31 Land and other property interests

31.1 INTRODUCTION

31.1.1 In the majority of PFI deals, the Authority will transfer to the Contractor, or the Contractor will procure for itself land, property or equipment as part of the Contract. During the life of the Project the Contractor manages the operation and maintenance of the relevant assets.

31.1.2 In the context of asset transfer by the Authority to the Contractor, consideration should be given to the nature of the interest that the Contractor should have in the asset during the life of the Project and, in the context of procurement of assets for the purpose of delivering the Project, consideration should be given to whether or not the Authority would be best placed to manage such procurement.

31.1.3 The Authority must (where transferring land to the Contractor at financial close) ensure that it conducts due diligence over its property rights early in the procurement process to ensure that the Project will not be jeopardised during the procurement due to a late discovery of a problem relating to the nature of the Authority's interest in the property.

31.2 LAND/PROPERTY TRANSFER

31.2.1 As part of the Authority's feasibility study for a proposed Project, and prior to preparation of the Authority's Outline Business Case, the Authority should consider:

- the extent to which it will be required to transfer assets to the Contractor (so as to allow the Contractor to carry out and perform the Service);
- its ability to transfer such assets to the Contractor[1]; and
- the extent to which the Authority requires control over, and/or access to the assets during the life of the Project.

31.2.2 If the Project will involve both the Authority and the Contractor accessing and using the asset – for example, school teachers or hospital clinicians accessing a building managed and maintained by the Contractor – then the Authority should seek advice from its legal advisers as to the best way of ensuring that the Authority's rights of use are maintained following transfer of the asset.

31.2.3 The Authority may already own the freehold to the land and property. In this case, it can transfer an interest in the land and property (freehold or long leasehold/headlease) to the Contractor, whilst at the same time securing for itself a sub-lease or licence, which allows it to access and use the land and property for the term of the Contract (but see Section 31.5).

31.2.4 If the Authority only has a leasehold interest in the land and property it is likely that the consent of the freeholder will be required before the Authority can grant any interest in the land and property to the Contractor. Typically, a sub-lease is granted in favour of the Contractor (with the consent of the freeholder), and a further sub-lease or license is granted back to the Authority by the Contractor to enable the Authority to gain access to and use the land and property.

[1] The nature of the Authority's interest in the relevant asset will dictate the extent to which, and manner in which the Authority can transfer the benefit of the relevant asset to the Contractor. Legal due diligence over the Authority's interest in the asset will highlight any restrictive covenants, conditions of transfer and /or claims over the relevant asset.

31.3 LAND/PROPERTY PURCHASE

31.3.1 In some Projects it may be necessary for a new site to be secured for the purposes of the Project. Historically, where there has not been a requirement for the Project to be operated from a certain site, Authorities have required bidders to price the cost of the land acquisition into bids with a view to making the acquisition after selection of preferred bidder. However, such an approach should not be taken on Projects where the location of the site is critical to the success of the Project for the following reasons:

- deliverability of the Project should be demonstrated at the time the Outline Business Case is prepared by the Authority. This may be best achieved if the Authority secures the site prior to, or at the time of the Outline Business Case being prepared;
- requiring bidders to commit to pricing of land acquisition prior to making the acquisition is unlikely to offer best value for money to the Authority, as bidders are likely to include a contingency in their bid to allow for difficult negotiations with the owner of the site or future variability in the purchase price. Furthermore, delay in contract award may arise if the owner of the site realises that the preferred bidder has priced its bid on the assumption that the Project will be delivered on that site, therefore giving the owner a strong negotiating position against the preferred bidder; and
- the result of competition could effectively be determined, not by the best value for money bid, but by the best property deal available.

31.3.2 Where location of the site is not critical to the success of the Project, bidders should be encouraged to offer innovative solutions in respect of land acquisition.

31.3.3 Where land and property owned by the Authority becomes surplus as a result of the Project and this is signalled by the Authority and forms part of the competition, the Authority must ensure that it receives open market value[2] from the Contractor. When surplus land and property features as an integral part of a bid, it can be difficult for the Authority to reach clear judgements about open market value. However, this does not relieve an Authority from its obligation to demonstrate that it has achieved open market value. Where the Authority cannot satisfy itself that open market value has been achieved it should consider seeking bids that remove the financial benefit of the surplus land and property.

31.3.4 The Authority needs to take care that the inter-relationship between the realisation of proceeds from the sale of surplus land and property and the facilities from which services will be delivered during the term of the Contract supports the overall objectives of the Project and also does not prejudice the Authority's position should an event of early termination arise.

