



HM Treasury

PPP Policy Note: Early termination of contracts

June 2015



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1 Introduction

Some public sector contracting authorities¹ (the “Authority”) are considering options for reducing the costs of existing PFI (or PPP²) contracts, consistent with Treasury’s Operational PPP Efficiency Programme and wider objectives for managing public services within constrained budgets. As part of this, the Authority may be considering the potential for the termination of a PFI arrangement by exercising the voluntary termination provisions within the existing contractual terms.

Infrastructure UK expects the incidence of voluntary terminations of PFI arrangements to be low, due to affordability challenges and the requirement to be able to demonstrate value for money for the public sector as a whole.

The purpose of this note is to set out the budgeting, accounting and fiscal implications of a voluntary termination of a PFI contract by an Authority, as well as the review and approval process that should be followed. This note supports and expands on the addendum to DAO(Gen) 02/14³, which sets out the policy specifically related to the early termination of PFI or PPP contracts, through no fault of the supplier.

¹ Public sector contracting authorities in the context of this note include central government departments and their associated NDPBs etc., local authorities including police and fire authorities, NHS Trusts and Foundation Trusts. This is not an exhaustive list and in case of any doubt, Authorities should check with their sponsoring department.

² Throughout this document, the use of the terms “PFI” and “privately financed” refers to all forms of PPP contract.

³ <https://www.gov.uk/government/publications/dao-0214-early-termination-of-ppp-and-pfi-contracts>

2 Overview

2.1 The Government remains committed to the use of private finance to deliver public assets and infrastructure, as set out in the Government's reformed public private partnership model, PF2.¹

2.2 For existing PFI contracts, a value for money analysis will have been undertaken at the time of procurement to establish whether a PFI contract would likely yield better value for money than conventional procurement. That value for money analysis should not be revisited unless there have been fundamental changes in circumstances that affect the realisation of public value, such as contract failure, performance failure or change in service requirements.

2.3 Although the fundamental value for money decision should not be revisited as a matter of course, as part of the normal contract management arrangements, Authorities must ensure that the services delivered by the contract continue to be provided to the required standard and deliver the benefits expected. Authorities should also consider the scope for operational savings² to be made to improve value for money from existing contracts.

¹https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/205112/pf2_infrastructure_new_approach_to_public_private_partnerships_051212.pdf

² See <https://www.gov.uk/government/publications/making-savings-in-operational-pfi-contracts>

Business case and value for money quantitative assessment

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3.1 PFI contract termination is a novel, contentious and potentially repercussive transaction within the terms of Managing Public Money, for which approval must be sought by the proposing Authority from its sponsor department who must also seek the consent of Treasury.

3.2 Termination of existing PFI contracts may only be approved where changes in circumstances make it likely that a significant improvement in the delivery of public value for money will be achieved. An Authority should not begin developing a business case for any PFI termination proposal unless they have strong reason to believe that such changes in circumstances give a reasonable prospect of improving public value through the termination of the contract.

3.3 Any change in PFI contract terms is a public spending decision and as such requires careful appraisal through the development of a business case assessing the value for money of a contract change (including termination if that is proposed) compared with leaving existing contract arrangements in place. The business case must be submitted for approval to the sponsoring department which must in turn share the business case with, and seek approval from, Treasury.

3.4 The appraisal of value for money must be carried out in line with the Treasury's Green Book Guidance¹ on Appraisal and its supplementary guidance on Business Cases. Those who are engaged in developing business cases should be trained and accredited as understanding the Treasury methodology as set out on the Green Book web pages². Value for money must be assessed from the perspective of the public as a whole, rather than from the perspective of an individual Authority or department, taking into account the effect on all public services. In addition, tax paid by the contractor should be deducted from the future unitary charge payments due from the Authority in any given period. This will allow a comparison of PFI costs with alternative options involving direct in-house financing to reflect true resource costs and allow a fair comparison of economic efficiency based on a level playing field (although the whole unitary charge cost including contractor corporation tax payments is relevant from an Authority affordability perspective).

3.5 The high level principles for the quantitative value for money assessment are set out below. Authorities should also consider in their analysis any other costs relevant to the contract termination or future delivery of an equivalent service post termination if there will be a continuing need for the service or a modified service.

3.6 The quantitative value for money assessment should compare:

- the present value of future PFI unitary charge payments from the Authority to the contractor, assuming that the existing PFI contract continues to term, against

¹ See <https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government>

² <https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government/access-to-training-and-accreditation-in-best-practice-business-cases>

- the cost of contract termination plus the present value of the cost of future delivery of an equivalent or modified service.

3.7 Future PFI unitary charge payments: The value for money analysis should include all forecast costs that would be assumed to occur if there was no termination by the Authority. This could include other payments in addition to the unitary charge e.g. any pass through costs.

3.8 Contract termination cost: Each PFI project agreement will set out the costs to be included in the calculation of the compensation payment to be made by the Authority on a voluntary termination (detailed guidance³ is provided in Chapter 21 of SoPC4 and Chapter 23 of SoPF2C).

3.9 Contracted compensation will usually be an amount that would leave the contractor in the same position as if the contract had run to full term and typically comprises:

- the Base Senior Debt Termination Amount (including breakage costs under interest rate swaps for bank financed transactions, or a modified Spens payment for bond financed transactions, together with any other bond prepayment costs including bond security and trustee agents' charges and any acceleration of the outstanding premium due to monoline insurers, if applicable);
- redundancy payments for employees of the contractor that have been or will be reasonably incurred by the contractor as a direct result of termination;
- sub-contract break costs; and
- compensation for either the base case value or open market value of contractor equity and junior debt (as specified in the project agreement reflecting the contractor's original bid).

