NATIONAL AUDIT OFFICE

Darent Valley Hospital: The PFI Contract in Action

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 209 Session 2004-2005 | 10 February 2005

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Darent Valley Hospital: The PFI Contract in Action

LONDON: The Stationery Office
£11.25

Ordered by the
House of Commons
to be printed on 7 February 2005

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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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Comptroller and Auditor General
National Audit Office

7 February 2005

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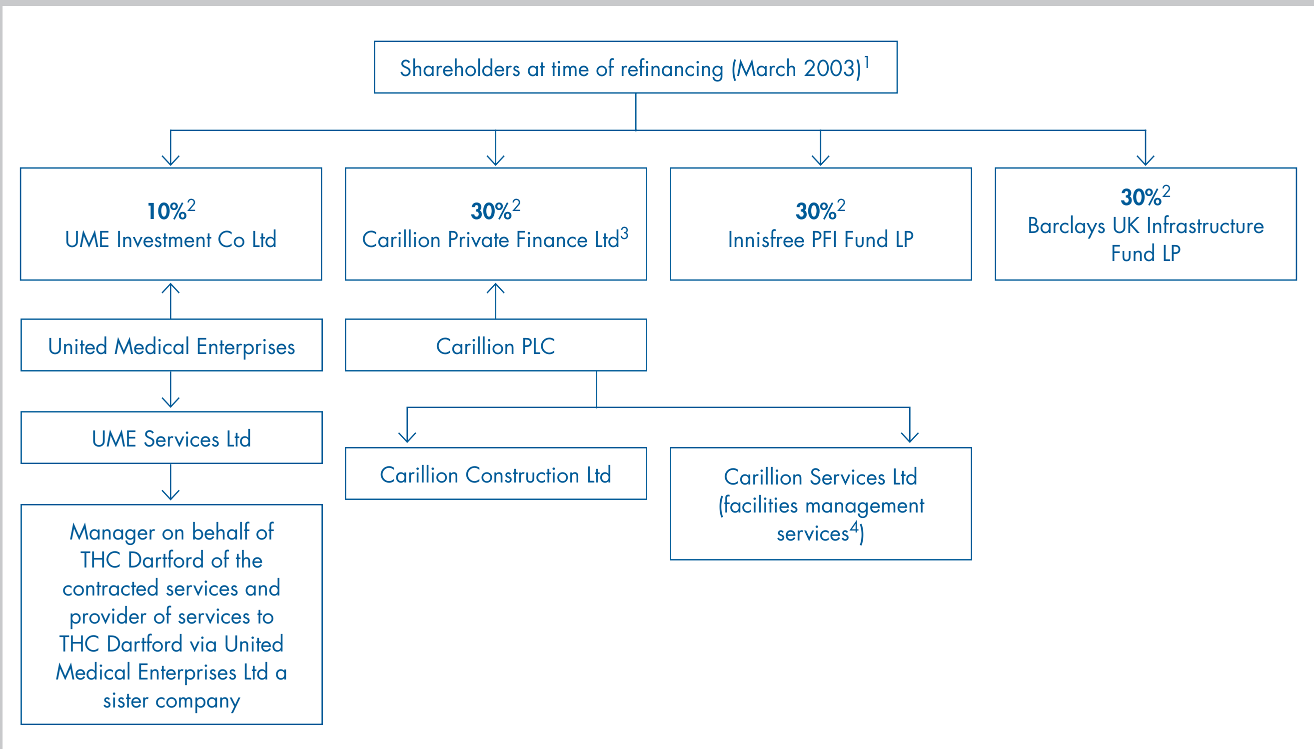


NOTES

1 Shareholdings in THC Dartford are through various holding companies.

2 All investors invested proportional to their overall holding (as shown) in both ordinary share capital and shareholders' loans.

3 Carillion Private Finance Ltd sold its shareholding in THC Dartford to Barclays Infrastructure Ltd (a general partner of Barclays UK Infrastructure Fund LP) in December 2003.

4 Carillion Services Ltd has overall responsibility for the provision of services except for car parking which is contracted for by THC Dartford directly with Meteor. Medirest is a sub-contractor to Carillion Services Ltd.

OVERVIEW

Overview of how the Darent Valley PFI hospital project has developed since the contract was let in 1997 by the Dartford & Gravesham NHS Trust (the Trust)

Service

New hospital delivered early.

Subsequent service delivery overall has been satisfactory.

Relationships with contractor

Now good after some initial settling in problems.

Price

Initially in line with the contract and reduced since 2003 following a refinancing.

Low level of payment deductions.

Dealing with change

New Trust management have been appointed and have achieved three star status for the Trust.

The project has been refinanced. The Trust has shared in 30% of the gains.

The contract period has been extended.

There is the possibility of increased termination liabilities.

An additional building programme is in progress, not all under the PFI contract.

In managing the risks arising from future change the Trust must make effective use of contractual mechanisms to maintain value for money.

SUMMARY

1 In 1997, the Dartford & Gravesham NHS Trust (the Trust) awarded the first NHS PFI contract for a new hospital at Darent Valley, to a company now known as The Hospital Company (Dartford) Limited (THC Dartford) *(see diagram opposite page 1 for structure of THC Dartford)*. The letting of this PFI contract was the subject of previous reports by the National Audit Office and the Committee of Public Accounts. The main findings of those reports are set out in Appendix 2.[1]

2 We revisited this project to examine the value for money the Trust is receiving now that the PFI hospital has been in operation for three years. We found that:

a THC Dartford has delivered the facilities and services the Trust contracted for, and to a quality that overall has been satisfactory.

b A refinancing of the PFI deal has generated large accelerated financial benefits for THC Dartford's shareholders which have been shared with the Trust by applying the voluntary code relating to the refinancing of early PFI deals. In return for its share of the financial gains the Trust has accepted additional risks.

c Significant change over time is likely to affect any hospital, whatever the form of procurement. The Trust will need to manage this risk and make effective use of the contractual mechanisms in its PFI contract aimed at maintaining value for money over the remainder of the 35 year contract.

3 The Trust received the new hospital from THC Dartford in 2000, two months early and for the price agreed in the contract. Subsequently there were Trust management problems which resulted in poor performance by the Trust. The NHS appointed a new senior management team and the performance of the Trust then improved. In 2003, and subsequently in 2004, CHI[2] awarded the hospital three stars (the highest CHI performance category). Establishing any new hospital will present major challenges to the management of a NHS Trust. The Trust's experience on this project has shown that, even with the risk transfer inherent in a PFI contract, managing the PFI contract and the clinical activities in a new hospital requires a large amount of senior management time.

4 THC Dartford has made the hospital available, and provided services such as catering, cleaning and portering with only occasional service lapses. The pricing of the hospital and the services provided to the Trust was in line with the original contract until the project was refinanced in March 2003. The Trust received an immediate lump sum of £1.5 million and a reduction of £2 million to its annual contract price over the remainder of the contract as a result of sharing in the refinancing benefits and agreeing to extend the contract period. Following this price reduction the PFI contract (including the provision of facilities management services) now accounts for around £17 million out of the Trust's annual costs of £94 million. The expected total cost to the Trust of the PFI contract in present value terms over the minimum period of the contract, at contract letting, prior to the refinancing and after the refinancing is set out in **Figure 1**.

1 The expected total cost to the Trust of the PFI contract in present value terms

	Expected net present value of the cost of the PFI contract to the Trust[1] £m		Minimum contract period
	Based on 6 per cent real discount rate	Based on 3.5 per cent real discount rate	
At contract letting in 1997	170.7	240.9	28 years
Prior to the refinancing in 2003	170.7	240.9	28 years
Following the refinancing[2, 3]	170.6	251.9	35 years

Source: The Trust and Ernst & Young, the Trust's financial advisers for the refinancing

NOTES

1 Contract payments in real terms discounted to 1996 (the year the original deal was approved).

2 The net present values following the refinancing include a receipt of £1.5 million on 31 March 2003 arising from the refinancing in addition to the reduction to the annual contract payments.

3 A year by year analysis of the effect of the refinancing on the contract price in both present value and cash terms is set out in Appendix 3.

1 The NAO's report: The PFI Contract for the new Dartford and Gravesham Hospital (HC 423 1998-99) and the PAC's report: The PFI contract for the new Dartford & Gravesham Hospital (HC131, 12th Report 1999-2000).

2 Commission for Health Improvement.

5 In a hospital any shortfall in the standard of basic facilities services could be of even greater concern than in other buildings because these services can have an effect on patients receiving health care. For example, the quality of facilities services could influence infection rates, whether operating theatres are available or whether patients can be moved promptly to receive care. The occasional service lapses were in important areas such as waste collection, cleaning and food production but the problems were overcome and service performance returned to a satisfactory level. The low level of payment deductions (0.1 per cent of THC Dartford's charges to date) mainly reflected the largely satisfactory service delivery. While the Trust believes that the performance scores awarded were appropriate, in our view, lower scores could justifiably have been given for some of the lapses that occurred. The deductions which were made were fully in line with the scores awarded, but the deductions would have been greater with lower scores. The Trust is continuing to reassess its performance measurement system which was finalised after the contract was let and relied on subjective assessment.

6 THC Dartford refinanced the project in March 2003. The Department of Health (the Department) assisted the Trust in negotiating a share worth, in net present value terms, £11.7 million of the £33.4 million refinancing benefits by applying the new refinancing code for early PFI deals. The Treasury gave some advice on this early application of the code, in particular the discount rate to be used when calculating the refinancing gains. As a result of this refinancing the Trust is benefiting, in terms of affordability, from the lower annual contract price (worth around £60 million in cash terms over the original minimum contract period) with the prospect of a further seven years of services at that reduced price and a reduction to its financial deficit.

7 But as well as the benefits for the Trust there are new risks arising from the refinancing: the Trust agreed to extend the minimum contract period from 28 to 35 years and to accept that the cost of terminating the contract might increase above the cost of the hospital to include some or all of the additional £46 million debt THC Dartford took on to generate the refinancing gains. The Trust considered these acceptable risks as, although the government places value on having the option to terminate contracts due to changes in its requirements, the Trust expected the hospital to be needed for the foreseeable future with a low probability of the contract being terminated. Taking account of these factors, the Trust concluded, prior to agreeing to the refinancing, that the benefits from the refinancing would be value for money despite the risk of higher termination liabilities.

8 At the time the Trust was negotiating the refinancing it was one of the first authorities to be doing so following the introduction of the new detailed Treasury refinancing guidance issued in July 2002. The Treasury and the Department agree that best practice in applying this guidance, developed since learning the lessons of this refinancing, would have been for the Trust, before agreeing to the refinancing, to have undertaken further analysis to support the value for money case of the refinancing proposals. The further analysis would have involved greater consideration of the implications of THC Dartford's proposal to increase its debt, including discussions with THC Dartford about what its refinancing terms would have been with no increase to the Trust's termination liabilities. The Trust, its financial advisers Ernst & Young, and the Department doubt, however, whether THC Dartford could have offered alternative refinancing proposals which would not have increased the Trust's termination liabilities. The Trust also considers that it had sufficient information to support its decision to accept the risk of higher termination liabilities at the time that it agreed to the terms of the refinancing.

9 Following advice from the Department, the Trust elected to receive most of its share of the refinancing gain evenly over the remaining contract period through a reduced contract charge rather than as a lump sum. This created a potential risk regarding the future receipt of the refinancing gain if the contract was terminated. But the Trust considers that, if the contract were to be terminated, it would still receive its share of the refinancing gain either through a reduction to its termination liabilities or by continuing to pay a reduced contract charge to a new contractor. Taking the gain as a lump sum would also have required THC Dartford to further increase the level of its debt to fund the lump sum in order to maintain the proposed level of benefits for the THC Dartford shareholders.

10 THC Dartford's shareholders have benefited substantially as a result of the refinancing by both increasing and accelerating their returns from the project. After investing £13 million in the project they have withdrawn £37 million following the refinancing, within three years of the hospital coming into use. This large early benefit was not in THC Dartford's initial financial plans. Based on the 15 per cent nominal discount rate agreed for the purposes of calculating the refinancing gains, the benefits THC Dartford's shareholders now expect, including the large early benefit they have taken, are £51 million, in net present value terms over the minimum contract period. On a comparable basis, these returns represent an increase of around 60 per cent compared with the returns of £32 million which the shareholders had anticipated when bidding for the contract. The shareholders' internal rate of return is now 56 per cent **(Figure 2)**.

11 THC Dartford's principal contractor Carillion was one of the initial shareholders in THC Dartford. As well as receiving its share of the immediate financial benefit following the refinancing Carillion has further reduced its risks by subsequently selling its shareholding in THC Dartford. Including refinancing gains, Carillion realised £16 million by 2003 having initially invested £4 million in 1997. This is equivalent to an annual rate of return on the investment of around 50 per cent. Carillion previously told the Committee of Public Accounts it was normally looking for a return of 15-17 per cent on its investment in PFI hospitals. Carillion emphasises, however, that its returns on successful projects need to be at a level to offset the effect of projects which do not go to plan and, on this project, it suffered higher than expected construction costs which were not passed on to the Trust. Carillion also informed us that it is reinvesting funds realised from the Dartford & Gravesham project in five new PFI projects where it is currently preferred bidder. There is a potential risk that, having realised these benefits, Carillion may have less incentive to provide a satisfactory service. Both Carillion and the Department consider, however, that Carillion will be suitably incentivised as it stands to earn more by performing well, will be under pressure from the THC Dartford shareholders to perform and its reputation for winning future PFI contracts is at stake. This is a judgement which the other shareholders of THC Dartford and the purchaser of Carillion's investment would also have needed to make.

12 In the light of our analysis of this early refinancing under the new refinancing code, and the Treasury's monitoring of other refinancings, the Treasury Refinancing Taskforce has been re-emphasising to departments the content of the Treasury's existing refinancing guidance which underlines the importance of departments carrying out rigorous analysis of the value for money implications of any refinancing proposal. The Taskforce continues to have regular contact with departments on refinancing issues which includes the option of related training.

13 The Trust is operating in a changing and competitive healthcare environment. This requires the Trust to react to changes in NHS healthcare policy and changes in the local health strategy. A programme of further building work on the site is already in hand. To manage change well the Trust will need to continue to develop a good relationship with THC Dartford and to make effective use of contractual mechanisms aimed at maintaining value for money. The PFI contract allows the Trust flexibility to increase or decrease the usage of the facilities within the constraint that it must continue to pay for a fully maintained hospital until the end of the contract period.

2 Change in the net present value of THC Dartford's shareholders' expected returns following the refinancing

Timing and basis of calculation	At contract letting	Prior to the refinancing	After refinancing
Calculations by THC Dartford when bidding for contract based on discount rate of 21 per cent (nominal), the expected rate of return to THC Dartford shareholders	£21 million over the minimum contract period of 28 years		
Calculations in connection with the refinancing based on agreed discount rate of 15 per cent (nominal)[1,2]	£32 million over the minimum contract period of 28 years	£29 million over the minimum contract period of 28 years	£51 million over the extended minimum contract period of 35 years (of which £37 million was taken at refinancing within three years of the new hospital opening).
Internal rate of return to THC Dartford's shareholders[3]	21 per cent[4]	23 per cent	56 per cent

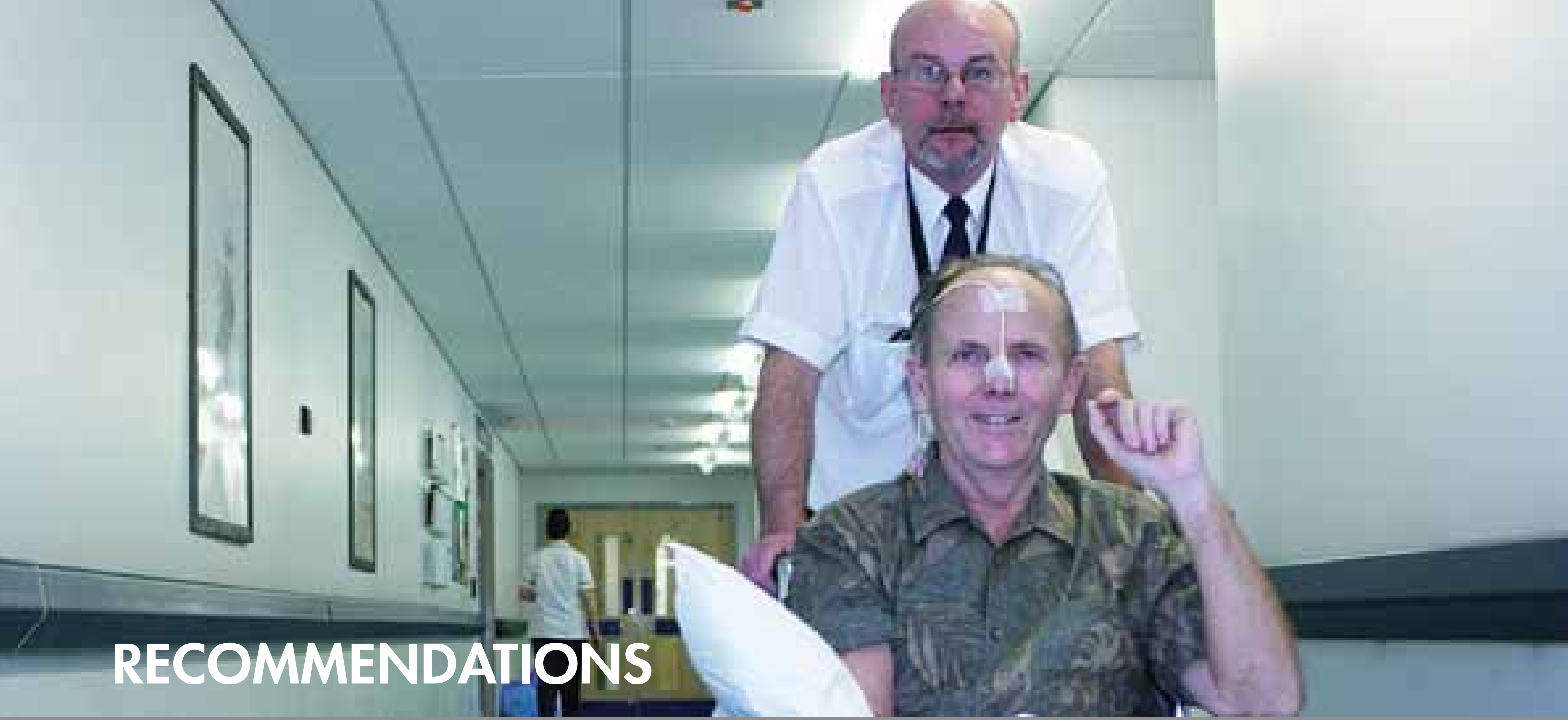
NOTES

1 Calculated at the agreed 15 per cent nominal discount rate used for calculating the refinancing gains to be shared with the Trust. THC Dartford's internal calculations show lower figures for the net present value of their shareholders' returns after refinancing (see Figure 12, (note 1), page 26).

2 A year by year profile of the returns to THC Dartford shareholders in cash terms, before and after the refinancing, is set out in Figure 11, page 26.

3 The internal rate of return to shareholders is the standard measure which the public sector has used to compare the returns expected by shareholders of consortia bidding for PFI contracts. It is not an indication of the future rate of annual returns which the investors in THC Dartford anticipate realising from the project but reflects the time value of when benefits are received including the benefits realised immediately following the refinancing. The increase to 56 per cent following the refinancing reflects the high value of receiving large returns early in the contract period.

4 The internal rate of return expected by THC Dartford when bidding for the contract.



RECOMMENDATIONS

14 We make the following recommendations:

A As an urgent priority, the Trust should complete its evaluation of its experience of performance measurement and how payment has been linked to performance so that the evaluation can contribute to the five yearly benchmarking of services, the results of which are to be implemented in July 2005. In particular the Trust should:

- i reduce, as far as is possible, subjectivity in the way that performance is measured. This will ensure that payment deductions as permitted by the contract are commensurate with the impact of poor performance on the Trust and its patients; and
- ii work with the Department to disseminate to other NHS Trusts the lessons from the Trust's review of performance measurement and payment deductions alongside the Department's current views on best practice drawn from its portfolio of PFI hospital projects.

