NATIONAL AUDIT OFFICE

PFI refinancing update

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 1288 Session 2001-2002: 7 November 2002

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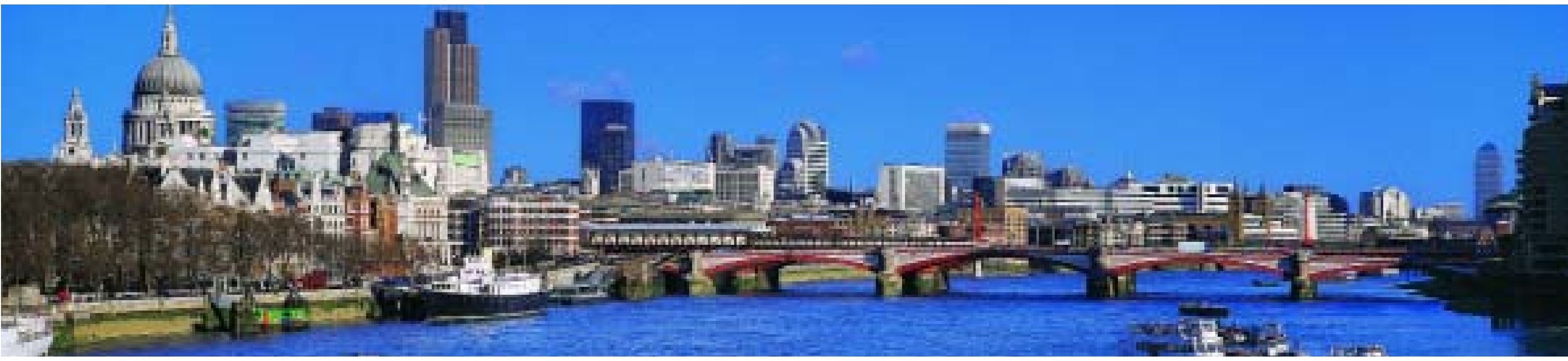
PFI refinancing update



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John Bourn
Comptroller and Auditor General

National Audit Office
4 November 2002

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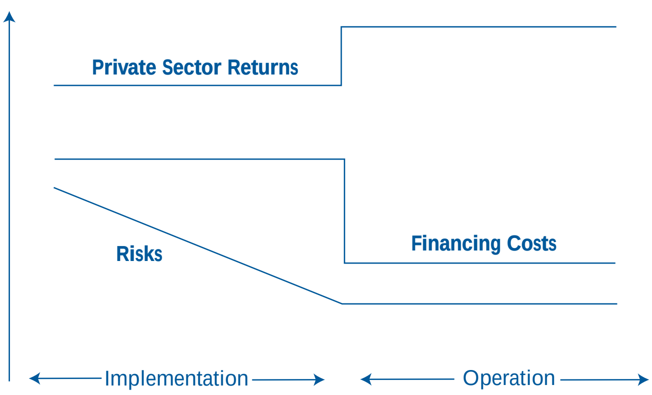
1 In June 2000 we published a report on the refinancing of the Fazakerley PFI prison contract.[1] Having considered the report and taken oral evidence, the Committee of Public Accounts (PAC) published its own report.[2] Both reports highlighted the potential for the shareholders of private sector companies contracted to deliver PFI projects to increase their returns significantly by refinancing the projects **(Figure 1)**.

2 The PAC recommended that departments should share in the financing benefits from a successful PFI project and that the Office of Government Commerce (OGC) should complete its planned updating of central guidance on refinancing as a matter of priority.

1 Relationship between risk and returns in a typical PFI contract

This figure shows that, once the required service has been brought into operation, the project risks are lower, as the risks associated with commencing service delivery are no longer relevant. This creates opportunities to reduce the annual financing costs, as funders are prepared to offer better terms for projects with lower risks. Improved financing terms have also been possible in early PFI projects as PFI has become an established procurement method with which the financing market is familiar. Lower annual financing costs improve the returns that can be paid to the private sector shareholders.



NOTE

1. These are the expected returns to the private sector shareholders over the life of the contract. The returns normally become payable to the shareholders once the implementation of the service has been successfully inaugurated.

Source: National Audit Office

1 *HC584 1999-2000.*
2 *HC995-i) 1999-2000.*

3 We examined how far the OGC and departments have responded to these reports. The methodology we adopted to undertake this study, based on a wide ranging survey of PFI contracts, is set out in Appendix 1. In summary we found that:

- Early PFI deals: The OGC is now helping departments to generally secure 30 per cent of future gains in those cases where the contract does not explicitly entitle the department to a share of such gains;
- New PFI deals - guidance: Over the past two years, the OGC has carried out a large work programme to change the approach by departments and the market to refinancing, culminating in the publication of revised guidance in July 2002; and
- New PFI deals - implementation: The benefits of most refinancings of new deals will be shared 50/50, but the implementation of the new approach will need to be carefully managed.

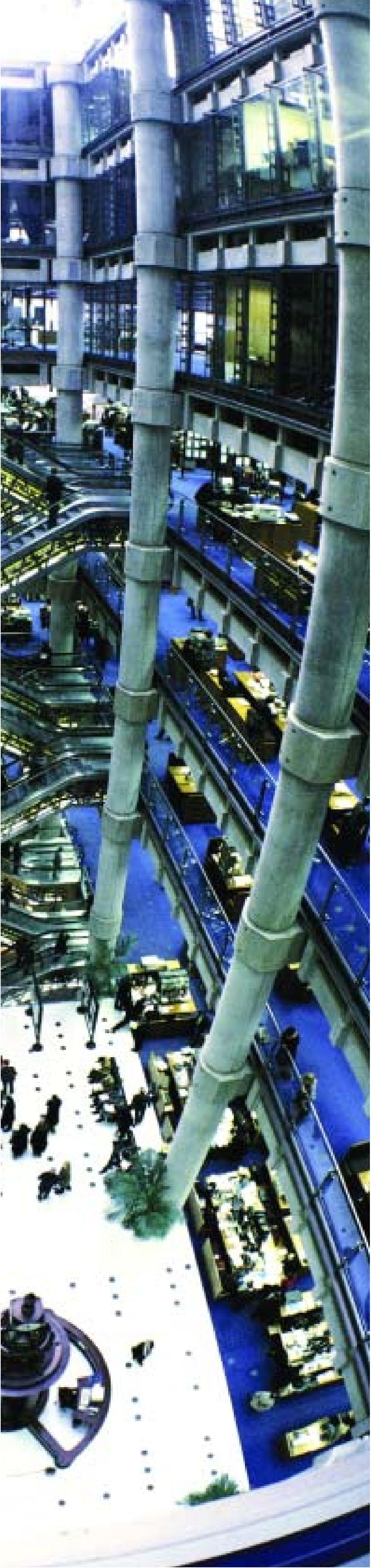
The OGC is helping departments generally to secure a 30 per cent share of future refinancing gains on early PFI deals

4 Refinancing is an established technique whereby improved financing terms can be obtained in projects where risks have been successfully managed. Only one in four of the early PFI contracts, however, had clear arrangements to share refinancing gains. The 1997 and 1999 guidance referred to refinancing but did not recommend seeking particular shares of refinancing gains. This reflected the Treasury's desire to encourage the development of the PFI market and its recognition that contracts for similar projects in other countries did not then normally provide for the sharing of refinancing gains.

5 Deals originally without arrangements to share refinancing gains had been concluded by departments on the basis that they would deliver value for money to the taxpayer. If the taxpayer now gets the benefit of a 30 per cent share of refinancing gains, then such a deal will be even better value for money than it was before. But, as the PAC pointed out, a refinancing that results in rewards for the private sector which are not commensurate with their risks can call into question the value for money of the original deal.

6 Following both NAO and PAC concerns about the lack of sharing by the public sector in such refinancing benefits, the OGC, with assistance from the Treasury Private Finance Unit and Partnerships UK (PUK), has taken the initiative in devising a centrally led strategy to seek a better share of the refinancing gains on these early deals. A new voluntary code of practice, which the OGC launched in October 2002, states that departments should generally receive a 30 per cent share of future refinancing gains on these early PFI deals. This code has been launched with the support of the CBI.

7 If these arrangements work effectively, a 30 per cent share of refinancing gains on early PFI deals will be a considerable improvement over what the contract terms for most of these deals would have achieved. There can be no guarantee that the new arrangements will work, as they are based on a voluntary code and will not be contractually binding - although the emphasis upon public sector contractual approval rights being exercised, to the extent that they exist, does provide some leverage, which has been recognised by the private sector. There are still some concerns in the private sector about, for example, how the gains to be shared will be computed.



8 The OGC acknowledges that a good deal of further work will be required to gain full benefit from the new arrangements. A PUK task force is being established to assist OGC in providing central support to departments whose early PFI deals may be refinanced under the code. The extent to which the new code proves effective will be very important. Although new contracts are now required to include arrangements to share refinancing gains, 61 per cent of contracts we surveyed (covering the whole of the period the PFI has been operating), do not have these arrangements. For the next few years, departments, in most cases, will be reliant on the new voluntary code to secure a share of gains where projects are refinanced.

9 We were advised by departments of 12 projects which had completed refinancings **(Figure 7, page 14)**. The outcome to the public sector varied but in nine of the 12 cases departments received a share of the gains with seven receiving at least 25 per cent. Based on departmental information, the public sector has secured at least £17 million out of total benefits of about £65 million from the 12 cases. But we also found evidence that other refinancing gains may have arisen without departments being aware. A lack of information about the contractors' financing, or understanding of situations where refinancing gains may have arisen, can result in departments not being aware of all refinancing gains.

Over the past two years, the OGC has carried out a large programme of work to change the approach of departments and the market in new contracts

10 During the past two years, the OGC has also been engaged in extensive work to bring about the desired change in the way refinancing is dealt with in new PFI contracts. It has had to define a proposed policy approach, carry out research to confirm that the policy approach was appropriate and deliverable and identify issues involved in implementing the policy. It then had to develop effective new guidance covering many complex issues and to secure the agreement of both departments and the private sector to the new arrangements. In developing this new approach the OGC was able to draw on the commercial experience on financing issues within PUK. As a result of this work, the OGC has changed the approach of departments and the market to how refinancing will be dealt with in new PFI contracts. This has been set out in the new OGC guidance, which ensures wide powers of approval and audit of refinancings for the public sector and that in most situations refinancing gains arising from new contracts will in future be shared 50/50.

11 Following the earlier NAO and PAC reports on refinancing, the Treasury and OGC took prompt steps to start to develop this new approach. The final stage of what proved to be an extensive programme of work - the publication of detailed revised guidance to reflect the new approach which was already being adopted on many new deals - took longer than the Treasury initially informed departments. It had told the PAC that guidance would be issued in spring 2001. The OGC made initial drafts of the detailed new guidance with model contract terms available to departments in autumn 2001 and they were able to use this in drawing up new contracts. Following extensive consultation with departments and the private sector the OGC refined the guidance and contract terms and published it in final form in July 2002.

12 The OGC attributes the time needed to complete the final guidance to the extensive work required to develop guidance for this complex topic and the need to agree it with both departments and the private sector. As potentially very large amounts of money and the continued participation of the private sector in PFI were at stake, the discussions with the private sector in effect

became detailed commercial negotiations. The OGC placed importance on developing the new refinancing guidance as part of an update of the comprehensive guidance on PFI contractual issues. It wanted this whole package to be accepted by both departments and the private sector at the same time. The OGC notes that, as the new refinancing provisions were seeking to improve the position of the public sector, there was little incentive for the private sector, made up of its various interests, to reach an early agreement. The private sector told us that it had concerns about the way in which the development of the new guidance was managed and considers that lessons could be learned for the future.

13 In the meantime, there has been a significant improvement in the proportion of new contracts with arrangements to share refinancing benefits. Since June 2001 91 per cent of contracts have included sharing arrangements and 50/50 sharing of refinancing benefits is now the norm **(Figure 2)**. It took some time for this new policy to become established as some deals with other arrangements (often a 30 per cent share for the public sector) were already at an advanced stage of negotiation and detailed revised guidance for new deals was being developed.

2 Sharing of refinancing gains has become much more common

	Prior to June 2000	Year to June 2001	Since June 2001
Contracts with at least 50% share	4%	4%	75%
Contracts with share of 30% or less	22%	50%	16%
Contracts with sharing arrangements	**26%**	**54%**	**91%**

Source: National Audit Office

The benefits of most refinancings of new deals will be shared 50/50, but this new approach will need to be carefully managed

14 These new 50/50 sharing arrangements should significantly improve the returns that departments receive from future refinancings of new contracts and largely reflects previous NAO and PAC recommendations. Departments will have contractual rights to approve, and audit, any refinancing situation where the department may be entitled to a share of any gains and to generally approve any situation which could increase their liabilities in the event of the contract being terminated. This will enable departments to ensure they receive the appropriate share of any gains and that they have the right to refuse additional liabilities. However, there are risks that departments will need to carefully manage. The main risks are:

- As some types of refinancing are excluded from the requirements for contractors to share the benefits with the public sector, this may encourage contractors to arrange their refinancings to take advantage of these exclusions.
- As with the voluntary code for existing deals, there could be disagreements over how the gains to be shared will be computed.
- Departments depend on contractors informing them of situations in which refinancings occur so there is a risk they could take place without the department knowing about them. The OGC thinks this risk is very small, as contractors would risk termination of the contract for failure to disclose a relevant refinancing.
- The new arrangements are intended to improve the value for money of the deal for departments. They would fail to do so if contractors, individually or collectively, obtain compensating improvements to the pricing or terms of deals that more than offset the share of refinancing benefit being given to the public sector.
- The general principle of 50/50 sharing does not apply to refinancing gains which make good any shortfall with respect to the contractor's originally expected returns. This potentially reduces the incentive for the contractor to perform well after the contract has been let. There might also be an incentive for contractors to quote unrealistically high expected rates of return when bidding. The OGC and PUK consider, however, that there is a low likelihood of these risks materialising in practice.

