House of Commons

Committee of Public Accounts

PFI refinancing update

Twenty-second Report of Session 2002–03

HC 203

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Report, together with formal minutes and minutes of evidence

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The Committee of Public Accounts

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Angela Eagle MP (*Labour, Wallasey*)

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Committee staff

The current staff of the Committee is Nick Wright (Clerk), Leslie Young (Committee Assistant) and Ronnie Jefferson (Secretary).

Contacts

All correspondence should be addressed to the Clerk, Committee of Public Accounts, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5708; the Committee's email address is pubaccom@parliament.uk.

Contents

Summary

Refinancing a PFI deal after the initial risks have successfully been overcome is one of the ways in which investors in such deals can make financial gains. On occasion, such refinancing gains have been very large and not wholly attributable to private sector enterprise and risk-taking. Yet even in these cases, gains have not necessarily been shared with the public sector. Only one in four of the early PFI contracts had clear arrangements to share refinancing gains. We recommended that departments should expect to share in refinancing gains and that the Office of Government Commerce (OGC), which had been considering updating its central guidance, should do so as a matter of priority.[1]

Subsequently, the OGC issued new guidance on how departments should provide in future PFI contracts for the sharing of refinancing gains. In addition, the OGC negotiated with the private sector a code of practice applying to past PFI deals under which a 70:30 split of refinancing gains would take place, even if no provision for sharing refinancing gains had been made in the original deal. Since 1 April 2003, policy responsibility for these matters has passed from the OGC to HM Treasury.

On the basis of a Report by the Comptroller and Auditor General,[2] the Committee took evidence from the OGC and its advisers, Partnerships UK, on the outcomes departments were likely to achieve from new refinancing arrangements put in place by the OGC.

Our key conclusions are as follows:

- **It is a good negotiating achievement for the OGC to have established with the private sector that refinancing gains on past PFI deals should be shared 70:30.** In respect of past deals which had not provided for refinancing gains to be shared, individual departments would have faced an uphill task in arguing to share them. Acting for government as a whole, the OGC was successful in its determined approach to the private sector. There may be other aspects of the PFI where a central approach might be worthwhile: for example in respect of the banks' standard terms for external finance of PFI deals, or for associated financial instruments.

- **Whilst the new guidance on sharing refinancing gains is welcome, the new arrangements can only work effectively if departments equip themselves to pursue refinancing gains.** To date, departments have not been good at recognising refinancings and understanding their complexities. Departmental staff involved in managing PFI contracts will need specific training to enable them to recognise when refinancing situations may have arisen, so that they can seek expert advice on how to handle them.

1 13th Report from the Committee of Public Accounts, *The refinancing of the Fazakerley Prison PFI contract* (HC 372, Session 2000–01)

2 C&AG's Report, *PFI refinancing update* (HC 1288, Session 2001–02)

1 PFI refinancing update

1. In July 2002 the OGC published revised guidance for departments which expects them generally to share refinancing gains 50/50 in new PFI contracts. In addition, in October 2002, the OGC launched a voluntary code of practice for early PFI deals. Under this code, departments will generally seek to receive 30% of any future refinancing gains on early PFI deals where the contract does not explicitly provide for a share of such gains.[3] The OGC accepted that this Committee had played an important role in creating a climate in which the OGC had been able to improve the public sector's position on refinancing. The OGC had reacted to our previous concerns that the taxpayer should be getting a lot more out of refinancing than had previously been the case.[4]

2. The public sector had received £17.5 million from 12 completed refinancings which had been reported to the National Audit Office (**Figure 1**).[5] The OGC estimated that its new voluntary code relating to past PFI deals would provide the taxpayer in the region of £175 million to £200 million assuming that all contractors complied with the code. The OGC was not in a position to estimate how much the public sector might receive from the arrangements to share refinancing gains which were being included in new contracts.[6]

Figure 1: Summary of completed refinancings reported to the National Audit Office

	Number of refinancings	Amount received by authorities
Share of gains to authority:		£m
50% or more	2	8.9
30–33%	4	7.2
Less than 30%	2	1.4
No share (Note 1)	4	–
Totals	**12**	**17.5**

Source: National Audit Office survey 2002[7]

Notes

1. The department reported on one deal that the benefit of the refinancing gains had been built into the contract price before contract letting.
2. The total refinancing benefits from these 12 completed refinancings were about £65 million.[8]

3 C&AG's Report, paras 1.22, 2.14–2.19

4 Qq 1, 5,144, 173. Concerns about refinancings had been raised in the Committee's Report on the Fazakerley Prison PFI refinancing (see footnote 1 above) and in the C&AG's Report on that refinancing (HC 584, Session 1999–2000).