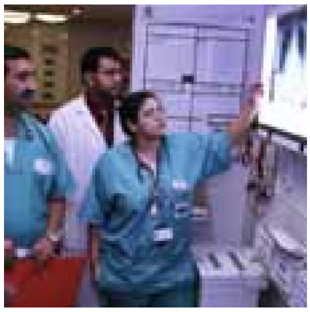
B Authorities should plan for the considerable senior management effort that will be needed in managing a PFI contract, particularly in the early years. It is a false expectation that senior management time will be freed up by contracting out major areas of service delivery whether by PFI or other forms of procurement.

C Refinancings are complex and the potential risks and benefits are often very large, particularly in early PFI deals. It is essential, therefore, that public sector project teams take timely experienced advice. Available sources for advice include departmental Private Finance Units and the Treasury Refinancing Taskforce which provides guidance on policy aspects of refinancings. The Taskforce should be consulted on a regular basis as refinancings are being negotiated. Departments should also take advantage of the training on refinancing issues which the Taskforce is able to provide to project teams.

D Authorities must assess the changes in risks and rewards to both them and their private sector partners that will arise from a refinancing before agreeing it. In particular authorities should:

- i determine that the private sector parties will still be adequately incentivised to perform well over the remainder of the contract after the refinancing;
- ii not agree to extend a PFI contract without very careful analysis of the quantifiable and non-quantifiable benefits and disbenefits of the contract extension including the implications of being contractually committed to a particular PFI project company for longer periods;



iii assess carefully the value for money case for accepting refinancings involving increases to the private sector borrowings and increased termination liabilities to the public sector. Although a low expected probability of termination may suggest that refinancing benefits in return for increasing termination liabilities will be value for money this has to be weighed against the consequence that, should termination be appropriate, it may be expensive to effect, particularly where the liabilities have increased and are greater than the capital cost of the project. Where refinancing proposals would result in increased termination liabilities authorities should explore with the private sector what refinancing terms would be available with no increase to termination liabilities; and

iv consider carefully the options of taking their share of the refinancing gain as a lump sum or over time. This should take into account that the lump sum option can give certainty of receipt of the refinancing gain and mirrors the private sector's approach to immediately realising refinancing gains. The lump sum option may, however, require the private sector to increase its debt with the possibility of increased termination liabilities for the public sector. The decision on how to take the refinancing gains should always be based on value for money considerations but there may also be accounting and financing issues for public authorities to consider.

E The Treasury, through its Refinancing Taskforce, should continue to emphasise to departments the Treasury's existing refinancing guidance and should draw departments' attention to the recommendations set out in paragraph D above. There will also be value in the Treasury Refinancing Taskforce producing a simplified introduction to the subject of refinancing which officials who are new to the subject could read before considering the detailed guidance which is available.

F The changes which are occurring within this project demonstrate that, as with any long term project, public authorities need to recognise, and plan for, the risks associated with future change which may affect their PFI projects. Any hospital is a major investment which commissioners of health care and Strategic Health Authorities have to recognise in planning their health care strategies. Their planning also needs to take into account the long term revenue implications of PFI hospital contractual arrangements.

PART ONE

The PFI deal as originally contracted has been delivered so far

1.1 In this pathfinder project the Trust's PFI hospital was delivered on time and for the contracted price. The subsequent service provision by THC Dartford has been delivered with only occasional service lapses. A low level of payment deductions has mainly reflected the largely satisfactory service delivery. But while the Trust believes that performance scores awarded were appropriate, in our view, lower scores could justifiably have been given for some of the lapses that occurred. Deductions which were made were in line with the contract but lower scores would have resulted in greater deductions. In terms of the hospital's overall performance the Trust initially scored poorly in the star rating system after the new hospital opened for reasons unconnected with the PFI contract. The Trust subsequently achieved and maintained three stars – the highest rating.

The new hospital has been delivered to time and cost in accordance with the contract

This pathfinder PFI hospital was delivered on time

1.2 The PFI contract between the Trust and THC Dartford, the first PFI hospital contract to be finalised, was let in July 1997 at an expected net present cost to the Trust of £171 million for the construction of the building and services over the minimum 28 year contract period at 1996 prices. In cash terms this was equivalent to £743 million (Appendix 3).

1.3 The contract required completion of the hospital by September 2000. Construction of the hospital commenced in August 1997 and was completed by July 2000 when the hospital started to become operational. The Trust started paying for the hospital from September 2000 when it became fully operational. The Trust estimates that being able to make early use of the hospital before it was obliged to make payments produced a benefit of around £2 million.

1.4 The 400 bed new hospital replaced, on one new site at Darenth Park, under-maintained old facilities which had previously been on three sites in the Dartford and Gravesend areas.

The cost to the Trust has been as expected with construction risk borne by Carillion

1.5 The annual payment that the Trust was contracted to pay once the hospital was fully operational remained unchanged during the construction phase of the project. Through the PFI contract the Trust had transferred the construction risk to THC Dartford who in turn transferred the construction risk to the construction subcontractor, Carillion, by a fixed price design and construction contract. For building the hospital and providing hospital equipment, Carillion received £95 million from THC Dartford. Carillion informed us that the mechanical and engineering element of the construction work was carried out at a loss resulting in Carillion only breaking even on its construction contract with THC Dartford. But the construction phase was still completed on time and the extra construction costs were not passed on to the Trust which is evidence of risk transfer under the PFI working.

The physical transition to the new hospital was completed smoothly

1.6 Our interviews with staff revealed that, as with any decant, there were some temporary problems but overall the move to the new hospital went smoothly. This included the transfer of patients from the three previous sites to the new single site facilities. There was some reduction in elective surgery during the move which had been expected but activity recovered once the Trust had moved into the new hospital. Despite some teething problems the decant was completed smoothly without serious problems.

The new hospital brought modern facilities but some problems emerged

1.7 CHI commented favourably on the design of the new hospital in October 2002.[3] It considered the design helps to facilitate clinical pathways for the treatment of patients and had flexibility to accommodate additional facilities. The local Primary Care Trust (PCT) commented that no major design issues had been raised by GPs or patients. The new hospital was considered to have good ward layout, quality of lighting and direction finding.

1.8 Despite CHI's positive design evaluation, clinical staff raised some concerns with us. They were concerned in the early days that the Accident and Emergency (A&E) Unit had problems of crowding and unacceptable waiting times. The Trust has addressed these problems and since March 2004 is one of the top performing Trusts in England.

1.9 Clinical staff also felt that it had been difficult to envisage what design plans would mean in practice. They suggested that it would be helpful for clinicians if scale models of designs were produced to diminish the risk that the actual design is different to expectations. Detailed drawings of proposed facilities were made available to clinical staff during the consultation process. It is now standard practice to use computer aided design (CAD) to help clinicians visualise what a hospital will be like to work in.

1.10 As noted in our earlier report on this deal the bed capacity in the new hospital of 400 in-patient beds (a reduction from the 475 beds which the Trust had previously in use) had been proposed by the then Regional Health Authority and was broadly consistent with NHS policy guidelines for new hospitals at the time.

1.11 After the new hospital opened, the Trust suffered some adverse press comment on the performance of the A & E Unit and also from a perception by some users of the hospital that the bed numbers were insufficient. The Medical Director informed us that after the move to the new hospital there were clinical concerns that an increase in emergency admissions had caused some deferrals of elective surgery admissions because beds were taken by the emergency admissions. This was dealt with by increased productivity, changes in clinical practice and reductions in delayed transfers to care. New additions to the A&E department, to address recent changes in GP out of hours services, were completed in August 2004 and are now fully operational. These additions were built as a conventionally funded variation to the project.

1.12 There was also a reduction in confidence by local GPs in the ability of the new hospital to cope with the demand from patients. Some GPs then increasingly referred patients to London hospitals. Intermediate care, those facilities and services which patients can be referred to by GPs rather than going to a hospital, struggled to cope with the effects of the reduction in bed numbers as other local facilities had not been sufficiently built up to cope with the reduction in beds. The local PCT commented to us that, with hindsight, intermediate care facilities should have been built up 18 to 24 months prior to the opening of the new hospital. Confidence in the new hospital has returned, evidenced by a decrease in the levels of activity being referred to London. The bed numbers at the hospital have been increased to around 420.

1.13 A view that was consistently expressed to us was that developing and implementing the PFI deal had taken up a lot of management time reducing focus on the other day-to-day responsibilities and ongoing strategic direction of the Trust. The Department recognises this and advises Trusts to identify adequate project management resources and also acknowledges that there is a difficult balance to be struck by Chief Executives managing a PFI deal as well as day to day operations of the Trust.

3 CHI Clinical Governance Review, October '02.

Initially the Trust performed poorly but new senior management improved performance

1.14 Following the new hospital opening in 2000, the Trust received a zero star rating for 2001 from the Department[4] because of various operational and financial concerns. At the time of the letting of the PFI contract there was a plan to keep the Trust's finances in balance. The Trust subsequently had financial difficulties, however, although the PFI contract price had remained unchanged. The Trust later became one of four NHS Trusts where the Department introduced its franchised management scheme in May 2002. The franchise involved the Trust working in partnership with the Basildon and Thurrock University Hospitals NHS Trust (a three star rated Trust) to benefit from sharing best practice and developing new ways of working.

1.15 The Trust's previous Chief Executive had retired in late 2001. The Chief Executive role was then carried out, initially on a temporary basis which later became permanent, by the Chief Executive of the Basildon and Thurrock University Hospitals NHS Trust.[5] In addition, there had been several other changes to the Trust's board. These resulted in the appointment of a new chairman, finance director and two new non-executive directors.

1.16 The new senior management instigated a management plan which succeeded in improving the overall performance of the hospital. The new management plan led to the Trust being awarded three star status (the highest rating) by CHI for 2003 and 2004. Some of the hospital's key performance statistics are set out in **Figure 3**. The Trust was in financial balance in 2003-04.

3 Darent Valley Hospital: Some key performance statistics

Years to 31 March	2000-01[1]	2001-02	2002-03	2003-04
Bed occupancy rate	90.46%	94.13%	94.4%	92.8%
National average	84.0%	85.1%	85.4%	85.8%
Number of attendances to A&E	50,634	48,330	49,443	56,729
% of admissions to A&E seen within NHS target time; see footnotes 6 & 7	Trolley wait target achieved	Trolley wait target achieved	90% (target achieved)	90.7% (target achieved)
National average	Not available	Not available	Not available	90.6%
% of patients with hospital acquired infection[2]	Not available	Not available	7.0%	4.4%
CHI Star rating	No stars[3]	1 star	3 stars	3 stars
Reported Waiting List (inpatient and Day Case)	3,284	3,346	2,680	2,543
Reported Waiting List (6 months and above)	921	1,046	557	266
Non-elective admissions	10,060	10,572	13,032	14,732

Source: The Trust, the Department and CHI

NOTES

1 2001 covers the move to the new Darent Valley hospital.

2 The Department estimates that on average around 9 per cent of inpatients at any one time will have a healthcare acquired infection.

3 Given by the Department before CHI assumed responsibility for awarding star ratings.

4 This was before CHI assumed responsibility for awarding star ratings.
5 The new Chief Executive was appointed in May 2002 though had been on secondment from November 2001.
6 The target for 2002-03 was set for March 2003 only.
7 Since May 2004 the Trust is achieving 98% of admissions to A&E seen within NHS target time. The demand for A&E services at Darent Valley Hospital has grown by 15 per cent per annum since 2002.

Employee issues were addressed as part of the transition to the PFI hospital

1.17 The Trust transferred facilities management and support staff to Carillion under TUPE[8] following detailed and lengthy consultation, including with trades unions. The transfer was effected without problems and all staff working within the hospital are regarded by the Trust as being part of the Trust's team irrespective of their employer. Within the PFI contract the Trust ensured agreement of continuity of recognition for the trade unions by the private sector partner. The Trust and Carillion continue to co-operate on any issues that arise regarding the conditions under which the transfer took place. The transfer included confirmation by the Government Actuaries Department that the Carillion pension scheme for transferring employees matched the NHS scheme that they were leaving. Carillion has accepted the implications of changes to early retirement rights for NHS staff.

The hospital facilities have generally been available for use

THC Dartford has not incurred sizeable deductions for lack of availability

1.18 The Trust currently pays annual payments of £17.2 million to THC Dartford under the PFI contract. Of this £10.6 million relates to payments for THC Dartford making the hospital facilities available for use. The balance of £6.6 million is for facilities management services such as catering, cleaning, laundry and portering, provided by subcontractors to THC Dartford.

1.19 There has only been one occasion where a shortfall in THC Dartford's performance necessitated a financial deduction by the Trust for a failure in keeping the hospital facilities available for use. In February 2002 there were electrical failures which resulted in Theatre 2 being unavailable for 48 hours and Theatre 3 for 72 hours. Patients were not put at risk since the operations planned to take place in these theatres were rescheduled to other theatres at the hospital which had spare capacity at the time. The Trust made a deduction of £4,448.[9]

But there will not always be financial deductions if facilities are unavailable

1.20 While THC Dartford can lose up to 100% of its availability fee in any month not all Hospital areas are liable to a financial deduction in the advent of unavailability. The Trust decided to place greater emphasis on those areas which it considered most critical to patient care. The contract specified the main areas for which deductions could be made and further details were finalised after contract letting. In July 2000 the Trust board gave approval to a list of areas where deductions are not possible for unavailability **(Figure 4)**.

4 Areas within the Hospital that THC Dartford is responsible for maintaining but are not subject to a financial deduction if an area becomes unexpectedly unavailable[1]

- Pathology
- Hospital Management
- Social Services
- Fracture Clinic
- Patient Services, Shops, Café, Main Reception, Waiting List Department
- Rehabilitation (including Physiotherapy)/Hydrotherapy
- Speech therapy
- Dieticians
- Medical Records
- Chapel
- Ellenor Foundation
- Hotel Redwood
- Occupational Health
- The Phillip Farrant Education Centre
- Children's Resource Centre

NOTE

1 THC Dartford is allowed, in agreement with the Trust, to make an area (such as an operating theatre) unavailable, without suffering a financial deduction, if this is to carry out the contractual programme of Planned Preventive Maintenance.

8 TUPE: Transfer of Undertakings (Protection of Employment) Regulations 1981.
9 This accounted for 0.4% of the unitary payment for that month.

1.21 Some of the areas where the Trust cannot make deductions if the facilities are unavailable could cause considerable difficulties for the treatment of patients if these facilities cannot be used. These include pathology, the fracture clinic, physiotherapy and medical records. The fact that THC Dartford cannot suffer a financial deduction for these areas could, in theory, reduce THC Dartford's incentive to keep these areas well maintained and to remedy any problems promptly. The Trust notes however that there has only been one significant problem in areas which are not subject to payment deductions. There was a flooding in Medical Records, and this was dealt with immediately by Carillion.

The Trust has assessed the facilities management services as largely in line with the contract though with some occasional exceptions

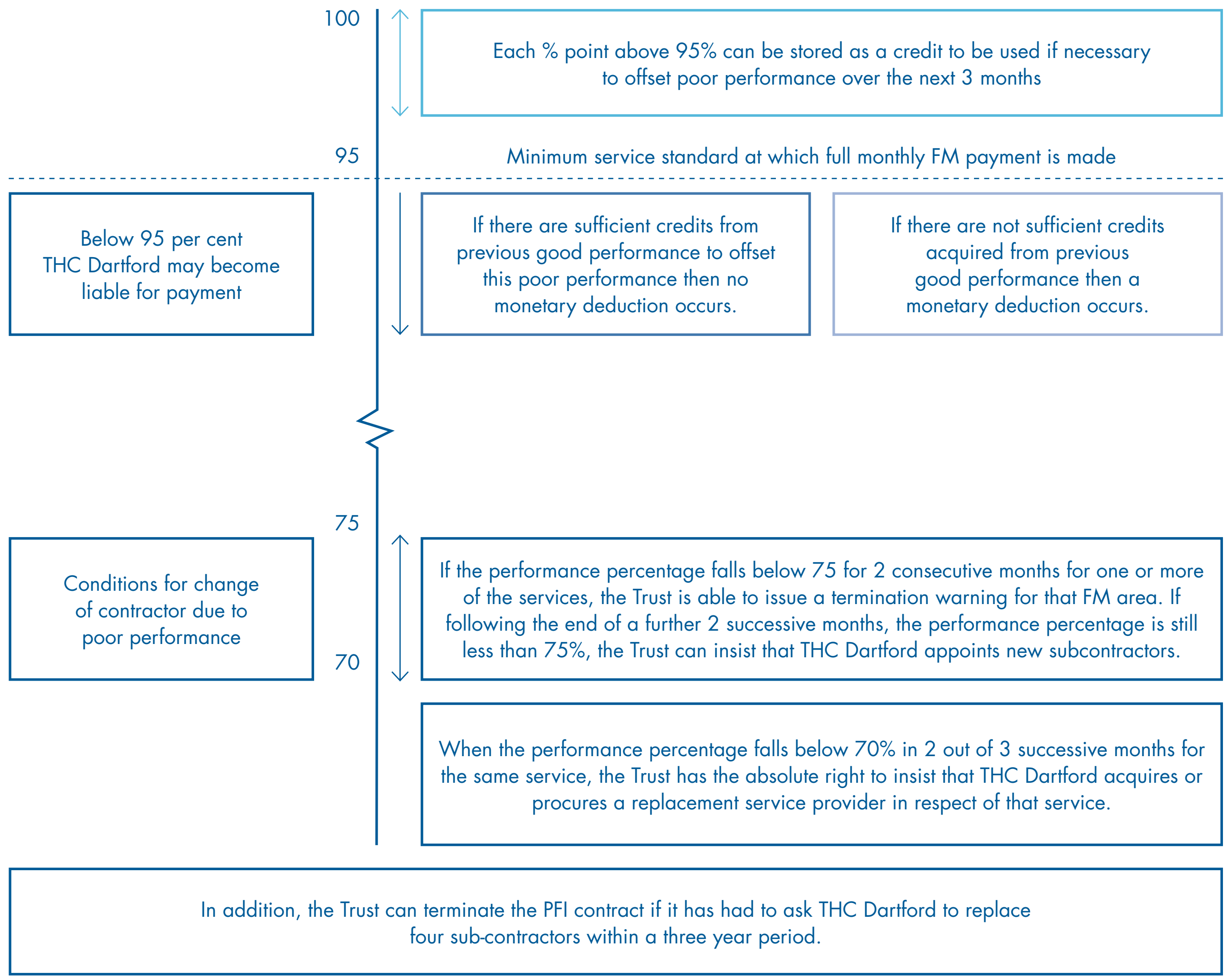
1.22 Performance of the facilities management (FM) services is measured according to a percentage scale. A key feature of the arrangements is the Minimum Service Standard, **(Figure 5)**.

1.23 **Figure 6** (see separate sheet) shows the achieved level of performance for FM services since the start of the contract. The main features are:

- the aggregate performance of FM services each month has been at least 95%, the minimum service standard required for THC Dartford to be paid in full for particular services.
- the aggregate performance of FM services was well above the minimum service standard up to mid 2002 but then declined through to mid 2003, partly due to the Trust being more rigorous in its assessment of performance. Performance then recovered and has remained largely above the minimum standard.

1.24 Aggregate performance, and also performance in each of the service categories used to determine payments to THC Dartford, is a composite of scores for a number of individual FM services. THC Dartford's performance over time is shown in Figure 6 (see separate sheet) and a summary of THC Dartford's performance by service category is given in **Figure 7** on page 16. This shows that there were some variations in performance, particularly in summer 2003, when THC Dartford experienced problems maintaining a satisfactory level of performance in some areas. Most of these problems have been overcome but some have yet to be resolved fully – for example, discussion between the Trust and THC Dartford continues over the necessary level of portering services.

