§1.1 Introduction

HM Treasury’s “Standardisation of PFI Contracts” (Version 3, April 2004—hereafter “SoPC”\(^1\)), provides (SoPC Chapter 35) that the Contractor shall obtain the consent of the Authority to any Qualifying Refinancing, with the Authority sharing 50% of the Refinancing Gain. SoPC requires an Authority to consider carefully the risk and value for money (“VfM”) implications of a Refinancing before giving their consent to proceed (SoPC §35.3); furthermore, if a refinancing involves an increase in the Authority’s termination liabilities (cf. SoPC Chapter 21), SoPC points out that a separate Authority consent is needed for this and states that:

An Authority should not use its separate approval rights over increases in termination liabilities to agree a greater than 50% share of the refinancing gain. In consequence, an Authority will be unlikely to agree to a refinancing that increases its termination liabilities unless the additional refinancing gain available to be shared, relative to a refinancing which does not involve such increase in termination liabilities, is judged to represent better value. (SoPC §35.3.1.6)

Refinancings of PFI transactions which were originally signed prior to 30th September 2002 are expected to be carried out under a voluntary code of conduct (HM Treasury: “Refinancing of Early PFI Transactions—Code of Conduct” (November 2002), hereafter “the Code of Conduct”). The Code of Conduct adopts the same definitions of Refinancing Gain, etc. as set out in SoPC; it likewise requires that Refinancings should be VfM; it expects that Authorities will generally receive a 30% rather than 50% share of Refinancing Gains.

It is also possible that, in parallel with the Refinancing, the Contractor may propose other amendments to the Contract: as with increases in termination liabilities, the VfM decision on such amendments should be also kept quite separate. Furthermore, the restriction of the Authority’s share of the Refinancing Gain to 50%\(^2\) does not apply in such cases.

The Application Note therefore considers:

(a) Issues for the Authority in giving consent to a Refinancing, namely:
   – Maximum level of Senior Debt (§1.2)
   – Increased termination liabilities (§1.3)

(b) Other issues which may arise for an Authority at the time of a Refinancing, and for which further consents are required, namely:
   – Contract amendments (§1.4)
   – Changes to the Unitary Charge profile or indexation (§1.5)
   – Contract extensions (§1.6)

Refinancings and the issues they raise are complex (cf. SoPC §35.2.4) and often create new risks for an Authority and so can make assessment of their risk and VfM far from straightforward. Accordingly, this Application Note has been prepared to help Authorities, and their Contractors who bring forward Refinancing proposals, to undertake a thorough analysis. It is based upon and cross-references throughout to the existing guidance available in relation to Refinancings, i.e. SoPC, the Code of Conduct, and SoPC Annex 1 (Guidance Note on “Calculation of the Authority’s Share of a Refinancing Gain”). The provisions of this Application Note do not alter or replace any of this existing guidance, but are designed to help Authorities and their Contractors apply it more rigorously and consistently. This Application Note does not substitute for the work which the Authority and its

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1 The capitalised terms used in this Application Note follow those set out in SoPC.
2 Or 30% in some cases under the Code of Conduct
own professional advisers will need to undertake; rather it emphasises the importance of Authorities seeking suitable expert advice when assessing Refinancing proposals.

The position of the Government remains unchanged: “…Refinancings can bring benefits to Authorities and the PFI market as whole. It wishes, therefore, to create a climate for mutually beneficial refinancing of PFI projects to take place, provided such refinancings also offer value for money to the public sector” (Code of Conduct §2); and “Refinancings carried out in accordance with this [SoPC] guidance can be of benefit to both the Contractor and the Authority; accordingly, proposals for refinancings made by the Contractor should be welcomed and considered positively by the Authority” (SoPC §35.1.1).

§1.2 Maximum Level of Senior Debt

At the time the Contract was originally signed, the Authority will have undertaken a rigorous assessment of a number of issues affected by the level of indebtedness of the Contractor, including:

– the extent and profile of incentives for shareholders over the life of the Contract;
– the financial flexibility which the Contractor will have to manage routine risks; and
– the financial robustness of the Contactor to withstand the adverse impact of major project risks.