5 C&AG's Report, Figure 7, p14 and para 1.33

6 Qq 2–4, 35, 62, 111–113,167

7 Summarised from C&AG's Report, Figure 7, p14

8 C&AG's Report, para 1.33

3. At the time of the National Audit Office's survey in 2002 there was no definitive central database of completed refinancings. In addition to the 12 completed refinancings which departments reported the National Audit Office also found evidence that some refinancings may have taken place without departments being aware.[9] Partnerships UK estimated that about two dozen of the 500 or more PFI contracts had probably been refinanced. Only a small proportion of PFI contracts had completed refinancings because over half had yet to reach the operational phase where refinancing was likely to take place; many were small projects or bond financed and unlikely to be refinanced; and refinancings had been deferred whilst the new refinancing provisions were being finalised. But there was now interest from the private sector in effecting more refinancings and the number of contracts reaching the operational phase where this is likely to take place is growing. The OGC was intending to capture data on refinancings. The new refinancing taskforce within Partnerships UK would create a comprehensive database of completed refinancings and those projects where refinancings were expected. It would use the OGC's new PFI Knowledge Network database to identify projects which appeared potential candidates for refinancing.[10]

4. The OGC had undertaken robust negotiations with the private sector in order to gain the private sector's support for a voluntary code for sharing refinancing gains on early PFI deals. This was an example where there were benefits from government acting in a collective way rather than each contracting authority attempting to negotiate with the private sector on the same issue. The OGC had used this Committee's earlier concerns about refinancing to persuade the private sector that it needed to do something on refinancing although they were under no contractual obligation to do so. The OGC had convinced the private sector of the risk that there would be fewer PFI contracts in future if refinancing gains accruing to contractors adversely affected the perceived value for money of PFI projects.[11]

5. Now the code had been launched, the OGC expected that contractors would comply with it. The code had been endorsed by the Confederation of British Industry (CBI) and several major contractors had confirmed they intended to operate within the code. There remained a risk, however, that existing contractors might seek to avoid complying with a voluntary code, or, that new parties might move into the market and take a more aggressive stance on whether refinancing gains should be shared. The OGC and Partnerships UK believed that the reputation of contractors would suffer if they deliberately sought to avoid sharing refinancing gains with the public sector. To avoid sharing refinancing gains would also be difficult as it would require connivance between a number of private sector parties with interests in the deal.[12]

6. Although the OGC had been successful in gaining the private sector's support for the new voluntary code, these voluntary arrangements were only needed because very few early PFI deals had contractual arrangements to share refinancing gains (**Figure 2**). The OGC considered that the 30% share of refinancing gains it had negotiated for departments

9 C&AG's Report, Figure 7, p14 and paras 1.29–1.44

10 Qq 18, 37–38, 95–97, 158–162, 164

11 C&AG's Report, paras 1.17–1.22; Qq 47–57, 63, 109–110, 145–147

12 C&AG's Report, para 1.22; Qq 7,9, 34, 118–119, 126–128

to receive was the best it could have achieved. To have sought more would have increased the risks that the private sector would not agree to the code or would seek to avoid complying with it. 60% of PFI contracts which had not given departments a contractual right to share refinancing gains had given the departments at least some form of approval over refinancings. Where approval rights already existed, they could, perhaps, have been used to seek more than a 30% share of refinancing gains where no percentage had been specified in the contract.[13]

Figure 2: Proportion of early PFI contracts with arrangements to share refinancing gains

Contracts let:	**Prior to June 2000**	**Year to June 2001**
Contracts with at least a 50% share	4%	4%
Contracts with a share of 30%	4%	23%
Contracts with a share of less than 30%	18%	27%
Total with some share of refinancing gains	**26%**	**54%**

Source: National Audit Office survey 2002[14]

7. Refinancing is a complex topic which will be new to many officials in the public sector. Most existing PFI contracts will have the potential for refinancing, but refinancings can occur in a number of different ways and departments are reliant on information from their contractors to know that a refinancing has taken place. Yet 21% of the public sector project teams could not say what their PFI contractor's current financial structure was. Such factors create a real risk that refinancings could occur without departments being aware, as was confirmed by the results of the National Audit Office's survey. In six cases, not reported as refinancings, contractors had improved the financing in a way which would be expected to generate refinancing gains. In around thirty other cases contractors had effected changes, sometimes complex, to their financing where further information would be required to ascertain whether or not refinancing gains had been generated.[15]