5 Scale for performance measurement



Source: Trust's performance measurement system

6 Summary of the payments and deductions made to THC Dartford from 2000 to July 2004 (excluding VAT)

	2000-01 £000's	2001-02 £000's	2002-03 £000's	2003-04 £000's	April-July 2004 £000's
Payments to THC Dartford before deductions					
Total Basic Charge[1]	9,990	17,941	18,306[1]	16,636[1]	5,662
Other Charges (analysed below)	1,037	2,341	2,168	2,423	937
	11,027	**20,282**	**20,474**	**19,059**	**6,599**
Deductions					
Availability	0	-4	0	0	0
FM Services	-10	-1	-0[2]	-7	0
Waste (discount)	0	-19	-4	-5	-1
Total deductions	**-10**	**-24**	**-4**	**-12**	**-1**
Payments to THC Dartford after deductions	**11,017**	**20,258**	**20,470**	**19,047**	**6,598**
Other Charges					
Utilities & Insurance	529	963	980	989	486
Rates	444	861	875	890	365
Capital works, minor works and additional works	5	221	220	382[4]	36
Additional FM services	59	296	216	152	47
Miscellaneous	0	0	-123[3]	10[5]	3[5]
Total	**1,037**	**2,341**	**2,168**	**2,423**	**937**

Source: THC Dartford invoices (with the exception of 2000-01 where the figures are taken from the Trust's final accounts).

NOTES

1 The total basic charges are based on THC Dartford's invoices in the respective financial years to 31 March. The charge for 2003-04 was lower than 2002-03 because the Trust had started to receive its annual share of the refinancing gain by way of a reduction to its PFI contract price. The amount for 2002-03 shown above was the charge before the additional lump sum receipt in that year of £1.5 million from the refinancing.

2 A deduction was made of less than £1,000.

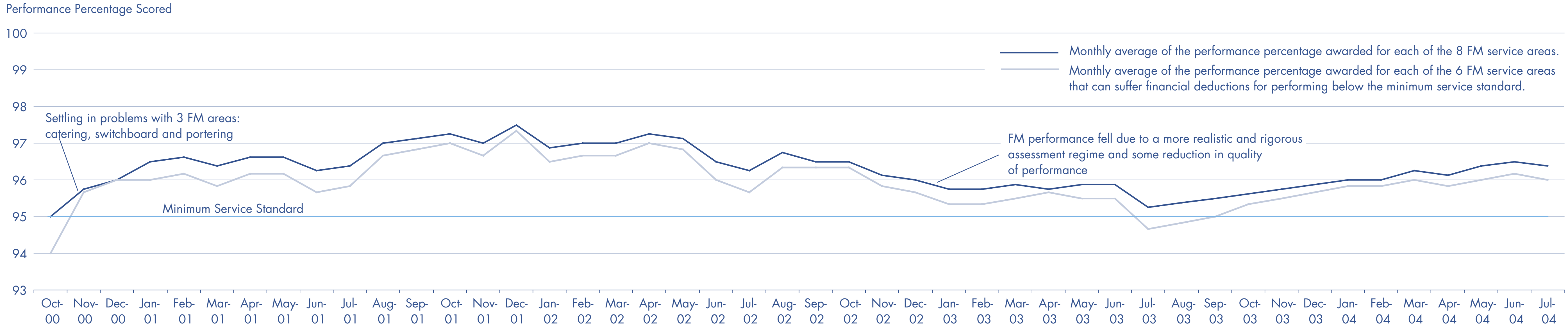
3 Credit to the Trust relating to a contractual agreement concerning £5 million for equipment.

4 This includes payments for the building works on the A&E extension, the staff common room and the day care pre-assessment.

5 Lease - The Learning Centre.

Figure overleaf

6 Trends in Facilities Management (FM) Services: average of the performance percentage scores awarded to the FM services each month



NOTE Since this detailed analysis to July 2004 performance has continued to meet the minimum service standard.

See over for summary of payments and deductions made by the Trust from 2000 to July 2004

Individual FM service area performance and months in which financial deductions occurred

Service	Oct-00	Nov-00	Dec-00	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02	Mar-02	Apr-02	May-02	Jun-02	Jul-02
Estates & Maintenance, Grounds and Garden	95	95	96	96	96	96	96	96	96	95	96	96	96	95	96	94	95	95	95	96	96	95
Domestic, Window Cleaning and Pest Control	95	96	96	96	96	96	97	97	95	96	97	97	98	97	98	97	97	97	98	97	95	95
Portering Transport and Internal Security	92	93	94	94	95	95	95	95	94	95	95	96	96	96	97	97	97	97	96	96	96	95
Linen and Laundry	98	98	98	98	98	98	98	98	98	97	98	98	98	98	98	97	97	97	97	97	97	97
Catering	92	96	96	96	95	94	95	95	96	96	97	97	97	97	97	97	97	97	98	97	95	95
Switchboard and Telecommunications	92	96	96	96	97	96	96	96	95	96	97	97	97	97	98	97	97	97	98	98	97	97
External Security	100	96	96	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98
Car Parking	96	96	96	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98

Service	Aug-02	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03	Mar-03	Apr-03	May-03	Jun-03	Jul-03	Aug-03	Sep-03	Oct-03	Nov-03	Dec-03	Jan-04	Feb-04	Mar-04	Apr-04	May-04	Jun-04	Jul-04
Estates & Maintenance, Grounds and Garden	96	96	96	96	96	96	96	96	96	96	96	94	94	95	95	95	95	95	95	95	95	95	96	96
Domestic, Window Cleaning and Pest Control	96	96	96	95	96	96	96	96	96	95	95	94	94	94	95	95	95	95	95	95	95	95	95	96
Portering Transport and Internal Security	96	96	96	96	96	96	96	96	96	95	95	94	95	96	96	96	96	96	96	96	96	96	96	94
Linen and Laundry	97	97	97	97	96	94	93	94	95	95	95	95	94	95	95	96	96	97	97	97	97	97	97	97
Catering	96	96	96	95	95	95	95	95	95	95	95	94	95	93	94	94	95	95	95	96	95	96	96	96
Switchboard and Telecommunications	97	97	97	96	95	95	96	96	96	97	97	97	97	97	97	97	97	97	97	97	97	97	97	97
External Security	98	97	97	97	97	97	97	97	96	97	97	97	97	97	97	97	97	97	97	98	98	98	98	98
Car Parking	98	97	97	97	97	97	97	97	96	97	97	97	97	97	96	96	96	96	96	96	96	97	97	97

Key
- Above minimum service standard, no financial deduction
- At minimum service standard, no financial deduction
- Performance below minimum service standard but no financial deduction due to retained credits from earlier above satisfactory performance
- Financial deduction due to below minimum service standard performance.

NOTE Financial deductions for below minimum service standard cannot be imposed on External Security and Car Parking.

Individual FM service areas and their credits earned each month

Service	Oct-00	Nov-00	Dec-00	Jan-01	Feb-01	Mar-01	Apr-01	May-01	Jun-01	Jul-01	Aug-01	Sep-01	Oct-01	Nov-01	Dec-01	Jan-02	Feb-02	Mar-02	Apr-02	May-02	Jun-02	Jul-02
Estates & Maintenance, Grounds and Garden	95	95	96	96	96	96	96	96	96	95	96	96	96	95	96	94	95	95	95	96	96	95
Domestic, Window Cleaning and Pest Control	95	96	96	96	96	96	97	97	95	96	97	97	98	97	98	97	97	97	98	97	95	95
Portering Transport and Internal Security	92	93	94	94	95	95	95	95	94	95	95	96	96	96	97	97	97	97	96	96	96	95
Linen and Laundry	98	98	98	98	98	98	98	98	98	97	98	98	98	98	98	97	97	97	97	97	97	97
Catering	92	96	96	96	95	94	95	95	96	96	97	97	97	97	97	97	97	97	98	97	95	95
Switchboard and Telecommunications	92	96	96	96	97	96	96	96	95	96	97	97	97	97	98	97	97	97	98	98	97	97
External Security	100	96	96	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98
Car Parking	96	96	96	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98	98

Service	Aug-02	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03	Mar-03	Apr-03	May-03	Jun-03	Jul-03	Aug-03	Sep-03	Oct-03	Nov-03	Dec-03	Jan-04	Feb-04	Mar-04	Apr-04	May-04	Jun-04	Jul-04
Estates & Maintenance, Grounds and Garden	96	96	96	96	96	96	96	96	96	96	96	94	94	95	95	95	95	95	95	95	95	95	96	96
Domestic, Window Cleaning and Pest Control	96	96	96	95	96	96	96	96	96	95	95	94	94	94	95	95	95	95	95	95	95	95	95	96
Portering Transport and Internal Security	96	96	96	96	96	96	96	96	96	95	95	94	95	96	96	96	96	96	96	96	96	96	96	94
Linen and Laundry	97	97	97	97	96	94	93	94	95	95	95	95	94	95	95	96	96	97	97	97	97	97	97	97
Catering	96	96	96	95	95	95	95	95	95	95	95	94	95	93	94	94	95	95	95	96	95	96	96	96
Switchboard and Telecommunications	97	97	97	96	95	95	96	96	96	97	97	97	97	97	97	97	97	97	97	97	97	97	97	97
External Security	98	97	97	97	97	97	97	97	96	97	97	97	97	97	97	97	97	97	97	98	98	98	98	98
Car Parking	98	97	97	97	97	97	97	97	96	97	97	97	97	97	96	96	96	96	96	96	96	97	97	97

Performance Score and number of credits earned per month Key: 95 - 0 credits earned; 96 - 1 credit earned; 97 - 2 credits earned; 98 - 3 credits earned; 99 - 4 credits earned; 100 - 5 credits earned. These credits can be carried forward for a 3 month period only

7 Performance of FM services compared to the minimum service standard

Service	Performance
Switchboard and telecommunications	Usually above
External security	Consistently above
Car parking	Consistently above
Estates & Maintenance, Grounds and Garden	Usually above
Linen and Laundry	High performance prior to February 2003, then problems following a change of supplier (Appendix 5). Performance has since improved and Linen and Laundry is now performing above minimum service standard
Domestic services (cleaning), window cleaning and pest control	Usually at or above minimum service standard, but some problems were experienced in Summer 2003
Portering, transport and internal security	Generally above minimum standard but some lapses
Catering	Some problems in Summer 2003 but performance currently above minimum standard.

Payment deductions for under-performance have been low, mainly reflecting the good delivery of services

1.25 The Trust is entitled to make payment deductions for unsatisfactory service performance. As this was the first PFI hospital contract to be let there was, at that time, no standard payment mechanism for the Trust to follow. However, the Trust's contract correctly provided for the amount of the deduction to increase in line with the seriousness of the incident and for the possibility that deductions in respect of a particular service could be made up to the full amount of THC Dartford's normal charges for that service in any month.

1.26 Over the four years that the hospital has been in operation there have been relatively few lapses in performance. The Trust's records show that up to July 2004 there were 24 examples of FM services being below minimum standards. These are detailed in Appendix 5.

1.27 The Trust made financial deductions totalling £18,691 in respect of 15 FM service events (equal to 0.1 per cent of the payments the Trust has made for these services of around £25 million). THC Dartford was liable for deductions of £8,411 for the other 9 events, but these were offset in full by credits acquired from previous good performance, and were not made.

1.28 The credit system, which allows THC Dartford to carry forward performance above the minimum standard for three months, is intended to incentivise THC Dartford to strive for above satisfactory performance. There is, however, also a risk with this system that, having built up credits, the providers of services can afford to let standards slip, as they will not suffer deductions. Such credit arrangements are no longer recommended under the NHS's current standard payment mechanism.

Evaluating the achieved level of performance requires some subjective judgements

1.29 Appendix 5 and our field work indicates that some of the elements of under-performance were potentially serious for patient care, for example:

- the Trust's performance reports for July 2003 noted that there had been a repeated waste collection failure. The Trust awarded a performance score of 94 for the month although on this occasion, there was no payment deduction;[10]
- in September 2003, the Trust's Performance Management System (PMS) records noted that there was a 'collection of dust underneath beds' and 'staining on walls'. The Trust awarded a monthly performance score of 94 to Domestic Services, Window Cleaning and Pest Control leading to a payment deduction of £1,153; and
- the PMS of September 2003 noted, 'extremely poor levels of hygiene and cleanliness of premises and personnel' in the food production area. A performance score of 93 was awarded leading to a payment deduction of £1,621.

10 THC Dartford was able to claim a credit from the good performance of previous months.

1.30 In our opinion the scores awarded seem high in relation to the nature of the incidents. In part this reflects the subjective nature of assessments. The performance measurement system in use incorporates mainly subjective assessments and this means that there can be different interpretations of how serious a particular lapse in performance has been. This is important as lower scores would have resulted in greater deductions.

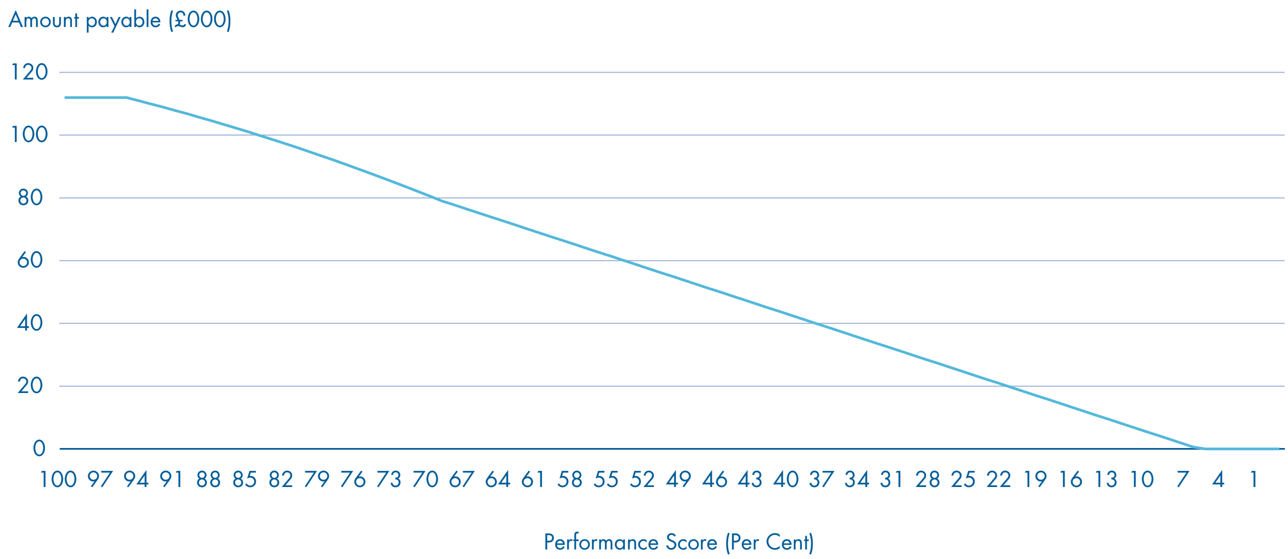
1.31 The contract allows for increasingly greater payment deductions to be made as performance scores decline **(Figure 8)**, and deductions which were made were fully in line with these arrangements. While it has to be recognised that the cost of ensuring a perfect service would be prohibitive, there is a risk that the incentives for maintaining good performance will not bite unless the assessments made of lapses fully reflect their potential seriousness. Making assessments commensurate with the nature of events is also necessary to ensuring that good value for money is obtained from the contract. THC Dartford notes, however, that the PFI deal was priced on the basis that the consequential losses for service lapses that THC Dartford can be expected to bear are limited to its charge for the particular service in the month in which the lapse occurs.

A number of lessons have been learnt as the PMS has evolved over time although further improvements could be made

1.32 The contract set out principles by which a performance measurement system (PMS) would operate for measuring the delivery of facilities management services. This included the rate at which payments would be reduced for performance scores which were unsatisfactory, the performance indicators and their weighted effect on the payment deductions if not met. However, in seeking not to delay closing the contract, the previous Trust management left the detailed development of performance measures and determining the standards of performance that would result in particular performance scores until after the contract had been let. THC Dartford has told us that the intention was that the work to be completed after contract letting would not change the previously negotiated basis of risk transfer which had informed the terms of THC Dartford's finance and THC Dartford's pricing of the PFI contract. Nevertheless, determining performance measures and how they would interrelate with performance scores after the contract was let means that in practice potentially important issues relating to risk transfer were still being refined after the contract was let.

8 The contract payment mechanism set out in the original contract

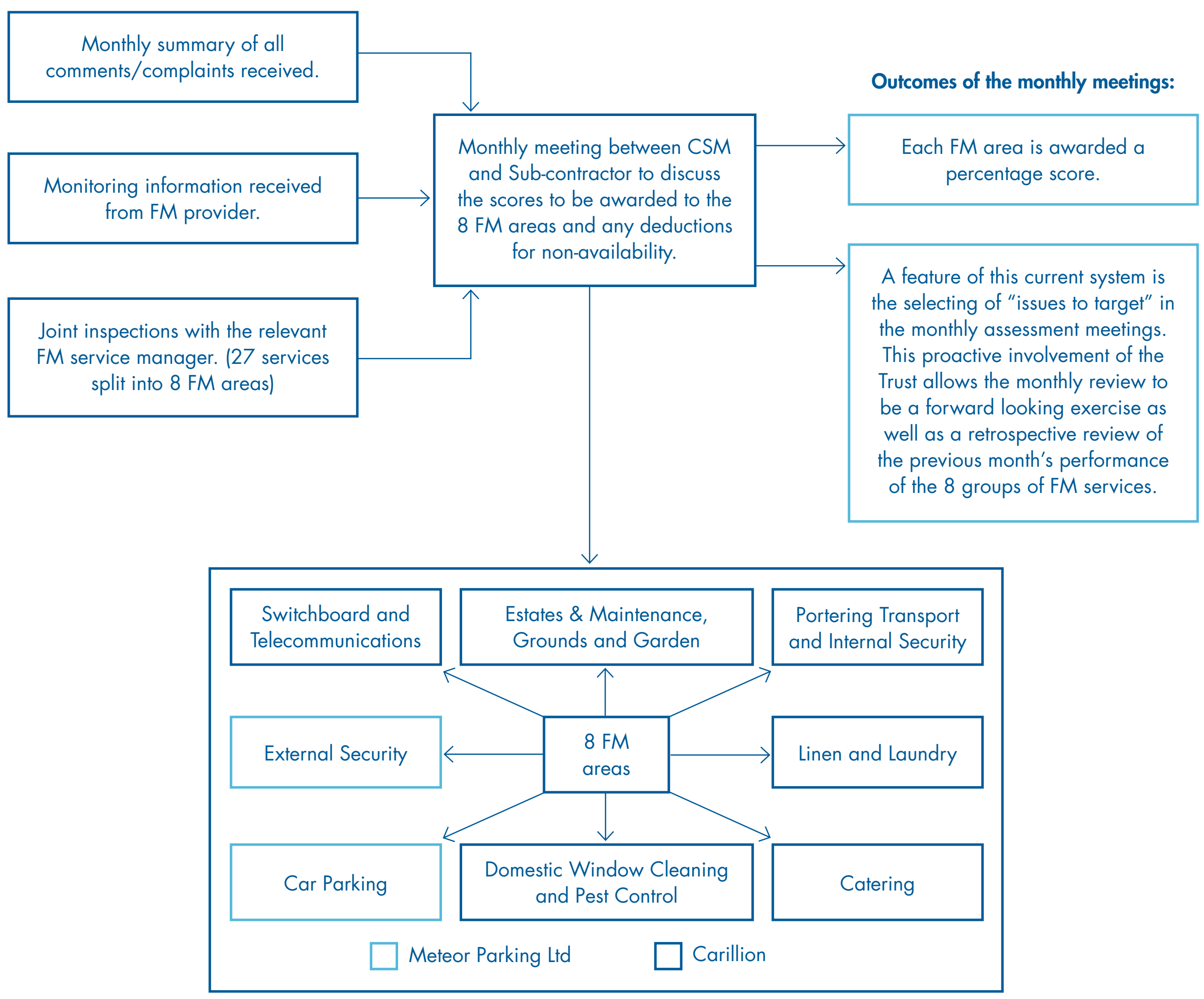
The monthly performance related payment for portering, internal security and transport



1.33 The Trust and THC Dartford subsequently developed a performance measurement system (PMS) but initially found it to be cumbersome and in any case in need of refinement in the light of experience of using it. The current PMS **(Figure 9)** has, as a result, evolved over time and in so doing, a number of useful lessons have been identified, which are of wider applicability for those managing PFI hospital contracts on a day to day basis. In addition to the need to agree before letting a contract the detail of how payment deductions will relate to performance deficiencies, other learning points have been:

- **The Trust's experience confirms that events will inevitably occur that were not covered in the contract**. The Trust has sometimes been in disagreement with THC Dartford regarding circumstances that have arisen, which were not foreseen, or not explicitly stated, in the contract. For example, there was disagreement over whether the contractor was responsible for de-icing the car park when there was an exceptionally heavy snowfall. In this case, a common sense approach to the problem by all parties prevailed but the Trust has found that resolving contract disputes through the contract process can be time consuming. The Trust and THC Dartford have increasingly developed a reasonable balance between pragmatism and over reliance on seeking contractual solutions.
- **There is a balance to be found between ensuring the PMS provides relevant information without it becoming unmanageable**. Initially, the PMS underlaid possible generic deductions (relating to failures to deliver the minimum service standards across the whole hospital), specific deductions (which included tasks specified in the procedures manuals in nominated areas of the hospital) and deductions for non-availability. Both the Trust and Contractor agreed that this initial system was too complex and involved excessive form filling. In recognition of these problems, the Trust combined the generic and specific monitoring forms to produce around ten key indicators for each FM service. These key indicators then had weightings attached and were used as the basis for scoring the FM areas. This more simplified structure sought to achieve easier performance monitoring on a day to day basis.
- **Attempting to replicate the contractor's performance monitoring will cause problems**. As with most PFI contracts, the monitoring of the FM services at the Trust is the responsibility of the Contractor. The Trust has itself devoted resources to monitoring the performance of the contract on a day-to-day basis. In the Trust's and THC Dartford's view this has unnecessarily replicated the process and has also created some tensions when monitoring staff at the Trust have taken action in telling the contractor how to rectify a problem. It intends to work with THC Dartford to ensure that all parties play their role fully in the performance management system and further that systems are in place to ensure information is shared and acted on appropriately.
- **A PMS works better if subjectiveness is minimised**. Both the Trust and THC Dartford would like to see more objectivity in determining the way performance scores are awarded in the PMS. For example, THC Dartford told us that the PMS needed to be more objective since it was currently unclear as to what standards could be regarded as satisfactory. Whilst some degree of subjectivity is inevitable, subjectiveness in the PMS system can make it harder to agree performance scores and can also lead to problems of consistency if key staff change jobs. The Trust plans to take action on this issue by developing with THC Dartford more objective measures in a number of areas of service delivery.
- **There will be relationship issues in applying a rigorous PMS which co-operation can overcome**. The Trust has been developing a partnership relationship with THC Dartford to help realise solutions to identified problems. The adjustment to a more realistic and rigorous assessment of the FM areas meant that, in general, the monthly FM scores fell, although in most cases the performance of the FM services remained satisfactory. Attempting to apply a more rigorous appraisal of FM performance, which relied on subjective assessments, initially created tensions in relationships between the Trust and THC Dartford. These problems are being worked through by the introduction of more objectivity into the PMS and by some restructuring of the responsibilities of staff involved in FM appraisal.