15 The OGC intends to emphasise the need to manage these risks. Authorities will need to follow the new PFI and other best practice guidance and draw upon the expertise of PUK and the authorities' advisers. Monitoring will be carried out by the OGC, supported by PUK and by Treasury expenditure teams.

16 As the growing maturity of the PFI market is increasingly enabling better terms of financing to be obtained at the outset, future refinancing opportunities may be reduced. Nevertheless, it is very likely that the private sector will continue to seek refinancing opportunities wherever possible. As our survey identified, the private sector may also seek new opportunities, such as refinancing a group of projects. Refinancing will, therefore, continue to require careful attention by departments.

Recommendations

17 As a result of this examination we make the following recommendations:

a) The OGC's central approach to negotiating a 30 per cent share of the refinancing gains on early PFI deals is one of several examples where a collective approach by the OGC to negotiations with the private sector has been beneficial. There may be other areas of the public sector where it may be appropriate to consider whether benefits would arise from the negotiating strength of government as a single body.

b) The OGC should take steps to ensure departments are fully aware of the issues covered in the new OGC guidance. Refinancing issues are complex and our work has shown that departments may not always recognise situations that give rise to refinancing gains. Departments need to : better understand the situations that could give rise to refinancing benefits; to be able to compute correctly their share of refinancing gains; and to manage the risks attached to making the new arrangements work effectively. As well as carrying out its plan to encourage departments to follow the new OGC guidance and to consult PUK on refinancing matters, the OGC has agreed that this issue should also be addressed as part of the new Successful Delivery Skills training programme for the public sector. It also proposes to arrange seminars for departments to improve their awareness of the issues involved and to share experience.

c) Where a complex area of new central policy is to be introduced, initial feasibility work should be undertaken to establish a realistic timetable for the implementation of the policy. If this indicates that a long period will be needed to develop the new central policy, or the guidance that departments will need to implement the policy, the Treasury and OGC should consider carefully whether departments should be given interim guidance. It may be helpful to outline the issues that departments will need to keep in mind pending the finalisation of the new policy and how it will be implemented.

d) Departments should gather sufficient information to assess whether their refinancing arrangements are increasing value for money to the taxpayer. This needs to take account of any effect refinancing gain sharing arrangements may have on the pricing of contracts and on incentives to contractors to perform throughout the contract period. The OGC should gather feedback from departments on these matters to enable it to assess the effectiveness of the new approach to refinancing that has been adopted across government.

e) Departments should obtain from their contractors sufficient information about their financing to ensure that they are aware of all refinancings for which the benefits should be shared. This information should be sufficient to enable departments to be aware of any significant changes to a project's financing structure and to understand whether or not such changes will create refinancing benefits.

f) Given the complexities and specialist nature of refinancings, departments should seek advice on refinancing matters from suitably experienced advisers including OGC and PUK as appropriate. Advice should be taken, initially, when reviewing bids and financing proposals to identify the scope for refinancing and should always be sought when faced with any refinancing situation (including situations that may have been described as a "financial restructuring").

Part 1

Early PFI deals

1.1 In the early days of PFI, departments were not encouraged to seek a share of refinancing gains. In part, this reflected the Treasury's desire to encourage the development of the PFI market and its recognition that similar deals overseas did not then usually have contractual arrangements to share refinancing gains. As the PFI market has matured and projects have been successfully implemented this has created opportunities for many early PFI deals to be refinanced as the risks attached to the projects have reduced. In light of emerging experience, and following NAO and PAC concerns in 2000 and 2001 about the lack of sharing of refinancing gains, the OGC has taken the initiative in devising a strategy which has led to a voluntary code launched with the support of the CBI. Under the code, departments will generally seek a 30 per cent share of future refinancing gains on these early deals where the contract does not explicitly provide for a share. If achieved, this will be a considerable improvement over what the contract terms for these deals would have achieved. But there are risks attached to making this voluntary agreement with the private sector work. A good deal of work will be required to gain full benefit from the new arrangements which will need to be utilised in many future refinancing situations.

There are opportunities to refinance PFI projects and there are many ways in which this may come about

1.2 A refinancing in its broadest sense can be any change to a project's original financing arrangements. Such changes often involve taking advantage of more advantageous financing terms that can improve a project's cash flows. This is a technique that is often used in project finance and is not solely related to PFI deals. Refinancings tend to fall into two categories:

- Those undertaken for the purpose of rectifying or avoiding actual or potential default under existing financing arrangements, commonly known as a "rescue refinancing"; and
- Those undertaken with the intention of improving the financing terms in a successful project. This can improve the cash flows and can also increase the shareholders' returns from the project. Such improvements in returns are commonly known as "refinancing gains".

1.3 While it is not possible to give a comprehensive definition of all situations that may give rise to refinancing gains, some typical situations are shown in **Figure 3**.

3 Changes in financial arrangements that may indicate a refinancing

There has been an increase in the number of years over which the consortium will repay its financing

There has been a change in the consortium's finance provider

There has been a reduction in the "margin" used to determine the amount of interest payable on the financing

There has been a reduction to the consortium's borrowing costs as a result of fixing interest rates lower for the balance of the contract term than had been expected at contract letting

There has been a repayment to the consortium's shareholders of some or all of their equity or subordinated debt (usually facilitated by introducing into the project new finance from other sources)

Constraints on dividend payments have been removed or eased

There has been a change in the financing arrangements that allows the reserve accounts to be reduced or released

Source: National Audit Office

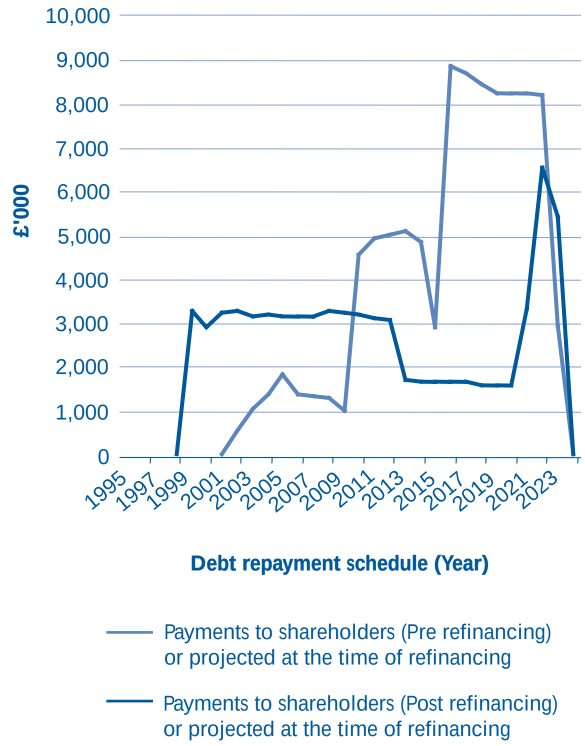
1.4 A number of factors create opportunities to refinance PFI projects, some of which are particularly relevant to early PFI projects:

- **Improved financing terms may be available once the required service has been implemented satisfactorily**. The terms of finance are linked to project risks. Once a service is operational and the initial implementation risks have been dealt with, funders may be prepared to improve the terms of the original financing. This may include a change whereby the private sector shareholders in the project can be repaid most of their original investment. This can significantly improve the shareholders' rate of return, as they continue to earn dividends from the project but on a lower level of investment.
- **Financing terms for all PFI projects have improved because more lenders are willing to take on the risks of PFI projects**. The financing terms for early PFI deals reflected the risks of funding a new form of procurement with newly developed contract terms. Subsequently, there was an increase in confidence within the financial markets that PFI projects could be a good investment or credit risk. More banks and investors entered the market and terms improved, including lower interest margins and longer loan terms.
- **Borrowing rates generally have fallen in recent years**. Prevailing economic conditions and general competitiveness within the banking industry have caused base interest rates and margins for most types of commercial borrowing to fall.
- **Funders earn fees for arranging new forms of finance**. Funders can earn fees both from arranging financing for a new project or from arranging or underwriting a refinancing for an existing project. They therefore have an incentive to seek refinancing opportunities, either as an arranger or as an underwriter of a refinancing. Alternatively, a funder of an existing project may choose to use a refinancing as an opportunity to withdraw funds from the project to seek new opportunities to fund other projects. This can help to facilitate the flow of deals that the market is financing.

1.5 A refinancing has the effect of bringing forward distributions to shareholders **(Figure 4)**. Because earlier distributions will be worth more to the shareholders, this has the effect of increasing their returns from the project in net present value terms. Also, as this is often accompanied by a repayment to the shareholders of some of their initial investment in the project, this can produce a significant increase in their returns relative to funds invested in the project. This was illustrated in the Fazakerley prison refinancing, where the shareholders' rate of return increased from 16 per cent to 39 per cent as a result of the refinancing.[3]

4 How the Fazakerley prison refinancing increases – and brings forward – the returns to the shareholders of the consortium

The figures below show how the Fazakerley prison refinancing affects returns to shareholders of 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 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.



Source: National Audit Office based on Figure 3 from the PAC report HC (995-i (1999-2000)

3 *National Audit Office report on the refinancing of the Fazakerley PFI prison contract, paragraph 3.17.*

Before our previous refinancing report, departments had generally not sought a share of refinancing benefits

1.6 Early central guidance did not encourage departments to seek a share of refinancing benefits. Our report on the refinancing of the Fazakerley prison contract, and the subsequent PAC report, together with emerging experience, gave the public sector a more detailed awareness of refinancing issues and highlighted the significant gains that can arise from refinancings. Our current work confirms that only one in four of early PFI contracts have clear arrangements to share refinancing benefits.

In early PFI deals departments were generally not encouraged to put in place explicit sharing arrangements

1.7 Taking advantage of better financing terms through a refinancing is an established technique which can help a project's cash flows. It can, as a result, significantly improve the returns which the shareholders in the project will receive. A key principle of PFI projects is that appropriate benefits should go to those successfully managing risks. In the context of the PFI partnerships which the Government is seeking to establish with the private sector it is reasonable for the private sector to benefit from refinancings where it has successfully managed project risks and its overall returns from the project following the refinancing are commensurate with the risks it has borne. It may also be reasonable for the public sector to seek a share in refinancing gains. Sharing these gains is consistent with the concept of partnership. Refinancing gains, if not shared, could adversely affect the perceived value for money of PFI projects.

1.8 There were references to refinancing in 1997 and 1999 Treasury guidance but these did not establish a general principle of sharing refinancing gains. Early guidance in 1997[4] said departments and their advisers should consider the private sector's scope for refinancing and try to capture some of the benefits. The 1999 guidance[5], based on greater experience of the UK PFI market, said the sharing of refinancing gains is likely to be appropriate only in limited circumstances but also said authorities should bear in mind the potential risks to perceptions of value for money if they were unable to share in significant refinancing gains. This approach reflected the then Treasury view that the value for money of PFI had to be evaluated in the round and that seeking to share in refinancing benefits would not necessarily result in good value. There were risks that contractors might seek an unduly large price increase to compensate for sharing later potential refinancing gains. The Treasury was also aware that, where private finance had been used to fund public infrastructure overseas, these arrangements did not usually include contractual provisions for the public sector to share in refinancing gains.

1.9 The early approach to refinancing also reflected the Government's desire to stimulate the PFI market, which it believed could be damaged if inappropriate claw-back arrangements were entered into. It considered that contractors would be less likely to take on the risks inherent in PFI projects if they were being asked to share the potential refinancing benefits with Government. The Treasury Taskforce was also trying to encourage competitive pricing of PFI contracts and wanted to avoid the possibility of refinancing clauses pushing bid prices higher.

We reported on the first major PFI refinancing

1.10 The NAO published a report in June 2000 on the refinancing of Fazakerley prison that highlighted the issue of refinancing in PFI deals. This report, together with the subsequent PAC report, reinforced by NAO seminars and media coverage of the issues, as well as emerging experience elsewhere, gave the public sector and its advisers a more detailed awareness of refinancing issues and highlighted the need for authorities to address this issue when negotiating contracts. The recommendations set out in these reports are summarised in Appendix 4.

