Report by the
Comptroller and Auditor General

The Prison Service

The refinancing of the Fazakerley PFI prison contract

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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

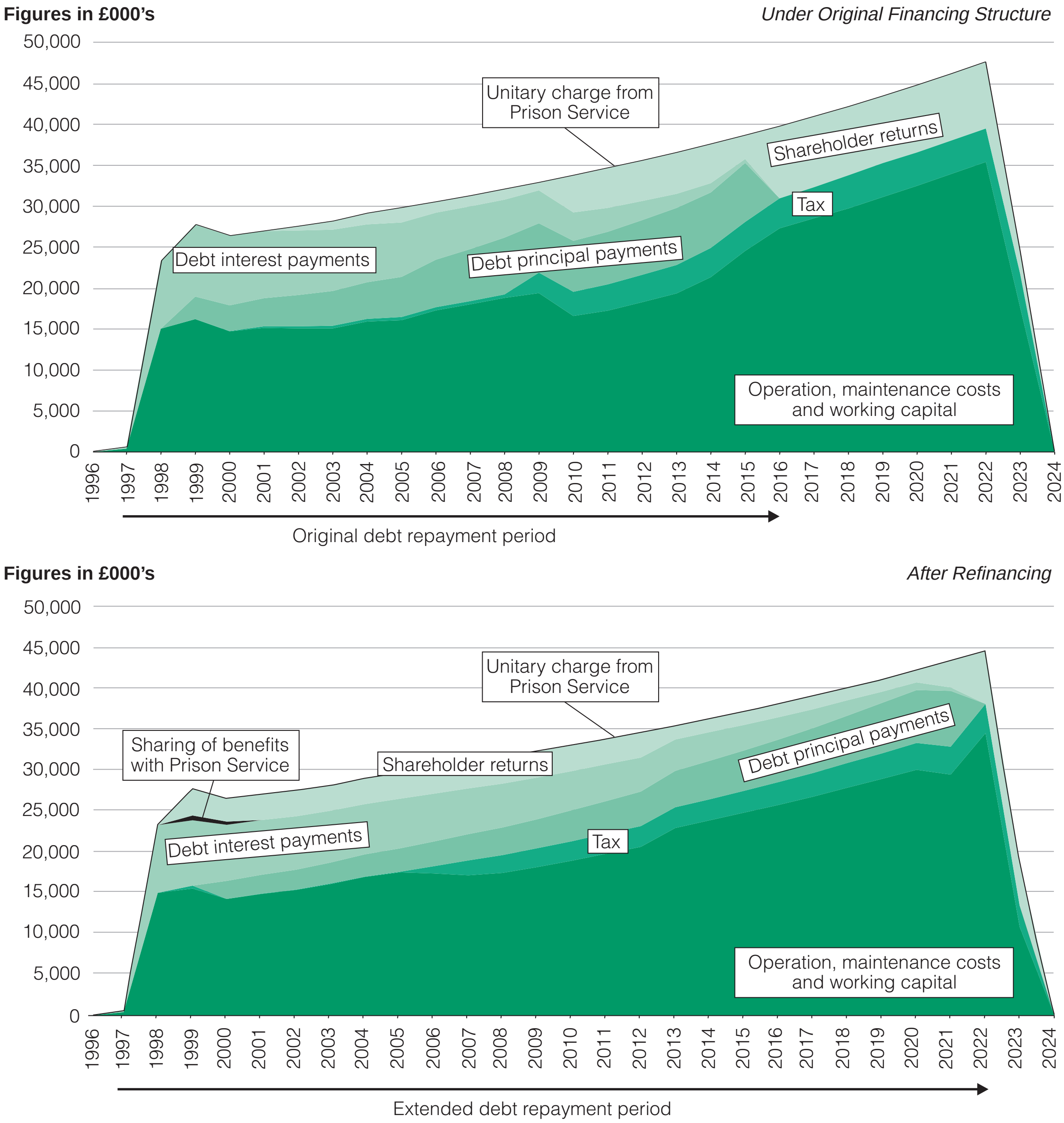
3 The refinancing has been a major factor - but not the only one - in increasing shareholder returns. FPSL had already been rewarded financially by completing the prison ahead of schedule and by achieving savings on construction and commissioning costs. These factors, in combination with the refinancing,

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.

Figure 2

Summary of increase in expected returns to FPSL's shareholders

	£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**	

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.

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

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.