9 Schematic to show how the performance measurement system works



Overall relationships between the Trust and THC Dartford are now good. The steps the Trust and THC Dartford have taken to build a good relationship with THC Dartford include:

- The Trust and THC Dartford now attend part of each other's Board Meetings.
- THC Dartford has appointed an experienced non-Executive Chairman who provides a senior point of contact for the Trust with an overview of the whole of THC Dartford's approach to delivering the project.
- The General Manager of THC Dartford now has his office located within the senior management suite at the Trust.

In building their joint approach to the project, the Trust and THC Dartford have relationships at different levels, ranging from operational day to day interaction about levels of FM performance, to strategic discussions about the development of the hospital. There is always the potential for tension between these different elements but co-operation can overcome them. For example, in the summer of 2003, the senior management of the Trust was in a collaborative relationship with THC Dartford to develop extra facilities on the hospital site, while at the same time, at the operational level, the Trust was awarding performance scores to some FM areas which led to financial deductions. The Trust took account of these different issues in progressing its overall relationship with the THC Dartford.

Developing the PMS

1.34 There are still further improvements to the PMS which can be made:

- **Timeliness of performance information**. While largely up to date, information regarding the performance of each FM service does not always appear on time for the monthly performance review meetings. This was noted during our fieldwork when we sat in on performance review meetings and also reported in the Trust's internal audit report for 2002. The Trust and THC Dartford have now reorganised the monitoring process and THC Dartford now attend the meeting and have accepted responsibility for making this information available on time.
- **Ongoing development of weightings for aspects of service delivery**. The weightings applied to each aspect of service delivery do not always appear appropriate and sometimes are not consistent across services. In catering, hygiene has a weighting of 40 out of 485 points, which seems low compared to the weighting of 90 out of 485 points for presentation. Individual service reviews are underway to produce a more effective specification and subsequent monitoring arrangements.
- **Developing full effectiveness of the Feedback System**. Complaints and praise by users are two of the considerations relevant to the determination of the overall level of service performance and in turn whether performance deductions are applicable. It is important therefore that the process for reporting complaints and offering praise works well. During ward visits, we became aware of a reluctance on behalf of Trust staff to complete service complaint forms. Part of the reason for this is the time consuming nature of form filling, but some Trust staff felt they did not want to report on a contractor's employee for fear that the employee might lose their job. Similar concerns had been raised by the Trust's own internal audit review in the previous year. Modern Matrons are now part of the monitoring team and receive direct feedback from Ward sisters. They are also now part of the Infection Control and Hospital Cleanliness team and will visit wards and departments with the Assistant Director of Infection Control to ensure standards are maintained. There is also a helpdesk being established where patients and staff will be able to give direct feedback on matters.
- **Neutrality in dealing with service problems**. UME is employed by THC Dartford to manage its FM services and is obliged to administer the FM services contract fairly. In doing this, it acts as the main interface between the Trust and the FM contractor Carillion. The Trust has found UME to be helpful in dealing with a number of service problems that have occurred, but because UME is contracted to THC Dartford, it is questionable whether UME will, as the Trust initially hoped, always be motivated to be completely neutral in settling problems between the Trust and Carillion. THC Dartford notes that it is not in its interest for UME to act unfairly towards the Trust, as this would result in escalating disputes requiring dispute resolution.

PART TWO

A refinancing has created benefits but also new risks for the Trust

2.1 THC Dartford's shareholders refinanced the PFI deal in March 2003, just over two years after the new hospital came into operation. The refinancing generated large accelerated financial benefits for THC Dartford's shareholders. This refinancing was one of the first applications of the voluntary code for early PFI deals which the Treasury and OGC negotiated with the private sector in 2002. It has followed the main principle in the code that the public sector would generally receive 30 per cent of refinancing gains on early PFI deals. The Treasury's proposed approach to calculating refinancing gains had not been fully accepted by the private sector at the time the code was launched. The negotiations with THC Dartford helped to establish how future refinancing gains would be measured. In return for its share of the refinancing gains the Trust, in consultation with the Department, also agreed to extend the contract period and accepted some additional risks. The Trust assessed the refinancing on these terms to be value for money although the Treasury and the Department agree that under current best practice further analysis to support this conclusion would have been undertaken before the refinancing. This early example of a refinancing under the new code which incorporates a contract extension gives rise to learning points for future PFI refinancings.

The Trust approved a refinancing believing the benefits outweighed the costs and risks

THC Dartford's refinancing plans gave the prospect of large benefits for its shareholders in which the Trust shared

2.2 Once the construction phase of a PFI project has been completed there can be opportunities to refinance the deal on more favourable terms as a major risk element of the project has been completed. Thus a refinancing can be seen as an indicator of a successful project. The potential for refinancing gains is greater on early PFI deals because of the better terms which are also available now that the PFI financing market has matured. Through sharing of refinancing gains, refinancings have the potential to benefit both the public and private sectors.

2.3 In this project, once the new hospital had been completed, THC Dartford were able to utilise these opportunities to refinance the contract on better terms and to thereby generate refinancing gains. The particular factors which contributed to the refinancing opportunity were:

- this contract, let in 1997, was the first PFI hospital contract. The terms of finance which had been available in 1997 reflected risks which lenders attributed to what was then a new, complex and untested form of procurement. On refinancing, THC Dartford had the opportunity to access better terms that reflected the fact that many PFI projects had been successfully delivered, including THC Dartford's new hospital for the Trust; and
- the successful opening of the hospital in 2000 had eliminated much of the construction risk inherent in the project at the time the original finance was provided. New finance would be on better terms to reflect the lower level of risk which could affect the remainder of the project.

2.4 The above factors gave THC Dartford the opportunity to reduce the risk premium in its interest rate charges, to extend the repayment of its borrowings over a longer period and to negotiate other relaxations in the terms specifying how debt should be repaid. As well as increasing their potential returns by these improvements to the financing terms THC Dartford's shareholders were also in a position through other factors to significantly accelerate the benefits that they would derive from the project. Their plan involved:

- significantly increasing THC Dartford's borrowings although THC Dartford had no immediate need for additional funds to operate the project. This would create cash resources which could be used to enable THC Dartford's shareholders to draw immediate benefits from the project with the increased borrowings to be repaid out of planned profits later in the contract period; and
- utilising the benefit THC Dartford had derived as a result of the fall in general interest rates since the contract was let in 1997. THC Dartford had left part of their borrowings exposed to fluctuations in interest rates and the falling interest rates had worked in their favour. By being able to fix its interest rates at lower levels as part of the refinancing THC Dartford had greater funds available for early distribution than it had expected when entering into the contract. As THC Dartford had taken the risk that it would be exposed to higher costs if the interest rates had increased, this benefit from falling interest rates did not have to be shared with the Trust.[11]

11 As provided for in Treasury standard contract terms for refinancing paragraph 35.4.4.1.

2.5 The factors outlined above created an opportunity whereby the benefits to the shareholders of THC Dartford over the contract period would be both accelerated and increased (in present value terms) compared to the financial plans they had presented to the Trust when bidding for the contract. THC Dartford saw this as a reward for successfully bringing into operation this first PFI hospital project to reach contract letting. It also gave THC Dartford's shareholders the possibility of using the benefits they would draw from this project to help fund bids for other PFI projects.

2.6 THC Dartford's refinancing plans also presented the prospect of important financial benefits to the Trust. When the Trust let its PFI contract its plan was to keep its finances in balance.[12] Subsequently, however, although there were no material changes to the PFI contract price, the Trust had an underlying deficit during 2002-03 in the order of £4 million. The deficit had arisen because of the impact of the increases in activity, losses of funding and higher than expected costs arising from running the hospital, for example rates. Securing a share of THC Dartford's refinancing gains was, at the time, one of the measures available to the Trust to help achieve financial balance.

The new code provided a framework for the Trust to benefit from the refinancing

2.7 In common with most other early PFI contracts the Trust's contract did not refer to refinancing although THC Dartford, at contract letting, did provide the Trust with a letter saying that refinancing gains would be shared in accordance with rules in force at the time of a refinancing. Under the new voluntary code introduced in October 2002 following negotiations between the Treasury, OGC and the private sector, the private sector agreed to allow authorities to generally receive 30 per cent of the refinancing gains on early PFI deals provided the contract did not specify otherwise. This gave the Trust a fair degree of certainty about the benefits it could expect from THC Dartford's proposed refinancing. Without the code the Trust would have had to negotiate to share in the refinancing gains, but there would have been no certainty about the level of benefits, if any, it would have secured. In addition, this refinancing was an early opportunity to put the operation of the code into practice.

The refinancing was completed in March 2003 and the gains were shared

2.8 THC Dartford completed the refinancing of the project in March 2003 in line with the plans it had developed. The final arrangement was that THC Dartford replaced its outstanding[13] bank borrowings of £85.9 million repayable over 14.5 years with a bond of £132.5 million repayable over 28.5 years and at lower interest rates than had applied to the bank finance. The new finance increased THC Dartford's outstanding borrowings by 54 per cent **(Figure 10)**.

2.9 Before any sharing of the benefit, the resulting refinancing gain – the increased cash flow available for distribution over the remaining years of the project – was calculated as £33.4 million in net present value terms.

2.10 After applying the voluntary code the NPV gain was allocated: £21.7 million to THC Dartford's shareholders and £11.7 million to the Trust (Figure 10).

2.11 Key features of the refinancing from the perspective of THC Dartford's shareholders were:

- THC Dartford's shareholders were able to accelerate the benefits that they withdrew from the project. Following the refinancing they realised, within three years of the hospital opening, a financial benefit from the project of £37.4 million, a benefit not included in their financial plans at contract letting. They were able to realise £37.4 million immediately following the refinancing by agreeing that they would take lower shareholder benefits than they had previously been projecting over the remainder of the contract **(Figure 11 overleaf)**. The net effect, in the long run, would be to leave the shareholders with the gain in present value terms of £21.7 million following the refinancing.
- The immediate distribution to shareholders of £37.4 million following the refinancing was substantially more than the total shareholder returns over the 28 year contract period which THC Dartford had projected in its financial model when the contract was let. Discounted from the date of the refinancing the present value of those projected returns (based on the discount rate of 21 per cent nominal used in the financial model) was £20.9 million.

12 The plan, as described at paragraph 1.13 of the NAO's report: The PFI Contract for the new Dartford & Gravesham Hospital (HC423 1998-99), was based on the Trust receiving additional financial support from within the NHS and savings being achieved by the consortium and the Trust.

13 £85.9 million was outstanding out of the original bank debt of £98.2 million.

10 Summary of the refinancing

This figure shows that by taking on higher borrowings over an extended period THC Dartford achieved a refinancing gain (in net present value terms) of £33.4 million. The Trust will receive just over a third of the gain mainly by way of lower annual contract payments. THC Dartford shareholders receive two-thirds of the gain. They have taken this and further amounts as an immediate accelerated distribution at the expense of reduced distributions later in the contract period.

	Borrowings pre-refinancing		Borrowings post-refinancing
Higher borrowings	£85.9m to be repaid over 14.5 years	→ Refinancing →	£132.5m[1] to be repaid over 28.5 years
Led to refinancing gains[2]			**Refinancing gains (NPV)** £33.4m

£21.7 m (65%) to **Consortium Shareholders**	£11.7 m (35%) to **Trust**

	Consortium Shareholders	£m (NPV)	Trust	£m (NPV)
Shared under the refinancing code	Immediate distribution	37.4	Immediate distribution	1.5
	Reduced distribution over remainder of contract	(15.7)	Lower annual payments over remainder of contract	10.2
		21.7		11.7

NOTES

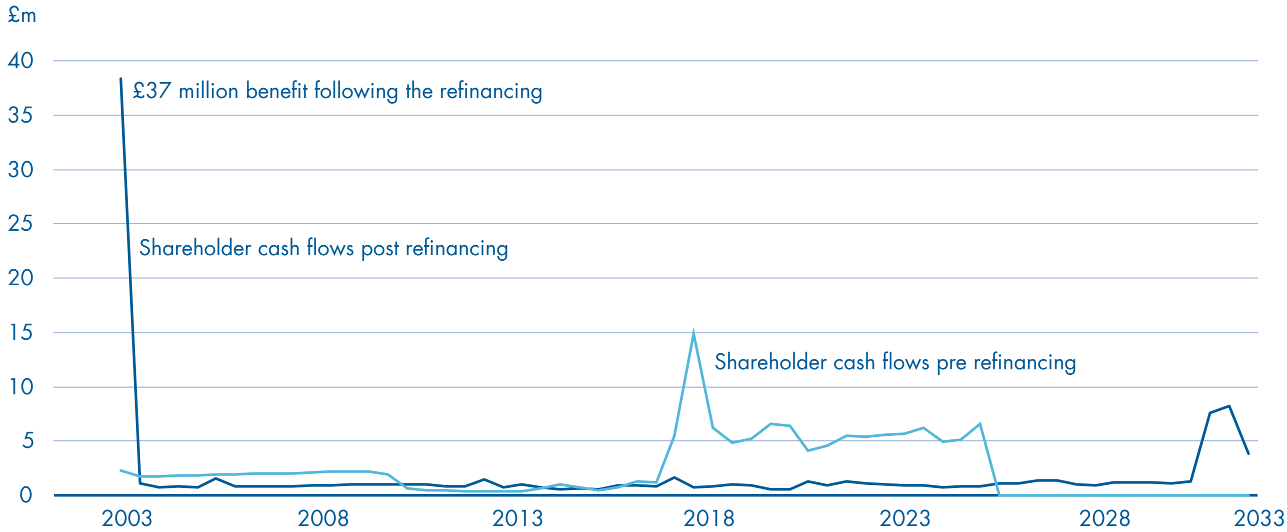
1 The borrowings increased by 54 per cent following the refinancing.

2 The refinancing gains were evaluated at a discount rate of 15 per cent (nominal).

- The total benefits to THC Dartford's shareholders over the life of the contract are now expected to be £51.0 million in present value terms based on the 15 per cent nominal discount rate agreed for calculating the refinancing gains. Using the same discount rate this represents an increase of 74 per cent compared to the shareholder returns of £29.3 million THC Dartford projected prior to the refinancing **(Figure 12 overleaf)**. Based on the same discount rate and excluding the refinancing benefit, the shareholders' expected returns at the time of the refinancing had reduced by £2.2 million from their expectations at contract letting. Following the refinancing the shareholders' returns are 62 per cent higher than their anticipated returns when bidding for the contract.

- The internal rate of return to THC Dartford's shareholders over the contract period is now expected to be 56 per cent nominal compared to 21 per cent nominal which THC Dartford had predicted when bidding for the contract (Figure 12). The internal rate of return is not an indication of the future rate of annual returns which the shareholders anticipate realising from the project but reflects the time value of when benefits are received. It is particularly sensitive to benefits taken early in a project's life such as the large benefits realised following the THC Dartford refinancing. An alternative evaluation by THC Dartford of the benefits to its shareholders in present value terms is also set out in note 1 to Figure 12.

11 Change in profile of shareholder benefits following the refinancing



Source: Ernst & Young (the Trust's financial advisers on the refinancing) based on THC Dartford information

12 How the refinancing has accelerated and increased THC Dartford shareholders' benefits in present value terms

This figure shows that the total benefits the shareholders now expect over the life of the contract are £51.0 million in present value terms, an increase of 74 per cent over what they were expecting prior to the refinancing calculated using a 15 per cent discount rate. Evaluation at the agreed 15 per cent nominal discount rate at the time of the refinancing[1]

	At contract letting £m	Pre-refinancing £m	Post refinancing £m	Refinancing gain £m	% Gain from refinancing
Refinancing distribution in 2003	-	-	37.4	37.4	
Other projected distributions over contract period	31.5[2]	29.3	13.6	(15.7)	
Total projected distributions (in NPV terms)	**31.5**	**29.3**	**51.0**	**21.7**	**74%**
Funds invested by the shareholders	13.4	13.4	13.4	13.4	
Projected internal rate of return[3]	**21%[4]**	**23%**	**56%**		

Source: THC Dartford

NOTES

1 THC Dartford has informed us that although it agreed through negotiation at the time of the refinancing that a 15 per cent nominal discount rate would be used to determine the refinancing gain its internal calculations are based on a 10 per cent nominal discount rate. Using a 10 per cent nominal discount rate THC Dartford calculate the present value of its returns to its shareholders following the refinancing as £57.2 million compared to £43.3 million prior to the refinancing. This represents an increase to THC Dartford's shareholders' returns arising following the refinancing of £13.9 million compared to the increase of £21.7 million calculated using the negotiated 15 per cent nominal discount rate.

2 In our earlier report on the PFI Contract for the new Dartford & Gravesham Hospital (HC 423 1998-99) the expected shareholder returns shown in Figure 9, page 37 were £25.7 million. That was on the basis of 1996 prices at a discount rate of 21 per cent nominal, being the shareholders expected rate of return disclosed in THC Dartford's bid information. The figure of £31.5 million shown above is on the basis of prices at the time of the refinancing in 2003 at the negotiated 15 per cent nominal discount rate used for calculating the refinancing gain. On the basis of 2003 prices and a 21 per cent nominal discount rate the returns to shareholders at contract letting were £20.9 million.

