Darent Valley Hospital: The PFI Contract in Action

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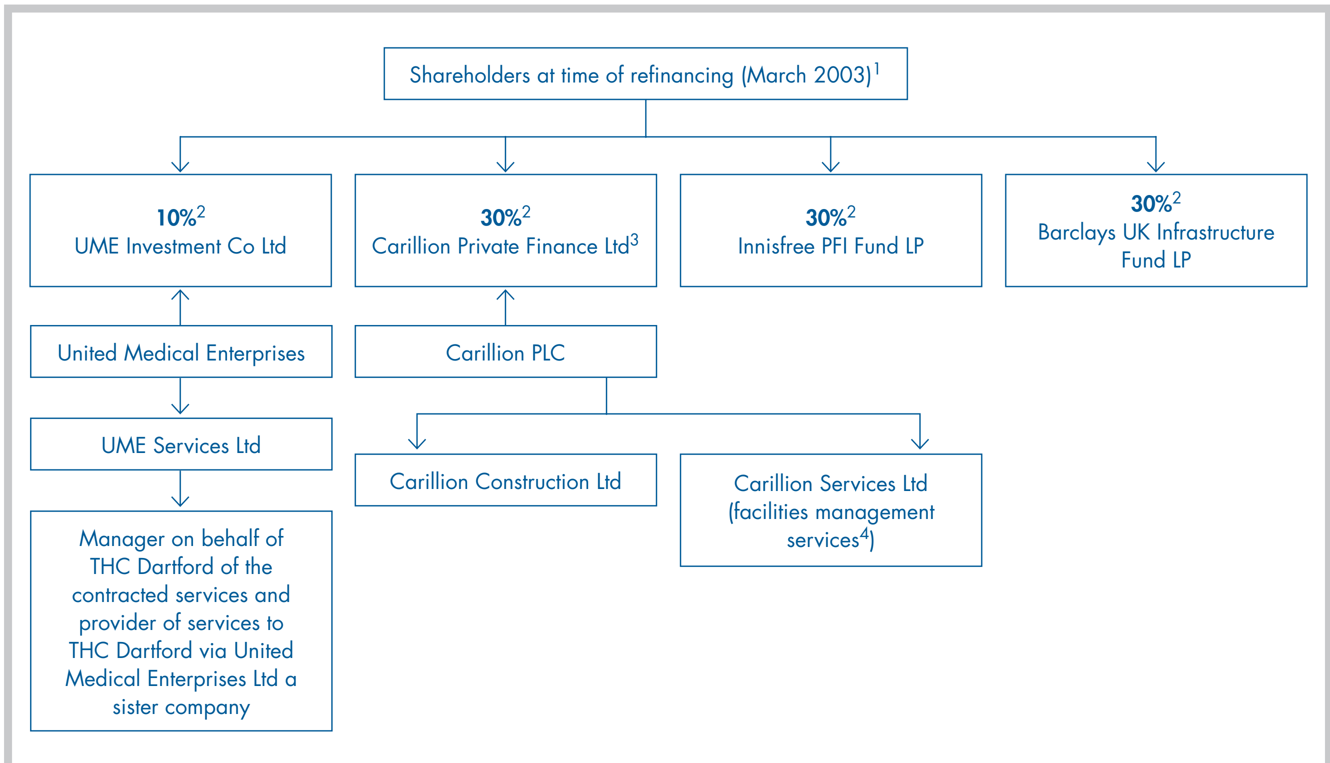
The Hospital Company (Dartford) Limited (THC Dartford): Shareholders and Main Contractors



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.

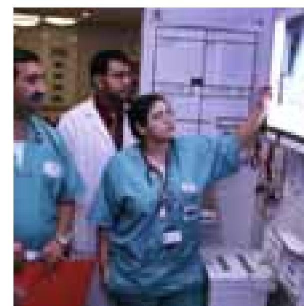
B Authorities should plan for the considerable senior management effort that will be needed in managing a PFI contract, particularly in the early years. It is a false expectation that senior management time will be freed up by contracting out major areas of service delivery whether by PFI or other forms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