Each of these issues will have been considered from both short and long-term perspectives; longer-term perspectives are particularly important in relation to the proposed amortisation profile of the Senior Debt and the proposed pattern of distributions to shareholders. All these factors will need careful consideration given that Refinancing proposals may involve both increased borrowings and shareholders realising substantial gains from the Project at the time of the Refinancing.

Whilst there are many areas where the interests of Senior Lenders and an Authority may be the same under a Contract, this is not always so, and an Authority cannot rely on Senior Lenders’ judgement about the acceptable level of indebtedness of the Contractor. An Authority and its advisers must form their own view on an appropriate level of indebtedness. The situation is exactly the same in the case of Refinancing. An Authority receiving a Refinancing proposal must repeat this rigorous evaluation of the maximum acceptable level of Senior Debt.

Since a Refinancing is normally undertaken in circumstances where a project has successfully passed a major risk-reduction milestone (such as completion of construction) it will normally be the case that the maximum level of Senior Debt which is acceptable for a Contractor under a Refinancing will be greater than at the time the Contract was originally signed. Indeed, Contractors’ Refinancing proposals often assume a significant increase in their level of borrowings. In evaluating such a proposed increase, it is important for the Authority to remember that the level of Senior Debt it considered acceptable at Financial Close was somewhat below the original funding requirement3 of the Project, whereas a Refinancing proposal may involve a level of Senior Debt in excess of this original funding requirement. As SoPC cautions (SoPC §35.3.1.7), a move to such an increased level of indebtedness should only be accepted by an Authority after rigorous evaluation.4

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3 The original funding requirement against which the gearing ratio of senior to junior capital was quoted at the time of financial close (e.g. 90/10), i.e. all construction period hard costs as well as soft costs such as rolled-up interest

4 An important exception exists to this general note of caution about increased Contractor indebtedness and where the Authority’s interests will generally be well served by the Senior Lenders insisting on their own view of acceptable increases in levels of Senior Debt. This is when the Project is in financial distress and Senior Lenders have decided to make further advances under the Additional Permitted Borrowings provisions of SoPC (cf. SoPC Annex 4: Guidance Note on “Permitted Borrowing”) to help restore the Project to financial health. In such cases Authority consent is not required. However, in considering the position on future termination liabilities at the time of a Refinancing (cf. §1.3), an Authority should have in mind the possibility that these may be increased through Additional Permitted Borrowing.
§1.3 Increases in Termination Liabilities

As discussed in §1.1, the Authority’s decision to agree to an increase in termination liabilities is quite separate from agreement to the Refinancing: this section considers the factors which the Authority should take into account in considering this issue.

As discussed in §1.2, the first step for the Authority is to establish its view of the maximum acceptable level of indebtedness for the Contractor. The proposed Refinancing will thus have been modified, as necessary, to comply with the Authority’s view on the maximum acceptable level of Senior Debt. The Authority should then consider whether it is prepared to accept any increase in termination liabilities to reflect this increase in Senior Debt and, if so, on what basis.

Compensation is payable to the Contractor in a range of Contract termination scenarios, and the VfM implications of any increase in termination liabilities should be considered in each scenario, namely:

- Contractor default (cf. §1.3.1)
- Authority voluntary termination (or default) (cf. §1.3.2)
- Force majeure termination, and termination for Corrupt Gifts (cf. §1.3.3)

§1.3.1 Contractor default

For Contracts based upon SoPC (SoPC §20.2, or its antecedents) it should not be possible for any Refinancing to increase the compensation payable to a defaulting Contractor (assuming that only Basic Amendments are made to the Contract at the time of Refinancing—cf. §1.4.1).5

For earlier PFI Contracts which do not follow SoPC, however, the position may be different (for example giving Senior Lenders greater protection than available under SoPC), but in such cases the Authority should not consent to a Refinancing which results in an increase in termination liabilities in the case of Contractor default. Instead, the Authority should consider whether a case could be made for the compensation on termination provisions to be changed to comply with SoPC, as part of the Refinancing, even though this could result in increased compensation being paid in certain circumstances including Contractor default.6

The assessment for the Authority in this case is clear: there should be no increase in compensation payable by an Authority to a defaulting Contractor as a result of a Refinancing, unless there is a clear VfM case to the contrary, which will necessarily involve a judgement on the benefits of introducing SoPC provisions to a Contract which previously lacked such risk transfer.