3 The internal rate of return to shareholders is the standard measure which the public sector has used to compare the returns expected by shareholders of consortia bidding for PFI contracts. It is not an indication of the future rate of annual returns which the investors in THC Dartford anticipate realising from the project but reflects the time value of when benefits are received including the benefits realised immediately following the refinancing. The increase to 56 per cent following the refinancing reflects the high value of receiving large returns early in the contract period.

4 This is the original internal rate of return projected by THC Dartford when bidding for the contract.

- In simple cash terms the shareholders projected total receipts from the project fell from £187 million to £117 million following the refinancing. This is acceptable to the shareholders because they place particular value on the immediate benefit of £37.4 million which they can reinvest to generate further income which is reflected in the increased internal rate of return and the higher value of the returns in present value terms following the refinancing. A year by year analysis of the benefits to THC Dartford shareholders in both cash and present value terms is set out in Appendix 3.

2.12 Because this first PFI hospital contract was, at the time it was let, breaking new ground both the Trust and THC Dartford were exposed to risks which had not occurred in previous projects to build new hospitals. There are, therefore, no direct benchmarks from previous experience for what a reasonable rate of return to private sector shareholders should be on this project. In part, THC Dartford's benefits following the refinancing can be considered as a reward for successfully managing the risks of bringing this first PFI hospital into operation. The Department would not, however, expect private sector shareholders on more recent PFI hospital contracts to make the level of returns which have accrued to THC Dartford's shareholders because better financing terms can be obtained at the outset and be reflected in the contract price. The Department, taking a view across all its PFI projects, also expects the private sector to bear losses on PFI contracts where they arise. An example is the Dudley hospital where the contractors Sir Robert McAlpine reported losses of £27 million in the two years to 31 October 2003.

2.13 Following the refinancing, Carillion plc, whose operating companies had built the new hospital and are responsible for the ongoing facilities management services, also sold its investment in THC Dartford. Carillion sold the £4.1 million investment it had made in 1997 to Barclays Infrastructure Ltd, a general partner of Barclays UK Infrastructure Fund LP, one of the other shareholders in THC Dartford, for £5.2 million in November 2003. Benefits from the earlier refinancing, together with the proceeds of the sale of its investment, provided Carillion with £16 million from the project which contributed to the net exceptional profit of £11.2 million on its investment in the project which Carillion plc reported in its 2003 accounts. This was equivalent to an annual rate of return on Carillion's investment of around 50 per cent. Carillion previously told the Committee of Public Accounts it was normally looking for a return of 15-17 per cent on its investment in PFI hospitals. But Carillion emphasises, however, that its returns on successful projects need to be at a level to offset the effect of projects which do not go to plan. On this project, although Carillion gained on its investment in the project, it incurred higher than expected costs and only broke even on its construction work. The additional construction costs were not passed on to the Trust.

2.14 The extent to which contractors have funds available to invest in projects is a factor which contributes to whether they will enter bidding competitions for new projects. Carillion informed us that it has a policy of selling its equity interests in mature projects and reinvesting in new projects. It currently expects to invest over £20 million in five new PFI projects where it is part of private sector teams which have been selected as preferred bidders.

Implementing the refinancing code required negotiations with THC Dartford but the outcome helped to establish the Treasury's intentions for how the code will operate

2.15 This refinancing, completed in March 2003, was one of the first after the launch of the new refinancing code. Together with other refinancings completed during 2003, it helped to establish how the new code would operate. Despite the code's general principle that authorities will receive 30 per cent of the refinancing gains on early PFI deals, and further guidance from the Treasury on how the gains should be calculated, the Trust's experience has shown that reaching agreement on the gain to be received by an authority is not straightforward. The Treasury Refinancing Taskforce, which monitors refinancing activity across all PFI projects, considers that, given the complexities of refinancings, it was inevitable that a detailed understanding of how to operate the code would be built up from refinancings that occurred after the code came into operation.

2.16 The gains were shared in line with the code with 30 per cent of the gains that related to the original minimum contract period of 28 years being allocated to the Trust. There were, however, extensive negotiations over:

- the calculation of the amount of the refinancing gains in which the Trust would share; and
- the basis of how the refinancing gains that arose from the Trust's agreement to extend its original minimum contract period by seven years should be shared.

The calculation of the refinancing gains

2.17 The Treasury had issued guidance to departments in October 2002 on how refinancing gains should be calculated. This guidance was referred to in the code but had not been fully accepted by the private sector when the code was published in October 2002. The private sector had concerns about the Treasury's proposal that refinancing gains should be calculated using as a discount rate the investors' rate of return set out in the base cases the private sector submitted when bidding for the PFI deals.

2.18 As a result of the private sector concerns, in this early refinancing under the new code, THC Dartford challenged the 21 per cent nominal discount rate proposed by the Treasury based on THC Dartford's rate of return for its investors set out in its bid information. THC Dartford considered that using the Treasury's proposed 21 per cent nominal discount rate would require THC Dartford to allocate to the Trust an unreasonably high amount from the refinancing given the risks THC Dartford had borne in taking forward this pathfinder deal. THC Dartford proposed a discount rate of 10 per cent nominal which it uses as its target reinvestment rate of return. The Department and the Treasury agreed, after extensive negotiation with THC Dartford, to a compromise that the discount rate would be 15 per cent nominal. The Department and the Treasury considered this was the best outcome which could be achieved on this refinancing and was in line with the basis for calculating refinancing gains they expected to achieve on future refinancings.

2.19 If the 21 per cent nominal discount rate for this deal (the rate required to be consistent with the Treasury guidance) had been adhered to it would, other things being equal, have increased the amount of refinancing gain to the Trust by £1.4 million. Further information on the negotiations over the discount rate is set out in Appendix 4. The Trust's financial advisers, Ernst & Young consider, based on discussions with THC Dartford, that THC Dartford would, however, have sought to recover from the Trust a £1.2 million reduction in benefits from taking the refinancing gains over time **(Figure 13)** if the Trust had sought to increase its share of the refinancing gains by using a 21 per cent nominal discount rate.

13 The allocation of the refinancing gains agreed by the Trust and THC Dartford

	THC Dartford £m	Trust £m	Total £m
Without contract extension (70/30)	18.3	7.8	26.1
From contract extension (50/50)	4.6	4.6	9.2
Adjustment from taking gains over time	(1.2)	(0.7)	(1.9)
Total	**21.7**	**11.7**	**33.4**

Source: NAO (based on analysis by Ernst & Young, the Trust's financial advisers on the refinancing)

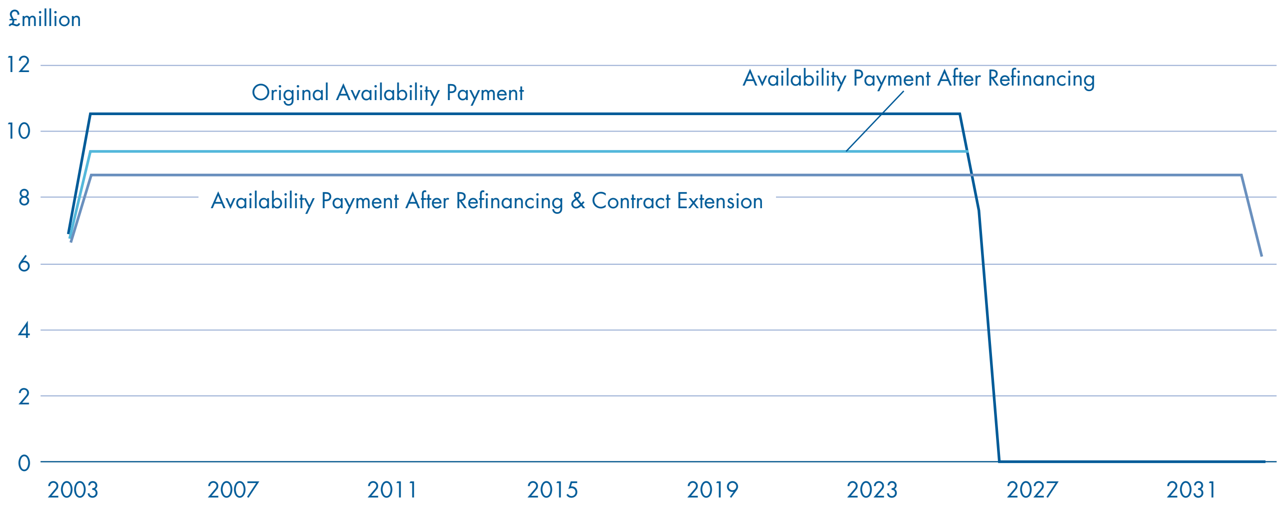
NOTES

1 The above figures are expressed as net present values based on the negotiated discount rate of 15 per cent nominal used for calculating the refinancing gains.

2 The adjustment from taking gains over time arose because, after taking account of the interest THC Dartford would pay to the Trust on its deferred share of the refinancing gain, THC Dartford was not able to raise as much debt, or generate as great a refinancing gain, as would have been possible if the Trust had taken the refinancing gain as a lump sum.

2.20 The Department and the Treasury consider they achieved a very good outcome from these negotiations over the discount rate to be used in calculating the refinancing gains. They believe it was the best deal for the Trust that could have been secured on this first hospital refinancing under the refinancing code. They also consider that it moved the market by establishing a satisfactory marker with the private sector for the type of discount rate to be used in calculating the gains arising from future refinancings (which were expected to involve deals where bidders' base cases had often assumed a rate of return of between 15 and 17 per cent nominal). The Treasury Refinancing Taskforce notes that, subsequent to the Darent Valley hospital refinancing, the private sector has accepted the calculation of subsequent refinancing gains on other deals using discount rates in line with the Treasury's guidance.

14 Revised availability payments in real terms to be made by the Trust as a result of the refinancing and the contract extension



Source: Ernst & Young, the Trust's financial advisers on the refinancing

NOTE

The graph is presented in real terms. In cash terms, after taking account of inflation, the total reduction to the Trust's annual PFI payments arising from both the contract extension and the refinancing is around £2 million.

The sharing of refinancing gains relating to the contract extension

2.21 To maximise the loan repayment period and hence the resulting refinancing gains, which both the Trust and THC Dartford would receive, the Trust agreed to THC Dartford's proposal that the minimum contract period should be extended from 28 to 35 years. The Department agreed with this as it brought the contract period into line with more recent PFI hospital deals. The Trust's financial advisers Ernst & Young also note that, as the refinancing was to be bond financed on terms linked to the contract period, it would not have been straightforward for the Trust to seek an extension to the minimum contract period once the refinancing had been carried out.

2.22 The Trust obtained THC Dartford's agreement that the refinancing gain that was dependent on the contract extension would be shared 50/50. This was better than the basic 30 per cent entitlement under the code and treated the extension as similar to a new contract on which the Treasury's guidance now expects refinancing gains to be shared 50/50. It could be argued that THC Dartford was not exposed by the contract extension to as much risk as in a new contract where the construction has yet to be undertaken. THC Dartford, however, resisted the Trust's attempts to seek more than 50 per cent of the gains as it did not consider the refinancing would have been economically worthwhile on this basis. THC Dartford considers that it faced new risks as a result of the contract extension in ensuring that a gradually ageing building would continue to be fit for purpose.

The Trust extended the contract term to share in higher refinancing gains and improve affordability, also considering other benefits were worth having for a longer period

2.23 THC Dartford's plan to maximise both the amount of the refinancing gains and its ability to increase the early benefits its shareholders could draw from the project relied on THC Dartford increasing its borrowings by 54 per cent from £85.9 million to £132.5 million with the repayment period being extended (Figure 10). THC Dartford therefore proposed to the Trust that the minimum contract period should be increased. After negotiation a seven year extension was agreed increasing the minimum contract period from 28 to 35 years. Had it not been for the refinancing the Trust says it would not, at that time, have sought to extend the contract period. It was still developing its partnership relationship with THC Dartford and wanted to make sure the relationship would work well before giving any thought to extending its contractual commitments. In considering the refinancing, however, the Trust saw the following attractions to THC Dartford's proposed contract extension:

- the main attraction was that the contract would become more affordable for the Trust. Before taking account of the increased refinancing gains, THC Dartford was prepared to reduce the part of the annual contract payment by the Trust relating to availability by £1.1 million (a cash benefit[14] of £24.2 million in aggregate over the remaining 22 years of the original 28 year contract period) in return for the Trust continuing to pay this lower amount relating to availability for a further seven years (an additional commitment in cash terms of £64.6 million[15]). The Trust, using a 6 per cent real discount rate, evaluated that this arrangement would be neutral in present value terms – that is to say, it would neither increase nor decrease the present value of the total cost of the contract **(Figure 15)**. But the lower annual charge for the first 28 years of the enlarged contract period was attractive to the Trust in cash terms as it would further help the Trust balance its annual accounts;
- in addition, the refinancing gains would be larger if the contract was extended and the Trust would receive a share of the increased gains. The contract extension needed to be effected at the time of the refinancing to maximise the opportunities for refinancing gains from the proposed bond refinancing. The Trust estimated that the additional refinancing gains that it would secure would have a present value of £4.6 million evaluated at a public sector discount rate of 6 per cent real (Figure 15) which would further help the Trust at a time when it was in financial deficit; and
- the Trust considered that receiving THC Dartford's services for an additional seven years made sense based on demographic data which suggested the population of the local community would increase. The Trust also placed value on transferring the building life cycle cost and facilities management risk for a further seven years and estimated it would, as a result, save maintenance and management costs with a total net present value of £2.1 million. The new minimum contract period of 35 years which the Trust agreed to is in line with the terms of new PFI hospital contracts currently being entered into by other NHS Trusts.

The financial case for extending the contract and taking refinancing gains over time is not clear cut

2.24 Although the Trust expects to receive significant financial benefits from the refinancing over the life of the contract the following factors mean the financial case for extending the contract period and taking the refinancing benefits over time is not clear cut.

Lowering the Treasury discount rate reduces the benefits attributed to the contract extension

2.25 In the run up to finalising the refinancing in March 2003 the Trust and THC Dartford focused primarily on calculations which had been based on a 6 per cent real discount rate when negotiating the terms of the contract extension and assessing its expected financial effect on the Trust. At this time it was widely known, however, that the Treasury was developing new guidance which would require authorities to use a lower discount rate of 3.5 per cent real.[16] The Treasury guidance effective when this refinancing was completed in March 2003 was, however that 6 per cent real should be the principal discount rate for evaluating new investment decisions until the end of March 2003.

2.26 Although the negotiations surrounding the contract extension were based on calculations using a 6 per cent real discount rate the Trust's financial advisers Ernst & Young had evaluated for the Trust, in March 2003 shortly before the refinancing was completed, the comparative financial effect on the Trust of the contract extension using a 3.5 per cent real discount rate. These calculations summarised in Figure 15 show that the financial benefit to the contract payments for availability in net present value terms which the Trust had anticipated from extending the contract, and taking the refinancing gain over time would reduce to £1.4 million if the 3.5 per cent real discount rate is used. This reletively small benefit depended on an assumption that the Trust would have incurred higher maintenance and management costs of £3.9 million, in present value terms at a discount rate of 3.5 per cent real, without the contract extension. These calculations, whichever discount rate is used, are only a partial analysis of the effect of extending the contract period. They do not

14 In real terms. The actual price payable by the Trust each year will be adjusted for inflation as permitted by the contract. After also taking account of inflation, facilities management costs and the Trust's annual share of the refinancing gains the Trust's payments under the contract are expected to reduce by around £60 million over the original 28 year minimum contract period (Appendix 3).

15 Including inflation and facilities management costs the Trust's payments over the seven additional years are expected to be around £230 million (see year by year analysis in Appendix 3).

16 Draft guidance had been issued to departments in the latter half of 2002. The final guidance was published in 2003 in the new Treasury Green Book effective from 1 April 2003. As well as introducing a lower discount rate the new guidance required separate calculations showing the effect of optimism bias and taxation.

15 Comparison of financial costs and benefits of the contract extension to the payments for availability using alternative discount rates

	At 6 per cent real discount rate £m	At 3.5 per cent real discount rate £m
Reduction/(increase) to net present value of the contract price relating to availability before taking account of the refinancing benefit[1] (based on contract payments for a further seven years less benefit of a reduced annual contract charge for the original 28 year contract period)	Nil	(8.5)
Increase to the net present value of the Trust's share of the refinancing gain as a result of the contract extension on the basis of the gain being taken as a lump sum[2]	4.6	4.6
Maintenance and management savings assumed by the Trust	2.1	3.9
Net financial benefit arising from the contract extension arrangements assuming Trust takes gain as an upfront lump sum amount	6.7	Nil
Increase/(decrease) to the net present value of the Trust's share of the refinancing gain as a result of taking its share of the refinancing gain as a reduction in the PFI contract availability payments[4]	(0.4)	1.4
Net financial benefit arising from the contract extension arrangements with Trust receiving gain over time	**6.3**	**1.4**

Source Derived from financial analysis of the refinancing by Ernst & Young, the Trust's financial advisers

NOTES

1 In cash terms the extra seven years of payments for availability, before taking account of the refinancing benefit and inflation, would cost the Trust £64 million. The lower contract charge for the original contract period would reduce the same part of the Trust's cash payments by £24 million. The net increase to these payments is therefore £40 million. Taking account of all aspects of cash payments (including the refinancing benefit, inflation and facilities management costs) the Trust's expected cash payments increased by £165 million (from £625 million to £790 million) following the refinancing and contract extension (Appendix 3). The NAO estimates that £11 million of the £46 million increase in THC's borrowings depended on the Trust's agreement to make these additional payments over the extended minimum contract period.

2 The evaluation of the refinancing gain by Ernst & Young is the same under each discount rate because the evaluation assumed that the refinancing gain would be taken as a lump sum at the time of the refinancing. It is not therefore subject to the discounting process which is applied to future cash flows.

3 THC notes that in the negotiations over the amount the Trust should receive when receiving its share of the refinancing gains as a reduction to the annual PFI contract price THC granted the Trust an additional £1 million gain based on calculations using a 6 per cent discount rate. THC would not have expected to make this amount available to the Trust if the calculations had been based on a 3.5 per cent real discount rate.

4 The implicit interest rate on the deferral of the Trust's gain was 6 per cent real. As this was above the cost of capital the refinancing gain, calculated at a 6 per cent real discount rate, was reduced as THC could not raise as much debt as if the Trust had taken a lump sum gain. Evaluating the Trust's savings at a 3.5 per cent real discount rate increased the gain.

reflect the additional risks to the Trust from the contract extension such as higher termination liabilities[17] and the requirement to remain committed to the contractual service for a further seven years.

2.27 The case for extending the contract period was, therefore, much less clear cut than the Trust believed. On the issue of the discount rate used to assess the contract extension, the Trust was not formally required by Treasury guidance to use a 3.5 per cent discount rate as the main basis for evaluating the contract extension proposals as this requirement only became effective from the beginning of April 2003 for new investment decisions. This refinancing was completed at the end of March 2003 based on an investment decision taken in September 2002. In addition, the Trust and its financial advisers Ernst & Young consider that the refinancing would have had to be completely renegotiated with a 3.5 per cent discount rate, as the negotiations around extending the contract period, and the effect this had on the refinancing gains, had been based on the calculations using a 6 per cent discount rate. They also note that they were able to secure a further £1.2 million from THC in the refinancing negotiations (Figure 13) specifically arising from the use of the 6 per cent real discount rate. They would not have expected THC to make this amount available if the calculations had been based on a 3.5 per cent real discount rate.

17 The higher termination liabilities arise from the additional borrowings which THC Dartford were able to take on as a result of the contract period being extended.

The accounting treatment did not reduce the Trust's accounting deficit as much as it had hoped

2.28 The Trust negotiated with THC Dartford to receive £1.5 million of the refinancing gain as a lump sum prior to 31 March 2003. The Trust agreed to receive the rest of the gain by way of reduced annual contract payments over the remainder of the contract period. The Trust had hoped to be able to account for the £1.5 million as 2002-03 income to enable it to achieve its planned reduced deficit level of £0.9 million. In the event, because the completion of the refinancing was delayed until just before the end of March 2003, it was not appropriate for the Trust to bring this lump sum into its accounts in 2002-03.

