MOD Private Finance Unit Guidance Note PFI Refinancing

(Consultative Draft)
Version 1

MOD PFU Contacts

This document can be found on the MoD PFU website at :

http://www.mod.uk/DefenceInternet/AboutDefence/WhatWeDo/FinanceandProcurement/PFU/PrivateFinanceUnit.htm

For general enquiries about MOD PFU and its work, contact:

MOD Private Finance Unit Front Desk
Spruce 1, #1103,
MOD Abbey Wood,
Bristol BS34 8JH

Tel: 0117 9132639 (9352 32639)
Email: MODPFU-Front Desk@mod.uk

DCD
Defence Commercial Directorate

DOCUMENT CHANGE RECORD

This is a controlled document. Additional copies can be obtained through the issuing authority. Amendment shall be by whole document replacement. Proposals for change are to be forwarded to the issuing authority.

	Details Of Amendments Made	Amended By	Date
	First draft for internal review	N Short	March 2007
	Minor editorials changes	R Haria	July 2008
	First formal issue		August 2008

CONTENTS LIST

Document Change Record 3
Contents List 4
Constraints 5
Authoritative Guidance Summary 5
Authoritative Guidance 5
Background 5
What is Refinancing 6
Key Issues 6
Authority Consent 7
Calculation of the MOD's Share of the Refinancing Gain 8
Method of Receipt of the MOD's Share of the Refinancing Gain 9
Impact of the Refinancing on Termination Liabilities 10
Contractor Default 10
Authority Voluntary Termination 10
Force Majeure 11
Separation of the Refinancing from other Commercial Changes, which may be included in a Refinancing Proposal 11
Assessment of the Level of Senior Debt Sustainable by the SPV 12
Value for Money Assessments 12
Audit Rights 14
Reimbursement of Advisors Costs Associated with the Refinancing 15
Further Information 15
Relevant Guidance for Project Teams 15
Other Relevant Reference Documents 16

Constraints

1. This guide provides acquisition teams with the basic principles of refinancing of PFI projects. The refinancing voluntary code of conduct published by the Office of Government Commerce in October 2002 is to be used for early PFI projects to share the gains from refinancing whilst later deals are governed by Standardisation of PFI Contracts (SoPC) provisions.

Authoritative Guidance Summary

2. The purpose of this guidance note is to explain how the Department should seek to protect its interests with regard to any potential refinancing of a PFI deal. Users of this note should gain:

   a. An understanding of the key issues associated with refinancings;
   b. An appreciation of the relevant guidance applicable to refinancing; and
   c. An understanding of the relevant stakeholders who require consultation prior to a refinancing.

Authoritative Guidance

Background

3. The majority of PFI projects use project finance in the form of bank borrowing in order to fund up-front capital investment. The borrowing is secured against the payment stream of the project, with the interest rate based on the degree of risk that the financial institution sees in the project. Banks generally view the risk as being at its highest during the construction phase. However, once service delivery has successfully commenced, the risk is lower. It is at this stage that the service provider may be able to achieve a substantial refinancing gain by replacing the original bank debt with new bank debt on terms that are more favourable.

4. A key issue in refinancing is the degree to which this increased return should be shared with the public sector. This issue first arose on the Fazakerley PFI prison contract. This was an early PFI contract and the first to be subject to a major refinancing and did not contain any contractual right for the Prison Service to share in the benefit of the refinancing. However, the Prison Service's advisors were able to demonstrate that the refinancing increased the Prison Service's termination liabilities and they should be compensated for the additional risk. The NAO subsequently

reported on the refinancing in June 2000 and concluded that the Prison Service had negotiated a reasonable deal. More importantly, the NAO produced a list of general principles that Departments should apply to refinancing. These principles were subsequently included in a refinancing 'Code of Conduct' issued by the Office of Government Commerce (OGC) in October 2002.

What is a Refinancing?