1.11 In the Fazakerley prison refinancing, completed in 1999, the Prison Service secured £1 million of the £10.7 million refinancing gain. The contractors' returns increased from 16 per cent to 39 per cent as a result of the refinancing, largely because shareholders were able to reduce their level of funds invested in the project. The £1 million return to the public sector was given to compensate the Prison Service for its increased termination liabilities.

1.12 Our report also set out guiding principles on refinancing **(Figure 5)**.

4 *The Treasury PFI Panel guidance on further contractual issues.*
5 *1999 Treasury Taskforce Standardisation of PFI Contracts.*

5 General principles that departments can apply to refinancings

- 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
- 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.

Source: National Audit Office

1.13 At the PAC hearing on the NAO's Fazakerley prison refinancing report in November 2000, the Prison Service said that it had been in the dark about refinancing both when letting the Fazakerley contract in 1995 and when faced with the refinancing in 1998 and 1999. The Treasury acknowledged that there had been a lack of knowledge in departments about refinancing in the early days of the PFI. It said that changes had been, and were continuing to be, made in the light of experience and that more changes would be made in guidance to be issued in spring 2001.

Subsequent surveys have confirmed that most early PFI deals do not contain arrangements to share a refinancing gain

1.14 The PAC survey in July 2000 found that 24 per cent of contracts at that time had arrangements to share refinancing gains. A November 2000 NAO survey[6] found only 15 per cent with sharing arrangements (a lower percentage because the sample was biased towards early contracts that had been let for over a year).

1.15 Our current survey confirms the findings of the previous surveys. This found 26 per cent of contracts let before the NAO report in June 2000 had a sharing arrangement. Only half of these (13 per cent) would always require the authority's approval for a refinancing, with an agreed basis for sharing refinancing gains. The level of deals with sharing mechanisms began to rise after the standard contract terms were issued in 1999.[7]

The OGC has taken the initiative in devising a strategy to seek a better share of the refinancing gains on early deals to address earlier concerns

1.16 Contracts without arrangements to share refinancing gains had been concluded by departments on the basis that they would deliver value for money to the taxpayer. This was usually based on the results of a competitive procurement and a comparison with a conventional procurement option (the public sector comparator). But often the initial evaluation was without full information on the possible effect of a future refinancing. Contractors cannot be certain when bidding for a contract that they will be able to refinance the project and have generally not disclosed when bidding what the effect of a refinancing would be. But it has, nevertheless, become a reasonable expectation that many projects will be refinanced assuming they are delivered successfully. As the PAC has pointed out, where a private sector contractor is able, from refinancing, to significantly increase its rewards in excess of those disclosed when bidding for the contract as reasonable for the risks being borne, this can create a perception that there may have been scope at the outset to improve the deal for the public sector. If the prospect of refinancing, and its impact on returns from the project, had been a factor in negotiations at the outset, this might have changed the assessment of value for money at contract letting.

1.17 Following NAO and PAC concerns about the lack of sharing of refinancing benefits, the OGC has made new arrangements for helping departments to share refinancing gains on early PFI deals. OGC drew heavily upon the expertise of PUK, which was set up to assist in such matters, and also received assistance from the Treasury Private Finance Unit. Establishing such arrangements has not been easy, given that in many cases the private sector has been under no contractual obligation to share refinancing benefits. Drawing upon extensive research commissioned from PUK, the OGC evaluated the following options in respect of these early deals:

a) To let refinancings on early deals be dealt with in accordance with each individual deal's specific contract terms. This would generally give departments little or no share of refinancing gains.

6 *Managing the relationship to secure a successful partnership in PFI projects (HC 375 2001-02).*
7 *As reflected in Figure 12, page 25.*

b) To encourage public sector project teams to negotiate individually for a share of the refinancing gain on each deal where there was no contractual sharing provision. For example, by using as a negotiating lever any requirement to approve all or part of any refinancing (e.g. where increases in termination liabilities would arise).

c) To draw up a code of practice stating that the public sector should receive a specified share of the gains from future refinancings of early deals; to be implemented by authorities with additional dedicated central support made available to the public sector in the form of a PUK refinancing taskforce.

1.18 All three options would only apply to deals that are refinanced after the OGC reaches agreement with the private sector about these new arrangements and would therefore not re-open deals which have already been refinanced.

1.19 The OGC decided to pursue option c), a code of practice. The OGC considered this would achieve the best outcome for the public sector by using the negotiating power of central government acting collectively, making use of considerable assistance from PUK to implement such a code. This option would also produce an outcome that could be applied consistently to future refinancings of existing PFI contracts and would reduce the need for each project team to spend time negotiating with their contractors over how refinancing gains should be shared. The OGC considers that a voluntary agreement will also minimise the risk of adverse consequences for the PFI market and wider damage to private sector willingness to contract with the public sector for fear of retrospective government action.

1.20 Because many of the early PFI deals do not have contractual arrangements to share refinancing gains, there is no contractual obligation on the private sector to agree to sharing. This meant that the OGC had to discuss with representatives of the private sector a level of gain sharing that would be considered reasonable by both sides.

1.21 The OGC decided to seek a 30 per cent share of the refinancing benefits on these early contracts. The OGC took into account that, although its aim was to seek a 50 per cent share in future new contracts, it would be unreasonable to expect this percentage in existing situations where the contracts did not provide for sharing refinancing gains. It was aware that a 30 per cent share had been built into a number of new contracts in the interim period in 2000-2001 while it was revising its guidance on refinancing and considered that this would be a very good outcome to achieve on the early deals. Early deals previously assessed as value for money but without a right to share refinancing gains would be even better value for money if the public sector obtained 30 per cent of any refinancing gains.

1.22 Following extensive discussions with a range of private sector stakeholders, the OGC launched in October 2002 a voluntary code of practice for early PFI deals. The code was launched with the support of the CBI. Under this code, departments will generally seek to receive 30 per cent[8] of any future refinancing gains on early deals where the contract does not explicitly provide for a share of such gains. This applies to all deals entered into before the OGC's arrangements for new contracts to include 50/50 sharing came into operation. If achieved, a 30 per cent share for departments of the refinancing gains on early PFI deals will be a considerable improvement over what the contract terms for most of these deals would have achieved.

1.23 Private sector representatives told us that they had always considered it had a reasonable right to retain refinancing gains on early PFI deals as a reward for taking on the risks of these new projects. Although most early PFI deals had not contractually required the private sector to share refinancing gains, the private sector had entered into the discussions with the OGC about sharing the refinancing gains on these deals in response to strong pressure from the OGC that this issue should be addressed. There was a concern that refinancing gains might create adverse perceptions about the value for money of PFI deals that could damage the PFI market. The OGC has gained the private sector's acceptance that some of the gains from refinancing existing deals should be shared as a way of further developing the PFI market. The private sector recognises the high standards of public accountability that are required in PFI deals. They told us they had sought to be helpful in agreeing to share refinancing gains on early deals but stressed that further clawbacks of profits by the public sector could result in reduced interest by contractors, banks, and other investors in participating in future PFI projects.

8 Where existing PFI deals have clear contractual arrangements for the public sector to receive a share of refinancing gains then those arrangements will continue to apply, except in certain cases where the contractual share to the public sector is less than 30 per cent and where the public sector's approval for the refinancing is required or where the private sector has sought to improve its returns through other renegotiations of the contract. In those circumstances, the public sector will expect to apply the code to improve its share of the refinancing gains to a share not exceeding 30 per cent.

The outcome of future refinancings of early PFI deals will depend on making the new arrangements work

1.24 The new voluntary code is being offered to authorities as the basis for negotiations on any future refinancings of their past PFI projects. The code intends that, other than the proposal that 30 per cent of refinancing gains should be shared rather than 50 per cent, many of the details should be consistent with the revised general guidance relating to new contracts.

1.25 As to situations where the new code may be applied, ten authorities (seven per cent of our survey) said they were aware that their contractors had plans to refinance **(Figure 6)**. In addition, the private sector consortium for the Norfolk and Norwich hospital project is thought to be planning a refinancing. This information may, however, be an understatement of all the plans that may be in train to refinance early deals. Authorities may not always receive information about the planning of refinancings and the private sector may have deferred some refinancings because of uncertainty about what share of the gains would be given up. Not all projects will be refinanced. For example, a number of projects are bond financed which are unlikely to be refinanced. In some other situations, such as rescue refinancings, a refinancing may take place but the the public sector would not expect to share in the benefits.

1.26 There are a number of risks that will need to be carefully managed if the proposed agreement that the public sector should generally receive 30 per cent of the refinancing gains on early PFI deals is to work effectively:

6 Projects where we were informed a refinancing is planned

Forest Bank (Agecroft) Prison

Dartford and Gravesham Hospital

South Manchester University Hospitals - Wythenshawe Hospital

Sheffield City Council - Group Schools Projects

London Underground Power

Newcastle Estate Development Scheme

ELGAR (DTI)

Manchester High Powered Computing

Croydon Tramlink

Enfield New School

Norfolk and Norwich Health Care NHST - New hospital (thought to be planning a refinancing)

Source: National Audit Office

- The agreement is a voluntary code of practice that is not contractually binding

The principle that the public sector should generally receive 30 per cent of the refinancing gains on early PFI deals has been set out in a voluntary code of practice. As these new arrangements are being introduced after contract letting the OGC considered that a contractually binding approach was not appropriate. There will therefore be no legal remedy if a contractor on a particular contract is not prepared to give up 30 per cent of any refinancing gain. The OGC acknowledges this, but considers that such occasions should be relatively few because, in addition to the code being supported by the CBI, a range of private sector participants have indicated that they will support it. In addition, the OGC notes the emphasis on public sector contractual approval rights being exercised, to the extent to which they exist, which does provide some leverage which has been recognised by the private sector.

- There could be disagreements as to what constitutes a refinancing benefit to be shared with the public sector.

Defining what constitutes a refinancing and calculating the gains that have arisen on a refinancing are complex matters. There are risks that there could be disagreements between departments and contractors given that the sharing arrangements are not contractually binding. Private sector representatives told us that they may seek to have some issues negotiated on a contract-by-contract basis and that they had concerns about how the gains to be shared would be computed. In particular, they considered further discussions were required with the public sector about the discount rate to be applied to the project cash flows in order to compute the gains to be shared.[9] The private sector hopes, however, that accepted practices for how the code will operate will quickly develop.

- Contractors may seek to avoid the need to share the refinancing gains

Because of the complexities surrounding refinancings, there is a risk that some contractors may structure their financing arrangements to receive a refinancing benefit without sharing it. This could arise either because it is not transparent to the department that a refinancing has occurred or because the refinancing has been effected in a way that is outside any definition of refinancing that may have been agreed as part of the code.

1.27 In order to help to implement the code, and to overcome these risks, the OGC is arranging to have additional, dedicated PUK services available to help ensure there is a well-informed and consistent approach to any negotiations based on the new code of practice.

9 *The application note issued by the OGC to departments in July 2002 states that the most appropriate discount rate to use is the original base case equity internal rate of return (the rate investors expected to earn from capital invested in the project).*

The OGC acknowledges that considerable further work will be required to ensure that the full benefits of this new approach are realised.

1.28 This new code, and the extent to which it proves effective, will be very important to the public sector's ability to share in the benefits of refinancing. Despite the fact that new contracts are now required to include arrangements to share refinancing gains, the majority of contracts which have been let since the beginning of the PFI do not have these contractual sharing arrangements. 61 per cent of the contracts we surveyed (covering the whole of the period the PFI has been operating) do not have these arrangements (39 per cent of all contracts we surveyed had contractual sharing arrangements (Appendix 3) compared with 24 per cent when the PAC conducted a similar survey in 2000). It will take some time for the newer contracts which have contractual sharing arrangements to reach the stage where refinancings are likely to take place. So, for the next few years, departments will be reliant on the new voluntary code to secure a share of many of the refinancing gains which may arise.

There have in the meantime been some additional reported refinancings, but others may also have occurred

We were told about 12 completed refinancings with varying results for the public sector

1.29 There is no definitive central database of completed refinancings, though much information is now available centrally and this will be built up and maintained. A key difficulty in attempting to compile a summary of completed refinancings is that in many early PFI contracts the private sector consortium was not contractually obliged to notify the department of a refinancing. From the PUK work, and from other market information, the OGC has been able to gather considerable data about refinancings.

1.30 In our survey, we asked departments whether their projects had been refinanced. We were told of 12 projects that had been refinanced, including three roads, two prisons, a hospital, a school and several other types of project **(Figure 7 overleaf)**.

1.31 Outcomes from these initial refinancings which have been reported to us have varied. In nine of the 12 refinancings departments received a share of the gains with seven receiving at least 25 per cent. These included the Inland Revenue receiving 60 per cent (£8.5m) in respect of the Newcastle Estate and DEFRA receiving 50 per cent on a small refinancing in respect of its Cambridge site. There had been no share of refinancing gains in three projects: the M1-A1 link but the Highways Agency had secured just over 30 per cent of the gains arising in two other projects; Parc (formerly Bridgend) prison, where the Prison Service had no contractual right to share the benefit but had made attempts to negotiate a share; and the Customs and Excise IT infrastructure project (where the department considers the operation of the contract will be improved by the refinancing).