§1.3.2 Authority Voluntary Termination (or default)

In this case, SoPC links the compensation payable by the Authority in part to the level of Senior Debt (SoPC §20.1 & §20.5), and therefore the Authority will have to conduct a VfM analysis before agreeing to any increases in these termination liabilities. This is the most complex termination scenario which the Authority will have to consider in reviewing the effect of a Refinancing.

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5 This is because compensation does not relate to the debt outstanding, but rather to the market value (or estimated market value) of the Contract.

6 A change in Contractor default compensation provisions to introduce SoPC (i.e. market value-based compensation) with associated increased risk transfer to the Contractor may make a positive VfM contribution.
The starting-point should always be the principle of there being no increase in termination liabilities. These liabilities have to be considered as a whole, taking into account both the payment made on account of Senior Debt, and that made on account of junior capital (i.e. the combination of equity and subordinated debt). Thus an increase in termination liabilities relating to Senior Debt may be counterbalanced by a decrease in liabilities relating to junior capital. However, the proper assessment of this requires detailed financial modelling for each period over the Contract life and proper account to be taken of all the breakage costs incurred as a result of a Refinancing (see below). SoPC offers three formulae applying to junior capital compensation, from which the Contractor can make an initial choice (cf. SoPC §20.1.3.6) at the time of Contract signature. Annex 1 to this Application Note gives a brief summary of the possible scenarios which result from these choices.

It follows from this counterbalancing effect that a Refinancing involving increases in levels of Senior Debt may be arranged without increases in the total termination liabilities for the Authority, potentially even up to the limit of maximum acceptable Senior Debt. If, nonetheless, a Refinancing proposal does involve an increase in total termination liabilities, the Contractor making the proposal should be required to offer a choice of Refinancings to the Authority: one involving increased total termination liabilities and one not. Only in this way will it be possible for an Authority to assess fully the VfM benefit of agreeing to these increased liabilities as required by SoPC (SoPC §35.3.1.6). Importantly, this is not only a quantitative exercise but is likely to require qualitative analysis by the Authority.

If an increase in termination liabilities needs to be considered, it is important that the Authority has a clear understanding of what these increases actually are. There are two points to bear in mind here:

− **Profile of termination liabilities**

Termination liabilities vary (generally decreasing) over the life of the Contract. Hence for an Authority to apply the principle of there being no increase in termination liabilities relative to the situation prior to a Refinancing, requires a time-dependent profile of termination liabilities extending over many years to be calculated and compared with the original profile (i.e. pre-Refinancing) calculated using the Base Case financial model.

− **Breakage costs**

Breakage costs on Senior Debt may be incurred if a Senior Debt facility (whether bank or bond) is repaid early (that is pre-paid in the case of a bank loan or redeemed in the case of a bond)—such costs would be added to the Authority’s termination liabilities. In the case of a bank loan carrying a fixed rate of interest these are referred to as swap-breakage costs (cf. SoPC §32.2.1) and in the case of a bond they are referred to as Spens costs (cf. Office for Government Commerce’s “Guidance on Certain Financing Issues in PFI Contracts” (July 2002), §2: “Using The Capital Markets For Finance”, §2.12).

In many cases, Spens costs will be greater than swap-breakage costs for a given Senior Debt amount, so a bond issue will involve greater termination liabilities for an Authority and thus greater costs in terms of lost flexibility (see below).

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7 Some projects may also include mezzanine capital which will have its own compensation régime which needs also to be taken into account in the assessment of aggregate termination liabilities.
Moreover, if long-term interest rates have gone up since the financing was originally put in place, this should result in a breakage profit on a swap—which will reduce termination liabilities—rather than a swap-breakage cost. This may not be the case under a bond with a Spens clause. Thus the possibility of both higher and lower long-term interest rates at the time of termination (and a variety of different termination dates) need to be taken into account in assessing likely termination costs where a Refinancing takes the form of a switch from a bank loan to a bond financing.

A further element of breakage-cost risk is introduced if the funders make use of an RPI swap (to hedge against changes in inflation). Again the breakage costs on such a swap would have to be evaluated in a variety of inflation scenarios.

