been faced with a refinancing. Also, Treasury guidance on standard PFI contract terms, which includes refinancing issues, was only issued towards the end of the negotiations over the Fazakerley refinancing. The Prison Service used its advisers well in assessing the impact of the refinancing on its termination liabilities, but the refinancing also increased significantly the rewards FPSL would receive from the project compared with those anticipated when the Prison Service originally let the contract. The Service might, therefore, have achieved an even better deal if it had asked its advisers to consider whether there were issues other than the increase in termination liabilities which were worth negotiating over and, if so, sought more input from its advisers during the negotiations.

3.39 The Service decided to remunerate Rothschild based on hourly rates. During the negotiations with FPSL, the Service arranged for FPSL to pay the Service's advisers' costs. The Service made this arrangement because the refinancing had been proposed by FPSL and it was FPSL who would receive most of the resulting benefits. We are concerned that such an arrangement could have created a restriction on the extent to which the Service could use its advisers. The advisers' costs were £40,000 for a transaction which yielded benefits of £10.7 million and took a year to complete (partly attributable to periods of inactivity in the negotiations). Both the Prison Service and Rothschild say, however, that there was no such constraint in practice.

Glossary of terms

bond issue	A method of borrowing by which debt is raised from a wide variety of individual or institutional investors. Bonds usually carry a fixed coupon payable by the issuer (borrower) to the bondholder (investor) and have a predetermined repayment date.
breakage costs / (profits)	The costs (or profits) of withdrawing from *interest rate hedging* agreements prior to the end of the contracted period for such agreements. The extent of costs (or profits) incurred depends on the nature of the hedge and the market conditions prevailing at the time of breakage.
cash reserve	Accounts set up by the project company containing cash balances earmarked to meet future liabilities as they arise, for example cost overruns on the construction of the prison or future major maintenance programmes or debt service.
debt service costs	The periodic instalments of loan principal and interest, and associated fees and commissions, due from a consortium to its lending banks.
discount rate	The percentage rate applied to cash flows to enable comparisons to be made between payments occurring at different times. The rate quantifies the extent to which a sum of money is worth more to the Government today than the same amount in a year's time.
fixed interest rate	A rate of interest which is guaranteed not to change for the period over which the fix prevails.
floating / variable interest rate	A rate of interest which varies periodically in accordance with a stated market reference, usually the London Interbank Offered Rate (LIBOR).
FPSL	Fazakerley Prison Services Limited; the consortium company - set up and owned by Tarmac (now Carillion) and Group4 - which has entered into the contract for the Fazakerley prison with the Prison Service.
hedging / interest rate hedging	Instruments used by the consortium company to manage the risk of variations in future interest rates. In most cases, the company will choose to fix its future interest rate thereby providing it with surety about what its financing charges will be.
interest / lending margin	An additional amount that a bank charges on a commercial loan over and above its own cost of providing the loan. The margin serves to provide the bank both with a profit and compensation against the risk of not having the loan repaid.

Invitation to tender	A formal communication to selected suppliers.
lender liabilities	A defined term in the contract between FPSL and the Prison Service which, in certain circumstances, determines the amount of compensation payable by the Prison Service to FPSL's banks in the event of the contract being terminated prematurely. It is based on the aggregate of outstanding loan principal and interest and *breakage costs*, less amounts standing to the credit of the equity reserve.
present value / net present value	The discounted value of a series of payments occurring over time taking into account the extent to which a sum of money is worth more to the Government today than the same amount in a year's time.
private placement	The issue of bonds to a limited number of select institutions.
refinancing	The process by which the terms of the funding which was put in place at the outset of a PFI contract, are later changed during the life of the contract, usually with the aim of creating *refinancing benefits* for the consortium company.
refinancing benefits	The benefits to shareholders of increasing and/or bringing forward their *returns* from the project as a result of changes to the financing structure of the consortium company.
residual value of contract	The net present value of the contract to FPSL as at the date of termination, as defined in the contract between FPSL and the Prison Service.
returns to shareholders	Payments made by FPSL to its shareholders (Tarmac – now Carillion – and Group4) in the form of dividends, interest on subordinated debt, and repayment of subordinated debt principal.
senior debt	Debt that, in the event of bankruptcy, must be repaid before *subordinated debt* receives any repayment. Senior debt lenders have the highest ranking claim over the assets of the project company compared to all other lenders and investors.
subordinated debt	Debt over which *senior debt* takes priority. In the event of bankruptcy, subordinated debt lenders receive payment only after senior debt is paid off in full.
term / repayment period of loan	The date by which the last instalment of principal is due so that the loan is repaid in full.
termination liabilities	The amount of compensation payable by the Prison Service to FPSL's banks in the event of premature contract termination (see paragraph 2.21 and footnote 11, page 19). Depending on the circumstances of the termination, the compensation may be *lender liabilities* or the *residual value of the contract*.

unitary charge	The single periodic payment due from the Prison Service to FPSL in respect of the provision and operation of the prison.
working capital	In this context, cash flows resulting from the variations in current assets and liabilities of FPSL.

Appendix 1: Methodology used by the National Audit Office

1 The National Audit Office examined the extent to which the Prison Service achieved its objectives in the refinancing negotiations with FPSL and whether there were any general lessons to be drawn for such negotiations in the future.

2 The National Audit Office used an issue analysis approach to design the scope of the examination and this identified three main issues, namely:

i) whether the Prison Service achieved its objectives for the refinancing;

ii) whether further cases of refinancings are likely to recur; and

iii) whether there were general principles which departments can apply to refinancings.

3 The main areas of analysis carried out by the National Audit Office were:

- Financial models relating to the refinancing in November 1999 and the PFI contract award in December 1995 (supplied by FPSL's advisers PricewaterhouseCoopers) were compared to produce an analysis of the sources of the benefits that had accrued to FPSL's shareholders since December 1995 as a result of the refinancing and other factors (Figure 7, page 25);

- Calculations of the impact of the refinancing on the Prison Service's termination liabilities and the expected additional costs arising for different probabilities of contract termination (supplied by the Prison Service's advisers Rothschild) were reviewed (Figure 3, page 15 and Figure 5, page 19); and

- the contract between the Prison Service and FPSL was examined to identify what rights the Prison Service had to share refinancing gains and approve FPSL's refinancing proposals.

4 The National Audit Office team for this examination included staff who had previously worked in the field of project finance. The National Audit Office was also advised by solicitors Theodore Goddard in respect of legal issues relating to the refinancing.

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Notes: References refer to paragraph numbers in Parts 1, 2 and 3; ES indicates paragraphs in the Executive Summary on pages 1-7; a number followed by (n0) refers to a footnote attached to the paragraph – for example 1.2(n6) refers to footnote 6 to paragraph 1.2.

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