The Refinancing of the Norfolk and Norwich PFI Hospital: how the deal can be viewed in the light of the refinancing

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SUMMARY

1 The Norfolk & Norwich University Hospital NHS Trust (the Trust) currently pays £37.8 million a year to a private sector consortium Octagon under the terms of one of the first PFI hospital contracts let in January 1998 **(Figure 1)**. The contract was a pathfinder deal which helped the Department of Health (the Department) to establish a new market in PFI hospital procurement.

2 The Trust's 1998 contract required Octagon to build the new hospital, to then maintain it and provide facilities management service for a minimum period of 30 years. The current contract also reflects additional building work that the Trust commissioned from Octagon in 2001, the cost of which was fully offset by a subsequent price reduction following a refinancing completed by Octagon in 2003. The minimum period over which facilities management services will be provided by Octagon was extended to 35 years at the time of the refinancing. The total minimum contract period, including the construction phase, which had initially been for 34 years, then became 39 years to 2037.

3 Octagon's refinancing in December 2003, nearly six years after the letting of the contract and two years after the opening of the new hospital, generated large gains for Octagon, part of which were shared with the Trust **(Figure 2 overleaf)**. The large refinancing gains arose because, having successfully delivered the new hospital, Octagon was able to obtain better financing terms, not available when the 1998 contract was entered into, as a result of the maturing PFI market and also the reduction in general interest rates which had arisen since 1998.

4 In common with other early PFI deals, this early PFI hospital contract had placed no obligation on Octagon to share any refinancing gains. A subsequent agreement by Octagon to share with the Trust refinancing gains, on additional borrowings funding the further work which the Trust commissioned in 2001, had been limited to allocating the Trust 10 per cent of these refinancing gains. On refinancing in 2003, Octagon shared, however, approximately 30 per cent of its total refinancing gain with the Trust **(Figure 3 overleaf)**. This was in accordance with the voluntary code for sharing refinancing gains on early PFI deals which the Treasury had negotiated with the private sector in 2002.

1 Payments under the PFI contract in relation to the Trust's budget: 2004-05

	£m	%
Revenue	269.0	
Outgoings:		
PFI contract	37.8	14
Other expenditure	231.2	86
	269.0	100
Surplus[1]	–	

Source: The Trust

NOTE

1 The Trust's revenue and expenditure for 2004-05 are based on unaudited information at 4 May 2005. In 2003-04 the Trust achieved a surplus of £0.9 million due to the receipt of non-recurring income of £3.4 million.

2 Gains to Octagon shareholders arising from the refinancing

Expected net present value of returns to Octagon shareholders over contract period	£m[1]	Internal rate of return (IRR) to Octagon shareholders[2]
At contract letting	**47.3**	**18.9%**
Decrease up to time of refinancing	(11.9)	
Prior to the refinancing	**35.4**	**15.9%**
Increase from refinancing[3]	115.5	
	150.9	
Refinancing gains shared with Trust (Figure 3)	(33.9)	
Following the refinancing	**117.0**	**60.4%**

Source: Royal Bank of Canada, the Trust's financial advisers on the refinancing (from Octagon records)

NOTES

1 Figures expressed as net present values based on cashflows discounted at 18.94 per cent in nominal terms, the anticipated base case internal rate of return (IRR) to Octagon's shareholders as reported by Octagon when the contract was let. The base case IRR is used as the discount rate for the evaluation of refinancing gains in accordance with the voluntary code and related Treasury guidance. The base case IRR is not necessarily the discount rate that Octagon's shareholders would use to evaluate their expected returns.

2 The IRR 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 Octagon 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 in the IRR following the refinancing reflects the high value of receiving large returns early in the contract period.

3 The large refinancing gains arose because, having successfully delivered the new hospital, Octagon was able to obtain better financing terms, not available when the 1998 contract was entered into, as a result of the maturing PFI market and the reduction in general borrowing rates since 1998. The refinancing gains of £115 million arose on a project where the capital value of the hospital building was £229 million (equivalent to over £300 million in prices at the time of the refinancing).

4 The shares of Octagon at the time of the refinancing, and at 28 February 2005, were held:

3i Group plc	25%
Barclays Infrastructure Limited	25%
Innisfree Partners Limited	25%
John Laing plc	20%
Serco Investments Limited	5%
	100%

3 Analysis of the Trust's share of the refinancing gain

	Refinancing gain £m	Retained by Octagon £m	Gain shared with the Trust £m	% received by the Trust	Basis of sharing
Extension of minimum contract period	5.0	2.5	2.5	50	Octagon agreed to allocate to the Trust 50 per cent of the refinancing gain which arose from extending the minimum contract period.
Balance of refinancing gain	104.7	73.3	31.4	30	Octagon agreed to allocate to the Trust 30 per cent of the remaining refinancing gain in accordance with the voluntary code for sharing refinancing gains on early PFI deals.
Allocation of refinancing gain for sharing with the Trust	**109.7**	**75.8**	**33.9**	**31**	
Part of refinancing gain excluded from gains to be shared with the Trust	5.8	5.8	–	–	Where the private sector project company has not been achieving its expected internal rate of return then the voluntary code allows the private sector to retain that part of the refinancing gains which will allow the rate of return (before taking account of any refinancing gains) to return to the level expected when bidding for the contract.
Allocation of total refinancing gain	**115.5**	**81.6**	**33.9**	**29**	