8. To address this lack of awareness, the new refinancing taskforce within Partnerships UK would provide direct technical support to departments to help them understand refinancing. The OGC's skills training programme launched in September 2002 included training on refinancing. Departments would be encouraged to take a more proactive approach to monitoring the financing structures of PFI contractors. Departments would have an incentive to discuss and encourage contractors' plans to refinance as the Treasury would allow departments to retain the benefits they received from refinancings. It could be in departments' interest to be more proactive by incentivising contractors to pursue

13 Qq 12–22, 141–144, 148–149

14 Table derived from C&AG's Report, Figure 12, p25

15 C&AG's Report, paras 1.34–1.44; Qq 23–25, 27–34, 36

refinancing opportunities since they would share in the gains that arose from refinancing. The OGC and Partnerships UK considered, however, that existing arrangements gave sufficient incentives. Contractors stood to gain from refinancing, they knew that the public sector would take refinancing proposals seriously and any costs incurred in planning a refinancing would be recovered from the proceeds.[16]

9. Although departments would generally now share refinancing gains with contractors, the scale of the benefits to be shared might be greater if the original financing costs were minimised. We have previously recommended that departments should always consider the use of funding competitions in PFI procurements.[17] The OGC told us that departments now reserved the right to run funding competitions. But the OGC would not expect a funding competition at contract letting to capture gains which are contingent on future project risk reductions, future project efficiency or future improvements in the financial market.[18]

10. New PFI contracts would now generally provide for departments to receive 50% of most refinancing gains. But contractors would not have to share 50% of the refinancing gains where, at the time of a refinancing, they were projecting a shortfall in returns over the life of the contract compared to their expectations at contract letting.[19] As an unintended consequence, departments would in effect be supporting contractors' poor performance by allowing them to make good shortfalls in profits by keeping a greater share of refinancing gains. Although contractors would be allowed to keep more than 50% of refinancing gains if they were not earning as much as they had expected (generally 12 to 14% according to Partnerships UK) there would be no requirement for them to give up more than 50% of the gains if they were earning much more than expected. The OGC and Partnerships UK told us that that concession had been made in order to reach agreement with the private sector on the whole of the new refinancing arrangements. The concession did not involve the public sector in paying out money to the private sector. It reflected the one way nature of the concept of sharing refinancing gains without sharing losses.[20]

11. Gains made by contractors and other investors from the sale of shares in PFI project companies were excluded from the definition of gains which were to be shared under the new refinancing provisions.[21] The reason for such an exclusion was that the sale of shares in a PFI project company would not affect the department, the integrity of the contract or the financial stability of the project company which was responsible for the contract. Nevertheless, there would be a risk that an initial investor in a PFI project company could sell its shareholding to another investor who might not comply with the voluntary code to share refinancing gains on early PFI deals. The OGC acknowledged that these were theoretical risks but considered that only investors who were not concerned about their

16 Qq 8–11, 26, 33, 57–62, 172; Ev 19

17 43rd Report from the Committee of Public Accounts, *The use of funding competitions in PFI Projects: The Treasury Building* (HC 398, Session 2001–02)

18 Qq 134–136; Ev 19

19 C&AG's Report, paras 3.2–3.6

20 Qq 101–108, 128–134, 150–157, 165–166, 168–171

21 C&AG's Report, para 3.3

reputation, or participating in future PFI projects, would be likely to avoid sharing gains in such a way.[22]

12. The OGC's provisions, relating to both new contracts and the voluntary code, require that, for a refinancing to be subject to gain sharing and departmental approval, it must be a "qualifying refinancing" (**Figure 3**).[23] Such a definition could create loopholes. Partnerships UK told us the new provisions had included detailed and technically complex definitions of refinancing to try to anticipate ways in which compliance with the new arrangements might be avoided. It considered that the cost to contractors of trying to avoid these tightly drawn provisions would not be worth the benefits of doing so.[24]

Figure 3: A qualifying refinancing

For a refinancing to be a qualifying refinancing it must fall within the definition set out in the revised OGC guidance on refinancing published in July 2002.

Transactions excluded from the definition (which do not therefore require gain sharing or a department's consent) include:

- Refinancings of a contractor's general finances (as opposed to project specific finance, which would be a qualifying refinancing).
- Gains made by contractors and other investors from the sale of shares in PFI project companies.
- Arrangements to fix interest rates at rates lower than those assumed at contract letting where the contractor has borne all interest rate movement risk since contract letting.