1.32 In only one of the 12 cases had the authority been informed by the contractor of its intention to refinance the project before the contract was let. Contractors generally reported to authorities that they proposed a refinancing close to the time the service came into operation. In eight, two-thirds of the cases, the contractor had informed the authority within 13 months of the service coming into operation. In the other four cases although the intention to refinance was announced at a later date this was still at an early stage in the contract period.

1.33 In the 12 refinancings listed in Figure 7 the public sector, based on departmental information, has secured a total share of refinancing benefits of at least £17 million out of total benefits of about £65 million[10]. This is, however, only an early indication of more extensive refinancing activity that may emerge over time. As over 500 PFI contracts have now been let, including some 200 where the service is already operational (which in many cases increases the likelihood of a refinancing occurring), there may be considerable scope for further refinancing. In addition, the information on completed refinancings summarised above is based on information from departments. Its degree of completeness is dependent on contractors having informed departments of changes in their financing arrangements and departments identifying correctly when refinancing benefits have arisen.

10 The refinancing benefit to the public sector in the pricing of the Sheffield New Office Accommodation project has not been quantified.

7 Completed refinancings notified to NAO (in order of completion)

Project Name	Contract signature	Service Operational	Intent to refinance notified	Refinancing completed	Share for dept/ Local Authority		Contractors
1 Colfox School (DfES) (Note 1)	11/97	09/99	03/99	06/99	25%	£0.4m	Jarvis Workspace FM Ltd, Compass, Research Machines
2 Altcourse Prison (Fazakerley) (Prison Service) (Note 2)	12/95	12/97	11/98	11/99	9.3%	£1m	Group 4 Falck, Carillion
3 A19/A168 Dishforth-Tyne Tunnel (Highways Agency)	15/10/96	09/98	10/99	03/01	33%	£1.5m	Autolink Concessionnaires (A19) Ltd
4 Sheffield New Office Accommodation (ODPM)(Note 1)	03/99	02/01	pre-contract	04/01	The department reports that refinancing gains were built into the original unitary charge before contract letting		Kerkehout Beheer B.V, Heart of the City Ltd, Taylor Woodrow Construction Ltd
5 Parc Prison (Bridgend) (Prison Service) (Note 3)	01/96	11/97	05/01	05/01	0%	£0	Securicor, Deutsche Bank, Costain, Skanska, WS Atkins
6. Newcastle Estates (IR)	01/08	1st phase 04/00, remainder 09/03	09/00	06/01	60%	£8.5m	Newcastle Estate Partnership Ltd, Amec plc, Interserve
7 IT Infrastructure PFI (IS PFI) (C&E) (Note 4)	08/99	04/00	12/00	07/01	0%	£0	ICL plc (now Fujitsu)
8 M1-A1 Link (Highways Agency)	26/03/96	02/99	04/01	09/01	0%	£0	Yorkshire Link Ltd
9 M40 Denham-Warwick (Highways Agency)	10/96	12/98	06/01	10/01	31%	£1.7m	UK Highways plc
10 Cambridge Site (DEFRA)	02/01	05/03	11/01	02/02	50%	£0.4m	Kajima Construction Europe (UK) Ltd
11 Calderdale Hospital (DoH)	07/98	04/01	11/01	05/02	30%	£3.6m	Bovis Lend Lease, ISS Mediclean, Bank of Scotland, Société Générale
12 Joint Services Command and Staff College (MoD)	06/98	09/00	02/02	06/02	30%	£0.4m	Laing Investments, Serco
					Total gains: £17.5m		

NOTES

1. This is a local authority project that has central government support.

2. The Prison Service received a 9.3% share of the total refinancing benefit but this represented 20% of the refinancing benefit that required its consent.

3. The Prison Service did not have the right to share refinancing gains. Based on an analysis of information provided by the consortium the refinancing gains to the contractor were £1.4 million.

4. The department reports gains for the contractor of £2 million over the course of the contract and that the operation of the contract will be improved.

Source: Survey returns from departments

There is evidence that some refinancings may have taken place without departments being aware

1.34 As refinancings are contractor led transactions departments will only be aware of them if (a) they have regular information about contractors' financing arrangements (and can correctly identify refinancings from this information), (b) the contractor informs them of the refinancing, or (c) they become aware of the refinancing from other sources such as financial journals or advisers. Our survey has shown that it is likely that some refinancings have occurred without departments' knowledge, either because they had insufficient information or because they did not recognise a refinancing from the information they were given.

Many early deals have limited or no approval rights over refinancings

1.35 Many early PFI contracts do not need the department to approve a refinancing. Twenty-nine per cent of contracts let before June 2000 give the department no approval rights over refinancings, while a further 21 per cent have approval rights but only in limited circumstances. This may have limited the extent of information which departments received about refinancings.

A fifth of authorities are unaware of the contractor's current financing arrangements

1.36 Twenty-one per cent of the project teams surveyed could not say what the contractor's current financial structure was. This contributed to some authorities being unable to give us information on whether or not there had been any change to the contractor's financing arrangements since contract letting. Information about such changes can help to indicate whether or not refinancing gains may have arisen.

1.37 The absence of information in these cases reflects the fact that authorities do not always have open access to their contractors' financial records. In our *Managing the Relationship* report survey in November 2000, we found that 55 per cent of authorities had open-book accounting arrangements with their contractors (although this may not always provide full information about the contractors' financing arrangements). The OGC considers, however, that the proportion of projects with open-book accounting has been increasing since this survey.

1.38 In situations where departments do not have information about their contractors' current financing arrangements or there is no requirement to seek approval for refinancings and no benefit-sharing arrangement, other refinancings could have been occurring without the departments being aware.

Even where authorities do have information, they may not recognise when a refinancing has occurred

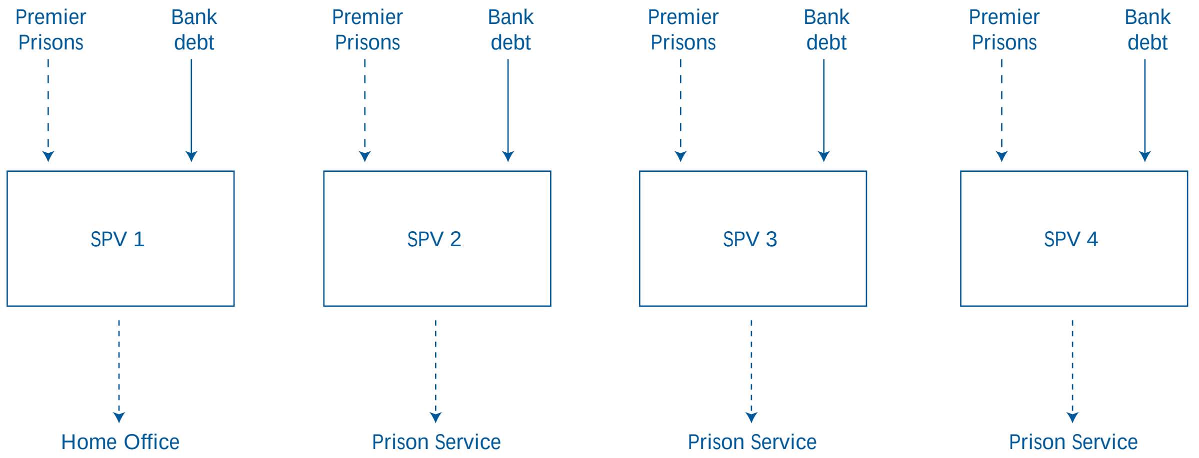
1.39 An additional problem is that, even where authorities do have evidence about their contractors' financing arrangements, they may not recognise situations where a refinancing has occurred. In addition to the 12 refinancings listed in Figure 7 we found evidence that other refinancing gains may have arisen without authorities recognising this. These were mainly, but not exclusively, in situations where the departments did not have a contractual right to share in refinancing gains. In all these cases the project teams did not consider their project had been subject to a refinancing but often reported that the contractor had effected a "financial restructuring". An example of a financial restructuring involving a group of projects is set out in **Figure 8**.

1.40 We found six cases, not reported by the departments as refinancings, where contractors had improved the financing in a way which would be expected to generate refinancing gains. And in around thirty other cases contractors had effected changes, sometimes complex, to their financing where further information would be required to ascertain whether or not refinancing gains had been generated. These situations often involved increases or other changes to the borrowings. This can be associated with refinancing gains if the new borrowing allows the private sector shareholders to be repaid debt or equity they have previously invested. A number of these latter cases where further information would be required may have involved financial changes which would have been unlikely to have been defined as refinancings under the arrangements now in place. These include deals involving corporate finance and rescue refinancings of projects in distress.

8 Premier Prisons financial restructuring

Before the restructuring

Premier Prisons had four PFI contracts, three with the Prison Service and one with the Home Office. Each project was owned by Premier Prisons through a project company known as a special purpose vehicle (SPV) and separately financed by bank debt.

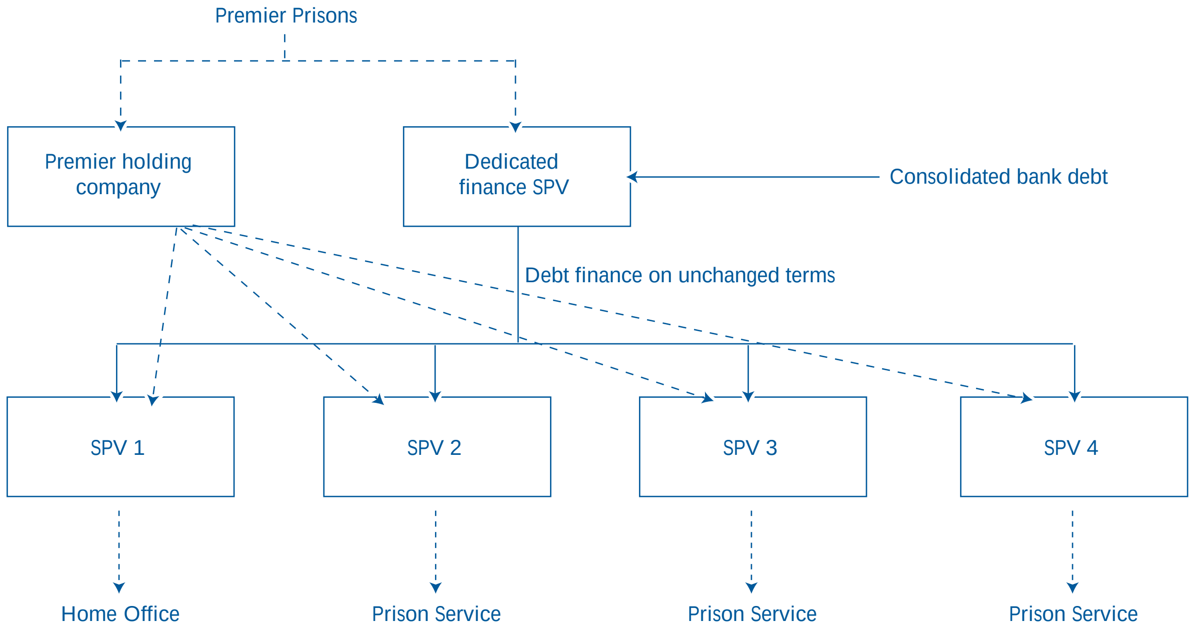


After the restructuring

The debt for each project is now provided by a dedicated finance subsidiary of Premier Prisons, which is in turn financed by a consolidated bank debt facility. The terms of the debt to each of the project SPVs remain unchanged, as does the potential liability of the public sector in the case of a default of any one of the projects.

Premier Prisons may now be able to refinance the terms of the bank debt to the dedicated finance SPV on a consolidated basis, which might release greater benefits than refinancing each project's debt individually.

The original contracts did not contain express refinancing provisions but protected the public sector from exposure from making any increased payments. The Prison Service and Home Office took legal advice on the restructuring to protect their rights in situations such as contract terminations and to prevent cross-defaults between the projects. In line with the original contracts there is no obligation on Premier Prisons to inform the Prison Service and Home Office if a refinancing of the consolidated debt is effected and Premier Prisons will not be contractually obliged to share any refinancing gains that may arise. Premier Prisons has, however, given a guarantee that there will be no increases to the termination liabilities of the Prison Service and Home Office.



1.41 The six situations where there was clearer evidence that project teams had not recognised situations potentially yielding refinancing benefits included: reducing lending margins, fixing interest rates at lower rates, increasing the length of debt repayment period, repaying shareholders' debt and increasing dividends by reducing restrictions on dividend payments. In one of these six cases the authority would have been entitled to a share of refinancing gains.

1.42 Given that a fifth of projects could not give us information about their contractors' current financing there may be other incidences of situations where refinancing benefits may have arisen without the department being aware or where further information would be needed to clarify whether or not there had been refinancing gains. Authorities need to be alive to situations that may give rise to refinancing benefits and to have access to information on changes in their contractors' financing arrangements.

