

Standardisation of  
PFI Contracts

Version 4  
Addendum

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Amended Refinancing Provisions

October 2008



HM TREASURY

## Introduction and Application

In March 2007 Her Majesty's Treasury ("HMT") published Version 4 of Standardisation of PFI Contracts ("SoPC 4"). HMT is now providing further guidance on the refinancing provisions in SoPC 4 in light of challenges in the funding market. This includes revised drafting of section 34.5.3 (Sharing) and of clause 34.8 (Model Refinancing Provisions) of SoPC 4. The revised provisions constitute core principles and replace the existing drafting within SoPC 4. The application of the revised guidance is mandatory for all PFI projects that are still in competitive procurement (i.e. where final bids have not yet been received or the Competitive Dialogue process has not been closed) as at 1 November 2008. The guidance is therefore not mandatory for those PFI projects at preferred bidder or where final bids are received before this date. However, adoption of the revised guidance and adherence to the principles contained therein is encouraged for those projects where its use is not mandatory and, subject to applicable procurement principles, an Authority and Contractor should consider these principles in any event and discuss their position with the Refinancing Taskforce or HM Treasury.

The key changes comprise (i) changes to the refinancing gain sharing proportions between an Authority and Contractor and (ii) the introduction of an Authority right to request refinancing.

### Changes to the Authority gain share proportions

The revised drafting alters the provisions for sharing of refinancing benefits resulting from a refinancing. This reflects the fact that potential additional refinancing gains may be generated on projects signing in the current market, if credit margins or other terms were subsequently to move significantly towards pre-credit crunch levels.

### Authority right to request refinancing

The changes to the gain sharing proportions will have an impact on the incentives for the owners of equity in PFI projects to initiate a refinancing. The revised provisions therefore increase the sharing percentage at fixed thresholds in order to encourage both refinancing within smaller projects and those refinancing activities with smaller benefit within larger projects.

It is recognised that the objectives of the holders of equity in the project and the Authority are largely aligned in relation to creating reasonable refinancing benefits. However, an Authority right to request refinancing has been introduced to deal with the limited circumstance where, in the absence of an equity-led refinancing request, the Authority believes that terms available in the market are more favourable than those within the existing agreement. A broad view should be taken of the potential benefits of any refinancing and accordingly, the Authority's right to request a refinancing allows for consideration of the range of issues which may need to be taken into account.

### Most Favourable Terms

The Contractors' obligations under the Authority right to request refinancing (see paragraph 34.9.3.2 of the required drafting) are expressed in terms of "the most favourable available terms". This is intended to allow Contractors and Authorities to investigate and discuss proposals that involve the balancing of a number of potentially competing priorities.

The principal issues from the perspective of an Authority are likely to include:

- the larger the refinancing gain the greater the benefit in cash terms, and
- if the project's gearing is increased through an increase to the outstanding senior debt, this potentially increases the Authority's termination liabilities under termination scenarios other than Contractor default, and also potentially reduces the financial robustness of the Contractor.

The principal issues from the perspective of the Contractor and its shareholders are likely to include:

- Refinancings generally have an economic benefit for shareholders of the Contractor. The calculation of this economic benefit may differ from the contractual calculation of Refinancing Gain. For example, shareholders may have different views of what is an appropriate discount rate in the light of the risks of the project as assessed at that time;
- Contractors may have concerns over the implications for the robustness of the SPB due to increased gearing or lower lender cover ratios;
- Similarly, shareholders (particularly those which consolidate the financial performance of the Contractor into their group accounts) may have concerns about accounting presentation, for example in relation to the breakage of any interest-rate or inflation swap insofar as this is required to implement a Refinancing.

More detailed guidance on considerations that an Authority should bear in mind in relation to these issues may be found in the 2005 Application Note "Value for money in refinancing".

[http://www.hm-treasury.gov.uk/d/covering\\_note\\_value\\_for\\_money\\_280205.pdf](http://www.hm-treasury.gov.uk/d/covering_note_value_for_money_280205.pdf)

[http://www.hm-treasury.gov.uk/d/application\\_note\\_value\\_for\\_money\\_280205.pdf](http://www.hm-treasury.gov.uk/d/application_note_value_for_money_280205.pdf)

#### Cooperation in the implementation of refinancing

In any refinancing it is important for the Authority and the Contractor to work together through open and timely communication. The new clauses 34.9.1 and 34.9.2 provide for initial discussion between Authorities and Contractors, through the Refinancing Notice and meeting process. It is envisaged that, in practice, close dialogue would continue throughout the development of proposals and that Authorities would consult their departmental Private Finance Units or other departmental resources, the Refinancing Taskforce and their own financial and legal advisors for additional help where required.