In addition, situations known as rescue refinancings where a project is in serious difficulties will not require the sharing of gains. This arises from the method of calculating refinancing gains which only requires refinancing gains to be shared if the projected returns to the contractor are above those assumed at contract letting.

Source: The OGC's Standardisation of PFI Contracts (2002)

13. Departments would now be expected to include in their contracts the right to audit their contractors' financial models relating to any refinancing. The Comptroller and Auditor General would also now have enhanced powers to examine contractors' records where they are engaged in public business.[25] Such audit rights would enable departments to ensure that they receive the relevant amount of any refinancing gains. A particular case where there would be a risk that a department might not receive the appropriate amount was the concession allowing contractors to keep more than 50% of the refinancing gains if they say they are expecting to earn less than they were expecting at contract letting. The accuracy of their projected returns at contract letting and their revised projections at the time of the refinancing will be crucial to the operation of this concession. Partnerships UK told us that contractors would face a stiff penalty for breaching the refinancing provisions. If an audit discovers that a contractor has breached the provisions in new contracts to

22 Qq 43–46, 114–117

23 C&AG's Report, para 3.3

24 Qq 10, 39–42

25 Statutory Instrument No 489 (2003): Government Resources and Accounts

share refinancing gains the contractor will be liable to have the contract terminated and its equity investment in the project confiscated.[26]

14. The situations which will not give rise to the sharing of refinancing gains include refinancings of PFI projects which are funded from a contractor's general finances rather than through a PFI project company.[27] Partnerships UK told us that only around 6% by value of PFI deals are likely to have been financed by contractors from their own funds. Many contractors do not have the capacity to finance big PFI projects themselves which is why they use PFI project companies. Nevertheless, there remains a risk that contractors may look to make greater use of financing PFI projects from their own funds, even temporarily, in order to avoid sharing refinancing gains.[28]

15. There is also a risk that contractors may seek to increase the prices they bid for PFI contracts to offset the requirement to share subsequent refinancing gains.[29] The OGC considers this is unlikely to happen because of competition between bidders to win PFI contracts. It expects departments to be able to detect whether contractors are trying to recover refinancing gains in their bids. It may be in their interests to get 50%, or more, of future refinancing gains in the contract price rather than to use the new provisions to clawback such gains when they arise. As Partnerships UK acknowledged, there would still be the possibility of windfall gains, which could not be anticipated at contract letting, and the clawback mechanisms could be used to enable departments to share in those gains.[30]

16. Over 500 PFI contracts have been let to date involving the government in contractual liabilities of £17 billion. These liabilities will increase as more PFI contracts are entered into. Contracting authorities could have an interest in carrying out projects under the PFI so that through refinancing they could get additional funding which they might not otherwise have had approval for. The view of OGC and Partnerships UK was that refinancing gains would be invested in priority areas of a department's work with a view to securing extra benefits for the users of public services. In the case of the Department of Health, the benefits of refinancing gains would go back directly to the NHS trust which had let the PFI contract.[31]

26 C&AG's Report, paras 3.7, 3.9; Qq 118, 163

27 C&AG's Report, para 3.3

28 Qq 42, 98–100

29 C&AG's Report, para 3.7

30 Qq 6, 92–94

31 Qq 64–91, 120–125; Ev 18

Conclusions and recommendations

1. The OGC estimated that the new code sharing refinancing 70:30 on past deals will yield between £175 million and £200 million for the public sector. These impacts are a reflection of the previous work of this Committee and the National Audit Office as well as the more recent work of the OGC. The Treasury should measure the actual impacts from departments applying both the code and also the revised arrangements for new contracts.

2. To obtain the share of refinancing gains to which they are entitled, departments will need to manage their PFI contracts actively. There is evidence that a number of refinancings have occurred without departments noticing them. Recognising that refinancings are complex, departmental officials cannot all be expected to become experts in these matters, but officials concerned with managing PFI contracts should be trained sufficiently to identify when they need to call in expert help.

3. As a source of such expertise, Partnerships UK has established a refinancing taskforce to provide support to departments faced with refinancing situations. It would be prudent for that taskforce not to rely solely on departments to spot refinancings, so the taskforce will need to be proactive in approaching departments where market knowledge suggests refinancing situations are likely to occur.

4. To date, departments have had to rely on contractors notifying them about planned refinancings. 21% of public sector project teams did not have information about their contractors' current financing arrangements. Departments should include in future PFI contracts the right to receive information on their contractors' financing arrangements and any material change to those arrangements.