Lack of information and understanding has contributed to departments not being aware of all situations where there was a possibility of refinancing gains having arisen

1.43 Our evidence suggests that departments do not appear to fully understand all situations that may yield refinancing benefits. The OGC considers that this is in part because some of these financial changes would not have been classified as refinancings in the earlier 1999 Treasury guidance. A further problem is that, while some financing changes, such as lower lending margins or extending the period of the debt, will clearly create refinancing gains, in other cases further information would be required to determine whether or not the change will have created a refinancing benefit for the consortium's shareholders.

1.44 There is a particular issue relating to information about local authority PFI projects that have been subject to central government approval and financial support. PFI credits from central government, a form of financial support for local authority projects, are running at £2 billion a year. The OGC and departments receive only limited information about these projects after they have approved the letting of these contracts. We also found it difficult to gather information about the current financing of these projects. It is therefore unclear how much refinancing activity may be taking place on these projects. The OGC notes that many local authority projects are small and may not be susceptible to refinancing, although this sector also includes some large local transport projects and school redevelopments where the OGC and PUK would take a close interest in any refinancing.

Part 2

The changing approach to refinancing in new contracts

2.1 The OGC took prompt steps to start to develop a new approach to refinancing. During the past two years it has been involved in extensive work to develop and agree new guidance with departments, contractors and the financial community **(Figure 9)**. As a result of this work, and with the assistance of PUK and the Treasury Private Finance Unit, the OGC has changed the approach of departments and the market to dealing with refinancing in new PFI contracts. Most new contracts now share refinancing gains 50/50 although it has taken some time for this policy to become established. The final stage in this new approach was the publication by the OGC of revised guidance in July 2002. This was later than initial expectations but departments had been made aware of the new approach earlier. Some authorities, however, are not yet fully aware of all the detailed issues.

The OGC set out to consider quickly whether 50/50 sharing arrangements in new contracts could be delivered

2.2 Very soon after our report on the Fazakerley prison refinancing in June 2000, the Treasury informed departments in July 2000 of the OGC's intention to produce new guidance. The Treasury said that the OGC was commissioning PUK to expand existing refinancing guidance and that the new guidance would be issued by the end of 2000 as part of the update of Standard Contract Terms. The Treasury underlined the need for departments to ensure refinancing gains do not threaten the perceived value for money of their projects.

2.3 The newly formed OGC, created as an office of the Treasury in April 2000, was charged with developing the new guidance. As a first step, following the publication of the NAO report on the Fazakerley refinancing, it immediately made clear to the private sector that new arrangements on sharing refinancing gains would be expected.

2.4 The OGC took an early view that, subject to the outcome of research it proposed to undertake, its aim would be to agree with the private sector that 50/50 sharing of refinancing gains would be required in new contracts. The OGC set out to consider whether 50/50 could be achieved and whether any changes in contracts to secure 50/50 sharing would be value for money.

2.5 At the PAC's hearing on the NAO report on the Fazakerley prison refinancing on 1 November 2000, the PAC expressed concern that, with £17 billion of PFI contracts signed, the Treasury had not confronted the issue of refinancing. The Treasury said that changes would be incorporated in new guidance that would be issued in spring 2001.

2.6 On 20 November 2000, the OGC issued a bulletin to departmental Private Finance Units. It repeated that new guidance was being developed that would be available "around the turn of the year". This bulletin focussed on what departments should do if they faced a refinancing on an existing contract. It advised departments to seek an equitable outcome that would protect the taxpayer's interests and be defensible publicly. It said that, where a department's approval was required for a refinancing, it should seek to share the benefits 50/50 - or consult the OGC if this was not possible.

2.7 The OGC did not formally advise departments at this stage what arrangements should be built into new contracts, as it wished to carry out further research before issuing guidance. However, the reference to 50/50 sharing on existing deals, together with the OGC's informal discussions with departments and others created an impression that 50/50 sharing was likely to become the norm in new deals when the new guidance was finalised. The OGC's informal advice to departments at this time was to seek 50/50 sharing in new contracts or to justify why any other arrangement had been negotiated. Both the OGC and PUK reinforced this view in discussions with departments and their advisers but acknowledged that in deals already at an advanced stage of negotiation 50/50 sharing might not be achieved.

9 Timeline of production of guidance on refinancing

Date	Guidance	Recommendations
1997	Treasury PFI Panel guidance on further contractual issues	Consider the scope for refinancing and try to capture some of the benefits
1999	Standardisation of PFI Contracts - HM Treasury	It may be appropriate to share refinancing gains in limited circumstances
June 2000	NAO report on refinancing of Fazakerley prison	Benefits from reducing costs in a developing market should be shared. Compensation should be obtained for increased termination liabilities
July 2000	Letter to all principal finance officers from HM Treasury	Departments to consult with experts and the OGC. More guidance will be published later in year.
November 2000	OGC Circular to PFU Heads	Departments should seek an equitable outcome on refinancings of existing contracts. Seek compensation for any increased liabilities and 50/50 share if departmental approval is needed
December 2000	Deutsche Bank appointed as financial adviser to assist with financing issues	
March 2001	PAC report on the refinancing of the Fazakerley prison contract	Departments should receive a 50/50 share of all refinancing gains
April 2001	Drafting of new guidance commenced	
July 2001	OGC Circular of November 2000 was posted on the OGC website and PFU Heads and PFOs notified	
August 2001	PUK start to develop approach to negotiating with private sector on sharing refinancing gains on past deals	
Autumn 2001	Letter from the Chief Executive officer of the OGC Accounting Officers which explained the OGC approach to all refinancings	Revised guidance aimed at 50/50 sharing of refinancing benefits in most situations
	Drafts of revised OGC refinancing guidance circulated to departments and discussions take place	
	OGC/PUK conference which conveyed the emerging approach to contract guidance, including refinancing to a large audience	
December 2001	New draft revised general guidance (including refinancing) circulated to private sector	
January 2002	Draft report on refinancing of past deals completed by PUK	
Spring-Summer 2002	Ongoing consultation with departmental PFUs and private sector about new guidance for future deals and basis of sharing refinancing gains on existing deals	
July 2002	Revised refinancing guidance in final form available on OGC website as part of revised general guidance	50/50 sharing of refinancing benefits in most situations
October 2002	OGC launched voluntary code of practice for early PFI deals with CBI support	Departments will generally seek to receive 30 per cent of refinancing gains on deals where the contract does not include an explicit sharing arrangement

Source: National Audit Office from OGC and PUK records

The OGC became aware that considerable work would be required to fully understand refinancing and to bring about private sector acceptance of 50/50 sharing of refinancing benefits

2.8 The OGC took prompt steps to start to develop a new approach which would address NAO and PAC concerns about refinancing. The OGC realised that extensive work would be required to bring about the desired change to dealing with refinancing in new contracts. The key stages would be:

- To define a proposed policy approach: this would need to consider, *inter alia*, whether and in what circumstances refinancing should be encouraged, the basis of sharing gains and how the public sector's share of the gains would be received;
- To research the complex subject of refinancing to confirm whether the proposed policy approach was appropriate and achievable and to consider the practical issues involved in implementing the policy;
- To devise effective contractual mechanisms that would achieve the desired policy approach; and
- To secure departments' and the private sector's agreement to the new arrangements.

2.9 The OGC was able to utilise the expertise on financing issues which resides within PUK. Its staff have commercial experience of how refinancing will be dealt with in new contracts. Following discussions with PUK, the OGC took an early decision in summer 2000 on what the basic policy for sharing refinancing gains should be, subject to confirming from further research in the market that the policy would be acceptable and practicable. In developing these policy proposals, the OGC considered whether it would be better to have a fixed arrangement that would apply to all projects or a more flexible arrangement that would require project-by-project negotiations between authorities and contractors. The issues considered included whether it would be possible to identify windfall refinancing benefits that had not been anticipated by the private sector and to use these as the basis for negotiations about sharing refinancing gains.

2.10 The OGC and PUK decided that it would be very complex for departments to attempt to analyse all the underlying factors that had produced a refinancing gain and to attempt to identify which were genuine windfalls. Furthermore, an arrangement that required such issues to be defined contract-by-contract was likely to be time-consuming for authorities and contractors. It would also leave contractors uncertain when bidding for the contract what share of any refinancing gains they might have to forgo. The OGC therefore decided that, subject to further research, it seemed more practicable to develop new guidance that expected a fixed arrangement for sharing refinancing gains, with all such gains (apart from some defined exceptions) to be shared 50/50. This would have the advantage of being easier to operate and would give the private sector certainty about arrangements for sharing refinancing gains when bidding for contracts.

2.11 With PUK's assistance, the OGC carried out initial research into the subject of refinancing and the private sector's approach to refinancing. In late 2000, PUK commissioned Deutsche Bank to advise on this topic. This initial research identified that there would be many complex issues to consider in developing new guidance. For example, a consortium can make many different types of change to its financing structure. These would need to be understood and consideration given to whether the new arrangements for sharing refinancing benefits should encompass all these types of changes.

2.12 The initial research also identified that there was a range of views in the private sector about the idea of sharing refinancing benefits. These would need to be reconciled and managed if the private sector was to be persuaded that 50/50 sharing of refinancing benefits should be the norm in future PFI contracts. There was considerable initial resistance from many in the private sector to the concept of sharing refinancing benefits 50/50. One view expressed to us by the private sector was that applying 50/50 sharing to all new contracts may deter some contractors from bidding for relatively risky projects (for example, services that have not previously been contracted for under the PFI). Contractors consider that the prospect of retaining all refinancing gains if a project is successful is an incentive for taking on risky projects at a price that will be acceptable to the public sector.[11]

11 *The OGC notes that its July 2002 guidance, although generally expecting 50/50 sharing of refinancing benefits, specifically allows variant bids without 50/50 sharing for projects where there are substantial market risks.*

2.13 The OGC could not afford to ignore the private sector's views, as there was a risk that contractors would stop bidding for PFI contracts if they felt that their opportunities to make a reasonable return from them had been severely impaired by new arrangements on refinancing. Most contractors recognised, however, that in the light of the publicity surrounding the outcome of the Fazakerley prison refinancing some sharing of refinancing gains would be appropriate in future deals. If these new arrangements can be adopted without significantly increasing the pricing of PFI deals then they will contribute to improved value for money from PFI deals.

The OGC undertook extensive further work which has secured the market's acceptance that most refinancing gains should be shared 50/50

2.14 After the initial research, the OGC undertook extensive further work to enhance its understanding of refinancing and to develop appropriate new refinancing arrangements that would be acceptable to the private sector. This would require bringing about a major shift in the market towards accepting the 50/50 sharing of refinancing benefits.

2.15 With assistance from PUK and Deutsche Bank, the OGC continued to research refinancing. This included such complex topics as what constitutes a refinancing and how refinancing gains are measured. These were important issues, as there are many different types of refinancing and many possible ways of computing the gains arising from a refinancing. The OGC was concerned that any new provisions should ensure that the benefits which the private sector would be required to share with the public sector would be equitable and also not jeopardise the value for money of the deal for the public sector. The OGC then considered how the guidance and proposed new contract terms should be formulated and what the private sector's attitude to new refinancing arrangements would be. This work continued through the first half of 2001. In September 2001, the OGC was able to write to Accounting Officers setting out its proposed approach to settling all refinancing issues in a comprehensive fashion. Drafts of new guidance, including proposed new contract terms based on 50/50 sharing of refinancing gains, were then made available to departments in autumn 2001.

2.16 The OGC then embarked on extensive consultation with departments, the NAO and private sector contractors and financiers. A number of further complex issues came to light that had to be considered and appropriate amendments to the guidance were drafted and negotiated with departments and the private sector.

2.17 This included, in autumn 2001, PUK being commissioned by OGC to prepare a report on refinancing of past deals. This informed the discussions with departments and the private sector and underpinned the OGC's conclusion that a code of practice on past deals should be introduced. This report, which incorporated data on how over 100 existing PFI contracts had approached refinancing, took several months to develop and was completed in early 2002.

2.18 By early 2002, the OGC considered that it had largely secured private sector agreement to the principle of 50/50 sharing of refinancing gains. However, further complex technical issues emerged in spring 2002 in the final consultations. These needed to be resolved in finalising the contract terms and the related guidance.

This large programme of work has taken two years to complete

2.19 This extensive programme of work culminated in revised guidance on refinancing for new contracts, which the OGC published in July 2002. The work that the OGC carried out to develop this guidance was significantly more than was expected at the outset in summer 2000. The Treasury, in consultation with the OGC, had stated to departments that new guidance would be available by the end of 2000 and to the PAC (in November 2000) that new guidance would be available in spring 2001. Detailed guidance had not been issued by spring 2001 but departments had been made aware by the Treasury and OGC, through interim and informal guidance, of the importance of considering refinancing issues and that, pending the completion of research, 50/50 sharing in new contracts was likely to become the norm.

2.20 As potentially very large amounts of money were at stake, as well as the confidence of the private sector in the PFI market, the discussions with the private sector were effectively commercial negotiations. Considerable attention was given to the detail of how the new contract terms on refinancing proposed in the guidance would operate. A further and very important complexity was that the new guidance was an integral part of the OGC's larger update of all standardised PFI contractual issues and it wanted this whole package to be accepted by the private sector. It considered that there was a significant risk that the refinancing terms would be rejected by the private sector if presented in isolation or that it would have been difficult to obtain acceptance of the standardisation of contract terms, with a consequent increase in the time and cost of delivering deals that were under negotiation.