Source: Royal Bank of Canada (from Octagon records)

5 In response to issues raised with us by Norman Lamb, Member of Parliament for North Norfolk, we considered:

- whether the large benefits which have accrued to the private sector shareholders as a result of the refinancing indicate that the Trust could have improved the original PFI deal it negotiated with Octagon; and
- how the price the Trust is paying for this deal following the refinancing compares with current PFI hospital deals.

6 In summary we have found that:

i The terms of the original bank finance appear in line with other early PFI deals but subsequent improvements in PFI financing terms mean that, although the Trust has received a share of the refinancing gains, it continues to pay a premium on the financing costs compared to current deals.

ii There are other factors which may affect the overall comparison of the Trust's deal with current PFI deals including the fact that the benefits of a new hospital have been received earlier than in many other communities and the high rates of recent construction cost inflation have been avoided.

iii It might have been possible for the Trust to have improved the original deal with greater competition and better defined requirements in the closing stages but the Trust is not convinced this would have brought added benefits as it sought to close a pathfinder deal which had already been assessed as value for money.

7 Our detailed findings were:

1 The terms of the original bank finance appear in line with other early PFI deals but subsequent improvements in PFI financing terms mean that, although the Trust has received a share of the refinancing gains, it continues to pay a premium on the financing costs compared to current deals

i The terms of the bank finance in the original deal appear competitive for a bank financed PFI deal at that time (paragraph 1.1).

ii The successful delivery of the new hospital and the maturing PFI market have enabled better financing terms to be obtained on the funding in place prior to the refinancing producing a £34 million gain (paragraph 1.2).

iii Octagon has been able to generate further refinancing gains of £81 million from the improved market for financing PFI hospitals and lower general interest rates, mainly by increasing its borrowings and accelerating its shareholder distributions (paragraph 1.3).

iv The Trust is receiving both benefits from the refinancing in accordance with the new code and also new risks but has assessed the overall effect of the refinancing as value for money (paragraph 1.4).

v After sharing in refinancing benefits NHS Trusts continue to pay a premium on the financing costs of early PFI hospital deals compared to current deals (paragraph 1.5).

2 There are other factors which may affect the overall comparison of the Trust's deal with current PFI deals including the fact that the benefits of a new hospital have been received earlier than in many other communities and the high rates of recent construction cost inflation have been avoided.

i There are a range of factors, some of which have yet to be fully analysed by the Department, which will have affected the pricing of current PFI hospital deals compared with early PFI deals (paragraph 2.1).

ii One significant factor, construction cost inflation, has been much higher than general inflation in recent years (paragraph 2.2).

iii The Department has demonstrated that, if no other savings are priced into a current bid, then the additional building costs arising from construction cost inflation probably offset the benefit of the lower financing costs which are now available (paragraph 2.3).

iv The Trust and the local community have received the benefits of a new hospital earlier than many other communities (paragraph 2.4).

3 It might have been possible for the Trust to have improved the original deal with greater competition and better defined requirements in the closing stages but the Trust is not convinced that this would have brought added benefits as it sought to close a pathfinder deal which had already been assessed as value for money

i The Trust's approved business case assessed this early PFI hospital deal as value for money when the contract was let in 1998 and when the additional works were commissioned in 2001 (paragraph 3.1).

ii Alternative financing solutions were not seriously explored to ensure the financing terms remained competitive during a two year deal closure, the Trust considering that it did not wish to further delay the project and that it was not convinced that the overall terms of the deal could be improved bearing in mind the relatively undeveloped state of the PFI financing market at that time (paragraph 3.2).

iii The annual charge increased by a fifth in a non-competitive situation due to specification changes, including an increase in the number of beds of over 40 per cent, although the Trust took steps to test through benchmarking that the pricing of this additional work was reasonable (paragraph 3.3).

RECOMMENDATION

8 As the market in PFI hospitals continues to develop, the nature of the deals, and the way that the deals are priced, will change due to a range of factors. The Department should use the information which it collects, in its monitoring of PFI deals entered into by NHS Trusts, to identify the effect that different factors are having on the pricing of deals. This analysis will assist the Department and NHS Trusts in assessing bids for new deals and will be valuable to the Department's existing work in evaluating the progress of the PFI hospital programme. The analysis should include identifying the effect on the pricing of PFI deals of changes in:

a the nature of the deals being entered into;

b general economic factors such as construction cost inflation and commercial borrowing rates; and

c other factors specific to the PFI market such as the improved financing terms on more recent PFI deals and any cost efficiencies arising from the increased experience of the private sector in delivering PFI projects.