Since the Authority is concerned about aggregate termination liabilities in respect of the Contractor’s finances (i.e. the combination of compensation due to Senior Debt and that due to junior capital and not just Senior Debt), it follows that investors in junior capital can elect to pledge their share of compensation to Senior Lenders to secure either more Senior Debt, or to cover incremental increases in termination liabilities arising from changed profiles of termination liabilities and/or changed breakage costs, without affecting the Authority’s overall liability. If, nonetheless, the Contractor is proposing a Refinancing which increases the Authority’s aggregate termination liabilities, then these additional costs must be weighed against the benefits of an increased Refinancing Gain made possible through these increased liabilities.

**Contract Flexibility**

Furthermore, in carrying out this cost-benefit analysis, proper account must be taken of the reduction in Contract flexibility which arises as a result of increased termination liabilities. HM Treasury: “PFI—Meeting the Investment Challenge” (July 2003, §8.45-8.47) emphasised the importance which the Government places on PFI Contracts maintaining adequate flexibility. Loss of flexibility derives from at least two sources:

- **Policy flexibility**

  It is important for Government to maintain the flexibility to allow for future changes in policy affecting the services provided under the Contract. Accordingly, at the time it entered the Contract, the Authority will have placed a distinct value not only on having the option to terminate the Contract voluntarily but also on the exercise price of this option (i.e. the compensation it would have to pay to the Contractor in such circumstances). An increase in termination liabilities and hence exercise price will reduce the value of this option.

- **Operational flexibility**

  If the environment within which the services are provided are subject to rapid or continuous change, then it is likely that the Authority will need to make extensive use of the change control provisions of the Contract or, indeed, have a need to negotiate substantial changes to the contract itself. This may place stresses on the Contractor which were unforeseen by both the Authority and the Contractor at the time of entering the Contract. Even if such circumstances do not give rise to instances of Contractor default, they may nonetheless take the partnership working between Contractor and Authority beyond limits with which the Contractor is comfortable. In such circumstances, the cost of voluntary termination by the Authority (as an alternative to negotiating difficult changes) becomes important. The greater the termination liabilities the less flexibility there may be in the Contract.
The VfM assessment of loss of Contract flexibility is not straightforward, since it may not be possible to predict how policy or operational needs could change in the long term. Nonetheless even if such an analysis cannot be carried out quantitatively it must still be carried out qualitatively by the Authority. Moreover, even if an Authority believes there is a low probability of future changes being necessary, it does not diminish the need for an Authority to give due weight to these important scenarios in its VfM assessment.

§1.3.3 Force majeure termination, and termination for Corrupt Gifts

In these cases, the termination payment made by the Authority is also based, *inter alia*, on debt outstandings (SoPC §20.3-20.4). The position for Senior Debt is thus similar to that for Authority voluntary termination (cf. §1.3.2).

However, it should be noted that the Authority does not pay future profits, or an amount greater than the Senior Debt outstanding, accrued interest and actual breakage costs to the Senior Lenders in these termination scenarios.

§1.4 Contract Amendments and Refinancings

Amendments to the Contract (between the Authority and the Contractor) and to the Direct Agreement (between the Authority and the Senior Lenders) may be proposed by the Contractor at the time of a Refinancing. However, it is essential for the Authority to distinguish between those amendments which form an intrinsic part of the Refinancing and so are wholly necessary for the Refinancing to proceed (“Basic Amendments”), on the one hand, and those amendments which are proposed at the time of a Refinancing, but are nonetheless optional for the Authority (“Additional Amendments”), on the other. Examples of each category of amendment as are follows:

§1.4.1 Basic Amendments

- Amendments necessary to provide for payment of the Authority’s share of the Refinancing Gain by:
  - a constant reduction in the Unitary Charge, and/or
  - a continuing increase in scope of services in cases where the Authority has not chosen to have its share paid wholly as a lump sum
- Amendments necessary to implement the agreed position on termination liabilities as a result of the Refinancing, whether these are to remain constant or to increase (cf. §1.3)
- Execution of a new (but unchanged) Direct Agreement with new Senior Lenders