## Amendments to Chapter 34 of SoPC 4

The following change applies to the guidance in Chapter 34:

### 34.5.3 Sharing

**34.5.3.1** The Refinancing Gain should be shared ~~50:50~~ between the Authority and the Contractor as set out in the required drafting that follows. However, the sharing of the Refinancing Gain with the Authority should only apply if the projected performance of the Project, at the time of refinancing, is above that included in the original Financial Close Base Case financial model.

The following changes apply to the required drafting included in Chapter 34:

#### 34 Refinancing

- 34.1 The Contractor shall obtain the Authority's prior written consent to any Qualifying Refinancing and both the Authority and the Contractor shall at all times act in good faith with respect to any Refinancing.<sup>7</sup>
- 34.2 The Authority shall be entitled to receive:
- (a) a 50 per cent share of any Refinancing Gain arising from a Qualifying Refinancing, in respect of any Refinancing Gain up to (when considered in aggregate with all previous Qualifying Refinancings) a Refinancing Gain of £1 million;
  - (b) a 60 per cent share of any further Refinancing Gain arising from a Qualifying Refinancing, in respect of any Refinancing Gain up to (when considered in aggregate with all previous Qualifying Refinancings) a Refinancing Gain of £3 million, and also
  - (c) a 70 per cent share of any other Refinancing Gain arising from a Qualifying Refinancing.
- 34.3 The Authority shall not withhold or delay its consent to a Qualifying Refinancing to obtain a greater share of the Refinancing Gain than ~~50 per cent share of the Refinancing Gain, that specified in clause 34.2~~<sup>8</sup>
- 34.4 The Contractor shall promptly provide the Authority with full details of any proposed Qualifying Refinancing, including a copy of the proposed financial model relating to it (if any) and the basis for the assumptions used in the proposed financial model. The Authority shall (before, during and at any time after any Refinancing) have unrestricted rights of audit over any financial model and documentation (including any aspect of the calculation of the Refinancing Gain) used in connection with that Refinancing (whether that Refinancing is a Qualifying Refinancing or not).
- 34.5 The Authority shall have the right to elect to receive its share of any Refinancing Gain as:
- (a) a single payment in an amount less than or equal to any Distribution<sup>9</sup> made on or about the date of the Refinancing;

<sup>7</sup> The Authority may terminate the Contract for a wilful breach of this clause or of clause 34.9. In such circumstances, the amount of compensation payable to the Contractor shall be the same as that paid to the Contractor if the Contract is terminated under Clause 21.5 (Termination on Corrupt Gifts or Fraud). See Section 21.6 (Termination for Breach of the Refinancing Provisions).

<sup>8</sup> Please see Section 22.3 (Changes to Financing Agreements and Project Documents) in relation to requests made to the Authority for increases in its termination liabilities.

<sup>9</sup> Any Distributions projected to be made after the Refinancing will be net of any payment to be made to the Authority on or about the date of the Refinancing. If a Distribution is made on or about the date of the Refinancing which would have been made if the Refinancing had not occurred, the amount of that Distribution will not be taken

- (b) a reduction in the Unitary Charge over the remaining term of the Contract;  
or
  - (c) a combination of any of the above.
- 34.6 The Authority and the Contractor will negotiate in good faith to agree the basis and method of calculation of the Refinancing Gain and payment of the Authority's share of the Refinancing Gain (taking into account how the Authority has elected to receive its share of the Refinancing Gain under Clause 34.5 above). If the parties fail to agree the basis and method of calculation of the Refinancing Gain or the payment of the Authority's share, the dispute shall be determined in accordance with Clause 28 (Dispute Resolution).<sup>10</sup>
- 34.7 The Refinancing Gain shall be calculated after taking into account the reasonable and proper professional costs that each party directly incurs in relation to the Qualifying Refinancing and on the basis that all reasonable and proper professional costs incurred by the Authority will be paid to the Authority by the Contractor within 28 days of any Qualifying Refinancing.
- 34.8 Without prejudice to the other provisions of this Clause 34, the Contractor shall (a) notify the Authority of all Notifiable Financings on becoming aware of the same and again when they are entered into and provide full details of the same and (b) include a provision in the Financing Agreements whereby it is entitled to be informed of any proposals which the Senior Lenders may have to refinance the Financing Agreements.

34.9 **Authority right to request refinancing**

34.9.1. If the Authority (acting reasonably) considers the funding terms generally available in the market to be more favourable than those reflected in the Financing Agreements, the Authority may, by notice in writing to the Contractor, require the Contractor to request potential funders to provide terms for a potential Refinancing (a "Refinancing Notice").