31.4 CAPITAL ALLOWANCES ACT, 2001

31.4.1 The effect of Chapter 14 of the Capital Allowances Act, 2001 (the **"CAA"**) is to draw a distinction between the treatment of licences and leases for the purposes of assessing whether or not a party with any such interest in land can claim capital allowances in respect of expenditure incurred on the provision of fixtures to the relevant land and/or buildings.

[2] As defined in Government Accounting, Chapter 32.

31.4.2 For the purposes of any PFI Contract, the Contractor can currently only claim capital allowances in respect of expenditure on fixtures if it has a qualifying interest in the land to which the fixtures are attached. Whether or not the Contractor has a qualifying interest turns on the meaning of "interest in land" in Chapter 175(1) of the CAA and, very often, whether it has a licence to occupy land. The Inland Revenue considers that a licence is a "licence to occupy land" for the purposes of Chapter 175(1) of the CAA if the licence itself gives the licensee an exclusive right to occupy the land.

31.4.3 By way of example, if under a PFI Schools Contract the Authority grants the Contractor a right of access to enter the school for the purposes of providing certain services, such a right of access is unlikely to be sufficient for the Contractor to claim capital allowances under Chapter 14 of the CAA as the right will not be exclusive. The Authority will also be ensuring that the school's staff and pupils can access the site for the purposes of delivery of the education service. However, in the context of any Project, issues surrounding the Contractor's ability to claim relief under Chapter 14 of the CAA should be considered by both Parties and their respective legal and tax advisers.

31.4.4 Whether the Contractor claims capital allowances or pursues alternative taxation treatments, such as composite trader status, could have material impact on the project's economics and the level of Unitary Charge bid by bidders. Distinctions between licences and leases may well therefore be significant commercial issues affecting the financial model for the Project, as well as being technical legal points. Accordingly, the Authority and its advisers should satisfy themselves that the taxation assumptions within the bidders' financial models are realistic, consistent with the proposed contractual structures and fully anticipated within the Unitary Charge bid.

31.5 COMPOSITE TRADER

31.5.1 It has been normal in PFI projects for the SPV to hold a lease of land from, and to grant a lease back to, the public sector. Construction expenditure in the SPV should thereby be capital qualifying where appropriate for capital allowances tax relief. Under this treatment, part of the unitary charge is treated as rental income in the SPV. Typically, as much of the expenditure by the SPV is on buildings not qualifying for capital allowances, tax relief is limited.

31.5.2 Composite trade tax treatment has recently become more common in PFI projects. Under composite trade tax treatment all SPV expenditure on the project may be treated as being trading expenditure and thereby, in principle, wholly eligible for tax relief. This may give tax relief to design and construction expenditure that would not otherwise qualify.

31.5.3 The facts of each case must of course be considered, but as a general guide, in order for composite trade tax treatment to apply, the SPV must show that it has a trade of design and construction services (as well as the services it provides once the project is up and running). The SPV must have no lease in the project land (only a lesser right of access) and no rental income derived from the land as such an interest in the land would give the SPV a capital asset from which it was deriving an income and would disqualify the SPV from composite trade tax treatment.

32 ALTERNATIVES TO AND VARIANTS OF PROJECT FINANCE

32.1.1 Development of the Private Finance Initiative has relied heavily on project finance techniques. This is due principally to the following factors:

- the amount of finance required to meet the investment needs of many PFI schemes is beyond the balance sheet capacity of most of the companies bidding for these schemes;
- the opportunity that project finance presents for proportionately more senior, and so lower cost, debt to be raised to meet the investment needs of the project;
- the ability of the project finance markets to provide term finance which matches the long term service delivery horizons of many Contracts; and
- to ease affordability for the public sector and achieve strong performance incentives for the private sector, most payment mechanisms are based on unitary charges which are payable over the full period of service delivery and are linked to sustained standards of service performance – a common characteristic of project finance transactions.

32.1.2 Central to project finance are systematic and rigorous techniques for credit analysis which continue to play an important role in achieving value-for-money risk transfer to the private sector within PFI. Nevertheless many, transactions are financed from within the balance sheet resources of the contractors or through capital contributions from the public or voluntary sectors.

