



Refinancing

*Profiteering from
Public Services*

Issue 1: November 2001



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Executive summary

Lots of PFI contractors are 'refinancing' their loans - changing the terms of their borrowings to increase profits by as much as 80%.

Most public bodies making PFI deals have allowed contractors to keep all these windfall profits.

The National Audit Office and the Public Accounts Committee have condemned these arrangements and said the benefits of refinancing should be shared between contractor and client.

The Treasury has been blamed for not protecting the public purse from the 'refinancing bandits'.

The Fazakerley prison PFI contract was refinanced, giving the contractors Group 4/Carillion a windfall profit of £10.7m. The Prison Service was given £1m to compensate for an increased risk exposure of £47m by 2013.

What is refinancing?

The cost of finance is one of the most expensive ingredients in a PFI contract. Indeed, the private sector pays much more for loans than does government and other public bodies.

It follows that cutting the cost of financing a PFI contract can achieve a big increase in profitability - for the contractor. Changing the terms of a loan - to repay a loan early and at lower rates of interest - can be responsible for profit increases of as much as 80%.

PFI contractors agreed at the outset of many contracts to borrow money on expensive terms. In lots of cases they have been able to negotiate improved repayment terms - rather like remortgaging a house to take advantage of lower interest rates.

Why is refinancing possible?

Lenders' willingness to reduce the rates of interest charged reflects the reality of risk not being spread evenly through the life of contracts. Tenders are submitted on the basis of quoted interest rates from banks. But once a facility - which might be a prison, school or hospital - is built, the level of risk falls substantially.

There is a real and significant risk of a building not being completed by its due date, or of some failure which might prevent its completion. There may also be a chance of not being able to recruit sufficient numbers of qualified and experienced workers to open a facility on time. But once the facility is built and staffed, the operators have a guaranteed market and a client who will not go bust.

The risk factor is minimal once a facility is in place. Banks are then receptive to a review of interest rates charged and a proposal to cut the cost of the loan.

Further, the cost of borrowing for the first PFI deals was comparatively expensive. The City perceived - wrongly - that the contracts entailed significant risks for contractors, and that this meant that lenders might not be repaid in full.

As experience has grown of PFI contracts, lenders have become more relaxed about the level of risk taken on by the contractors. Lenders now see that the loans are of very low risk. Accordingly, the rate of interest charged has fallen.

Who gains from refinancing?

Morally, there is little doubt who SHOULD gain from refinancing. Both the House of Commons Public Accounts Committee - under the chairmanship of Conservative MP David Davis - and the National Audit Office have stated that the benefits of refinancing should be split between the contractor and the client public body.

The reality has been very different. Contractors have been able to negotiate refinancing of debts and the client bodies have approved these arrangements without sharing the benefits. All the windfall profits have fallen to the contractors and their shareholders.

What is being done about this?

In June 2000, the National Audit Office produced a highly critical report, 'The Refinancing of the Fazakerley PFI prison contract'. This concluded that public bodies "should consider what provisions they should make to share in some of the financial gains and whether their consent should be required before a refinancing can proceed". It added that benefits should be shared between contractor and department.

Yet it was only in July 2001 that the Office of Government Commerce issued guidance on its web site on the refinancing of PFI projects. This repeated the much earlier view of the NAO that the benefits of refinancing should be shared between departments and contractors. The OGC revealed that it had commissioned Partnerships UK - the private sector led body, which advises public bodies on PFI contracts - to draft new guidance on refinancing, which is to be published in Autumn 2001. This represents a delay of over a year from the NAO report, even though it exactly implements the NAO's view of what should happen.

The OGC says that departments had been notified previously by letter of the need to ensure that the proceeds of refinancing were shared with clients. The Department of Health did issue advice in December 2000, but this was not retrospective. So schemes signed before that date could still be refinanced with no claw back. Nor does this explain why it took over a year before the revised advice drafted by Partnerships UK is to become available.