2.21 The OGC notes that, as the new refinancing provisions were seeking to improve the position of the public sector, there was little incentive for the private sector (itself made up of various different interests) to reach an early agreement. Private sector representatives that we consulted told us that they had concerns about the way in which the development of the new refinancing guidance was managed and considered that lessons could be learned for the future. They expressed concern that, having been put on warning that new arrangements would be introduced, it was not until December 2001 that they were consulted on the detail of the proposed new contract terms and then any changes they requested had to be referred back by the OGC for departmental approval. The private sector suggested a faster approach might have been to convene at the outset a panel of public and private sector representatives to discuss and then agree all the details of the new contract terms.

2.22 The factors outlined above contributed to the time taken to complete the new contract terms and guidance. The conclusion of this exercise in July 2002 was more than two years after the earlier NAO refinancing report in June 2000 and almost two years after the PAC hearing on that report in November 2000. The OGC sees the finalisation of the new contract terms and guidance as the formalisation of a major process of change which it had brought into effect over the previous two years. It notes that the main principles of 50/50 sharing have been accepted by the public and private sectors for some time now and that detailed draft guidance was available to departments from autumn 2001. It considers finalisation of the revised contract terms and guidance to be confirmation of the new arrangements that have been established.

Departments have in the meantime been making definite progress in securing better terms in new contracts, but sometimes without fully understanding the issues involved

2.23 Since June 2001, most new PFI deals have included arrangements to share refinancing benefits 50/50. Pending the finalisation of revised guidance with proposed contract terms, it had taken some time for the 50/50 policy to be widely adopted by departments although they were increasingly seeking some sharing of refinancing benefits in new contracts. Although there has been much work in the last two years to raise the public sector's awareness of refinancing issues, and the OGC has advised authorities to take advantage of the expert advice available from PUK, there is evidence that some authorities are insufficiently aware of all the issues. This suggests that training and possibly further information is needed. The OGC considers that a number of initiatives should help to address this.

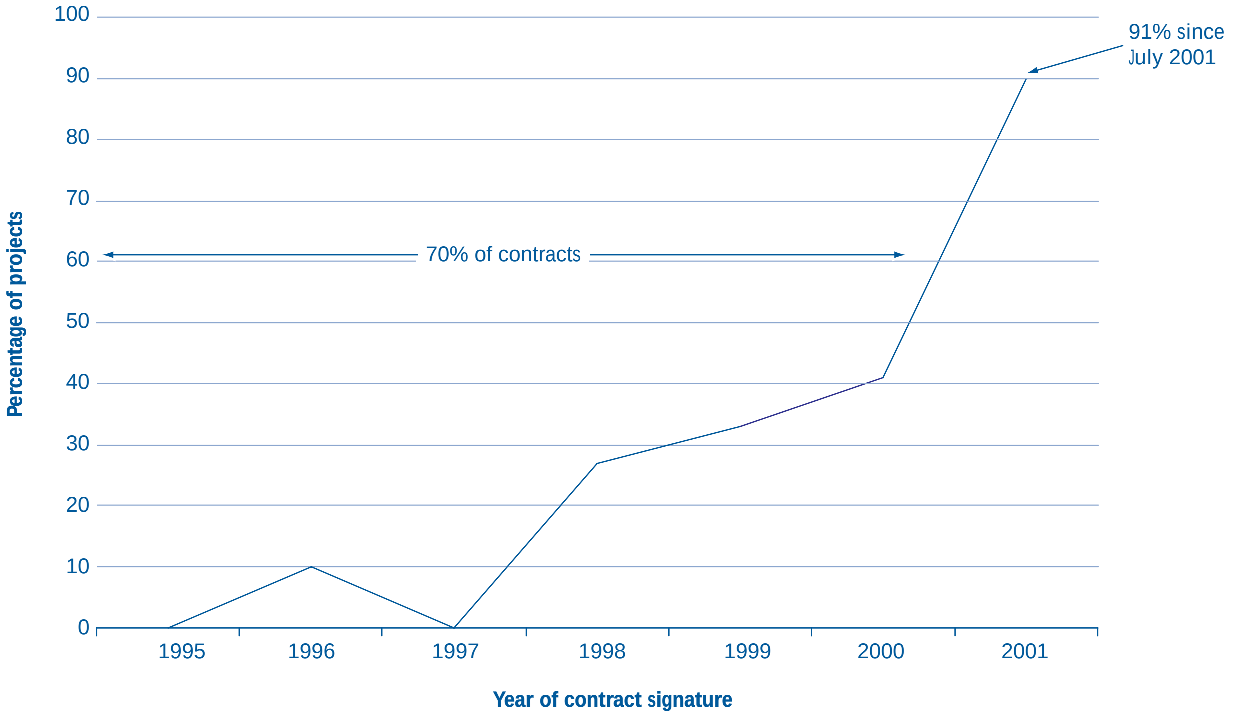
It took some time for the new policy to be adopted, but better refinancing arrangements are now being secured, with most contracts sharing benefits 50/50

2.24 The OGC was not able to issue final formal guidance until the detail of all the new model contract terms had been fully agreed with both departments and the private sector. However, throughout the past two years the OGC and PUK have been encouraging departments and their advisers in other ways to seek approval rights and 50/50 sharing arrangements in new contracts. This included the interim guidance and informal discussions referred to in paragraphs 2.2-2.7.

2.25 68 per cent of all new contracts signed since the publication of the NAO report on the Fazakerley refinancing in June 2000 reported a mechanism for sharing refinancing gains. This proportion is on the increase, with 91 per cent of contracts signed since June 2001 having such mechanisms **(Figure 10)**. These are substantial increases over the comparative figure of 26 per cent for contracts signed prior to June 2000. In addition, arrangements for approving refinancings have been strengthened in contracts signed in the past two to three years **(Figure 11)**.

10 Percentage of projects with refinancing gain-sharing mechanisms

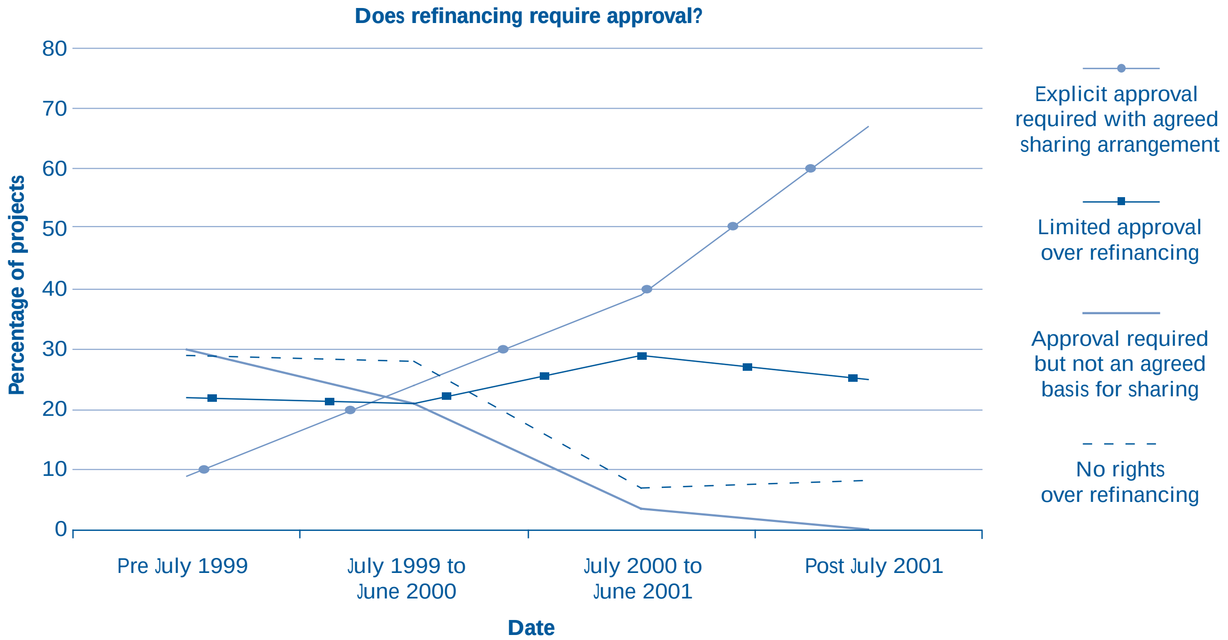
This figure shows that 70 per cent of PFI contracts were let prior to June 2000 when most PFI contracts did not have clear refinancing gain sharing mechanisms. The proportion with such mechanisms has increased substantially in recent years and rose to 91 per cent for contracts signed since July 2001.



Source: National Audit Office survey

11 Level of approval required for financing

This figure shows that the level of deals where explicit approval is required for a refinancing and there is a refinancing gain-sharing mechanism (black line) has risen from 9 per cent of deals signed before July 1999 to 69 per cent of deals signed after July 2001. This has increasingly replaced other lesser forms of approval arrangements (other lines).



Source: National Audit Office survey

12 Arrangements to share refinancing gains

This Figure shows that 50/50 sharing is now included in most new contracts

Contracts let:	Pre 6/00	7/00-6/01	Post 6/01
At least 50%	4%	4%	75%
30%	4%	23%	8%
A share but less than 30%	18%	27%	8%
No contractual share	74%	46%	9%

Source: National Audit Office survey

2.26 Before publication of our report on the Fazakerley prison refinancing in June 2000, most contracts (74 per cent) did not have explicit arrangements to share refinancing gains. In the year following our report, more new contracts had sharing arrangements. In most cases these provided for the department to receive a share of between 1 per cent and 30 per cent of the refinancing gains. Since June 2001, however, the new policy of seeking 50/50 sharing of refinancing gains has been widely adopted by departments, with most new contracts (75 per cent) having this arrangement **(Figure 12)**.

2.27 The results shown in Figure 12 show that although 50/50 sharing is now being widely adopted by departments in new contracts it took some time for this new policy to become established. The OGC considers that there were inevitable lags in the new policy becoming effective. It attributes this to the following factors:

- Although the OGC was encouraging departments to seek 50/50 sharing in new contracts where possible in the year to June 2001, this was still an aspiration that was being researched to see if it could be delivered.
- In deals that were at an advanced stage of negotiation, departments had to take a view as to whether it would be value for money to insist on a 50/50 arrangement. There were deals where insisting on 50/50 sharing arrangements may have delayed the deal closure significantly or caused the contractors to seek an improvement to the contract price or other terms of the deal that would not have produced value for money.

2.28 As noted in Part 1 most PFI contracts to date were let before these new arrangements came into force. Where the contracts do not have sharing arrangements the new code of practice described in Part 1 will apply which is intended to generally secure 30 per cent of future refinancing gains for departments.

More needs to be done to raise awareness in authorities about refinancing issues

2.29 The policy to incorporate 50/50 sharing of refinancing benefits in new contracts is now being widely adopted. However, to ensure that these arrangements are used effectively, authorities will need to gain an understanding of the OGC's new guidance and to apply it in practice. In particular, they will need to understand what constitutes, in the OGC's guidance, a refinancing for the purposes of gain sharing; how to be aware when such refinancings are taking place; and to know how to compute the gains that are to be shared. To assist this last point, the OGC has provided further information on how refinancing gains will be calculated in an application note published in July 2002 to accompany its new guidance.

2.30 These are complex issues. The fact that a number of project teams responding to our survey in early summer 2002 did not recognise situations that may have generated refinancing gains (paragraphs 1.34-1.40) underlines the need for the new guidance to be fully absorbed. We therefore consider that training on refinancing issues will help departments to absorb these complex issues and additional information for departments on specific technical issues may also be helpful. The OGC agrees that further sharing of experience with the public sector is necessary and is considering how this might best be achieved drawing on the expertise on refinancing that exists within PUK and the National Audit Office. The OGC has agreed that there should be seminars for departments to raise awareness of key financing issues.

2.31 The OGC stresses that the expertise on refinancing that exists within PUK must be used by departments and that this message will be repeated regularly. The private sector too considers it important that authorities dealing with refinancing matters should always gain input from central government staff with expertise on refinancing. The OGC considers that PUK's Helpline, augmented to deal with the revised general guidance on contract terms, and the PUK Taskforce on refinancing, should help to address this. The OGC also believes that the public sector's ability to handle refinancing will be improved by: the greatly increased emphasis upon departments and advisers following best practice guidance (including that on PFI); other mechanisms, including the OGC's Gateway[12] and Project Review Group[13] processes; the OGC's Successful Delivery Skills training approach (which will cover PFI); and its new PFI knowledge network which will also help to spread information about best practice on refinancing throughout the public sector. Bringing available knowledge to departments' attention is important as evidence from our survey suggested that information that could help project teams had not been widely read. Only 22 per cent of project teams had read the PAC report on the Fazakerley prison refinancing and only 33 per cent had read the NAO report on this subject. This is disappointing, especially since the OGC told us it drew these reports to the attention of departments.