§1.4.2 Additional Amendments

- Re-profiling of the Unitary Charge, other than to provide for payment of the Authority’s share of the Refinancing Gain (cf. §1.5)
- Increase in the scope of services, other than where this is done to provide for payment of the Authority’s share of the Refinancing Gain
- Introduction of benchmarking of “soft” services
- An extension to the term of the Contract (cf. §1.6)
- Amendments to the payment mechanism to introduce improved performance régimes
- Changes to compensation on termination provisions to bring them into line with SoPC

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8 It should be noted that the payment by the Authority on termination for breach of the Refinancing Provisions is the same as that paid on termination for Corrupt Gifts (SoPC §20.6).
9 In case of force majeure termination, compensation is also based on initial share capital and sub-debt less dividends and coupons already paid (SoPC §20.3.2).
Value for Money in Refinancing

(potentially relevant to earlier PFI deals). A change in contract structure or an Authority consent which is required to enable the Contractor to switch from capital allowances to contract debtor accounting Any other Contract amendment which requires the Authority’s consent

Basic Amendments should be evaluated as part of the Refinancing proposal.

It may well be, for reasons of administrative convenience, minimisation of transaction cost and, most importantly, the incremental increase in Refinancing Gain made possible, that the Contractor proposes to implement the Additional Amendments at the same time as the Refinancing. But only if an Additional Amendment passes a separate and specific ViM assessment should it then be considered as an optional feature of a Refinancing. Moreover, the incremental Refinancing Gain resulting from an Additional Amendment should be largely if not completely for the benefit of the Authority—the appropriate split to be negotiated by the parties.

§1.5 Unitary Charge Profile and Indexation Régime

An Authority and its Contractor may, from time to time over the life of the Contract, decide that minor amendments to the payment mechanism are to their mutual advantage, e.g. by achieving a better match between key performance measures, incentives and changing operational priorities (cf. §1.64.2). However, these amendments should not change the original Unitary Charge payment profile (in real terms), nor its indexation régime, without very careful assessment of the ViM implications.

The Unitary Charge payment profile and indexation régime are fixed at Contract signature, and are fundamental determinants of both the original ViM justification of the Contract and of the finance plan adopted by the Contractor at the time. In consequence, changes to the Unitary Charge profile or indexation régime may enable major changes to be made to the Contractor’s finance structure which are disguised within a Refinancing proposal and the Authority must take great care to separate them out and evaluate them on a stand-alone basis.

In particular, Authorities should note that large incremental Refinancing Gains may be possible on the back of such changes regardless of the fact that, taken alone, these changes would not pass a ViM test. As a general principle, Authorities should assume that changes to the profile of Unitary Charge payments and indexation régime are not ViM—even if there are apparent affordability advantages—unless there is clear evidence to the contrary.

This is not to suggest that a change in scope of services initiated by an Authority on grounds of ViM may not give rise to an increase in Unitary Charges—but rather that such increases should only be made as set out in SoPC §12.4, and as a separate exercise to any Refinancing Gain calculation. Similarly, a reduction of the Unitary Charge to pay the Authority’s share of a Refinancing Gain should only be made as set out in SoPC Annex 1 (Guidance Note on “Calculation of the Authority’s Share of a Refinancing Gain”) §1.5.2(b).

§1.6 Contract Extensions

A Contract extension enables the Contractor’s debt to be amortised over a longer period. The resulting decrease in annual debt-servicing costs enables either more debt to be raised, which can be used to accelerate distributions to the Contractor’s investors, and so produce a Refinancing Gain, or the contracted Unitary Charge to be reduced—so easing a possible affordability constraint for the Authority, or a combination of the two.

But if the Contract extension cannot be justified as ViM on a stand-alone basis, it should not form part of a Refinancing proposal. Prospective improvements in affordability which may come from the

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11 An increase in termination liabilities as discussed in §1.3 will not be an Additional Amendment unless it is as a result of other changes to the Contract which come under this heading.
Authority sharing in the benefit from the longer-term amortisation of the Contractor’s debt are irrelevant to this VfM evaluation. The tests for justifying a Contract extension are similar to those for an Authority considering entering any new contract and, moreover, raise additional issues of management and loss of flexibility for the Authority under the Contract, based on scenarios many years into the future.