Most PFI contracts still do not contain any clause requiring refinancing windfalls to be shared. As at August 2000, Parliamentary Questions revealed that of 82 PFI projects with capital values totalling £9.7bn, just 15 had claw-back arrangements in place for windfall profits from refinancing. The total cost to the public purse of the failure to put these in place is many millions of pounds, and may even exceed a billion pounds.

Who is to be blame?

The Treasury is responsible, said the House of Commons' Public Accounts Committee. The potential for windfall profits for PFI contractors should have been anticipated by the Treasury and protective measures built into contracts, the PAC decided. Only increased profits directly arising from higher than expected

standard of service should be kept entirely by the contractor, said the PAC.

Prior to the advice issued by the Office of Government Commerce, public bodies were expected to comply with guidance issued by the Treasury Private Finance taskforce, 'Standardisation of PFI Contracts'. In effect, this instructed public bodies to accept that contractors had a right to windfall profits from refinancing.

"There is... evidence that bidders are entering projects with equity returns that are lower than the threshold they require over the life of their investment, but which are based on the assumption that they will be boosted by a refinancing after the construction phase is complete. In other words, the refinancing gain is already priced into the bid to the benefit of the Authority [the public body] and an appropriate return is achieved through risk management. It is also worth noting that refinancing gains will only occur if the Project is successful. It can, therefore, be considered one of the proper rewards of successful implementation of the Project. Bidders may consider it unreasonable for the public sector to share in the upside if it is not willing to share as well in the downside."

From: Treasury Taskforce Private Finance, Standardisation of PFI Contracts, July 1999.

Despite this, a common sense view must be that senior civil servants should have had the foresight and independence to recognise the potential for vastly inflated profits for contractors. That these officials apparently failed to recognise this suggests a restricted level of capability and raises further questions about the contract management skills of senior civil servants.

Case studies

Fazakerley prison

The Prison Service awarded contracts in December 1995 and January 1996 to commercial businesses to run on its behalf two prisons - Fazakerley in Liverpool and Bridgend in South Wales. The contract

for Fazakerley (now called Altcourse) was given to Group 4 and Tarmac. It was not the cheapest bidder, but the Prison Service decided that it was unwise to give the two contracts to the same bidder. (Securicor and Costain were cheapest on both.) After completion of the prison building, Tarmac sold its stake in the business to Carillion.

The National Audit Office calculated that the Prison Service saved £1m over the 25 year life of the contract, compared with traditional procurement and in-house service provision. This contrasted badly with projected savings of £53m from the similarly sized Bridgend prison contract.

The NAO criticised several aspects of the contracting. Failing to award the two contracts to the Securicor/Costain bid cost £19m, according to the terms of the actual tenders, but the consortium was willing to cut costs further to secure both prison contracts for itself.

Advice to the Prison Service for the contracting process cost the massive amount of £1.6m - compared with an estimate of £0.6m. The contract for financial advice, awarded to Lazards, was made without competition.

The PFI contract was in two parts: the prison construction and the service charges for its continued use. Those service charges are levied by the winning bidder, but are not subject to ongoing market testing. The NAO says that in future contracts they should be.

But the most serious failing of the Prison Service was its failure to anticipate that the bidders might refinance the contract. Accordingly there was no provision in the contract that should refinancing take place the financial benefits should be shared between contractor and client.

This failing was amplified when the Group 4/Carillion consortium requested approval to refinance - although it had no clear legal need to obtain approval - and the Prison Service endorsed this, with the very modest rebate of £1m to compensate for additional end of contract liabilities. Rothschild, the Prison Service's financial advisors, calculated that the refinancing arrangement increased the Prison Service's risk exposure to the tune of £47m in cash terms (£13.5m at today's values) by the year 2013.

The windfall to Group 4/Carillion of the refinancing were enormous - £10.7m. The rate of return for the shareholders increased from the projected 13%, to an actual 39%. The refinancing instantly

made the contract one of the most profitable PFI deals ever. Instead of recovering its costs over the 25 year life of the contract, the consortium has recovered them over the first two years - leaving the next 23 years payments as pure profit.