12 The OGC's programme for reviewing projects at key stages in their development and also post-contract.

13 The OGC's review group for overseeing local authority PFI projects.

Part 3

Implementation of the revised guidance for new contracts

3.1 In applying the OGC's revised guidance for new PFI contracts, most refinancings will need a department's approval and will lead to 50/50 sharing of benefits. While previous NAO and PAC recommendations have been largely incorporated in the revised OGC guidance, there are a number of important issues that will need to be carefully managed to ensure that these arrangements are effective in practice.

The revised guidance requires the private sector to seek departments' approval for most refinancing situations

3.2 The OGC's new refinancing guidance was published in July 2002 as part of its revised guidance on the standardisation of PFI contract terms. It includes contractual terms on refinancing to be included in new contracts. These were developed after extensive consultation with the private sector and departments. It also sets out guidance notes for departments explaining the Government's approach to refinancing.

3.3 An important aspect of the contractual arrangements are departments' approval rights. Departments will have rights to approve any refinancing situation where the department may be entitled to a share of any gains and to generally approve any increase to their termination liabilities[14]. For a refinancing to be subject to gain sharing, it must be a "qualifying refinancing". This covers all refinancings other than certain situations that are excluded. Excluded situations include refinancings of a contractor's general finances (as opposed to project specific finance, which would be a qualifying refinancing). Gains made by contractors and other investors from the sale of shares in project companies are also excluded.

3.4 The private sector is not required to notify a department of a refinancing unless it is of the type that requires the department's approval.

3.5 The situations that need to be carefully managed are:

- The private sector may seek to exploit the exclusion clauses by arranging refinancings in a way that will fall within these excluded situations.
- As a department does not contractually have to be informed about all refinancings, it cannot immediately check to see whether or not any given refinancing is one that needs its approval and requires benefits to be shared. It must rely on the private sector to apply the approval process correctly. The OGC says that penalties for not seeking a department's approval for a qualifying refinancing, which would include contract termination without compensation for shareholders, will be a big incentive for contractors to adhere to the correct approval procedures.

New contracts will require refinancing gains on qualifying refinancings to be shared 50/50, provided contractors are making their expected level of return

3.6 The new OGC guidance requires new contracts to provide for refinancing gains on qualifying refinancings to be shared 50/50, except in those cases where, at the time of the refinancing, a contractor is projecting a shortfall in returns over the life of the contract compared to expectations at contract letting. In such cases, sharing only applies to those gains that would result in the contractor earning more than the previously expected rate of return. The guidance gives the public sector audit rights over the computation of the refinancing gains.

14 *There are limited exceptions to departments' general rights to approve any increase to their liabilities in the event of contract termination. These exceptions are where the increased liabilities arise in connection with the exercise of lenders' step-in rights if a project is in difficulties or where additional bank facilities are used to fund construction contingencies. In these situations termination liabilities may be increased without the authority's approval but by an amount not exceeding 10 per cent of the original bank debt.*

3.7 The whole subject of measuring refinancing gains, and the impact that sharing refinancing gains may have on the value for money of deals, is complex and will require careful supervision and audit. Risks to be managed include:

- As with the voluntary code for existing deals, there is a risk of disagreement over how the gains to be shared will be computed. The choice of discount rate to be applied to the private sector cash flows is a key issue. The OGC has issued an application note setting out the most appropriate discount rate to be used.[15] But this approach has yet to be widely endorsed by the private sector and it remains an area of concern to them. PUK notes, however, that the OGC's recommended approach on the discount rate has already been used on at least one recent refinancing. In addition, there are uncertainties, within both the public and private sectors, in respect of the effect that proposed changes to the discount rate used to evaluate government investment projects[16] might have on the calculation of refinancing gains.
- Contractors may seek a price increase to offset the contractual obligation to forgo 50 per cent of future refinancing gains.[17] PUK says that it has seen examples of contractors seeking such price increases where the requirement to share 50 per cent has been introduced after the issue of the Invitation to Negotiate. Public sector project teams have often successfully resisted the proposed price increase but in some cases have had to make alternative concessions. Project teams will need to ensure that any price increases or other concessions do not more than offset the public sector's share of any refinancing benefit. PUK also notes that contractors have often claimed that their bid price has been reduced to reflect the benefits of future refinancings, but this is inevitably difficult to demonstrate and has generally been rejected by projects teams as ground for not sharing refinancing gains.
- When bidding for contracts, contractors might submit financial models that show a higher rate of return than they actually expect to earn (the price could be kept competitive by reducing the disclosed level of expected costs when bidding). Then, if they fall short of the model rate, they will be entitled to keep some of the refinancing gains before sharing the rest 50/50. Even if the rate of return quoted when bidding is reasonable, it could reduce the incentive for the contractor to perform well if shortfalls in profits can be made good from a priority claim on refinancing gains. The OGC and PUK consider that there is a low probability of this risk materialising. They consider that financiers' checks before contract letting and the effects of competition should identify unrealistic forecasts and that underperformance by the contractor after contract letting is likely to reduce opportunities for refinancing.
- The gain will be calculated at the time of the refinancing, based on the contractor's models of "projected returns" before and after the refinancing. If the refinancing is then transacted in some way that actually produces a different benefit than the one projected, it might be difficult for a department to detect this and seek a retrospective adjustment to its share of the refinancing gain. The OGC notes that the new arrangements give departments the right to seek an adjustment if a different refinancing from the one originally notified by the contractor is implemented. However, there will be no adjustment if the benefits from the notified refinancing ultimately prove to be better or worse than those projected at the time of the refinancing.

3.8 The OGC has told us that great effort will be put into managing these risks. This will be achieved through further advice to project teams and monitoring by the OGC (including, where appropriate, as part of its Gateway Reviews), PUK and Treasury expenditure teams.

There are other issues covered by the revised guidance

3.9 Other significant arrangements covered by the new guidance include:

- Refinancings must not be allowed to threaten the delivery of the contracted public services.
- Where a proposed refinancing would involve an increase in termination liabilities, contractors will generally need to secure the authority's consent both to the refinancing and to the increase in termination liabilities.
- Departments may receive their share of any refinancing gains as a cash sum at the time of the refinancing or by a reduced unitary charge.
- Authorities should have the right of access at any time to audit their contractors' financial models relevant to any refinancing, including those for which the authority would be due a share of the refinancing gains. This will enable authorities to ensure that they receive the relevant amount of any refinancing gains. Some of the contractors we spoke to said they accepted there was a need for greater openness by them on the impact of refinancing including in financial models at the time of bidding.

15 See paragraph 1.26 and footnote 7, page 10. The OGC's application note states that the most appropriate discount rate to use is the original base case equity internal rate of return (the rate investors expected to earn from capital invested in the project).

16 As set out in the HM Treasury consultation draft "Appraisal and Evaluation in Central Government" July 2002.

17 The PAC noted in its report on the Fazakerley prison refinancing (paragraph 6 (xvii)) that, where benefits are unexpected windfall gains, this should not have affected the pricing of a contract.

The revised guidance has largely incorporated previous NAO and PAC recommendations, which departments will need to put into action

3.10 Appendix 4 sets out the progress that the OGC and departments have made in implementing the recommendations that both the NAO and the PAC made following examination of the Fazakerley PFI prison contract refinancing. This shows that the recommendations have been largely reflected in the revised OGC guidance. The extent to which departments achieve satisfactory outcomes from refinancings will depend on them putting the revised guidance into practice effectively.

3.11 The growing maturity of the PFI market is increasingly enabling better terms of finance to be obtained at the outset which may reduce future refinancing opportunities. Nevertheless, it is very likely the private sector will continue to seek refinancing opportunities wherever possible. As our survey identified, the private sector may also seek new opportunities, such as refinancing a group of projects. Refinancing will, therefore, continue to require careful attention by departments.

Appendix 1 Scope and methodology of the NAO's examination

1. We examined whether the OGC and departments have addressed the concerns about the public sector's approach to refinancing raised by the NAO and PAC reports on the refinancing of the Fazakerley PFI prison contract.

2. We conducted a survey of all PFI contracts signed before May 2002 with a capital value of £10 million or over, based on records maintained by the OGC. We received responses from 116 central government projects, a response rate of 93 per cent. We also requested information from central government departments about local authority projects which OGC records showed had received central government financial support. Less information was available on these projects: we received 23 responses, a response rate of 31 per cent.

3. The survey was designed to address the PAC's request that we carry out a further analysis of the extent to which PFI contracts allow departments to share in refinancing gains.[18] It also sought to ascertain the extent of refinancing activity to date and to follow up other issues raised in the earlier NAO and PAC reports on the Fazakerley prison refinancing. A summary of the questions asked in the survey is set out in Appendix 2.

4. We discussed the results of our survey with the OGC and with PUK and with the Treasury Private Finance Unit, who had advised the OGC on refinancing issues. We also sought views from a number of private sector bodies about the Government's approach to the refinancing of PFI projects. The CBI, the Major Contractors Group, the Business Services Association and the PPP Forum were amongst those who provided comments.

5. We reviewed guidance on refinancing that had been produced by the OGC since our report on the Fazakerley prison refinancing.

18 The previous analysis was set out in Appendix 3 of the PAC report on the Fazakerley prison refinancing. It summarised replies to Parliamentary Questions tabled by The Rt Hon Alan Williams MP on the extent to which departments' PFI contracts had arrangements to claw back refinancing gains and whether the contracts had been refinanced. The key results of this previous analysis are set out in Appendix 3 of this report.

Appendix 2 Summary of questions in survey

The topics covered by our survey are described below.

Project details:

- Name and description of project
- Capital value and Net Present Value
- Project phase
- Name of consortium and key contractors

Refinancing arrangements

- Would a refinancing need approval and in what circumstances?
- Is there any mechanism for sharing refinancing gains?
- What percentage share is the authority entitled to receive?
- Is the authority entitled to compensation for increases in termination liabilities?

Refinancing experience

- Has the project been refinanced and if so what was the outcome?
- Are there plans for a refinancing?
- Have there been any other changes in financing arrangements?

The consortium's financial structure

- Is the authority aware of the consortium's current financial structure and of any changes since contract letting?
- What were these changes?
- How is the project funded?

Learning from experience and guidance

- Were refinancing issues considered during the procurement when assessing bids and when completing the contract?
- What guidance was used?
- With hindsight, would the authority approach refinancing differently - and if so how?

Appendix 3 Survey results by department compared with the earlier PAC survey

Alan Williams' MP survey (2000) and NAO Survey (2002)

Main survey responses by department

	Alan Williams' MP survey 2000			NAO survey 2002		
Department	Responses	Sharing mechanism		Responses	Sharing mechanism	
		Number of projects	% of projects		Number of projects	% of projects
Department of Health	18	9	50	35	20	57
Ministry of Defence	30	9	30	28	8	28
Department for Education and Skills (formerly DfEE)	3	0		13	12	92
Department for Transport. (formerly part of DETR and DTLR)	21	2	10	11	4	36
Office of the Deputy Prime Minister. (formerly part of DETR and DTLR)	-	-	-	3	1	33
Home Office	15 (including HM Prison Service)	0		8	1	12
HM Prison Service	(see above)			9	1	11
Lord Chancellor's Department	6	3	50	7	3	43
Inland Revenue	0			6	1	16
Department for Work and Pensions (formerly DSS and DfEE and DTLR)	1	1	100	4	1[19]	25
Department of Trade and Industry	3	0		3	0	
Foreign and Commonwealth Office	3	0		3	0	

19 *The PRIME project does not have a specific mechanism for sharing refinancing gains and thus we have excluded it from this column. However, it does have a mechanism for sharing windfall gains and profits which may include refinancing benefits and thus was included in the results from Alan Williams' survey.*

Main survey responses by department (continued)

Department	Alan Williams' MP survey 2000 — Responses	Alan Williams' MP survey 2000 — Sharing mechanism: Number of projects	Alan Williams' MP survey 2000 — Sharing mechanism: % of projects	NAO survey 2002 — Responses	NAO survey 2002 — Sharing mechanism: Number of projects	NAO survey 2002 — Sharing mechanism: % of projects
Department for Culture, Media and Sport	1	0		2	0	
Department for Environment, Food and Rural Affairs (formally MAFF)	1	0		2	1	50
UK Passport Agency	0			1	0	
Her Majesty's Treasury	1	1	100	1	1	100
Customs and Excise	0			1	0	
National Savings and Investments	0			1	[20]	
Office of Government Commerce	0			1	0[21]	
Wales	2	0		-	-	-
Total:	**105**	**25**	**24**	**139**	**54**	**39**

NOTES

1. The data analysed in the survey by Alan Williams MP was based on responses to Parliamentary Questions in 2000 asking departments to report all PFI contracts which had been let, whether the contracts had been subject to a refinancing and whether the contract had an arrangement to share refinancing gains. The NAO survey in 2002 asked more extensive questions (see Appendix 2), included contracts let since the Alan Williams survey but excluded any contracts with a capital value less than £10 million (as these are unlikely to yield significant refinancing gains).
2. The NHS responses to the Alan Williams survey were restricted to projects with a capital value of at least £25 million.
3. Following the change in audit arrangements regarding the devolved regions, the NAO survey in 2002 did not include Wales.
4. This is the percentage of all contracts responding to the NAO survey which had mechanisms to share refinancing gains. As set out in Figure 12 on page 25, 91 per cent of contracts let since June 2001 had mechanisms to share refinancing gains. The overall percentage is only 39 per cent because most contracts let at the time of the survey had been let before June 2000 and as set out in Figure 12 only 26 per cent of these contracts had mechanisms to share refinancing gains. In the intervening period (the year to June 2001) the percentage had risen to 54 per cent.