5. The term refinancing is actually quite broad in its scope; a useful definition found in the Standardisation of PFI Contracts, Version 4, published March 2007 is as follows:

- *During the life of the Project, the Contractor may wish to replace, augment or change the structure, nature or terms of the financing solution that it put in place at Financial Close for the purposes of financing the Project. Where such restructurings or changes will have the effect of increasing or accelerating distributions to investors or of reducing their commitments to the Project, these effects are individually and collectively referred to as Refinancing Gains.*

- *A non-exclusive list of transactions which could be undertaken by the Contractor following financial close and which could give rise to a Refinancing Gain is set out below:*

    - *reduction in interest margins;*
    - *reduction or release of reserve accounts;*
    - *release of contingent junior capital;*
    - *extension in the maturity of debt;*
    - *increase in the amount of debt; and*
    - *refinancings undertaken without the direct involvement of the Contractor, for example through a special purpose holding company, but which rely upon rights being granted in respect of the cash flow, assets or contracts of the Contractor."*

Key Issues

6. It is important to note that refinancings are highly complex and need to be analysed carefully in line with the guidance issued by HM Treasury/OGC (see page 15). Key issues associated with any refinancing which will require careful consideration by the Department include:

- Authority consent;
- Exemptions;
- Calculation of the MOD's share of the refinancing gain;
- Method of receipt of the MOD's share of the refinancing gain;

- Impact of the refinancing on termination liabilities;
- Separation of the refinancing from other commercial changes which may be included in a refinancing proposal;
- Assessment of the level of senior debt sustainable by the SPV;
- Value for money assessments;
- Approvals;
- Audit Rights; and
- Reimbursement of advisors costs associated with the refinancing.

Authority Consent

7. The MOD should be receptive to refinancing proposals because there is potential for both investors and the Department to share benefits. However, before consent is given it is important that the Department closely scrutinises any proposal to ensure that it represents value for money in its broadest sense. That is, any gain should more than compensate for increased risk taken by the Department. It should also ensure that any restructuring does not reduce the incentives on the Contractor to perform, especially in later years and that it does not undermine the financial stability of the SPV and thereby endanger the provision of services.

8. Should any of these concerns be raised the Department may refuse to consent to a refinancing, despite the Contractor offering to share the gain. The reasons for this refusal should be provided in a timely and transparent manner.

Exemptions

9. There are a number of specific exemptions where the MOD is not entitled to share any of the gain. The MOD must be particularly vigilant that these are indeed valid exemptions and not an attempt to avoid sharing the gain.

Base Case Refinancings

10. No approval is required for refinancings which form part of the original base case financing plan or for refinancings where there is no gain to the investor, for example, rescue refinancings.

Equity/Junior Debt

11. Consent from the MOD is not required for a change of share ownership (or junior debt, which is equity in all, but name). However, the MOD will wish to check the credit worthiness of the new equity provider and that there are no security considerations.

Corporate Finance

12. Transactions originally undertaken on a strictly corporate basis should not be subject to the refinancing guidance. However, if the Contractor seeks to introduce limited recourse finance to a Project which was initially corporately financed then it is likely that the refinancing guidance will apply. Any refinancing proposal put forward on the basis of corporate finance will again need to be closely scrutinised to ensure it is not an attempt to bypass the refinancing provisions.

Interest Rate Hedging

13. Interest rate hedges are similarly omitted provided they were agreed by the MOD at the outset; the Contractor bears interest rate risk after financial close; and the Unitary Charge has been determined by reference to market interest rates for the full term of the Contract.

Taxation and Accounting Policies

14. Changes in taxation or in the Contractor's accounting policies are not considered to be refinancings and therefore not covered by the guidance.

Calculation of the MOD's share of the refinancing gain

15. Where it has been established that the MoD is entitled to a share of a refinancing gain it is necessary to calculate how much the gain will be. Put simply this is: the distributions projected to take place after the refinancing less the distributions projected to take place before the refinancing. This is calculated using the base case financial model and comparing it with a post-refinancing model. The differences in cash flow for each period are calculated and then discounted to produce a net present value. This is the refinancing gain.

16. However, the MOD is only entitled to a share of this gain if the Contractor is projected to achieve its equity (or threshold) IRR. If the updated Equity IRR is above the threshold then the MOD is entitled to a percentage of the gain. However, where the updated Equity IRR does not breach the threshold then the Contractor is entitled to keep that proportion of the gain to bring it up to the Threshold Equity IRR. Any monies remaining thereafter will be split.

