

Guidance Note: Calculation of the Authority's Share of a Refinancing Gain

1.1 INTRODUCTION

1.1.1 Clause 34.6 of the model clauses on Refinancing set out in Section 34.8 of Standardisation of PFI Contracts Version 4 ("SoPC4") provides that:

"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...). 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)."

1.1.2 This Guidance Note is therefore intended to assist Authorities and their financial advisers in negotiating and agreeing the calculation of the Refinancing Gain, if and when this occurs, and the way in which the Authority's share of the Refinancing Gain is paid.

1.1.3 A series of inter-related steps have to be carried out for this purpose, as discussed in detail in this Guidance Note; a possible timetable for this procedure is set out in Annex I.

1.1.4 Please note that HMT issued an application note dated 9 February 2005 entitled "Value for Money in Refinancing" which can be viewed on the HMT web site.

1.1.5 Capitalised terms used in this Guidance Note are as defined in SoPC4.

1.2 REQUIRED DATA AND PROJECTIONS

1.2.1 In order to carry out the various calculations, the following information and data are needed from the Contractor:

- The base case financial model with projections which were originally used to calculate the Unitary Charge, adjusted for any changes in the project structure and funding (e.g. Authority changes in Service) which have taken place since Financial Close;
- Details of the actual timing and amounts of the investment of equity and shareholder subordinated debt from Financial Close to date (and estimated to the Refinancing date);¹
- Information on the actual cash flow of the Contractor from Financial Close to date (and estimated to the Refinancing date), set out under the same headings as the base case financial model;
- Details of the actual timing and amounts of Distributions to Relevant Persons from Financial Close to date (and estimated to the Refinancing date);
- A pre-refinancing financial model with projections for the cash flow of the Contractor from the estimated Refinancing date to the end of the Contract, including projected Distributions,² before taking the refinancing into account;

¹ These figures should be on the basis of cash investments, not commitments.

² Unless there is some clear reason to the contrary, the assumption should be made that all surplus cash flow is paid out not less than 6-monthly as Distributions, to avoid under-estimation of the Equity IRR.

- Term sheet or other relevant information on the terms of the Refinancing;
- A post-refinancing financial model with projections for the cash flow of the Contractor from the estimated Refinancing date to the end of the Contract, including projected Distributions, after taking the Refinancing into account;
- A calculation of the Refinancing Gain based on the above; and
- Information on the assumptions for the projections in the pre- and post-refinancing financial models.

1.2.2 If a Contractor believes that a proposed Refinancing is not a Qualifying Refinancing but there are grounds for doubt on this, the Contractor should seek confirmation from the Authority that it is not a Qualifying Refinancing prior to proceeding, in case this assessment subsequently proves mistaken.

1.3 CALCULATING THE REFINANCING GAIN

1.3.1 Two calculations have to be carried out—before and after the Refinancing is taken into account—covering the period from the Refinancing date to the end of the Contract term. The two new financial models required for this purpose (which form part of the information package set out in Section 1.2 above) are referred to herein as the pre-refinancing and post-refinancing models.

1.3.2 Apart from the effect of the Refinancing itself, all other assumptions and formulæ used in these two models should be identical.³ The original base case financial model—as updated for any changes in the Project since then (such as Authority Changes or Changes in Law)—can be used, with appropriate structural adaptation,⁴ for this purpose. However the assumptions in the new projections should be updated from the base case, based on the actual performance of the project to date, and macroeconomic assumptions such as inflation⁵ and interest rates will also need to be updated.⁶

1.3.3 The Refinancing Gain is then calculated as:

- The Net Present Value (NPV) of the Distributions shown in the post-refinancing model⁷
- minus*
- The NPV of the Distributions shown in the pre-refinancing model

³ The Authority and its financial advisers should review the assumptions carefully to ensure that projected Distributions are not being reduced or slowed down unnecessarily.

⁴ As the calculation only covers the cash flow from the date of the Refinancing, historical figures are irrelevant for this calculation; however they are needed to check that the Threshold Equity IRR has been exceeded.

⁵ It is usually preferable to use nominal figures (i.e. including projected inflation) rather than real figures (i.e. ignoring inflation) for these projections, as there are likely to be items in the projections such as debt service, tax depreciation, etc. which are not affected by inflation.

⁶ One simple way of doing this is to use the same assumptions as the lenders providing the refinanced Senior Debt; however care should be taken to ensure that these assumptions are not unduly conservative, and therefore show an unduly low rate of Distributions.

⁷ Typical patterns of changes in Distributions are:

- a single increased Distribution immediately after the Refinancing, because additional Senior Debt has been raised which is used to prepay shareholder subordinated debt, followed by decreases in Distributions as more cash flow is required to service the higher level of Senior Debt;
- a series of increased Distributions in the early years after the Refinancing because debt repayments have been delayed by lengthening the term of the Senior Debt, followed by later decreases in Distributions as more cash flow is required to service the higher level of Senior Debt outstanding;
- a series of increased Distributions because the Senior Debt interest rate is reduced;

(Obviously several of these effects may be combined together in a single Refinancing).