There are risks from not taking all the refinancing gain as a cash lump sum but the Department considers there are accounting and economic grounds for its decision not to do so

2.29 The total refinancing gain due to the Trust is £11.7 million in net present value terms. Other than the immediate payment of £1.5 million the remainder of the gain to the Trust is being taken over time. This is consistent with the Department's policy on this and other refinancings that NHS Trusts should take their share of the refinancing gains by way of a reduced annual PFI contract charge rather than a cash lump sum at the time of the refinancing. This inevitably creates a risk that the NHS Trust might fail to recover its full share of the refinancing gains if the contract does not run its full course. There is also a contrast between the private sector shareholders' decision to realise their refinancing gain immediately and the Department's approach of preferring to realise its share of the refinancing benefit over time. The Department sees this as a reflection of different objectives – the private sector companies under pressure to provide early returns to shareholders on projects where there will be some uncertainty about long term cash flows compared to the Department's priority of reducing the annual payments on a hospital which it expects to utilise for the long term.

2.30 The Department considers that there are both accounting and cash management issues which have caused it to recommend that NHS Trusts receive refinancing gains over time. The Department notes that under resource accounting taking the gain as a lump sum results in the Trusts having to create a depreciable asset which means an annual charge on the Trusts' accounts has to be funded. If the gain is taken as a reduction to the annual PFI contract charges the cash and accounting benefits are matched. The Department also considers that there is a risk that Trusts will use the lump sum benefit to address short term financial problems which the Department considers inequitable as this may be at the expense of future service provision. Finally, the Department considers that taking the gain as a reduction to the annual PFI contract price provides greater financial certainty by providing the Trust with the same benefit in all years of the contract. It is also possible that THC Dartford would have had to take on additional borrowings to pay the Trust's share of the refinancing gain as a lump sum which in turn may have increased the further the Trust's termination liabilities.

2.31 In recommending that NHS Trusts should receive refinancing gains over time the Department does not believe that there is a risk that the benefits will not be received by the Trusts. The Department expects that, in the event of a PFI contract being terminated, NHS Trusts would settle their termination liabilities by continuing to pay the reduced annual contract price to the funders (thus allowing the Trusts to continue to benefit from the refinancing). Or, alternatively, the outstanding balance of the Trusts' refinancing gains would be deducted from any lump sum termination liabilities payable by the Trusts.

But there are additional risks arising from the refinancing

2.32 The effect of the refinancing on the Trust should not be considered just in terms of the share of refinancing gains, which the Trust expects to receive. The refinancing also creates additional risks for both the Trust and the NHS.

The Trust could face significantly increased termination liabilities but expects the refinancing with this additional risk to provide value for money

The increase in the Trust's termination liabilities arises from the terms of this early PFI deal

2.33 The Trust's liabilities in the event of contract termination will depend on the circumstances that result in contract termination and the outcome of a number of financial calculations specified in the contract. There are three main types of termination event dealt with in the contract:

- Termination by default of THC Dartford;
- Termination by default of, or voluntary termination by, the Trust; and
- Termination without default due to major unforeseeable events (known as force majeure).

2.34 The Trust's termination liabilities due to default by THC Dartford (which is outside the Trust's control) would be computed according to the contractual provisions summarised in **Figure 16**.

2.35 As shown in Figure 16 the Trust took the opportunity during the refinancing negotiations to renegotiate aspects of its termination liabilities to limit the increase in termination liabilities following the refinancing. These liabilities could, however, still be as much as just over the whole of THC Dartford's enlarged outstanding debt following the refinancing. This means that following the refinancing, depending on the timing of a termination, the Trust's termination liabilities might increase above the cost of the hospital to include some or all of the additional £46 million debt THC Dartford took on to generate the refinancing gains. The Department notes, however, that for this to occur THC Dartford would have to default on a contract which gives them the prospect of further benefits and, in any event, the Trust would have the right to discharge its termination liabilities by continuing to pay the funders the reduced annual payments the Trust currently pays under the contract following the refinancing.

2.36 The original arrangements, which were part of this first PFI hospital contract let in 1997, were similar to arrangements in other PFI contracts at that time. But the terms are different in current contracts where termination liabilities are determined as the market value of the remaining project. The Trust and its advisers considered, during the refinancing negotiations, changing the contractor default termination clause to the market value basis. They decided not to pursue this as they had agreed with THC Dartford that minimal changes to the contract would be made and they placed particular value on the fact that the existing terms would provide the Trust with greater certainty, and a cap on the extent of its termination liabilities.

The Trust's approach to termination liabilities followed some, but not all, of what is now considered to be best practice in implementing the Treasury's refinancing guidance

2.37 Treasury guidance on refinancing (published in July 2002) was available at the time the refinancing of the Trust's PFI contract was being negotiated. At the time the Trust was negotiating the refinancing it was, however, one of the first authorities to be completing a refinancing using the code and new guidance. The Trust and its financial advisers Ernst & Young carried out, whilst negotiating the refinancing, certain financial analysis of THC Dartford's proposal that the Trust's termination liabilities should increase. We have been informed that this analysis included a consideration by Ernst & Young, the Trust's financial advisers, of whether the refinancing proposals would be value for money for the Trust taking account of the probability of the contract being terminated following the refinancing in situations where the Trust's termination liabilities may have increased as a result of the refinancing. This approach was consistent with that undertaken by the

16 Comparison of the Trust's termination liabilities for THC Dartford default before and after the refinancing

Original Termination Provisions	Post-refinancing Termination Provisions
The Trust's termination liabilities will be the lower of:	The Trust's termination liabilities will be the lower of:
■ The net present value (NPV)[18] of the remaining contractual payments for making the hospital available less certain allowable deductions including planned preventive maintenance and rectification costs to make the building fit for use.	■ As per the original contract but with the NPV discounted at a rate of interest related to bond rather than bank finance.
■ 120% of THC Dartford's debt at contract letting, paid up equity and subordinated debt (excluding Carillion's and UME's share).	■ 102% (rather than 120%) of scheduled debt following the refinancing with no repayment of paid up equity or subordinated debt.
■ The aggregate of THC Dartford's outstanding debt, paid up equity and subordinated debt (excluding Carillion and UME's share) less amounts due to the Trust	■ As per the original contract but with no repayment of paid up equity or subordinated debt.
Method of payment: By lump sum or, in the case of the amount relating to availability payments, at the Trust's option, over the term of THC Dartford's bank loan.	*Method of payment:* By lump sum or, at the Trust's option, over the term of THC Dartford's bond finance.

Source: THC Dartford

18 Discounted at a rate equal to the London Interbank Offer Rate (LIBOR) plus the interest margin on THC Dartford's senior debt.

Prison Service in connection with the refinancing of the Fazakerley prison PFI contract.[19] The Trust expected a low probability of contract termination and concluded, based on advice from Ernst & Young, that the refinancing would be value for money despite the risk of higher termination liabilities.The Department believes that the Trust's analysis was consistent with the manner in which the Treasury guidance was generally understood at the time.

2.38 In support of this report, the Trust and Ernst & Young carried out further detailed analysis in 2004, replicating the Prison Service's methodology, to support the conclusion previously drawn that the refinancing represented value for money for the Trust despite the risk of higher termination liabilities. In the light of the experience of this refinancing the Department and the Treasury agree that current best practice is that more detailed analysis than that undertaken by the Trust at the time of the refinancing would be undertaken before agreeing to a refinancing in order to fully comply with the Treasury guidance on assessing the value for money of refinancing proposals.

The steps which the Trust took in accordance with the code and related guidance

2.39 The provisions of the refinancing code say that:

- an authority will not be obliged to accept increased termination liabilities as part of any refinancing, except to the extent that the contract already provides. But, where the contract does provide for the possibility of increased termination liabilities following a refinancing, it is an overriding condition of the code that an authority should only consent to a refinancing if the outcome for the authority will be value for money; and
- if an authority does agree to increase termination liabilities to facilitate a refinancing it should do so without seeking or obtaining any higher share of any refinancing gain. This provision of the code recognised that, whilst ideally authorities should receive their 30 per cent share of refinancing gains from applying the code without increasing their termination liabilities, there may be some situations where increased termination liabilities may be necessary to allow a refinancing to be effected which will improve the value for money of the project for the authority.

2.40 The Trust's approach was within those terms of the code in that:

- the Trust was contractually obliged to allow termination liabilities to increase by amounts which could be as much as £46.6 million following the refinancing;
- the Trust did not seek any additional share of the refinancing gain for agreeing to the possibility of these increased termination liabilities; and
- the Trust's analysis of the increased termination liabilities compared to its share of the refinancing gain has given it satisfaction that the refinancing on these terms represented value for money (further details of this analysis are set out at paragraphs 2.43-2.45 below).

The areas where the Trust's approach did not fully comply with current best practice in applying the code and related guidance

2.41 In the following respects the Trust's approach to accepting higher termination liabilities did not fully comply with current best practice in applying the code and related guidance:

- best practice would now be for authorities to undertake, prior to a refinancing, the type of detailed analysis of the value for money of increased termination liabilities which the Trust's financial advisers undertook in 2004 to support decisions on whether to accept an increase in termination liabilities when agreeing to a refinancing proposal;
- to fully comply with the Treasury guidance which was in force when the refinancing was being negotiated the Trust would have been expected to evidence more extensively a consideration of the implications of THC Dartford's intention to increase by 54 per cent the amount of its debt as part of the refinancing. In these situations the Treasury guidance required authorities to obtain appropriate professional advice on the implications of the increased debt to ensure that value for money to the taxpayer is not undermined by the high level of debt.[20] Very high levels of debt could affect the financial stability of the private sector consortium, involve the public sector in increased termination liabilities and result in levels of debt which are well above the debt needed to fund the construction

19 See NAO report: The refinancing of the Fazakerley PFI prison contract (HC 584 1999/2000).
20 Paragraph 35.3.1.7 of PFI Standard Contract terms guidance on refinancing (July 2002).

and ongoing operations of the asset being provided under the PFI. The Department considers that the Department and Ernst & Young gave the Trust the professional advice required by the Treasury guidance in accordance with expected practice at the time. The Department also notes that the debt rating agency employed by THC Dartford rated the enlarged debt of THC as sound and investment grade which gave comfort that THC would be able to meet the payment obligations of the increased debt. Under current best practice, which reflects the experience of this and other early refinancings completed under the code, authorities would normally be expected to commission external financial advisers to fully assess and report on the value for money issues arising from any proposal to increase levels of debt in PFI project companies; and

- the Treasury July 2002 guidance said it was unlikely that authorities would agree to a refinancing involving higher termination liabilities unless it was judged better value for money than a refinancing which does not involve such an increase in termination liabilities.[21] Best practice would be for an authority, faced with a refinancing proposal involving increased termination liabilities, to obtain and carefully consider the alternative benefits and disbenefits of a refinancing deal which involved no increase to termination liabilities. The Trust did not have an alternative refinancing proposal involving no increase to termination liabilities but it doubts that THC Dartford would have been able to complete a refinancing on this basis.

2.42 Although the Trust's approach did not fully comply with what is now considered best practice in applying the Treasury's guidance which was available at the time the refinancing was being negotiated the Trust considers, however, that it had sufficient information to support its decision to accept the risk of higher termination liabilities at the time it agreed to the refinancing in March 2003.

The Trust's termination liabilities could increase significantly but the Trust has demonstrated that the refinancing is expected to provide value for money despite this added risk

2.43 Prior to the refinancing Ernst & Young assisted the Trust in considering the effect of the increased termination liabilities. Ernst & Young's analysis showed that, on a worse case scenario,[22] if the contract was terminated before 2019 the increase in the Trust's termination liabilities as a result of the refinancing (assuming the liabilities were paid as a lump sum) would exceed the Trust's benefits from the refinancing but there would be net benefits to the Trust from the refinancing if the contract was terminated after 2019.

2.44 As noted above, prior to the refinancing, Ernst & Young also considered the Trust's termination liabilities, taking account of the probability of the contract being terminated, and, for the purposes of this report, undertook further detailed analysis to support the conclusions previously drawn. The consideration at the time of the refinancing, and the further analysis, took account of the Department's view that, although the Trust has accepted the risk of increased termination liabilities, there will be a low probability of the contract being terminated. In forming this view they have taken account of the investment grade rating that was given to the bond issue which implies a very low risk of project failure together with controls, such as the THC Dartford's funders' right to appoint new contractors, which are likely to overcome project difficulties without recourse to contract termination.

2.45 Ernst & Young concluded that despite the risk of significantly increased termination liabilities, the refinancing, after taking account of the Trust's expectation of a low probability of contract termination, is expected to produce value for money for the Trust. This analysis shows that value for money from these arrangements will be achieved whether the Trust elects for its termination liabilities to be paid over time or as a lump sum **(Figure 17)**.

21 Paragraph 35.3.1.6 of PFI Standard Contract terms guidance on refinancing (July 2002).
22 Assuming no rectification costs which could be deducted by the Trust.

17 Ernst & Young's analysis of the value for money case for the Trust's agreement to the risk of increased termination liabilities for THC default based on the maximum capped amount payable

	If termination liabilities paid over time	If termination liabilities paid as a lump sum
The maximum amount of the Trust's termination liabilities following the refinancing[1]	If termination occurs in 2003: In NPV terms: £105 million	If termination occurs in 2003: In NPV terms: £135 million
The maximum increase in the Trust's termination liabilities as a result of the refinancing	If termination occurs in 2018: In NPV terms: £21 million	If termination occurs in 2018: In NPV terms: £89 million[2]
The NPV of the increase in the Trust's termination liabilities following the refinancing based on a conservative assumption that there will be a 10 per cent probability of the contract being terminated in any year during the contract period[3]		£1.8 million
The NPV of the Trust's refinancing benefit		£11.7 million
The NPV of the expected net refinancing benefit to the Trust after taking account of the increased termination liabilities and the probability of the contract being terminated[4]		£9.9 million

Source : Ernst & Young

NOTES

1 The capitol value of the project is £96 million. The value of termination liabilities paid over time in the original project was £114 million. The lump sum value represents 102% of senior debt less receivables. The value of termination liabilities following the refinancing could include some or all of the £46 million additional debt THC Dartford took on to generate the refinancing gains.

2 The maximum increase in the Trust's termination liabilities would have been £116 million had the Trust not renegotiated aspects of its termination liabilities prior to the refinancing to limit the increase in termination liabilities that would arise as a result of the refinancing.

3 The Trust expects the probability of the contract being terminated to be much lower than 10 per cent (in line with the judgement of the Prison Service in connection with the Fazakerley Prison refinancing), based on the independent assessment of the project default risk undertaken for THC at the time of the refinancing.

4 Ernst & Young also calculated that there would be a net benefit to the Trust from the refinancing in whatever year a termination of the contract might take place. This was based on the Trust's expectation that, following contract termination, it would pay the termination liabilities over time and not as a lump sum. Ernst & Young also calculated that, were the termination liabilities to be paid as a lump sum, unless there was a probability of more than 70 per cent, over the life of the contract, that the contract would be terminated, there would be an expected net benefit to the Trust from the refinancing.

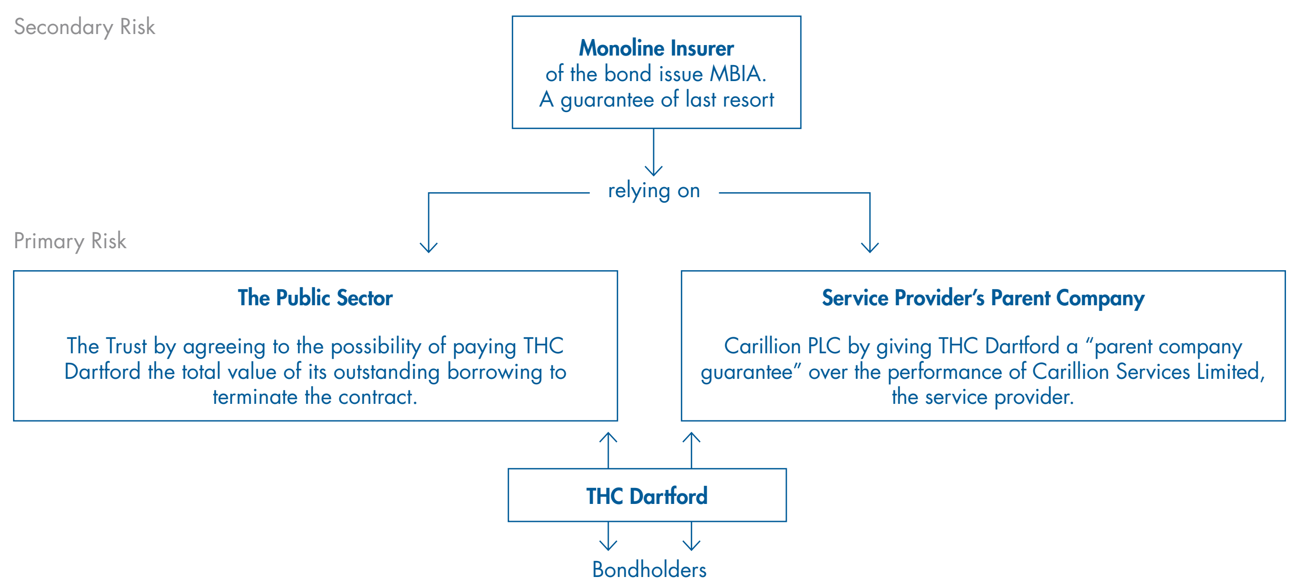
A consequence of these arrangements was that the Trust could become liable for some or all of THC Dartford's increased debt taken on to facilitate the refinancing

2.46 Following the refinancing the Trust's commitment to making payments in the event of contract termination continue to be important to ensuring that THC Dartford's outstanding debt will be repaid if the contract is terminated **(Figure 18)**. This is in a situation where THC Dartford's debt has increased by £46 million to enable THC Dartford's shareholders to draw accelerated benefits from the project and for the Trust to share in those benefits.

2.47 The Trust's termination liabilities may now include not just the borrowings used to build the hospital or to provide a refinancing benefit to the Trust, but part or all of the additional borrowings which THC Dartford has used to pay its shareholders accelerated benefits from the project. The Department considers that it would not have been possible for THC Dartford to complete the refinancing, and that the refinancing gain would certainly have been lower, from which the Trust stood to benefit, if the Trust had not agreed to these termination arrangements. Other approaches which could have further restricted the Trust's exposure to termination liabilities, but which may have reduced the refinancing gain which could be generated, would have been to seek to negotiate either of the following arrangements:

- That the termination liabilities would not increase above the levels the Trust accepted at the time the contract was let.
- That the termination liabilities in future would be calculated as the market value of the contract at termination (the recommended basis now set out in the Treasury and the Department's standard PFI contract terms).

18 The parties that have given guarantees to safeguard the repayment of the new finance provided by bondholders



Source: The National Audit Office

NOTE

THC Dartford's ability to repay the bondholders is safeguarded by guarantees given by Carillion PLC and MBIA, the monoline insurer. The Trust's obligation is particularly important as it has agreed to the possibility of being liable to pay THC Dartford the full value of its outstanding borrowings in the event of contractor default.

The large early benefits which THC Dartford's shareholders have received could reduce the incentives on THC Dartford to perform well over the rest of the contract period

2.48 Given that the refinancing has enabled THC Dartford's shareholders to receive in 2003 more than they had previously expected over the life of the contract there is a potential risk that THC Dartford may no longer have an incentive to perform well over the remainder of the contract. This particularly relates to Carillion, the main service provider, who has benefited from the refinancing and subsequently reduced its exposure to project risk by selling its shareholding in THC Dartford. Carillion and THC Dartford consider, however, that they each still have strong incentives to perform well as:

- THC Dartford's current shareholders still have projected revenues with a net present value of £13.6 million to earn over the remainder of the contract. The current shareholders also have their original investments totalling £13 million still invested in the project. The bondholders have £132.5 million invested in the project. Recovery of these investments and receipt of future revenues from the project will be dependent on satisfactory performance by Carillion who continue as the main sub-contractor. Their performance will be monitored closely by the current shareholders and MBIA, the monoline insurer of the bond issue. Following the refinancing in March 2003 there were some lapses in service performance during July to September 2003 but the overall performance of Carillion and THC Dartford in service delivery has since been satisfactory;

- THC Dartford's previous and current shareholders and contractors would not want to risk their reputation being adversely affected by poor performance as this would prejudice their ability to bid successfully for future PFI contracts. In addition, by withdrawing their equity investment in this project, Carillion is freeing up resources to bid for, and invest in, other PFI projects which should assist the competitiveness of the PFI market;
- THC Dartford has informed us that the amounts that Carillion still has at risk, in respect of its obligations as a contractor to the project, are significantly more than Carillion received on realising its investment in THC Dartford; and
- Before agreeing that Carillion could sell its shares the other shareholders in THC Dartford (and Barclays Infrastructure Ltd, the purchaser of Carillion's shares) would have assessed the risks associated with Carillion's future performance as a service provider and been satisfied that they expected Carillion, for the reasons set out above, to continue to perform in accordance with its contractual obligations. The purchaser of Carillion's shares would have taken these matters into account in reaching agreement on the £5.2 million price which was paid for the shares.