3.10 Where market value is the basis for compensation to equity holders, it is unlikely that the Authority will have entered into discussions with the contractor to determine the market value of equity at the pre-termination business case appraisal stage. The Authority will need to be able to demonstrate in its business case:

- the forecast cash flows that the contractor is likely to be facing as these could be significantly different from that shown in the financial model. In the absence of any current forecasts, then cost forecasts may need to be compiled or substantiated by an appropriate consultant e.g. a technical adviser in the case of operation and lifecycle costs;
- the market evidence for the discount rate used to estimate the market value of contractor equity.

3.11 If the underlying fixed interest rate of senior debt under the contract is materially higher than prevailing market interest rates, then breakage costs under the senior debt interest rate swaps (or modified Spens compensation to bond holders) may be significant. The Authority will require specialist advice in this area.

3.12 The assessment should take into account the method by which the termination payment is to be funded or financed by the Authority. If the termination payment is to be made from direct grant allocation or available cash budgets, then the appraisal should show the actual timing of the voluntary termination payment to the contractor. Alternatively, if the Authority intends to

³ See http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm and https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207383/infrastructure_standardisation_of_contracts_051212.PDF

raise debt to finance the compensation payment, then the quantitative assessment should take into account the future financing costs of new borrowing.

3.13 Cost of future delivery of the service: Post any termination, the Authority will be liable for the ongoing facilities and lifecycle costs of the asset. Unless the relevant service will no longer be required, the Authority should include in the quantitative assessment a forecast cost to deliver either a service level equivalent to the PFI contracted service or at a modified level if there has been a change in service requirements. As with calculating the market value of equity, this may require cost forecasts to be compiled or substantiated by an appropriate consultant e.g. a technical adviser in the case of operation and lifecycle costs.

3.14 Whereas the PFI contracted payments are non-variable (operational risk including changes in service input costs are borne by the contractor), post any contract termination any variability in future service costs will be a risk for the Authority. The quantitative assessment should include a risk premium in forecast future service costs, to reflect potential variations in these costs. As with any value for money analysis, any risk premium assumptions should be supported by clear evidence or arguments for that assumption.

3.15 Discounting: All cash flows should be discounted at the social time preference rate prescribed by the Treasury's Green Book Guidance⁴ (currently 3.5 per cent real).

3.16 Sensitivity analysis: Some future costs may be highly uncertain when the appraisal of public value for money is undertaken. The Authority should undertake a sensitivity analysis in accordance with Treasury's Green Book Guidance to determine the sensitivity of the analysis to likely variations in key variables and the switching point at which the potential termination would not represent value for money. Variables to analyse will include the private equity risk discount rate (if still subject to negotiation), interest rates (and impact on swap break costs) and future service costs.

⁴ See <https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government>

4 Budgeting, accounting and fiscal implications

4.1 Following a voluntary termination of a PFI contract, control, capital funding responsibility and risk for the property asset will rest with the public sector and the asset will be reclassified to the public sector. Accordingly, any PFI property assets that were off balance sheet for national accounts purposes would subsequently be on balance sheet. For the termination costs that are paid there will be a corresponding increase in Public Sector Net Debt and Public Sector Net Borrowing.

4.2 From a departmental budgets perspective the termination payment will be treated as a purchase of the property asset at its market value. Any amount paid over and above the market value of the asset would be recognised as a capital transfer. Grant payments should be treated as follows:

- Where a department is supporting a local authority (or other local body) termination through a one off upfront payment, the termination funding should also be recognised in departmental CDEL and future revenue funding (in respect of that contract) to the local authority should be reduced accordingly. Where a department is funding the termination of its own contract, the termination payment should be recognised in departmental CDEL;
- Where a department is supporting a local authority termination by continuing to pay PFI grant (previously PFI Credit grant) then the value of this support recognised in CDEL is the discounted value¹ of all future grant payments, to ensure equal treatment with where the support is provided through a one off capital grant; and
- Any reversionary interest in the asset that is derecognised as a result of the termination will be a benefit to non-fiscal CDEL.

4.3 In summary, there will be a one off hit to CDEL as the asset is acquired and that acquisition increases Public Sector Net Debt and Public Sector Net Borrowing, but with lower future RDEL costs.

¹ In determining the discounted value of future grant payments for budgetary purposes, the grants should be treated as a notional prepayment and so the financial asset discount rate of RPI +2.2per cent should be used. This does not affect the discount rate to be used for the value for money calculation.

5 Departmental considerations

5.1 Sponsoring departments will have a range of issues to consider when coming to a judgment as to whether to undertake a termination or to support a local authority to undertake one. However, unless the sponsoring department can demonstrate that termination delivers value for money taking into account the effect on public services as a whole, a proposed termination will not be authorised by Treasury. Sponsoring departments should take this into account particularly when considering a request for termination from a local authority. Other factors that should be taken into account in their assessment of the case for termination include, but are not restricted to:

- the affordability of the proposal to the sponsoring department;
- the opportunity cost of funding or providing financial support to a termination;
- the resources required and the ability of the terminating Authority to continue to provide the services provided under the PFI contract;
- the resources required and the ability of the terminating Authority to negotiate successfully a public value for money outcome;
- the terms and conditions of grant support payments (for a local authority PFI); and
- the relative priority of the proposed termination against any other possible termination proposal in an environment of constrained resources.

5.2 Treasury will consider the business case according to the Treasury's Green Book and business case guidance in the context of the public sector as a whole.

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www.gov.uk

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