17. The discount rate to be used to calculate the NPV should be agreed between the Contractor and the MOD. Generally speaking, this is normally the original base case equity IRR since this is the percentage used for calculating the gain and it is the rate of return that equity holders would expect on the original capital invested.

18. The sharing of the gain will depend on when the contract was signed. Deals signed before 30 September 2002 are governed by the Code of Conduct and as such, the MOD is entitled to 30% of any gain. Later deals are governed by SoPC and under its terms, the MoD is entitled to 50% of any gain.

19. It should be remembered that the Department provides consent prior to the actual refinancing. The final calculation cannot be completed until the refinancing date and the gain may go up or down as a result of changes in interest rates or advisors fees incurred in bringing the deal to a close.

Method of receipt of the MOD's share of the refinancing gain

20. The gain can be paid in one of three ways (or a mixture thereof): a lump sum at the time of the refinancing; a reduced unitary charge or an increase in the scope of services.

21. As a general rule of thumb if the investor is realising his gain at the time of the refinancing then the Department should look to do likewise.

22. If there are insufficient funds and they are locked in the original distribution the balance should be paid as reduction in the Unitary Charge.

23. If the gain is realised though a reduction in the interest rate or a lengthened debt tail rather than new debt then the refinancing gain generally accrues over time and it is more appropriate for the Department to take the gain in the form of a reduced unitary charge. This gives the investor an additional tax benefit because reduced income leads to a reduced corporation tax bill. As such, it will be necessary to recalculate the gain on a post tax basis to ensure that the MOD receives the correct amount.

24. Where the gain is not paid immediately after refinancing then the MOD is entitled to the payment of interest. The rate of interest will vary from project to project but will generally equate to the rate of interest on the senior debt.

25. Exceptionally, a Project may choose to take the gain in the form of increased services, but a full VFM analysis will need to be conducted and a review by the scrutineers as this may breach the projects Performance, Cost and Time (PCT) envelope which was approved by the Investment Approvals Board (IAB) (See Approvals).

Impact of the refinancing on termination liabilities

26. As part of its refinancing proposal a Contractor may suggest a new funding arrangement that impacts on termination liabilities. However, it is important to remember that the decision to accept an increase in termination liabilities is quite separate to any agreement to refinance; it is

perfectly feasible for the investor to realise a gain (albeit smaller) with no change to the termination liabilities of the MOD.

27. Compensation is payable to the Contractor in any of three broad categories – contractor default, authority voluntary termination and force majeure. The Department needs establish that any increase in termination liabilities is more than compensated for by the gain it receives as part of the refinancing.

Contractor Default

28. For earlier contracts that do not follow SoPC, the MOD should not accept an increase in termination liabilities for contractor default as part of a refinancing unless there is a clear value for money case. As part of this case, as well as considering any increase in termination liabilities against the gain, the value for money assessment should also consider the possible benefits of introducing SoPC provisions. Note: For contracts based on SoPC, it should not be possible for any refinancing to increase the compensation payable.

Authority Voluntary Termination

29. Authority voluntary termination is unique in that under the terms of SoPC the MOD not only has to pay out senior debt but also junior debt and equity. As a result of a refinancing, it is possible that the level of senior debt may increase but this may be counterbalanced by the fact that the Department has a reduced exposure to junior debt. As such it is important that a detailed assessment of the Department's exposure over the contract length is undertaken and the possible impact of breakage costs (costs incurred if senior debt – whether bank or bond – is repaid early) is fully understood. The counterbalancing effect means that it should be possible to construct a refinancing proposal that does not increase termination liabilities, and this should be the MOD's default position. However, where there is an increase in termination liabilities the MOD must carry out a full value for money analysis of the gain compared with the likely cost of a termination event should it occur. In order to do this the private sector is required to produce a refinancing proposal with increased termination liabilities and also another scenario without.

30. Thus far, the emphasis of the evaluation has been on the quantitative assessment of any gain against the increased termination liabilities, but there are also qualitative factors that need to be considered. At the outset, the Department will have placed a value on the option to terminate the Contract as a result of changes in policy. The increase in termination liabilities will reduce the value to the Department of this option. In the military, there is also invariably the possibility of operational change, which will affect service provision that had not been envisaged

when the Contract was let. Such change may place undue stress on the Contractor and the MOD may consider termination a more suitable option than negotiating a difficult change. The increased termination costs reduce this flexibility.