20 National Savings and Investments is financed internally by the contractor and therefore refinancing is not an issue.

21 This is a very early PFI contract let before the formation of the OGC but now managed by the OGC.

Appendix 4 Progress on NAO and PAC recommendations

NAO recommendations arising from the Fazakerley prison refinancing (June 2000)

1 Departments should give careful consideration to refinancing issues when preparing an Invitation to Tender and when developing a PFI contract. They should address whether they should establish within the PFI contract the right for them to share in refinancing benefits.

The OGC's revised guidance on refinancing, published in final form in July 2002, requires refinancing to be addressed in the standard contract terms that are set out as part of the procurement. These require departments to have the contractual right to share, in most situations, 50/50 in the benefits arising from refinancings as defined in the guidance.

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.

The OGC's revised guidance requires departments to have the contractual right to approve any refinancing as defined in the guidance. It also states that, where a proposed refinancing involves an increase in termination liabilities, contractors will generally need to secure the authority's consent both to the refinancing itself and to the change in termination liabilities, as these rights are separate and distinct.

3 When faced with a refinancing, departments should enlist the help of experienced legal and financial advisers. This can assist departments in understanding the full implications of the refinancing proposal and in establishing the best way to approach any negotiations.

The OGC's revised guidance says that it is very likely that authorities will need to seek the assistance of appropriate legal and financial advisers.

4 Where departments are likely to be exposed to increased termination liabilities as a result of a refinancing, in the absence of 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 capping the liabilities they are prepared to accept or by requiring the private sector to underwrite the risk themselves or through a third party.

OGC guidance requires departments to have the contractual right to approve any increase in termination liabilities (whether arising from refinancing or any other circumstances). In practice, this gives departments the right to decide whether to accept all, some or none of the proposed increase in termination liabilities. Although the revised OGC guidance does not specifically deal in any further detail with limiting increases in termination liabilities, the guidance also states that departments will be unlikely to agree to a refinancing that increases termination liabilities unless the additional refinancing gain available to be shared is judged to represent better value for money than a refinancing that does not involve such an increase in termination liabilities. The OGC and PUK consider that, as a result of this requirement, it is unlikely that departments will approve increases to termination liabilities arising from a refinancing.

5 Where a department has the flexibility to negotiate over refinancing benefits, it should prepare a robust but reasonable negotiating strategy taking account of the alternatives if a negotiated agreement cannot be reached.

The revised OGC guidance for new contracts sets out the sharing arrangements, normally 50/50, for refinancing benefits expected in new contracts. There should therefore be no need for departments to enter into negotiation over the sharing of refinancing benefits. In respect of existing contracts, the OGC is seeking agreement from the private sector that departments will generally receive 30 per cent of future refinancing gains (on contracts other than those that already provide for the public sector to receive a specific share). If this strategy comes into operation, this will also remove the need for negotiations on each refinancing of an existing contract. Previously, since November 2000, the OGC's advice in respect to refinancings of existing contracts was that departments should seek an equitable outcome that would protect taxpayers' interests and be defensible publicly, and to seek 50/50 sharing if the department's approval for the refinancing was sought.

6 Departments should consider linking at least part of their advisers' remuneration to the outcome of any negotiations to which the advisers contribute.

This is not specifically dealt with in the revised OGC guidance but, for the reasons noted in paragraph 5 above, contract-by-contract negotiations over the sharing of refinancing benefits should not normally be necessary.

PAC recommendations arising from the Fazakerley prison refinancing (March 2001)

Key PAC recommendations

1 Departments should ensure they are aware of and use the full strength of their negotiating position when dealing with requests to vary the terms of PFI deals.

The OGC has used the collective negotiating strength of central government to establish a code whereby departments will generally receive 30 per cent of future refinancing gains on early PFI deals (other than those contracts that already provide for the public sector to receive a specific share). Moreover, the OGC has published model contract terms that will provide in new contracts for departments to receive 50 per cent of the gains from most refinancings. (As part of this general update on refinancing, we have not undertaken detailed examinations of the negotiations on the further reported 11 refinancings that have taken place since our report on the Fazakerley prison refinancing.)

2 Departments should share in benefits that will arise through the successful delivery of a PFI project.

This is now established though the arrangements for departments to receive 30 per cent of future refinancing gains on early PFI contracts (or more in a small number of contracts that specified this) and 50 per cent of the gains from most refinancings of new contracts.

3 Better guidance is needed to help departments address refinancing issues and how the benefits of refinancing should be shared.

The OGC issued revised guidance on dealing with the refinancing of existing contracts in November 2000. It issued revised guidance on dealing with refinancing in new contracts in draft from autumn 2001 and in final form in July 2002.

Other PAC recommendations

1 Departments should obtain unambiguous arrangements for their approval of, and compensation for, increased termination liabilities.

This was stressed in the OGC's guidance for existing contracts issued in November 2000 and in its guidance for new contracts available in draft from autumn 2001 and published in July 2002.

2 Departments should take early legal advice when developing PFI contracts to limit their exposure to increases in termination liabilities.

This is for departments to consider, although the revised OGC guidance stresses the need for departments to have the right to generally approve increases in termination liabilities.

3 PFI deals should not permit perverse incentives which might tempt the private sector to cut and run. Departments should assess the risk of contract termination and should devise a pattern of rewards and penalties which continue to incentivise the consortium throughout the period of a PFI contract.

The revised OGC guidance published in July 2002 says that, when evaluating a refinancing proposal, authorities should consider carefully whether it could reduce incentives for the contractor to achieve sustained service standards, particularly in later years. In our view, however, there is in the new guidance a possible risk of a perverse incentive in respect of the arrangement that allows contractors to retain refinancing gains if their profits have been less than those expected when the contract was let. This could reduce their incentive to perform well, as payment deductions for poor performance could be recouped from subsequent refinancing gains. Both the OGC and PUK consider that there is a low risk of this risk materialising and that underperformance by a contractor would reduce the opportunities for refinancing.

4 When assessing alternative PFI bids, departments should take into account the various revenues that shareholders of a consortium can earn from a PFI project, the likelihood of a refinancing occurring and how this may affect the balance of risk and reward, for both the department and the service provider.

The revised OGC guidance says that refinancing is likely to be a matter for consideration by authorities at different times during the life of a PFI project, including when appraising bids. The guidance also makes various references to the effect refinancings may have on both risks and rewards.

5 Departments should make appropriate use of experienced advisers in developing, and participating in, refinancing negotiations.

The revised guidance says that it is very likely that authorities will need to seek the assistance of appropriate external advisers to ensure that the guidance is properly reflected in contract documentation and to assist with any negotiations with the private sector on proposed refinancings.

6 The Treasury should aim to anticipate future issues where departments may require guidance and should consult experts and the National Audit Office about emerging issues where central guidance would be helpful.

There is a close working relationship between the Treasury, the OGC and the National Audit Office on PFI matters. The National Audit Office is regularly consulted about areas where new central PFI guidance would be appropriate.

7 The Treasury and OGC should complete their planned updating of the central guidance on refinancing as a matter of priority (the PAC's recommendation was made in March 2001).

The OGC's revised guidance for new contracts was available to departments in draft from autumn 2001 and was published in final form in July 2002 (the OGC had already issued new guidance in respect of existing contracts to departments in November 2000). Completion of the revised guidance for new contracts was a priority for the OGC. However, completing the guidance took longer than the Treasury and the OGC had initially expected, because of the many complex detailed issues that the OGC had to consider and the consultation process that was necessary with both departments and the private sector if the new guidance was to have general acceptance in the market.

8 The benefit of improved financing terms that are likely from the successful delivery of the project may be secured through the pricing of the deal or through a share of the subsequent refinancing gains.

This is reflected in the revised OGC guidance on refinancing, which recognises that departments may receive their share of refinancing gains either in a cash sum at the time of the refinancing or by a reduced unitary charge. The guidance also provides for situations where a contractor explicitly offers a lower bid price so that refinancing gains can be captured in the pricing of the deal; in this situation, the subsequent refinancing would be exempted from the gain-sharing arrangements at the time the refinancing is effected.

9 Windfall refinancing benefits that have not arisen through a higher than expected standard of service from the private sector should be shared between departments and the private sector. This will have no impact on the pricing of deals, because deals will not have been priced in anticipation of windfall gains.

The OGC's revised guidance for new contracts expects most refinancing benefits to be shared 50/50 between departments and the private sector. It is also seeking to obtain the right for departments to generally receive 30 per cent of the refinancing gains on those existing contracts that did not give the departments an explicit right to a share of refinancing gains. The OGC will be monitoring whether these arrangements have any impact on the pricing of PFI deals.

10 All departments must give careful consideration to refinancing issues when they develop contractual arrangements with PFI consortia, taking account of the lessons from the Fazakerley prison refinancing and further Treasury/OGC guidance.

The OGC has been in regular contact with departments during the development of the new guidance. The evidence that 75 per cent of contracts let since June 2001 had 50/50 sharing arrangements indicates that most authorities have been adopting the new policy on sharing refinancing gains. Only 24 per cent of project teams, however, had read the PAC report and 38 per cent the NAO report on the Fazakerley prison refinancing, which suggests that more should be done to disseminate the refinancing lessons from these reports.

11 The National Audit Office should carry out a further analysis at the end of 2001 of the extent to which PFI contracts allow departments to share in refinancing gains.

This analysis has been carried out as part of this examination – see paragraphs 2.25-2.26, Figure 12 and Appendix 3.

Glossary

Authority	A public sector body that lets a PFI contract including a government department, local authority or other public or statutory body.
Clawback arrangement	Arrangements under which an authority receives refunds or reductions in future unitary charge payments, in certain circumstances.
Conventional/traditional procurement	A procurement for a contract in which a public sector customer, using government finance, pays a contractor as the works progress. Such projects are substantially paid for on completion. The public sector may face greater risks of delay and cost overrun and retains the risk that the assets will not perform once accepted, including in relation to whole life of asset costs. The provision of services, and operation and maintenance of the resulting assets, are dealt with in separate contracts.
Contractor	A party that has contracted with the Government, a local authority or other public or statutory body to provide services under a PFI contract.
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 given sum of money is worth more to the recipient today than the same amount in a year's time.
Equity	The value of a company or project after all liabilities have been allowed for. The equity is owned by the shareholders.
Fazakerley Prison	The first major PFI project to be refinanced and the subject of an NAO report.
Financial models	Spreadsheets designed to show the financial outcome of a particular set of estimated costs, revenues and fixed and capital charges for delivering a service over time.
FPSL	Fazakerley Prison Services Limited: the consortium company - set up and owned by Tarmac (now Carillion) and Group4 - that has entered into the contract for the Fazakerley prison with the Prison Service.
Gateway review	A Gateway review is conducted by independent experienced practitioners before key decision points in the life cycle of a procurement project. It is designed to be applied to projects that procure services, construction/property, IT-enabled business change projects and procurements using framework contracts.
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 with compensation against the risk of not having the loan repaid.
Invitation to tender/negotiate	A formal communication to selected suppliers.
Lender liabilities	A defined term in the contract between a contractor and an authority which, in certain circumstances, determines the amount of compensation payable by the authority to the contractor in the event that the contract is terminated prematurely.
Loan repayment period	The date by which the last instalment of principal is due so that a loan is repaid in full.
Private Finance Initiative	A policy introduced by the Government in 1992 to harness private sector management and expertise in the delivery of public services, while reducing the impact of public borrowing.
Reserve accounts	Accounts set up by a contractor containing cash balances earmarked to meet future liabilities as they arise, such as cost overruns on the construction of a prison or future major maintenance programmes or debt-servicing requirements.

Refinancing	The process by which the terms of the funding 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 contractor.
Refinancing benefits/gains	The benefits to shareholders of increasing and/or bringing forward their *returns* from a project as a result of changes to a contractor's financing structure.
Residual value of contract	The net present value to a contractor of a contract, at a particular date, reflecting i) the profits projected to be made by the contractor during the unexpired term of the contract; and ii) any residual value of contract assets in which the contractor retains an interest after expiry.
Returns to shareholders	Payments made by a contractor to its shareholders 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 a contractor compared with 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.
Termination liabilities	The amount of compensation payable by the authority to the contractor in the event of early termination of the contract, such amount depending upon the circumstances giving rise to termination.
Value for money (VFM)	Achievement of the optimum combination of whole-life cost and quality to meet a customer's requirements.
Unitary charge	The periodic payment due from an authority to a contractor in respect of the provision and operation of a service under a PFI contract.