32.1.3 Consequently, it is important to stress that alternative approaches to project finance, such as corporate finance, may be chosen by bidders and provide equally good performance incentives and drivers of value-for-money, so long as the principles underlying this standardisation guidance are followed. Foremost amongst these is the need for private sector capital to be at risk to the long term delivery of outputs specified by the public sector in the Contract. The form in which private sector capital is deployed is, in this sense, secondary so long as risks are transferred cost-effectively. The relative contributions of equity, debt and other forms of risk capital then depend upon the nature and extent of the risks to be borne by the Contractor, and the need to create an efficient and robust capital structure. Structures which rely wholly on fixed rate capital, essentially senior and subordinated debt, or in some cases potentially only senior debt, can be consistent with achieving value for money so long as the capital is at risk to long term performance of the Contractor.

32.1.4 Corporate finance models are those in which the Contractor arranges the necessary finance to meet the capital expenditure requirements of the project from within its own balance sheet resources. In such cases, there may be no need for a special purpose vehicle, the Contractor acting in principal capacity; nor need for a Direct Agreement between Authority and financiers, finance being secured solely on the covenant strength[1] of the Contractor. The absence of third party financiers, whose capital is at risk in long term reliable service delivery by the Contractor, places additional weight on the due diligence and assessment of long term financial strength that the Authority and its advisers need to carry out on the Contractor. The recommended approach to termination payments under corporate finance structures is set out at Annex 3.

[1] Depending on the nature of the project, the Authority should require its financial adviser to give appropriate advice on the covenant strength of any bidder proposing to finance the project from its own resources.

32.1.5 If the Contractor is funding the project from its own internal resources and there is no Senior Debt being provided to the Contractor, the Authority should consider the credit strength of the Contractor and consider whether or not it should require the Contractor to provide it with a guarantee from its parent or strongest credit within its group. In some projects (e.g. those where significant capital investment is required on an ongoing basis throughout the term of the Contract) the Authority should also consider whether or not it should require the Contractor to maintain a predetermined credit rating throughout the term of the Contract.

32.1.6 Private sector risk capital, as distinct from funding, may be deployed in support of a Contractor by means of guarantees, letters of credit and insurances where such instruments enable others funding an SPV to do so without exposure to underlying project risks. Examples include: mono-line insurance policies for the benefit of bond holders; and co-financings, under which the public sector makes a capital contribution to a project but, for reasons of value for money, holds security for its contributions (such as a letter of credit) until certain conditions, such as completion tests, are met by the Contractor.

33 COMMITMENT LETTERS

33.1 INTRODUCTION

33.1.1 Since the inception of the PFI, Authorities have frequently encountered protracted negotiations during the period between appointment of preferred bidder and financial close. Historically, one of the reasons for this was that Authorities refrained from producing draft contracts until late on in the procurement process (e.g. post appointment of preferred bidder). Over time, experience has shown that the production by the Authority of draft contracts as part of the ITN documentation represents best practice. Authorities (and their respective legal advisers) are now better equipped to include draft contracts as part of the ITN documentation due to the PFI market's acceptance of the standardisation of contractual terms.

33.1.2 Accordingly, except in very limited circumstances[1], there is no reason why a bidder and its lender(s) cannot commit to draft contractual terms at the time of its Best and Final Offer (**"BAFO"**) submission or include in its BAFO submission an exhaustive list of suggested amendments to the draft contracts. To the extent that such a list is included as part of a BAFO submission, the Authority would then need to take account of the suggested amendments in its comparative analysis of the value for money of the BAFOs submitted.

33.2 ENSURING COMMITMENT

33.2.1 Notwithstanding the problems surrounding delay in publication of draft contracts, protracted negotiations have also occurred where draft contracts have been provided to bidders as part of the ITN documentation. The reasons for protracted negotiations in such circumstances can be many and varied, but the underlying principle must be that the Authority should be afforded the best possible opportunity to manage, control and deliver contract award following the appointment of the preferred bidder. Following the appointment of the preferred bidder, the Authority will be under pressure to commit to timetables for contract award that are expected (by the end user and/or the relevant Government department) to be delivered on time.

33.2.2 To address the above concerns, the Authority should seek to ensure that each BAFO submission provides sufficient information so that the Authority can evaluate the length of time that it is likely to take to achieve contract award following appointment of the preferred bidder. Accordingly, each bidder's BAFO submission should set out:

- any suggested amendments to the Contract (and any other draft contracts provided to the bidders) and the reasons why;
- representations as to how well developed the bidder's sub-contracts and finance documents are; and
- an estimate of the amount of time that the bidder (and its lender(s)) believe it will take to reach financial close following the appointment of the preferred bidder.