Force Majeure

31. As with Contractor Default and Authority Voluntary Termination, a full value money assessment needs to be undertaken to assess whether any increase in termination liabilities for force majeure is outweighed by the refinancing gain.

Separation of the refinancing from other commercial changes, which may be included in a refinancing proposal

32. It is inevitable that changes will need to be made to the Contract (between the MOD and the service provider) and the Direct Agreement (between the MOD and the bank) because of the refinancing. These intrinsic changes are necessary for the refinancing to proceed and are described as ‘basic amendments’. However, the investor may consider that the refinancing offers an opportunity to revisit the contract and direct agreement and make changes that are not related to the refinancing. These are known as ‘additional amendments’. A separate VFM assessment should be conducted on these additional amendments and the gain split between the two parties in accordance with negotiations.

Changes to the unitary charge profile or amendments to the indexation regime should be evaluated separately to the refinancing proposal and as a rule do not represent value for money. Similarly, contract extensions should be assessed on a stand-alone basis to establish if they represent value for money.

Assessment of the level of senior debt sustainable by the SPV

33. At the time the Contract for the service was originally let an assessment will have been made to establish an acceptable level of indebtedness. This exercise needs to be repeated for any refinancing to establish the maximum level of senior debt. This may be, and indeed often is, greater than the original requirement. Such an increase is generally acceptable because by the time of the refinancing much of the risk in the Project has disappeared (with, for example, the completion of the construction phase). Nevertheless, any proposal to increase the level of senior debt should be rigorously evaluated.

Value for money assessments

34. Any gain that accrues to the Department without resulting in an increase in termination liabilities is considered to represent value for money. However, where there is an increase in termination liabilities it is necessary to establish whether the refinancing gain is greater than the likely cost of the additional termination liabilities. To establish whether this is the case it is necessary to undertake some form of probabilistic analysis, which compares the refinancing gain with the additional liabilities, multiplied by the probability of default under various scenarios (force majeure, authority voluntary termination and contractor default) for each year from the refinancing date until the contract end. Where the gain is greater than the likely additional termination costs then it is considered to represent value for money. There are a number of ways in which this analysis can be performed, but Partnerships UK recommends a standard calculation (see below).

Row	Year	1	2	3
1	Additional compensation, usually derived from SPV financial model	£120	£110	£100
2	Additional compensation, in present value ("PV") terms	£113	£98	£84
3	Probability of termination in a year given non-termination by the start of that year	1%	1%	2%
4	Probability of having not terminated by the start of this year	100%	=100%-1% =99%	=(100%-1%)^2 =0.99^2 =98.01%
5	Therefore, probability of termination in this year	=1%*100% =1%	=1%*99% =0.99%	=2%*98.01% =1.96%
6	Additional compensation in PV terms * probability of termination	£113*1% =£1.13	£98*0.99% =£0.97	£84*1.96% =£1.65

35. The VFM analysis is then performed by comparing the sum of all of the entries in the last row to the refinancing gain – if the total probability-weighted additional compensation exceeds the gain then the transaction is not VFM.

36. An alternative is to perform a 'break-even analysis'. In this case the Department assumes, as a starting point, that the total probability-weighted additional costs equals the gain, and then asks what that requires the probability of termination in any year (i.e. the contents of row 3 above) to be. To do this it is necessary to make some assumptions about the probabilities e.g. that they are the same in every year.

Approvals

Intra Departmental

37. If there is no change to the Termination Liabilities or the concession length as a result of the refinancing then no formal approval is required. However, in order to maximise the gain the Service Provider will often seek to increase the level of debt, which may lead to an increase in Termination Liabilities. The increased risk to the Department must be compared to the refinancing gain to establish if the refinancing represents value for money. This assessment should be reviewed and approved by DASA/DESA and MOD PFU. Additionally, if amendments have been made to the Contract then the Project will need to seek approval from their commercial director.

38. Where there are changes to the Performance, Cost and Time envelope agreed by the IAB the Project will need to present a review note to the IAB, staffed through IAB Sec.