As a general principle, Authorities should assume that Contract extensions are not VfM unless there is clear evidence to the contrary.

§1.7 Overall Approach

Given the complex issues which Refinancings raise, it would not be surprising for an Authority to conclude that the simplest Refinancing proposal—particularly one that does not involve any change to Contract termination liabilities—was also the best. However, this assumption cannot necessarily be made and Authorities should be prepared to consider positively Refinancing proposals made by Contractors which involve features (including potentially increased termination liabilities in certain circumstances) which require separate and thorough VfM assessment. The Authority’s work in completing this assessment will be greatly assisted by the Contractor presenting alternative Refinancing proposals which highlight the incremental VfM benefits available to the Authority of each proposal compared with another.

Refinancings raise important issues for Authorities both in evaluation and transaction implementation and so careful attention is needed in applying the relevant guidance. The VfM of each aspect of a Refinancing proposal should be thoroughly assessed, whether the assessment is quantitative, qualitative or both. Authorities should seek suitable expert advice, including financial and legal advice, from the outset of a Refinancing proposal and discuss, at each key stage, with HM Treasury the VfM assessment particularly in relation to refinancing proposals involving substantially increased levels of borrowings by the Contractor (§1.2).

HM Treasury
18th February 2005
Annex 1: Authority Voluntary Termination (or default)

Summary of alternative SoPC provisions for compensating junior capital

SoPC §20.1.3.6 allows Contractors to choose from one of three possible compensation régimes for junior capital at the time of Contract signature, and therefore the effect of the refinancing on termination liabilities may be different depending on which option was originally chosen. This Annex considers how each option affects termination liabilities.

A Refinancing may affect both the compensation due to Senior Debt (as described elsewhere in this Application Note) and that due to junior capital (i.e. the combination of equity and subordinated debt which is generally subscribed by shareholders of the Contractor). As a general principle, an increase in compensation payable in respect of Senior Debt should be counter-balanced by an off-setting reduction in compensation payable in respect of junior capital. However, this assumption cannot be relied upon in every case and must, accordingly, be checked with greater care by suitable financial modelling for each period over the life of the Contract, whether the Contract is SoPC-compliant or not. An Authority will be concerned by the overall level of compensation payable upon termination, and so the aggregated and inter-active effects of all the components of compensation must be rigorously checked.

The effects of the three possible SoPC approaches to compensation of junior capital are summarised below: 12

– **Junior capital compensation based on rate of return to termination date**

In this case, the termination compensation for junior capital is calculated so as to give the investors their Base Case Equity IRR over the period up to the termination date. If the Refinancing results in accelerated distributions to investors, this should also enable them to achieve the Base Case Equity IRR more rapidly, and thus decrease the payment to be made on account of junior capital at the time of a later termination. If this projected decrease is equal to or greater than the increase in termination liabilities on the Senior Debt, there will no overall increase in termination liabilities on this account.

– **Junior capital compensation based on market value**

In this case, the termination compensation for junior capital is based on its market value at the time of termination. The equity element of this market value will generally be reduced after the Refinancing (on account of the increased debt burden of the Contractor). If this reduction is equal to or greater than the increase in termination liabilities on the Senior Debt, there will be no increase in total termination liabilities on this account.

– **Junior capital compensation based on projected Base Case returns**

In this case, the termination compensation for junior capital is calculated as the future returns (from the termination date forward) payable under the Base Case, discounted at the Base Case Equity IRR. SoPC cautions (SoPC §20.1.3.9 footnote 13) that “Care should be taken that if a refinancing has occurred…and the original equity and Junior Debt reduced, there is no double counting”. In other words, the increase in Senior Debt termination compensation should be balanced by a decrease in the equity compensation. If this is so, there will be no overall increase in termination liabilities on this account.

12 As discussed in §1.3.2, compensation payable on Senior Debt will involve breakage costs (e.g. in respect of interest rate hedging instruments, Spens clauses on bond issues or RPI swap instruments). Breakage costs may also arise as a result of the use of mezzanine finance. The aggregated impact of all of these, over a reasonable range of scenarios, must be taken into account before an overall conclusion can be reached as to whether termination liabilities in a given period over the Contract life remain unchanged, increase or decrease.