[1] In the context of novel and contentious projects, it may be unrealistic for Authorities to expect bidders (and their lenders) to commit to contractual terms at BAFO, but this is only likely to occur if the information provided and the time given to bidders (prior to BAFO) to conduct technical due diligence was insufficient to reasonably expect the bidders (and their lenders) to commit to contractual terms at BAFO.

33.2.3 To help shorten the timescale between preferred bidder and financial close, it is now market practice for Authorities to require a commitment from all parties to the contract terms and in particular the payment mechanism. This is achieved by the Authority providing a letter to the preferred bidder, to be countersigned by the bidder, its lenders and subcontractors in which the parties confirm their acceptance of and commitment to the draft contracts contained in the ITN documentation. The letter will also set out any outstanding issues, which remain to be agreed between the parties.[2] Appointment of the preferred bidder will be conditional upon signature of the commitment letter.[3]

33.2.4 Whilst lenders are prepared to provide such letters, they typically vary in terms of commitment and often do not give the Authority the level of comfort that it is looking for. Accordingly, the Authority should include in the ITN documentation (or BAFO documentation if the ITN documentation did not include a form of commitment letter) the form of commitment letter that it will require the preferred bidder, its lenders and subcontractors to sign. Further guidance on how to apply the principles outlined above to funding competitions may be issued in the future and may supercede some of the above. Until such time as any such further guidance is issued, this section should be adhered to.

33.3 REQUIRED APPROACH

33.3.1 The form of commitment letter to be included in ITN documentation (or BAFO documentation if the ITN documentation did not include a form of commitment letter) to be countersigned by the preferred bidder, its lenders and subcontractors is set out below:

[ON LETTERHEAD OF AUTHORITY]

[Date]

[Name and Address of Bidder]

Dear [BIDDER CONTACT]

[PROJECT HEADING]

Following our letter to you of [ ] [and our subsequent conversations] I am writing to you to set out the position which has now been agreed between us.

Subject to receiving confirmation from you and [LENDER] on the points addressed in this letter, the decision has been taken by the Authority to appoint [BIDDER] as preferred bidder.

[2] The list of outstanding issues will be based on the information provided in the preferred bidder's BAFO submission. This will include any outstanding Senior Lender issues (e.g. areas of due diligence and credit committee approval).

[3] The European Investment Bank may require the commitment letter to be in respect of the Project rather than the individual bidder.

1. The unitary payments set out within your bid are fixed by reference to your design and services proposals (subject, of course, to any significant client changes) and on the assumption that financial close occurs on or before [•]. If financial close occurs after that date then your construction price will be increased only by movements in the [(] index from [EXPECTED DATE OF FINANCIAL CLOSE] up to [•] and thereafter increased in accordance with your proposal included in [REFERENCE] of your Bid submission of [DATE]. The Authority will take the risk of any movement in [LIBOR][applicable interest rates] [relevant index] between [DATE OF BID SUBMISSION] and financial close. The benefit of any reduction in [LIBOR] [applicable interest rates] [relevant index] (including the buffer) will be passed in full to the Authority.

2. As regards the draft contract terms, we are pleased that, [subject to the points discussed below], you have confirmed your acceptance to these terms. Again, we would ask for your confirmation by way of countersignature of this letter that, subject to the one point set out below, you have accepted the draft Project Contract *[refer to version and date]* [and *[refer to other relevant project documents]*] as issued to you, so that the only issues which will require negotiation between now and contract signature are matters of detail which are project-specific and which remain to be agreed.

3. The issue(s) that remained to be agreed relate to [•][4].

4. [As regards the draft payment mechanism, we would ask you to confirm; again by counter signature of this letter, that you have accepted the current draft in its entirety [subject only to [•]]].

We should be grateful if you, [SUBCONTRACTORS] and [LENDER] would countersign this letter where indicated below to confirm your approval to the terms of this letter.

Yours sincerely

………………..

[SIGNED ON BEHALF OF AUTHORITY]

……………….. ………………..

[SIGNED ON BEHALF OF BIDDER] [SIGNED ON BEHALF OF LENDER]

………………..

[SIGNED ON BEHALF OF SUBCONTRACTOR]

[4] Clearly this clause will not be included where there are no issues on the draft contracts.

