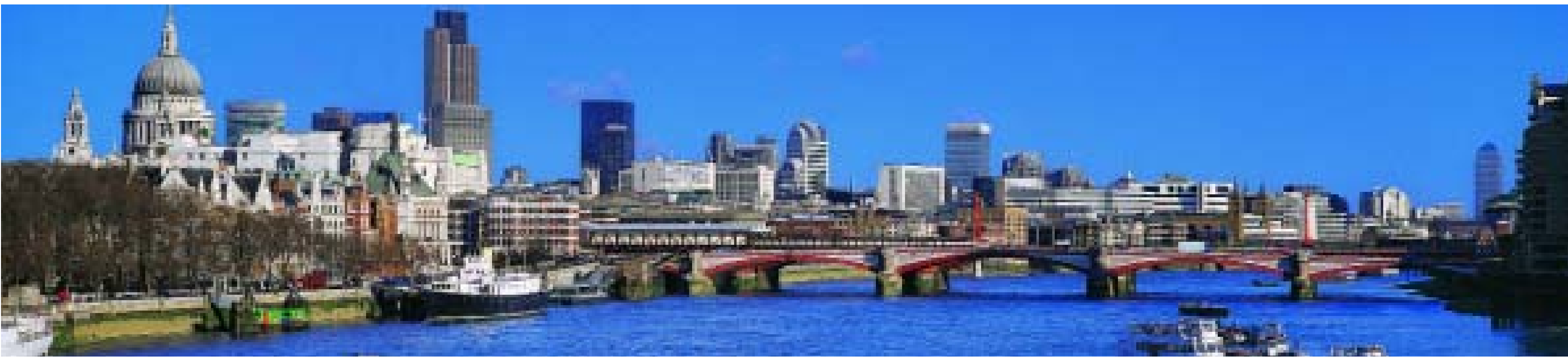
PFI refinancing update



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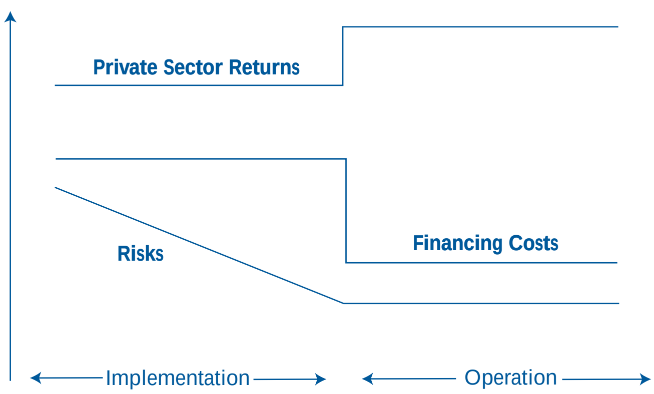
executive summary

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.

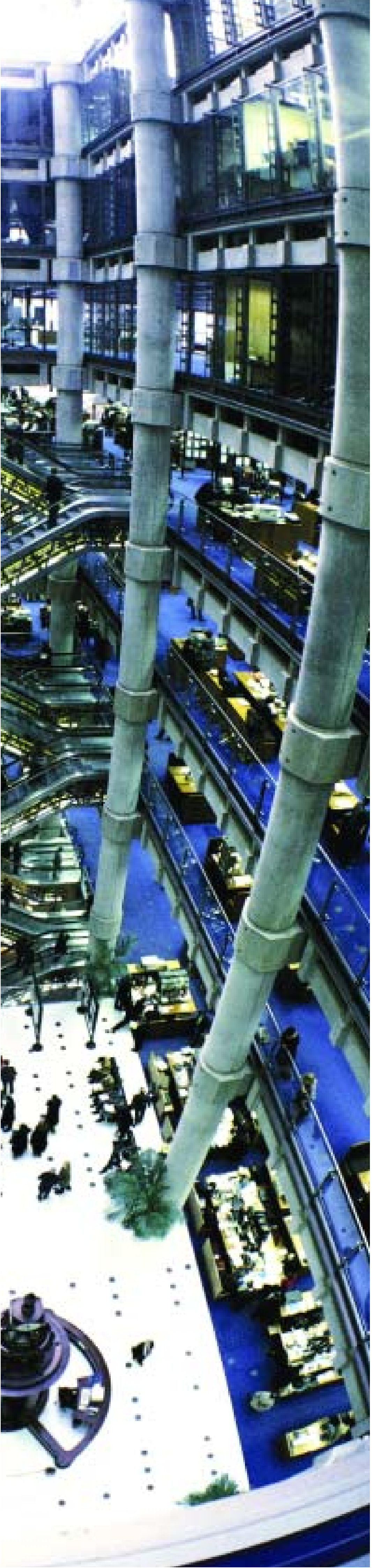
The OGC is helping departments generally to secure a 30 per cent share of future refinancing gains on early PFI deals

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").