MPs on the House of Commons' Public Accounts Committee strongly criticised the refinancing arrangements and said that the benefits of refinancing should be split between contractor and client. The committee, under the chairmanship of Conservative MP David Davis, said: "It is unacceptable that a department should accept without full compensation any risk of having to meet higher termination liabilities as a result of a refinancing which would greatly benefit the private sector shareholders."

Committee member Labour MP Alan Williams described the refinancing as "like coming up with the lottery several times a year."

The consortium awarded the contract for the other initial PFI prison at Bridgend subsequently obtained a profits windfall of £5m by refinancing its £77.5m loan at a 4% discount.

Dartford & Gravesham Hospital

Windfall profits of around £20m could be made from the refinancing of a 423 bed, £133m, hospital for Dartford and Gravesham, in Kent. A debt of £108m may be refinanced to take advantage of reduced risk. The Pentland consortium behind the contract is made up of Carillion (see Fazakerley), United Medical Enterprises and the specialist PFI investment fund Innisfree. Carillion bought out Tarmac, which had originally led negotiations for Pentland.

There are no arrangements in the contract between the NHS trust and the contractor for any clawback of windfall profits from refinancing. The House of Commons' Public Accounts Committee said: "The refinancing of a deal is an important potential source of additional profit for the private sector.... We therefore expect NHS trusts to reach a clearly agreed position on refinancing with their private sector partners when closing the deal."

Initially, the Dartford & Gravesham NHS Trust expected to achieve savings of £17m compared with conventional procurement of the hospital building and management of its support services. However, it is now believed that the actual savings will only be £5m. What this means in practice is that where the trust initially expected to pay the same for the new hospital as its predecessor, instead it will have to find an additional £4m

annually from its budgets for the next 25 years. This figure could have been heavily cut had the trust negotiated effectively over the profit reimbursement from the refinancing.

The PAC were strongly critical of the trust for failing to estimate correctly the costs of this long-term contract. The trust was found by the PAC to have been naive in its overall assessment of the risks and rewards accruing from the contract, and to have overlooked major mistakes in the calculations of how much it would have cost the public sector to finance the arrangements by traditional means. The effect of this was to greatly inflate the costs of the public sector procurement option.

Advisors to the trust charged it £2.4m for advice, almost 700% more than the trust expected. The PAC said that the NHS must drive down these costs.

The PAC also criticised the long-term nature of this hospital contract, which it said left the NHS trust committed to a hospital for 25 years - by which time it may prove out-of-date. The MPs said that it was important that NHS trusts achieved flexibility in hospital design, to enable buildings to be adapted to changing uses.

Norfolk & Norwich Hospital

There have been many press reports of alleged proposals by Octagon Healthcare, which is building the £230m Norfolk & Norwich Hospital, to refinance the loan for its contract. Shareholders in Octagon include Barclays Capital, Innisfree, 3i, John Laing Investments and Serco. It was predicted that the consortium would achieve a windfall profit of £70m - almost one third of the capital cost of the hospital - from the refinancing.

However, the consortium says that it has no plans at present to seek refinancing. A statement from Octagon said: "Octagon is currently focusing all its efforts on working with the Norfolk and Norwich University Trust to ensure that the new hospital is open and operating successfully in the autumn, significantly earlier than originally planned.

"In addition, Octagon can confirm that, it is not currently evaluating any financial restructuring, nor has it appointed any financial advisers to that effect."

Colfox School

Jarvis is the contractor for building the 1,060 place Colfox secondary school in Dorset and the Barnhill school in Hillingdon, West London. It is reported to be saving a high proportion of the costs of borrowing through refinancing its loan.

Inland Revenue

Redevelopment of the Inland Revenue's 11 property estate in Newcastle is being conducted by a consortium including Amec and Interserve. The costs of the project will be £241m, primarily financed through a loan arranged by the Royal Bank of Scotland. Refinancing is expected to increase the consortium's profits by many millions. RBS said that it had been agreed that the Inland Revenue would receive 60% of the benefit of the refinancing, with the consortium taking the other 40%.

Other prisons

A joint venture between Serco and US security company Wackenhut, called Premier Prison, runs five jails for the Prison Service. Bundling together the separate borrowings and refinancing them has reportedly raised the contractor's profits by £7m.