1.3.4 The calculations of Distributions in the financial models should be consistent with the definition in the Contract—*i.e.* including not just dividends or junior debt service, but also any other element falling into the definition of Distributions.

1.3.5 The NPV calculation is carried out on the cash flows each period⁸ from the Refinancing date to the final date of the Contract, which are then discounted at the Threshold Equity IRR⁹ to produce the NPV.¹⁰

1.3.6 The difference between the NPV of the pre- and post-Refinancing cash flows is the Refinancing Gain, subject to any deduction needed to meet the Threshold Equity IRR.

1.4 COMPARING AGAINST THE THRESHOLD EQUITY IRR

1.4.1 The Authority is only entitled to share in the Refinancing Gain if the Contractor is projected to achieve the original base case Equity IRR—the Threshold Equity IRR—before taking the Refinancing Gain into account.

1.4.2 To calculate whether this hurdle has been crossed, an updated Equity IRR projection (the Pre-Refinancing Equity IRR) should be calculated for the whole life of the Project, taking into account:

- Timing and amounts of the original investments of equity and shareholder subordinated debt;
- Distributions received by Relevant Persons up to the Refinancing date;
- Projected Distributions as shown in the pre-refinancing model.

1.4.3 If the Pre-Refinancing Equity IRR is greater than the Threshold Equity IRR, the Authority is entitled to its 50% share of the Refinancing Gain.

1.4.4 If this is not the case a calculation should be carried out to find the notional amount which, if received by investors as at the Refinancing date, would increase the Pre-Refinancing Equity IRR to the Threshold Equity IRR. This should be deducted from the Refinancing Gain; the Authority is then entitled to receive its 50% share of any remaining balance of the Refinancing Gain.

1.4.5 Payment of any such notional “catch-up” sum should be deducted from the increases in future projected Distributions before allowing for payment of the Authority’s share as set out in Section 1.5.

1.5 PAYMENT OF THE AUTHORITY’S SHARE

1.5.1 An Authority may opt to take its share of the Refinancing Gain either as a cash lump sum at the time of the Refinancing and/or by a reduced Unitary Charge. Alternatively, an Authority may opt, having discussed the matter with its sponsoring department or Private

⁸ Usually six-monthly.

⁹ *i.e.* the base case post-tax nominal equity IRR (cf. Section 34.5.2 of SoPC4).

¹⁰ It might be thought that, rather than discounting the two Distributions streams to their respective NPVs and then calculating the difference, it would be simpler just to divide the differences as they occur, and pay half to the Contractor and half to the Authority. However, as discussed in footnote 7, refinancings may, *e.g.*, produce an initial positive cash gain, followed by decreases in Distributions. In such cases if this simple division method were used, it would mean that the Authority would receive an initial cash sum significantly larger than 50% of the Refinancing Gain, and then have to make increased Unitary Charge payments in future. In effect the Authority would be borrowing surplus cash from the investors and paying it back—at the Contractor’s cost of debt—through the higher Unitary Charges, which is clearly inappropriate.

Finance Unit, to receive its share of a Refinancing Gain through an increased scope of services.¹¹

1.5.2 As discussed above, the Refinancing Gain is not necessarily an amount of cash which is available immediately after the Refinancing, and the Authority should not expect to get its share any faster than the investors in the Contractor. This means that no more than 50% of each projected increase in Distributions¹² should be paid to the Authority, which therefore determines the maximum speed with which the Authority's share of the Refinancing Gain can be paid.

(a) Lump-sum option

If the Refinancing involves raising a significant amount of new Senior Debt, and thus prepayment of shareholder subordinated debt, this is likely to lead to a large initial Distribution equal to the amount of new debt which is being raised, followed by reduced Distributions for the remaining term of the Contract caused by the increase in Senior Debt service. In such a case the Authority may opt to take its share of the Refinancing Gain out of this first Distribution. The Authority is entitled to take up to 50% of the first Distribution as the lump-sum payment.

If payment of the Authority's share cannot be fully satisfied out its share of up to 50% of the first Distribution, payment of the balance should be made by reductions in the Unitary Charge, as otherwise the Authority would be taking a long-term credit risk on the performance of the Contractor.

(b) Unitary Charge reduction option

If new debt is not being raised, the benefit of the Refinancing—e.g. from an extension of the debt maturity or a reduction in the interest rate—generally accrues over a longer period and it is generally more appropriate to take out the Authority's share of the Refinancing Gain over the remaining term of the Contract as a reduction in the Unitary Charge.¹³

If payment is not being made out of the first Distribution as discussed in (a), under most circumstances a reduction to the Unitary Charge spread evenly over the remaining term of the Contract is the most straightforward approach, although a faster reduction schedule could be agreed, within the limit of 50% of projected Distribution increases set out above. The requirements of the Refinancing itself—e.g. for debt cover ratios—should also be taken into account in considering the schedule of payments to the Authority.