Extra departmental

39. At an appropriate time in the maturity of the refinancing proposal, the HM Treasury Refinancing Taskforce (staffed by representatives from Partnerships UK (PUK)) must be consulted. The Refinancing Taskforce has a role supporting MOD in its assessment of value for money and provides input on the interpretation of the Code and its application to specific projects. The MOD PFU will facilitate consultation with the Refinancing Taskforce at the appropriate time, it is important that this consultation takes place early in the negotiation to inform the MOD's position. Where appropriate PUK will consult, direct with the Treasury.

Audit Rights

40. It is important that the MOD secures the right to review all the material produced by the investor, including the financial model, both before and after refinancing. This will enable the Department or its advisors to check that the gain has been calculated correctly and that in the future the Contractor is still incentivised to perform.

Reimbursement of advisors costs associated with the refinancing

41. Refinancing is particularly complex and Project teams should look to employ legal and financial advisors. The Department should be reimbursed for all reasonable costs that it incurs through the appointment of advisors. These would normally be added to the cost of the investor's advisors and netted off against the refinancing gain. As a consequence these costs should be carefully scrutinised to ensure that they are reasonable and were necessarily incurred in closure of the refinancing. The internal costs to the investor incurred during the refinancing would not normally be allowable. However, if the investor can demonstrate that the work undertaken would normally have been undertaken by external advisors then the costs incurred may exceptionally be allowed. It is also important that the Project secures a written undertaking from the investor that all reasonable advisor costs incurred by the MOD will be reimbursed if the refinancing does not proceed for whatever reason.

Further Information

Relevant Guidance for Acquisition Teams

Projects in Procurement

42. For projects in procurement, reference should be made to **Standardisation of PFI Contracts, Version 4, March 2007** – Issued by HM Treasury. Chapter 34 includes clauses which should be included in PFI contracts in respect of refinancing and Annex 1 includes guidance on the calculation of the MOD's share of a refinancing gain. http://www.hm-treasury.gov.uk/documents/public_private_partnerships/key_documents/standardised_contracts/ppp_keydocsstand_index.cfm

Signed Projects

43. For all projects signed since 30th September 2002, the refinancing provisions should clearly state the method of calculation for refinancing gains and the sharing mechanism which should be 50:50 between the Contractor and the Authority as mandated by the **Standardisation of PFI contracts** issued in July 2002 and subsequent versions thereof.

44. For all agreements signed before 30th September 2002, projects should refer to the **Code of Conduct** issued in October 2002 (see link below). This is a voluntary code, which enables the private sector to share any refinancing gain with the public sector. This should be at least equal to a 30% share as determined under the OGC Revised Guidance.
http://www.hm-treasury.gov.uk/media/924E0/PPP_Refinancing_Code_of_Conduct.pdf

All Projects

45. All projects should refer to the **OGC Guidance Note on Calculation of the Authority's Share of a Refinancing Gain** (see link below) – this guidance sets out the methodology for calculating gains and payment of the MoD's share.
http://www.hm-treasury.gov.uk/media/6/B/pfi_refinancingguidance21307.pdf

46. All projects should also refer to the **HM Treasury Application Note – Value for Money in Refinancing** (see link below) issued in February 2005. This document contains guidance on key issues associated with the value for money of refinancings. Including the requirement for "no increase in termination liabilities" scenario against which value for money will be assessed.
http://www.hm-treasury.gov.uk/media/5/2/application_note_value_for_money_280205.pdf

Other Relevant Reference Documents

47. The following reports by NAO give insight into their perspective on refinancing issues:

NAO Report : The refinancing of the Fazakerley PFI prison contract - June 2000	http://www.nao.org.uk/publications/nao_reports/9900584.pdf
NAO Report: PFI Refinancing update - November 2002	http://www.nao.org.uk/publications/nao_reports/01-02/01021288.pdf
NAO Report: Darent Valley Hospital:The PFI Contract in Action – February 2005	http://www.nao.org.uk/publications/nao_reports/04-05/0405209.pdf
NAO Report: The Refinancing of the Norfolk and Norwich PFI Hospital: how the deal can be viewed in the light of the refinancing – June 2005	http://www.nao.org.uk/publications/nao_reports/05-06/050678.pdf