The increase in the Trust's termination liabilities could, however, make it less willing to terminate the contract either voluntarily or in circumstances where THC Dartford was in default if alternative actions such as replacing contractors has not remedied the project difficulties.

There were also costs to the Trust in dealing with the refinancing

The refinancing absorbed large amounts of Trust management time

2.49 This refinancing has demonstrated that, even with the new Treasury code which sets out the framework for sharing refinancing gains on early PFI deals, completing a refinancing will absorb a large amount of authority management time. The Trust was first notified by THC Dartford in early 2001, soon after the new hospital had opened, that it was considering refinancing the project. The Trust's senior management then spent considerable time monitoring the refinancing plans, and negotiating over the refinancing, during the next two years although they also improved the operation of the hospital during this period achieving three star status. The large time commitment on the refinancing was to be expected as it was the Trust's management's first experience of a refinancing. The experience they have gained is now shared with other NHS Trusts who seek their advice.

There were advisers' costs but the benefit was limited as the financial advisers were engaged late

2.50 Because of the complexities of refinancing authorities must take advice from parties with experience of refinancing issues. The Trust was advised for the main part by the Department's Private Finance Unit who provided a large amount of support to the Trust during the refinancing negotiations drawing on the Private Finance Unit's knowledge of the PFI hospital portfolio which included other deals where refinancings were being considered. In addition the Department took advice from the Treasury including, but not limited to, the issue of the discount rate to be used for evaluating the amount of the refinancing gains. The new Treasury Refinancing Taskforce (resourced by Partnership UK) formed in late 2002 was not called on for additional advice prior to the completion of this refinancing in March 2003 but were advised on more than one occasion of the progress on the refinancing. The Trust also appointed Eversheds to provide legal advice and Ernst & Young to provide financial advice at a combined cost of £275,000.

2.51 The Trust appointed Ernst & Young as financial advisers in February 2003, as the refinancing was being finalised. The Trust asked Ernst & Young, at this stage in the negotiations, to provide a final review of the terms of the proposed refinancing and to report on these to the Trust Board. Ernst & Young completed this just before the refinancing was finalised in March 2003.

2.52 Ernst & Young's analysis of the refinancing, and its negotiations with THC Dartford on the Trust's behalf, was valuable to the Trust in closing the refinancing which had been proposed by THC Dartford. As the parties were seeking to complete the refinancing within a few weeks of their year-ends of 31 March 2003 the Trust had very limited time to absorb the information on the refinancing which Ernst & Young provided. If the Trust had appointed Ernst & Young earlier the Trust's understanding of the refinancing would have been greater at the time the main aspects of the refinancing terms were being negotiated. With this greater understanding the Trust would have had more time to consider whether alternative strategies to negotiating the refinancing, for example in respect of termination liabilities, could have been pursued.

2.53 The Trust acknowledges that it would have helped its understanding of the issues if it had appointed external financial advisers earlier in the negotiations but it does not consider it suffered financially from the timing of the appointment. At the time the Trust was advised by the NHS Private Finance Unit not to appoint advisers until it was certain that the refinancing would go ahead. In addition, authorities would now be expected to keep informed, and to make greater use of, the Treasury Refinancing Taskforce which has now built up experience of refinancing issues across government.

The Treasury has emphasised to departments the key features of its refinancing guidance in the light of early refinancing experience

2.54 The Treasury issued guidance to departments on refinancing issues in 2002 in connection with both the launch of the new refinancing code and revised standard PFI contract terms. In the light of the issues raised by our analysis of the Dartford & Gravesham hospital refinancing, and the Treasury Refinancing Taskforce's monitoring of all refinancing negotiations on which it has been consulted, the Treasury, through its Refinancing Taskforce, has taken steps to emphasise to departments the key features of the Treasury's refinancing guidance. The Taskforce is underlining the need for appropriate advice and rigorous value for money analysis before departments agree to refinancings, particularly where they involve the private sector increasing its levels of debt. The main points the Taskforce is bringing to departments' attention are set out in **Figure 19**.

19 The main aspects of its refinancing guidance which the Treasury Refinancing Taskforce is bringing to the attention of departments

- The importance of a rigorous value for money analysis to support the case for departments agreeing to a refinancing proposal.
- As part of this analysis, expert advice should be sought on the implications of any proposal which includes an intention to increase the amount of private sector debt, particularly where the proposal includes contract amendments such as an extension to the length of the contract.
- Increased termination liabilities should not be accepted without fully evaluating the benefits and disbenefits of alternative refinancing terms involving no increase to termination liabilities.
- Project teams should draw on experienced advice from their departmental Private Finance Units and external advisers.
- The Treasury Refinancing Taskforce should be kept informed about the refinancing negotiations. The Taskforce should be consulted on issues regarding the interpretation and implementation of the refinancing code and related Treasury guidance.

PART THREE

There are mechanisms in place to check future value for money and to respond to changing health needs

3.1 Future decisions on health provision have to take into account that any hospital, whatever the form of procurement, represents a major investment for the NHS. In this PFI contract the Trust is also committed to a total of 32 years[22] of payment to THC Dartford for the hospital facilities and associated facilities management services. There are mechanisms in place to allow assessment of the value for money being provided. The project has not yet reached the stage where these have been fully tested, however, and maintaining value for money will depend on the Trust making effective future use of these mechanisms. Over the period of the contract it is also inevitable that there will be changes in the level and type of services which the NHS provides, which will in turn affect the scale and nature of the work at the hospital. It will be possible for the Trust to seek to renegotiate payments either up or down, should its level of health care services alter. To date, the hospital is expanding with a programme of new building using different procurement methods.

There are mechanisms for the Trust to check over the life of the contract whether facilities management costs are good value for money

3.2 Because the prices for comparable facilities management services may change over time the contract has mechanisms which the Trust can use to ensure that THC Dartford's prices remain reasonable. Every five years THC Dartford will consider with its sub-contractors the pricing of FM services. THC Dartford will then present cost proposals to the Trust which then has the option to accept the proposed charges or to request a benchmarking exercise. This benchmarking exercise will compare THC Dartford's proposed costs with comparable services in the NHS or, if appropriate, elsewhere. If the Trust and THC Dartford are then unable to agree on the pricing of THC Dartford's services the PFI contract provides for the pricing to be determined by THC Dartford competitively tendering the services between its existing and alternative sub-contractors. In making decisions about the future delivery of FM services the Trust will discuss with THC Dartford the likely demand for future services and the previous delivery record as well as pricing considerations.

22 The minimum contract period is now 35 years. During the first three years the hospital was being constructed and no payments were due during this period. The Trust is committed to payments for the remaining 32 years.

Although the need to terminate the whole PFI contract currently seems very unlikely, if it was necessary it would be more burdensome than ending conventional arrangements

3.3 Both the Trust and the Department are currently confident that the hospital building will most probably be needed for the foreseeable future and that, if there should be serious problems with THC Dartford's performance, this will be resolved without terminating the PFI contract, for example by requiring THC Dartford to replace its sub contractors.

3.4 Nevertheless, it is not possible to anticipate now the factors that may affect decisions about the delivery of healthcare in the Dartford & Gravesham area in 20 or 30 years time. Views about the usefulness of part or all of the current hospital may change over time. Under conventional procurement the financial consequences for an NHS Trust of contract termination are likely to be less onerous than under the PFI. Conventionally, a NHS Trust's financial liabilities on termination to external parties are likely to only be the cost of terminating short term facilities management although a Trust would still bear capital charges from the Department in respect of the cost of the building. In this deal, as with other PFI projects, there would be more parties for the Trust to negotiate with to effect a termination and the cost of terminating the contract would be a major consideration for the Trust in deciding whether to do so. The termination cost to the Trust would include the capital cost of building the hospital (to the extent that the related borrowings are still outstanding) and may also include part of the additional finance obtained by THC Dartford to effect the refinancing together with any costs associated with breaking those financing arrangements.

There are contract mechanisms which the Trust can use to manage change

The Trust can specify changes to the facilities management services

3.5 As with conventional outsourcing of service delivery the Trust is able to propose additions, changes and reductions to the facility management services provided by THC Dartford's contractors. If no agreement is reached on the Trust's proposals (for example, on scope or cost) then the disagreement can be referred to the contract's Dispute Resolution Procedure. If an addition to the service is needed, and the Trust and THC Dartford cannot agree on the terms, the Trust can ask THC Dartford to tender in competition with others for the right to provide the additional service. If a new service provider is appointed, the Trust has to indemnify THC Dartford against any reasonable costs it may suffer as a result of the new arrangements.

3.6 A feature of PFI hospital contracts is that the core service, the delivery of clinical services to the public, is not part of the PFI contract. In this project, the Trust and THC Dartford have often had to discuss the implications of changes by the Trust to its clinical delivery (for example, the way in which a ward is being used) for THC Dartford's provision of facilities management services. In many cases THC Dartford has been able to adjust its service delivery without this being a formal contractual change but some cases have required changes to be negotiated to the contract terms and pricing. Following negotiations with THC Dartford, the Trust has paid around £600,000 for variations to the facilities management service. This has related to factors such as changing a ward use and additional services needed during winter periods when there have been exceptionally high levels of patients. The Trust sees this as a natural progression of the agreement as the services on the site develop.

The Trust has flexibility over how building changes should be procured but will need to negotiate effectively over the pricing of any building variations

3.7 The Trust pays THC Dartford a monthly amount for the provision of hospital areas that are available for use. During the minimum contract period (covering the first 32 years of payments) this availability payment will remain fixed in real terms with adjustments if the Trust asks THC Dartford to vary the level of facilities provided. If the Trust then continues the contract, the availability payment will be renegotiated every five years in line with THC Dartford's expected costs for operating and maintaining the buildings. If the Trust is not able to agree with THC Dartford's prices at these five yearly reviews the parties will use the contract's Disputes Resolution Procedure. The Trust would expect to negotiate with THC Dartford a reduced availability payment after the minimum contract period has ended as THC Dartford would have repaid the borrowings used to build the new hospital.

3.8 If the Trust wishes to commission additional building facilities then it has the flexibility to choose the method of procurement although THC Dartford approval is needed if the work is to be contracted for outside the PFI contract except where it relates to a proposed free-standing building on the site. The Trust has found conventional NHS funding to be the most economic option for small variations. It is also funding some larger variations conventionally, for example its recent A&E variations and a proposed new Heart Centre. Where the Trust wishes to consider commissioning additional building work under its PFI contract the Trust can invite THC Dartford to submit proposals. The Trust can take steps to test whether THC Dartford's proposed pricing for the building work is value for money, for example by requiring THC Dartford to obtain alternative quotations for the building work. If THC Dartford cannot obtain funding for the work on reasonable commercial terms, the Trust may pay for the additional work using funding mechanisms other than the PFI. These arrangements are designed so that, in theory, the terms for additional works should not be less favourable than under conventional procurement where the Trust would be able to tender for competitive quotes for any additional facilities.

3.9 The Trust considers that its PFI contract gives it no less flexibility to reduce activity than a conventional hospital and does not expect there to be any significant difference in the cost implications. The Trust would certainly expect to be able to reduce the level of payments on facilities management services if it ceases to use part of the hospital. It may, however, be less easy for the Trust to avoid expenditure on maintaining areas not in use compared with conventional procurement where a NHS Trust can make immediate decisions to stop, or reduce, expenditure on maintaining areas no longer in use. This is an aspect the Trust would have to negotiate with THC Dartford.

3.10 THC Dartford says it is prepared to accept some form of price reduction if the Trust stops using part of the hospital but THC Dartford notes that it will need to continue charging a good part of the current availability fee to ensure that it can cover its capital and interest payments to its bondholders. THC Dartford says it would only be prepared to accept some reduction to the availability payment if there was a corresponding relaxation in the standard the building has to be in when THC Dartford hands it back to the Trust at the end of the contract period. THC Dartford has also given an explicit undertaking to its bondholders that there will be no reduction to the availability payment if the size of the hospital is reduced.

New facilities are being built, indicating an ability to be flexible within the contract and respond to additional health service needs

The Trust is managing a programme of additional building work using the contract mechanisms to control the pricing of building changes

3.11 Changes to central health policy or the demand for particular services from the local community could result in the Trust needing building changes. The Trust has already commissioned additional building work since the PFI contract was let at an expected capital cost of around £15 million (Figure 20) with the Accident and Emergency improvements having been completed. The work is being carried out by Carillion, partly under the PFI deal through a bond variation and partly through conventional NHS funding. The Trust has taken steps to test that Carillion's pricing of the additional building works are reasonable by either competitively tendering the work or benchmarking Carillion's prices. The Trust may also need a change of use of existing facilities. This occurred when the Trust converted a children's ward into an adult ward.

3.12 Two of the additional building projects, the mental health assessment centre for older people and the renal dialysis unit, will be paid for by the NHS out of public capital by the West Kent NHS and Social Care Trust and Kings' College Hospital NHS Trust who are the relevant service providers.[23] Under the terms of the PFI deal the Trust was required to be contractually liable to THC Dartford for the cost of this work by way of a variation to the PFI contract as this was work being carried out on the Trust's site. The Trust will recover the cost from the two service provider NHS Trusts. Any facilities management services that the two NHS Trusts using the facilities may require will also be initially charged to the Trust under the PFI contract. The Trust's liabilities arising from these services for the two other Trusts are, however, being underwritten by the Dartford, Gravesham and Swanley Primary Care Trust.

23 If West Kent NHS and Social Care Trust should withdraw from the project, then the Trust has an agreement in place whereby Dartford, Gravesham and Swanley Primary Care Trust will underwrite their contribution.

20 The Additional Buildings Projects

Building	What it will provide	Who is doing the work	How much will it cost	How will it be contracted for and financed	Construction start date	Completion date
Treatment Centre	40 beds and the ability to treat 3,400 extra patients a year.	Medical provision by the Trust. Construction and facilities management by Carillion through THC Dartford (following independent surveyors reports that the costs were reasonable).	Estimated capital cost £8 million. The Trust's annual PFI charges will increase by £900,000.	As a PFI contract variation. Funded by THC Dartford from variation bonds raised as part of the refinancing.	March 2004	June 2005
A & E improvements	Improvements to current A&E to help the Trust deal with higher than expected usage.	Carillion (following competitive testing of their proposed price).	£600,000-£700,000	Separate building contract. Funded conventionally by the NHS.	March 2004	Completed
Mental Health Assessment Centre and Renal Dialysis unit	Facilities for use by West Kent NHS & Social Care Trust & King's College Hospital NHS Trust.	Carillion (following competitive testing).	Estimated capital cost £5 million. The Trust's annual PFI charges will not increase since the work is being funded by other Trusts	As a PFI contract variation with the cost to be borne by the two other NHS Trusts who will use the facilities.[1]	March 2004	February 2005
		Total Estimated Cost approximately £15 million				

NOTE

1 The Trust will recover the cost from the two service provider NHS Trusts: the West Kent NHS and Social Care Trust and King's College Hospital NHS Trust. To pay for this, these Trusts will draw on conventional funding.

The project is adapting to changes in technology

3.13 It is important that the Trust should be able to take advantage of improvements in technology. Since the beginning of the PFI contract, there have been several examples of how the Trust has been able to work with THC Dartford through the PFI contract to introduce technology improvements including:

- A video link between the operating theatres and the post graduate teaching centre;
- A pay communication/entertainment system (e.g. television, phone, e-mail) for each bed;
- A fully computerised laparoscopic operating theatre, the first in the country, known as OR1, the Operating Theatre of the Future.

The Trust retains responsibility for all new or replacement assets unless they are part of the physical infrastructure of the building. For example, certain large items of medical equipment such as scanners are centrally funded by the Department.

3.14 In 2001 the Trust decided to take back from THC Dartford responsibility for the network infrastructure of active equipment which Carillion had installed in the central infrastructure hub rooms. The Trust had been concerned that Carillion's maintenance and replacement schedule for some of the IT equipment was not quick enough after equipment failure and that Carillon was not required to provide skilled network staff to manage the equipment. THC Dartford agreed that the further IT upgrade required by the Trust could be best managed by the Trust directly.

The Trust and THC Dartford are working to maintain an effective relationship to manage the contract successfully over 35 years

3.15 Achieving success in managing a long term PFI contract will require not just a good contract with mechanisms for testing value for money and dealing with change but also an effective working relationship between the authority and its contractor. There will be a need for give and take when problems arise and an ability to work together constructively in adapting to changing circumstances. This is particularly important in a PFI hospital project because of the strategic decisions about the delivery of healthcare which could necessitate changes to the project.

3.16 Although there was some tension in the early stages of the relationship between the Trust's former management and THC Dartford as the project got under way, and later as the Trust sought to measure THC Dartford's performance more rigorously, the Trust and THC Dartford have taken steps to improve their relationship through effective regular contact at a senior level within their organisations. This has helped them understand strategic issues of concern to each other including situations which may necessitate change to the project. The Trust has found that working with the senior management of THC Dartford on the programme of additional building work has helped to progress the development of an improved relationship.

APPENDIX 1

Study Scope and Methodology

Study Scope

1 The objective of this study was to examine the Trust's management of the PFI contract to build and subsequently operate FM services at the Darent Valley Hospital. We used an issue analysis approach to design the scope of the examination. We set a series of four high level audit questions to answer to assess how well the deal was progressing. For each of the top level questions, we developed a subsidiary group of questions to direct our work and analysis. The top-level questions we set were:

- Have construction issues been satisfactorily dealt with?
- Are the operational aspects of the PFI contract going well?
- Have financial issues arising from the PFI contract been satisfactorily dealt with?
- Is the contract likely to enable the Trust to maintain value for money and adapt to changing health needs in the future?

Study Methodology

2 We collected information in order to obtain evidence that would allow us to answer the above questions. The majority of documentary evidence was provided to us by the Trust and its advisers. Certain additional information, particularly in respect of the refinancing of the contract, was provided by THC Dartford who carried out the refinancing and the Department who advised the Trust in connection with the refinancing. In the course of our study we also interviewed key staff within the Trust, including clinical staff, who are involved with, or affected by, the PFI project. The Treasury and its Refinancing Taskforce were also interviewed.

APPENDIX 2

Summary of previous NAO and PAC reports on the Dartford & Gravesham PFI hospital project

The NAO report (HC 423 1998-99)

1 The NAO report examined whether the PFI contract was likely to deliver the services the Trust wanted and how the contract payments would be funded; whether the Trust secured a good deal; how the Trust managed the procurement and their advisers; and what steps the NHS were taking to act on lessons learned from this project.

2 The NAO found that:

a The contract is likely to deliver the services the Trust wanted, but additional financial support was being provided to meet the costs of the new hospital. In determining the services to be provided the then Regional Health Authority told the Trust that the new hospital should not have more than 400 in-patient beds. Given the expected demand on the hospital, 400 beds was broadly consistent with the plans for bed capacity in new hospitals which the NHS was then pursuing. In taking forward the plans for the new hospital the Trust provided for more day-case and out-patient treatments, with in-patient care backed up by a range of high technology and treatment departments.

b The PFI deal was expected to deliver additional non-financial benefits compared with traditional procurement but there is uncertainty as to the level of savings, if any, that would be achieved.

c The procurement was not fully competitive but the Trust benchmarked most of the costs.