34.9.2. The Refinancing Notice shall set out in reasonable detail the grounds upon which the Authority believes such funding terms to be available. The Contractor and Authority shall meet to discuss the Refinancing Notice within 28 days. Such a meeting will consider the evidence available to both parties about the availability of funding terms for a potential Refinancing. The Authority shall be entitled to withdraw the Refinancing Notice at or before such a meeting, or within ten days following the meeting.

34.9.3. If the Authority serves a Refinancing Notice which is not withdrawn pursuant to clause 34.9.2, then the Contractor shall:

34.9.3.1. act promptly, diligently and in good faith with respect to the potential Refinancing;

34.9.3.2. use all reasonable endeavours to obtain the most favourable available terms from existing and/or new lenders for any potential Refinancing (provided that the Contractor shall not be required to

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into account for the purposes of paragraph (a).

<sup>10</sup> Any dispute should be determined under the dispute resolution process (see Section 28.3).

propose refinancing in a manner which a prudent board of directors of a company operating the same business in the United Kingdom to that operated by the Contractor, in similar circumstances, would not approve), for the avoidance of doubt also being terms which are likely to generate a positive Refinancing Gain after the deduction of costs in accordance with the provisions of clause 34.7; and

34.9.3.3. either:

a) as soon as reasonably practicable after receipt of the Refinancing Notice, provide to the Authority (i) full details of the proposed Refinancing, including a financial model and the basis for the assumptions used in the financial model and evidence to the reasonable satisfaction of the Authority that these assumptions represent the most favourable available terms for the potential Refinancing on the basis set out in clause 34.9.3.2 above and (ii) initial drafts of any changes to this Contract including in relation to potential compensation on termination which might be required to give effect to the proposed Refinancing; or

b) if the Contractor (acting reasonably) believes that it is not possible to obtain funding terms which are more favourable than those reflected in the Financing Agreements in accordance with the requirements of clause 34.9.3.2, provide evidence to the reasonable satisfaction of the Authority for such belief and evidence to the reasonable satisfaction of the Authority that the Contractor has complied with its obligations in clauses 34.9.3.1 and 34.9.3.2

34.9.4. Following receipt of the information referred to in clause 34.9.3.3 (a), the Authority shall (in its absolute discretion) either:

34.9.4.1. instruct the Contractor to implement the proposed Refinancing; or

34.9.4.2. instruct the Contractor to discontinue the proposed Refinancing

provided that if the Authority reasonably considers that the requirements of clause 34.9.3.3 (a) have not been satisfied, the Authority may require the Contractor to satisfy its obligations under clause 34.9.3.3 (a) whereupon the provisions of clauses 34.9.3 and 34.9.4 shall apply as if the Authority had served a Refinancing Notice.

34.9.5. If the Authority instructs the Contractor to implement the proposed Refinancing:

34.9.5.1. the Contractor shall, as soon as reasonably practicable, use all reasonable endeavours to procure that such proposed Refinancing is implemented;

34.9.5.2. such proposed Refinancing shall be deemed to be a Qualifying Refinancing; and

34.9.5.3. the provisions of clauses 34.1 to 34.8 shall apply.

34.9.6. If:

34.9.6.1. the Authority instructs the Contractor to discontinue the potential Refinancing pursuant to clause 34.9.4.2; or

34.9.6.2. the requirements of clause 34.9.3.3 (b) are satisfied

then, the Authority shall reimburse the Contractor for the reasonable and proper professional costs incurred by the Contractor in relation to the potential Refinancing, such costs to be paid to the Contractor by the Authority within 28 days after receipt of a valid invoice in respect of such amount. Such costs shall not include any internal management costs incurred by the Contractor except insofar as (a) it can be demonstrated to the reasonable satisfaction of the Authority that such costs have been incurred in place of professional costs which would in the normal course of such business have been paid to third parties and (b) the Authority has, by prior written agreement, approved the use of such internal management resource.

34.9.7. The Authority shall be entitled to issue a Refinancing Notice under clause 34.9.1 at any time but not more than once in any two-year period. For the avoidance of doubt, a Refinancing Notice that has been withdrawn under clause 34.9.2 has been issued for the purpose of this clause 34.9.7.

**The following change applies to the required drafting of Chapter 21 (Early Termination) in relation to clause 21.6.1 “Termination by the Authority for Breach of the Refinancing Provisions” in order to introduce reference to the above:**

**21.6.1 Termination by the Authority for Breach of the Refinancing Provisions**

- (a) If the Contractor wilfully breaches Clause 34.1 (Refinancing) or Clause 34.9 (Authority right to request refinancing) then the Authority may terminate the Contract at any time on or before its Expiry Date by complying with its obligations under paragraphs (b) to (d) below.