5. In theory, contractors might respond to the new arrangements for sharing refinancing gains by making compensating increases to their prices. In practice, competitive pressures and the uncertainty as to the timing and amount of refinancing gains might make it hard for contractors to put up their prices. As a further protection from that risk, departments could seek, in addition to the main bid in line with the new refinancing guidance, a variant bid from contractors on how they would price the contract to include the benefit of refinancing gains within the contract price.

6. A further reason for departments to resist any upward pressure on contractors' prices is the important caveat in the new arrangements: refinancing gains will be calculated after allowing the private sector a return at least equal to what was projected at contract letting. Such a provision protects the private sector from a shortfall in profits, even if due to its own under-performance or failure to project accurately the likely returns from the project.

7. There is a risk that, if there is a change in ownership of a PFI project company, the new shareholders may not feel obliged to share refinancing gains under the new voluntary code, particularly if they have no interest in bidding for future PFI contracts. Where there is to be a change in ownership of a PFI project company in a

case in which the department needs to rely on the voluntary code for sharing refinancing gains, the department should seek from the new owners a written assurance that they will comply with the code's principles.

8. The new guidance and voluntary code are both complex and the outcome of negotiations. It is possible therefore that there will be scope for contractors to avoid sharing refinancing gains. The OGC and PUK consider it unlikely that contractors would risk their reputation by exploiting such loopholes. Nevertheless, departments will need to be vigilant and should use the audit rights over refinancings which are being written into new contracts to ensure that they receive the correct share of all refinancing gains to which they are entitled.

9. The concept of refinancing gains does not apply so clearly to PFI if financing is provided from a contractor's general finances. The Treasury should monitor whether there is an increase in projects which are being funded in this way. It should take action to share refinancing gains in these projects if there is evidence that contractors are increasingly using such funding arrangements to avoid sharing refinancing gains.

Formal minutes

Monday 12 May 2003

Members present:

Mr Edward Leigh, in the Chair

Mr Ian Davidson	Mr David Rendel
Mr Frank Field	Mr Gerry Steinberg
Mr Nick Gibb	Jon Trickett
Mr George Osborne	Mr Alan Williams

The Committee deliberated.

Draft Report (PFI refinancing update), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 16 read and agreed to.

Conclusions and recommendations read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Twenty-second Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No 134 (Select Committees (Reports)) be applied to the Report.

[Adjourned till Wednesday 14 May at 3.30 pm

Witnesses

List of written evidence

List of Reports from the Committee of Public Accounts Session 2002–03

First Report	Collecting the television licence fee	HC 118 *(Cm 5770)*
Second Report	Dealing with pollution from ships	HC 119 *(Cm 5770)*
Third Report	Tobacco Smuggling	HC 143 *(Cm 5770)*
Fourth Report	Private Finance Initiative: redevelopment of MOD Main Building	HC 298 *(Cm 5789)*
Fifth Report	The 2001 outbreak of Foot and Mouth Disease	HC 487 *(Cm 5801)*
Sixth Report	Ministry of Defence: Exercise Saif Sareea II	HC 502 *(Cm 5801)*
Seventh Report	Excess Votes 2001–02	HC 503 N/A
Eighth Report	Excess Votes (Northern Ireland) 2001–02	HC 504 N/A
Ninth Report	The Office for National Statistics: outsourcing the 2001 Census	HC 543 *(Cm 5801)*
Tenth Report	Individual Learning Accounts	HC 544
Eleventh Report	Facing the challenge: NHS emergency planning in England	HC 545
Twelfth Report	Tackling pensioner poverty: encouraging take-up of entitlements	HC 565
Thirteenth Report	Ministry of Defence: progress in reducing stocks	HC 566
Fourteenth Report	Royal Mint Trading Fund 2001–02 Accounts	HC 588
Fifteenth Report	Opra: tackling the risks to pension scheme members	HC 589
Sixteenth Report	Improving public services through innovation: the Invest to Save Budget	HC 170
Seventeenth Report	Helping victims and witnesses: the work of Victim Support	HC 635
Eighteenth Report	Reaping the rewards of agricultural research	HC 414
Nineteenth Report	The PFI contract for the redevelopment of West Middlesex University Hospital	HC 155
Twentieth Report	Better public services through call centres	HC 373
Twenty-first Report	The operations of HM Customs and Excise in 2001–02	HC 398
Twenty-second Report	PFI refinancing update	HC 203

The reference number of the Treasury Minute to each Report is printed in brackets after the HC printing number