Guidance on Application of the Spens Clause to PFI Transactions

1.1 This note supersedes the previous guidance on Spens Clause as set out in Section 2.12 of the "OGC Guidance on Certain Financing Issues in PFI Contracts" July 2002.

Spens Clause

1.2 The Spens clause applies to UK listed bonds and therefore impacts on all PFI bond financed transactions. It provides protection to the investor, by ensuring that on an early termination of a bond the investor receives sufficient compensation that allows it to obtain the same cash flows by re-investing in risk free gilts.

Impact of Spens Clause

1.3 The formulation of the Spens clause often leads to issuers being penalised in voluntary early termination scenarios. The Spens clause provides for a cash payment to be made to investors equal to the higher of:

- the outstanding principal on the bond and
- the foregone coupon (interest and principal payments) on the bonds, discounted at a rate equal to the redemption yield of a gilt of comparable maturity.

1.4 Where interest rates have risen, because of the operation of the par floor (i.e. the 'higher of' formulae) the investor will receive the outstanding principal on the bond. However, this will produce a cash windfall as the investor will be able to obtain a higher return on its investment and also benefit from an improvement in the risk quality of the investment.

1.5 Where interest rates have fallen, the investors will receive an amount that is higher than the outstanding principal to ensure that it will yield the same return if it was invested in government gilts. In this scenario the investor enjoys the same cash flows but benefits from an improvement in the risk quality of the investment.

1.6 Therefore the inclusion of the Spens clause in long-dated sterling bonds used in PFI bond financed transactions may be seen as a "cost" which reduces the flexibility of the procuring authority in voluntary termination scenarios.

Market Practice

1.7 Recent changes in market practice have meant that the Spens element is generally paid in full only as part of the definition of "Senior Debt" for the purposes of paying compensation in respect of termination for Authority Default.

1.8 In the case of termination for Force Majeure and Corrupt Gifts, the Authority should only pay the par value of the bonds outstanding (plus any accrued and unpaid interest). In other prepayment circumstances the market practice has started to change towards the borrower paying an amount that is less than that payable under the terms of a Spens clause (i.e. a modified Spens clause is applied).

1.9 Although there have been a number of deals where a modified Spens clause has been included, there has been little or no consistency in the terms of the clause applied. Examples of modified Spens clauses that have been used or considered include changing the discount rate from government gilts to:

- an EIB reference issue with similar tenor as PFI issue,
- swaps flat,

- a fixed amount (e.g. 50 bps) over gilts or
- a percentage of project risk margin (e.g. 50% of the bond spread) over gilts

Application of modified Spens clause in PFI transactions

1.10 The use of the Spens clause increases prepayment costs and reduces the flexibility of procuring authorities in voluntary termination scenarios and given the development of the PFI investor market, it is recommended that a modified Spens clause is applied to PFI transactions.

1.11 In the absence of a widely accepted benchmark market measure for comparison with PFI bond issues, there is no compelling reason for the procuring authority to use a particular modified Spens clause option.

1.12 However, procuring authorities should consider whether it is appropriate to use the EIB reference issue or the swap rates as the discount rate. Historically the spread between EIB issues and gilts has fluctuated, while the spread between swap rates and gilts of equal maturity has differed to an even greater extent, which is likely to introduce some uncertainty to the valuation outcome over time. In respect of the EIB reference we also don't see a correlation between a supranational issue and the domestic PFI bond market.

1.13 Procuring authorities may wish to consider using a percentage of the project risk margin over the agreed underlying reference gilt as this ensures that the modification is set with reference to the specific project rather than on an unrelated variable such as the EIB reference issue or swap curves.

1.14 In the absence of alternatives solutions used by the procuring authorities for specific value for money reasons, we would suggest that the default option for the application of a modified Spens clause in PFI transactions should be 50 per cent of the project risk margin over the agreed underlying reference gilt. Apart from being an accepted market formula, the adoption of this approach would also help to encourage the establishment of a harmonised benchmark position across government, where authorities can consider project specific derogations for value for money purposes.

1.15 The incorporation of a modified Spens clause generally enhances the authority's flexibility in voluntary termination scenarios. However, there is a trade-off between the level of flexibility that can be incorporated and the premium that needs to be paid. Therefore, procuring authorities can invite bidders as part of the procurement process to provide alternative indicative pricings on modified Spens clauses that provide different levels of flexibility, in addition to the default option of using 50 per cent of the project risk margin.

1.16 To the extent that the indicative pricing is different for each solution, procuring authorities should consider the value for money of paying the higher premium for additional flexibility and consider this as part of the bid evaluation process. This will enable the private sector to price the procuring authorities preferred modified Spens clause, while allowing them to offer alternate options that they determine may offer better value.

HM Treasury

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