Payment of the Refinancing Gain by way of a reduction in the Unitary Charge gives the Contractor a further tax benefit—i.e. its corporation tax bill goes down because its income goes down—which has not been taken into account in the calculations set out above. A further iterative calculation should therefore be included in the post-refinancing financial model to ensure that the calculations are performed on a post-tax basis consistent with the use of a post-tax discount rate.¹⁴

Once calculated at the time of the Refinancing, any lump-sum payment or reduction in the Unitary Charge should not be contingent on the performance of the Contractor. If this were not the case the Authority would in effect become an equity investor in the project, without any of the controls or protections which normally accrue to an equity investor.

¹¹ Subject to suitable value for money tests and the application of any relevant procurement procedures.

¹² Subject to the payment of any "catch-up" sum to meet the Threshold Equity IRR (cf. Section 1.4 above).

¹³ Cf. Section 1.5(c) below

¹⁴ Cf. Section 34.5.2 SoPC4.

The Authority is also entitled to payment of interest where its share of the Refinancing Gain is not being paid immediately after the Refinancing date. As the Refinancing Gain was calculated by discounting at the base case Equity IRR it might be thought that the same rate should be used to accrue interest on any deferred payment of the Refinancing Gain. However this does not reflect the fact that the Authority has a fixed claim for a lump-sum payment, or the Unitary Charge reduction is already committed, and therefore the Authority is less at risk than the Contractor. Therefore a lower interest rate—e.g. similar to that for Senior Debt, based on the gilt or swap rate for the average life of the period of reduction in Unitary Charges, plus x%—should be used for this purpose. This interest rate should also be included in the calculations of the reduced Unitary Charge amounts, to produce a level schedule of reductions.

(c) Whether to choose Lump Sum or Unitary Charge Reduction?

It should be noted that the Unitary Charge reduction option may be less attractive to an Authority than a lump-sum payment where a lump sum is available because:

- It will tend to produce a lower Refinancing Gain, as reductions in the Unitary Charge will reduce debt cover ratios, and hence reduce the amount of new debt that can be raised. This means that the lump sum may be more attractive even where the interest rate on Unitary Charge deferral is above the public-sector discount rate.
- The interest rate earned on deferring payment *via* a Unitary Charge reduction is lower than the discount rate used to calculate the lump sum.
- The Contractor will probably pay out to its shareholders the portion of the lump sum which would have been paid to the Authority, thus in effect allowing them to borrow this sum from the Authority and pay it back *via* lower distributions as a result of the reduced Unitary Charges.
- It leaves the Authority at risk that later cash-flow problems prevent payment of its share of the Refinancing Gain.

Balanced against this is the fact that a Unitary Charge reduction should lead to the Contractor becoming less highly geared through a refinancing than would otherwise have been the case, if the refinancing had been predicated solely on lump sum payments, where a lower gearing may be something favoured by the Authority. There may also be budgetary issues which lead to an Authority favouring a Unitary Charge reduction over a lump sum payment.

1.6 FINAL CALCULATION AND PAYMENT

1.6.1 Although Authority consent for the Refinancing must be given, and the method and basis for the calculations of the payment of the Authority's share of the Refinancing Gain must be agreed, before the Refinancing takes place, the final calculation cannot be completed until after the Refinancing because the exact amount of the Refinancing Gain will depend on factors such as the final costs of the Refinancing and the interest rates fixed on the Refinancing date.

ANNEX I – Timetable

A possible timetable for the process at the time of a Qualifying Refinancing is as follows:

Section [§]	Timing*	Action
	RD – XX BD	Contractor approaches Authority with an outline proposal for a Refinancing; the parties agree the basis on which the Authority will be compensated for its costs, including costs of advisers, if the Refinancing does not proceed. (Cost recovery where the Refinancing does proceed is dealt with in Clause 34.7 of the model provision in SoPC4).
1.2	RD – 30 BD	Contractor provides information on the Refinancing and a projection of the Refinancing Gain.
1.3	RD – 20 BD	The Authority reviews the terms for the Refinancing and agrees the way in which the Contractor's estimate of the amount of the Refinancing Gain is calculated.
1.4	RD – 20 BD	The Authority checks whether the estimated Pre-Refinancing Equity IRR exceeds the Threshold (base case) Equity IRR, and hence whether a deduction from the amount of the Refinancing Gain to achieve the Threshold Equity IRR is required before the Authority's 50% share is paid.
1.5	RD – 20 BD	The Authority decides whether its share of the Refinancing Gain should be paid in one sum immediately after the Refinancing, by reduction in the Unitary Charge over the remaining project life, or by a combination of the two.
1.5(b)	RD – 15 BD	In the latter cases, the Authority and the Contractor agree the revised Unitary Charge schedule.
	RD – 10 BD	Authority final consent to the Refinancing. (This may be subject to review of any further changes in documentation).
	RD	Financial Close for the Refinancing is achieved by the Contractor.
1.6	RD + 15 BD	Final calculation and payment of the Authority's share of the Refinancing Gain.

[§] Refers to Section numbers in the text above.

* RD = Refinancing date; BD = business days.

This timetable is inevitably no more than indicative, as the circumstances of each transaction will be different, but it is a reasonable timescale for the decisions which the Authority has to take at various stages of the refinancing process in order to ensure that the refinancing process can proceed smoothly.