3 The NAO's recommendations included:

a Funding limits for PFI health projects should be agreed at the outset with confirmation that the project will contribute to the best use of NHS funds within the plans for local health services.

b Key decisions on whether a project represents value for money should be based on careful calculations of the likely costs and benefits which should be subject to rigorous review.

c The data for cost overruns on past traditional hospital procurements should be refined.

d Trusts should maximise competitive tension in the bidding process including checking whether bidders feel able to comply with the bidding requirements.

e The NHS may wish to consider whether it should commission certain advice centrally on PFI issues.

The PAC report (HC 131, 12th Report 1999-2000)

4 The PAC's key conclusions and recommendations were:

a The NHS failed to estimate correctly the costs of this long-term contract.

b Value for money comparisons must be rigorously checked

c Departments must understand the full range of risks and potential rewards available to the private sector when negotiating contracts

d The NHS must use its experience of the PFI to drive down advisers' costs.

APPENDIX 3

Year by year analysis of the contract price in present value and cash terms before and after the refinancing

Financial Year	At contract letting £'000	Cash Prior to the refinancing £'000	After the refinancing £'000
2001 (part year)	9,448	9,990	9,990
2002	19,415	17,941	17,941
2003	20,093	18,306	16,779
2004	20,797	19,649	16,636
2005	21,525	20,091	17,957
2006	22,278	20,549	18,366
2007	23,058	21,052	18,814
2008	23,865	21,578	19,284
2009	24,700	22,118	19,766
2010	25,564	22,671	20,260
2011	26,459	23,237	20,767
2012	27,385	23,818	21,286
2013	28,344	24,414	21,818
2014	29,336	25,024	22,364
2015	30,363	25,650	22,923
2016	31,425	26,291	23,496
2017	32,525	26,948	24,083
2018	33,664	27,622	24,685
2019	34,842	28,313	25,302
2020	36,061	29,020	25,935
2021	37,323	29,746	26,583
2022	38,630	30,490	27,248
2023	39,982	31,252	27,929
2024	41,381	32,033	28,627
2025	42,829	32,834	29,344
2026 (part year)	22,020	13,958	12,532
Total: Original 28 year minimum contract period	**743,312**	**624,595**	**560,715**
2026 (part year)	0	0	17,545
2027	0	0	30,829
2028	0	0	31,599
2029	0	0	32,389
2030	0	0	33,199
2031	0	0	34,029
2032	0	0	34,880
2033 (part year)	0	0	14,830
Total further 7 years post refinancing	**0**	**0**	**229,300**
Total: Extended 35 year minimum contract period	**743,312**	**624,595**	**790,015**

Source: The Trust and Ernst & Young, the financial advisers for the refinancing

NOTES

1 The NPVs are discounted to 1996, the year the original deal was approved.

2 The cash and NPV figures for 2003 include the lump sum receipt in that year of £1.5 million from the refinancing

3 The cash amounts increase each year for inflation as allowed by the contract.

NPV at 6 per cent real			NPV at 3.5 per cent real		
At contract letting £'000	Prior to the refinancing £'000	After the refinancing £'000	At contract letting £'000	Prior to the refinancing £'000	After the refinancing £'000
7,526	7,521	7,521	8,355	8,349	8,349
12,171	12,160	12,160	13,838	13,824	13,824
11,483	11,485	10,582	13,370	13,372	12,321
10,833	10,837	9,688	12,918	12,923	11,553
10,220	10,224	9,141	12,481	12,486	11,163
9,642	9,645	8,622	12,059	12,064	10,785
9,096	9,099	8,134	11,652	11,656	10,420
8,581	8,584	7,674	11,258	11,262	10,067
8,095	8,098	7,239	10,877	10,881	9,727
7,637	7,640	6,830	10,509	10,512	9,398
7,205	7,207	6,443	10,154	10,157	9,080
6,797	6,799	6,078	9,810	9,814	8,773
6,412	6,414	5,734	9,479	9,482	8,477
6,049	6,051	5,410	9,158	9,161	8,190
5,707	5,709	5,104	8,848	8,851	7,913
5,384	5,386	4,815	8,549	8,552	7,645
5,079	5,081	4,542	8,260	8,263	7,387
4,792	4,793	4,285	7,981	7,984	7,137
4,520	4,522	4,042	7,711	7,714	6,896
4,264	4,266	3,814	7,450	7,453	6,662
4,023	4,025	3,598	7,198	7,200	6,437
3,795	3,797	3,394	6,955	6,957	6,219
3,581	3,582	3,202	6,719	6,722	6,009
3,378	3,379	3,021	6,492	6,495	5,806
3,187	3,188	2,850	6,273	6,275	5,610
1,253	1,253	1,120	2,525	2,526	3,102
170,710	**170,745**	**155,043**	**240,879**	**240,935**	**218,950**
0	0	1,568	0	0	2,318
0	0	2,536	0	0	5,237
0	0	2,393	0	0	5,060
0	0	2,257	0	0	4,888
0	0	2,130	0	0	4,723
0	0	2,009	0	0	4,563
0	0	1,895	0	0	4,409
0	0	745	0	0	1,775
0	**0**	**15,533**	**0**	**0**	**32,973**
170,710	**170,745**	**170,576**	**240,879**	**240,935**	**251,923**

APPENDIX 4

The negotiations over how the refinancing gain would be calculated

- The Treasury's guidance to authorities (but not part of the code) said that the discount rate for calculating the refinancing gain is the consortium shareholders' expected rate of return at the time the contract was let – in this case 21 per cent in nominal terms.
- THC Dartford was not prepared to calculate the refinancing gain on this basis. It considered a rate of around 10 per cent nominal should be used in line with the level of returns which might be sought by a pension fund if it bought a shareholding in the project from the initial shareholders.
- The Treasury and the Department agreed to compromise over the discount rate to be used in the calculation. They considered 21 per cent nominal would have been an unusually high discount rate. The 21 per cent nominal return expected by the initial shareholders at contract letting had reflected the additional risks of what was the first PFI hospital contract.
- The Treasury and the Department negotiated with THC Dartford that a rate of 15 per cent nominal should be used. This was in line with the rate of return expected at contract letting by shareholders in more mature PFI hospital projects.
- The Trust's advisers, Ernst & Young, estimate that, had a discount rate of 21 per cent nominal been used in line with the Treasury's guidance, this would have increased the refinancing gain by £4.6 million. Based on the 30 per cent share to be given to authorities in accordance with the voluntary code the Trust would have been due around £1.4 million of this increased gain.
- The Treasury and the Department did not think they could gain THC Dartford's agreement to give up this higher amount of refinancing gains. The Treasury and the Department believe that the negotiated solution still gave the Trust a significant refinancing benefit which it could not have been certain of receiving without the code.

APPENDIX 5

Summary of Service Failures

Service	Month	Score	Deduction	Assessment (Reason)	Action Taken
Estates	Jan 02	94	None[24] (£978)[25]	Two of the ten standards (key indicators) achieved sub 95 scores: Grounds gardens and indoor planting effectively maintained scored 70; Roads and car parks effectively maintained scored 75. As a result of their relatively low weighting factor [Grounds and gardens 21/504 and Roads and car parks 14/504] the aggregated score for Estates only just fell below 95. The PMS noted that there had been no improvement in the Grounds & gardens despite repeated requests and there were also problems with rubbish, bottles, cigarette ends and chewing gum being left around the main entrance and car parks. Evidence was provided through the complaints procedure and site walk round.	Estates staff agreed to have a cleaning purge over the weekend.
	July 03	94	None (£1,008)	Five of the ten standards (key indicators) achieved sub 95 scores. Three standards, Effective planned preventative maintenance, Environmental control and Effective maintenance in respect of buildings all scored 94 due to issues such as 'lack of periodic cleaning of fans, fire sensors, vents, kitchens, light diffusers…'. Grounds and gardens and indoor planting effectively maintained scored 80 and Roads and Car Parks effectively maintained scored 87. Problems identified with the Grounds included 'Trees not secured, Kerb Lines unswept and not weed sprayed, weeds not removed…'.	
	Aug 03	94	None (£1,008)	Five of the ten standards (key indicators) achieved sub 95 scores. Effective planned preventive maintenance scored 93 as a result of the contractor failing to provide evidence of PPM being carried out during the month. Grounds and gardens and indoor planting effectively maintained scored 86 and Roads and Car Parks effectively maintained scored 87. Environmental control and Effective maintenance in respect of buildings scored 93 and 94 respectively with issues identified such as build up of insects in light diffusers and damaged kick plates not repaired or replaced.	The contractor now produces a report which details the PPM program Since January 2004, more resources (2 extra employees) have been put into grounds and gardens.

24 Deduction offset by credits previously acquired for above satisfactory performance (Figure 6).
25 Deduction that would have been imposed had it not been offset by credits (paragraph 1.27).

Service	Month	Score	Deduction	Assessment (Reason)	Action Taken
Domestics	July 03	94	None (£1,153)	Five of the ten standards (key indicators) achieved sub 95 scores. Cleaning Standards was awarded 94 with two areas identified: A&E and OPD. It is not clear from the data provided for the PMS, the extent of these cleaning concerns. Agreed staffing levels, Quick response to ad hoc requests, windows kept clean and cleaning schedules all scored 93 with concerns listed relating to 'insufficient management cover', 'poor standards of cleanliness', 'ingrained stains on stairways and corridors', 'windows not clean' and 'little evidence of reference to work schedules'.	
	Aug 03	94	£1,153.21	Four of the ten standards (key indicators) achieved sub 95 scores. Agreed staffing levels and Overall management of the service both scored 94. Reasons given in the PMS were 'insufficient management cover' and the 'attitude displayed by the management team'. Cleaning schedules and Windows kept clean both scored 93. Evidence provided included 'internal glass overlooked in all areas visited'.	
	Sep 03	94	£1,153.21	Five of the ten standards (key indicators) achieved sub 95 scores. Cleaning standards and cleaning schedules both scored 94. The issue identified in the PMS was a lack of attention to detail – hence there was criticism such as 'collection of dust underneath beds', 'soap underneath dispensers' and 'staining on walls'. Windows kept clean scored 93 with observations made of poor standards. Agreed staffing levels also scored 94 with concerns remaining over relief cover/training at ward levels. Quick response to ad hoc requests also scored 94 evidenced, for example, by the 5 days it took to clean the lifts.	
Portering	Oct 00	92	£3,380.20	The only documentation in the PMS archive are the complaints sheets. 8 complaints were received relating to Porters. These included long delays waiting for porters and issues regarding waste collection (such as the inappropriate use of yellow bins). 4 complaints were received relating to internal security – 2 of which referred to the reception desk not being manned.[26]	In 11 cases these complaints were 'noted'. Further action was instigated in 1 case with a letter from the Trust to Carillion.

26 The log of comments/complaints is what remains of the PMS documentation at this time.

Service	Month	Score	Deduction	Assessment (Reason)	Action Taken
Portering (continued)	Nov 00	93	£2,228.43	The only documentation in the PMS archive are the complaints sheets. 12 complaints were received relating to Porters including responsiveness to requests and poor practices e.g. clinical waste bins used to clear general refuse. 7 complaints were received relating to internal security including problems with key issues and slowness of response.[27]	In 11 cases these complaints were 'noted'. In the remaining 8 cases action, such as a meeting to discuss, was proposed.
	Dec 00 Jan 01	94 94	£1,101.69 £1,101.69	Five of the ten standards (key indicators) achieved sub 95 scores. For both months a score of 92.5 was awarded to 3 key indicators: Response times, Appropriately skilled and trained staff and Quick and easy access to services. The assessment was on the basis of comparison of SLA standards with Help Desk records, complaints and compliments from wards and departments and an analysis of staff duty rosters and training records. The complaint log identified long delays for porters and issues with dedicated Theatre porters. Another key indicator, Grounds and indoor planting, was awarded a score of 87.5 in both months. There were general staff comments regarding 'grounds not maintained' and 'lots of rubbish laying around'. A further key indicator, Roads and car parks effectively maintained, was awarded 92.5 for both months due to the paths and car parks not being kept ice/snow free. There were also complaints regarding poor security service (i.e. doors propped open, loss of sub master key).	Action taken included letters being written to THC Dartford, an investigation into one particular complaint, emails to staff and discussions with various staff members to rectify problems.
	June 01	94	£1,108.78	Two of the ten standards (key indicators), Response Times and Appropriately skilled and trained staff, were awarded a score of 92. There were several Portering failures resulting in one patient cancellation and 1-1.5 hour delays (although no specific data is provided regarding the duration of these delays). There were in total 16 complaints about shortfalls in the service.	Staff stepped in to help e.g. transporting patients from wards. Ongoing consultation between the Trust and FM managers regarding new rotas.

27 The log of comments/complaints is what remains of the PMS documentation at this time.

Service	Month	Score	Deduction	Assessment (Reason)	Action Taken
Portering (continued)	July 03	94	None (£1,162)	Five standards (key indicators) achieved sub 95 scores. Overall management of the service scored 93. The PMS identified an unresolved security breach in occupational health and 'smoking by staff in uniform and immediately outside entrances' as cause for this score. Four areas, Appropriately skilled and trained staff, Routine services, Compliance with the control of infection manual policies and Appropriate equipment kept clean and in good working order, scored 94. These scores were awarded for failure to resolve a lack of flexibility in the X-Ray service, failure to hold a security meeting along with no notes and no security reports received and repeated failure of the waste collection.	
	July 04	94	None (£1,192)	One of the standards (key indicators), Response Times, was awarded a score of 86. The following issues were identified: 13 Complaints: Renton Clinic (2), MRI (3), CT scanning (2), Linden (2) (3hr delay in transferring deceased patient), Daycare (4). Holly Ward: numerous complaints w/c 26/7/04. Ultrasound list cancelled 26/7/04. Pathology delays with samples 24/7/04. A&E incident (no further information given in PMS record).	During this month, Carillion had temporarily employed agency staff to meet an increased demand for Portering. There is an ongoing review of Portering.
Linen & Laundry	Jan 03	94	None (£383)	Two of the ten standards (key indicators) scored 93: Sterile Services Unit (SSU) linen service standards maintained and Minimum stock levels maintained. A third standard (indicator) Quick response to requests scored 91. The quality standards survey had not been completed for the monitoring meeting and neither were the satisfaction surveys available. It was reported at the PMS meeting that numerous complaints about the service had been received. Carillion had appointed a new sub-contractor, Synergy, to take over from East Kent Linen Services and hence there were a number of teething problems. This was reflected in a score of 90 awarded to the standard (key indicator) Overall management of the service.	The PMS identified a number of issues to target.

Service	Month	Score	Deduction	Assessment (Reason)	Action Taken
Linen & Laundry (continued)	Feb 03	93	None (£774)	None of the 10 standards achieved a satisfactory score. Five were scored 94, Four were scored at 93 and one, Overall management of the service, scored 85. It was noted in the Monthly Summary Sheet that "Numerous and regular complaints of insufficient supplies and deliveries received since November 2002 continued and escalated to levels which caused serious operational difficulties in the first week of February, leading to the hand-over to Synergy". The quality standards survey had not been completed. It is however difficult to assess the seriousness of the complaints from the PMS alone since the PMS lists the discussion topics – such as transition period difficulties, insufficient quantities of blankets – without providing more quantifiable evidence or source of evidence other than 'visible inspection'.	Carillion requested a report from Synergy and undertook to address all service issues.
	Mar 03	94	£382.68	None of the ten standards achieved a satisfactory score. Seven were scored at 94, one was scored at 93, one was scored at 91 and one, Overall management of the service, was scored at 90. The quality standards survey was not completed. The discussion at the PMS meeting again revolved around start-up period difficulties. Issues such as infected linen and static shocks were discussed.	Carillion agreed to meet with the Trust.
	Aug 03	94	£394.52	Seven of the ten standards were below 95. Three were scored at 94, two were scored at 93, one was scored at 92, and Linen appropriate for use was scored at 89. In the latter case, visible inspection had identified inappropriate: nightwear, underwear, bedspreads, pillow cases, canvasses and Theatre Gowns.	
Catering	Oct 00	92	£2,303.96	16 comments/complaints logged, some written, some verbal.[28] 6 related to catering at Trust meetings, 7 related to a poor standard of catering on a ward and 3 related to the prices and standard of catering in the staff dining room.	

28 The log of comments/complaints is what remains of the PMS documentation at this time.

Service	Month	Score	Deduction	Assessment (Reason)	Action Taken
Catering (continued)	Mar 01	94	None (£751)	One of the standards (key indicators), Accepted catering services, was scored at 92. There had been a poor Patient Environment Action Teams (PEAT) score, several formal complaints and bad external publicity. The patient satisfaction survey and restaurant satisfaction survey produced 'unusual scoring' and required 'reviewing'.	A meeting was set up to discuss the PEAT comments. Menus were rearranged. New instruction sheets were sent to wards regarding food preparation.
	July 03	94	£801.27	Six of the ten standards (key indicators) achieved sub 95 scores. Hygiene scored 92. This score was awarded as a result of several observed cleaning failures e.g. 'electrical fans… have a film of dirt', 'filthy ceiling tiles', 'the toaster had ingrained carbon…' and 'wheels on beverage trolley were filthy'. Availability of clean uniform crockery, cutlery etc. scored 93 due to a variety of issues such as 'plastic apron ties not used', 'no trays used' and 'condiments were filthy'. Temperature, Choice, Timely service and Overall management of the service scored 94 due to a variety of problems such as 'pre-heat of crockery not effective', 'special requirements not getting to the patients' and 'service is taking far too long'.	
	Sep 03	93	£1620.76	Eight of the ten standards (key indicators) achieved sub 95 scores. Hygiene scored 75. An inspection of the Medirest Food Production area by the CSM identified 'extremely poor levels of: hygiene and cleanliness of premises and personnel'. There were also concerns regarding equipment 'not appropriate/not working properly and ingrained with dirt', and 'poor food management practices'. Overall management of the service scored 80. Temperature, Timely service, Function catering and Services provided courteously all scored 94 for problems such as 'meal service taking too long'. Choice scored 93 for 'insufficient quantities of popular dishes'. Availability of clean uniform crockery, cutlery etc. scored 90 for a range of problems such as 'blast chiller never used' and 'industrial knives with no blade'.	The CSM called for an immediate action plan to recover the situation.

Service	Month	Score	Deduction	Assessment (Reason)	Action Taken
Catering (continued)	Oct 03	94	£801.27	Eight of the ten standards (key indicators) achieved sub 95 scores. Overall management scored 91 – although there had been improvements on the previous month's performance, there were still concerns e.g. 'No evidence of Feedback Sheets received by Medirest from STA – requested at each monthly review for over 12 months'. Function Catering scored 91. Two formal complaints had been received from users and the CSM considered that 'the management of this area is lacking'. Hygiene, Choice and Availability of clean uniform crockery, cutlery etc. all scored 92. With regards to Hygiene, there were still some cleaning concerns e.g. 'Maple Ward: seals on fridges dirty, build up of grime on cupboard shelves…'. Services provided courteously scored 93 with the PMS noting that 'customer care re-training was required' and that 'staff were eating in the wash-up area'. Temperature and Timely service scored 94 with unchanged practices in use. In the FM services exception report, April-October 2003, it was reported that '… a further appointment of a fourth Catering Services Manager… revealed some serious concerns with food hygiene issues and an obvious deterioration of cleaning standards, work methods and practices over a period of time'.	A Catering Manager was formally appointed.
	Nov 03	94	£801.27	Seven of the ten standards (key indicators) achieved sub 95 scores. Hygiene scored 91. A visit by the CSM to Rowan Ward identified 'seals on fridges dirty and damaged, build up of grime on cupboard shelves…'. Function catering and Availability of clean uniform crockery and cutlery both scored 92 for reasons such as 'two formal complaints' and 'cutlery and crockery not thoroughly clean during ward visit'. Choice scored 93 for various problems over menus. Temperature, Overall management of the service and Services provided courteously all scored 94.	
Switchboard	Oct 00	92	£358.07	Complaints suggests poorly trained operators and initial teething problems.	
Total:			£18,691 (£8,411)[29] £27,102[30]		

29 The total of the deductions that would have been imposed had they not been offset by credits.
30 The total of deductions imposed and deductions that would have been imposed had they not been offset by credits.