34 DUE DILIGENCE OVER SUB-CONTRACTS AND FINANCING DOCUMENTS

34.1 INTRODUCTION

34.1.1 Although the Authority should not generally seek to interfere in the management of the Contractor's affairs (in particular in relation to the Contractor's sub-contracts and finance documents) the Authority should ensure that it understands how the Contractor is seeking to deliver the Service (both in terms of sub-contractual arrangements and financing), and be comfortable that those arrangements are (on an ongoing basis) sufficient to allow the Contractor to deliver the Service. Ultimately, termination of the Contract will always be the last resort for the Authority; but such a remedy is no substitute for a thorough understanding and assessment by the Authority of how the Contractor proposes to deliver the Service to it.

34.1.2 Accordingly, the Authority (and its advisers) should conduct thorough due diligence over the sub-contracts and financing documents that the Contractor is seeking to put in place at the financial close. This is essential for several reasons, including the following:

- the amount of compensation payable to the Contractor on early termination will (except in the case of Contractor default) have reference to the amounts owed by the Contractor to its lenders under the financing documents. The Authority should therefore understand what those amounts will be and, in particular, understand how any breakage costs will be calculated[1].
- in various sections of this guidance it has been highlighted that the interests of the Authority and the Senior Lenders are typically common and that the Authority can rely on the requirements of the Senior Lenders as protection in relation to a certain risk (e.g. funding of ongoing maintenance[2]) Where this is the case, the Authority should ensure that the terms of the documents reflect its reliance;
- the Authority may be seeking to retain the right to take over the Contractor's sub-contracts in the event of termination of the Contract or, more significantly, may have the benefit of a collateral warranty from the relevant sub-contractor[3]. In such circumstances the Authority should conduct due diligence under the relevant sub-contracts to ensure that the principles agreed in the Contract are not undermined in the sub-contracts (i.e. the sub-contracts and the Contract are consistent); and
- the financing documents should reflect the terms of the Financial Model agreed at financial close. To the extent that there are discrepancies between the two, the Authority should make itself comfortable that the discrepancy is justified.

[1] See Section 20.1.3.7 (Compensation on Termination for Authority Default).
[2] See Section 8.2 (Sinking Fund).
[3] See Section 23.4 (Collateral Warranties).

34.2 FINANCING DOCUMENTS

34.2.1 The Authority should require copies of financing documents from the Preferred Bidder in advance of financial close, to allow it sufficient time to conduct its due diligence over the documents. The Authority's advisers should understand the areas to be focussed on in the due diligence process, which will include (amongst others) the following:

- **Interest rate ratchets** – it is common for the interest rate margin to reduce after the Service Commencement Date. The Authority should ensure that any reduction in margin reflects that set out in the financial model.

- **Maintenance and other reserving mechanisms** – the Authority should review the Senior Lenders' requirements in respect of the funding of the maintenance and other reserve accounts and be comfortable with the levels required. Moreover, the Authority should confirm that upon early release of reserving requirements, such release would be caught by the refinancing sharing mechanism[4].

- **Letters of Credit** – financing documents frequently allow the Contractor to withdraw the proceeds of reserve accounts and replace them with letters of credit (in a form agreed at financial close). Whilst the Authority should not object to such mechanisms in principle, it is important to ensure that the benefit of any such letters of credit are taken into account in the calculation of compensation on termination and that:

  (a) the amount capable of being claimed under the relevant letter of credit is set-off from the amount paid by the Authority to the Contractor. Without such protection, the Contractor will effectively be paid twice; and

  (b) the letter of credit does not automatically terminate on termination of the Contract. The effect of automatic termination of the letter of credit will be for the Authority to pay a higher compensation amount.

Accordingly, the Authority should require a pre-agreed form of letter of credit to be included in the financing documents if the Senior Financing Agreements contain a mechanism for replacing reserve accounts with letters of credit.

- **Breakage Costs** – the Authority must understand how any breakage costs are calculated under the financing documents. Breakage costs under interest rate hedging agreements (typically documented under the ISDA standard form agreement) should be calculated using the "Second Method and Market Quotation" formula which ensures that the breakage cost payable by the Authority is the "net" amount payable by the Contractor to the bank(s) after taking into account amounts owed by the bank(s) to the Contractor ("Second Method") and competitive ("Market Quotation").

- **Variable Interest Rates** – it is not uncommon for the interest payable under Subordinated Financing Agreements to be that which is from time to time notified by the Subordinated Lenders to the Contractor. If the compensation payable by the Authority to the Contractor on early termination cross-references amounts owed by the Contractor to the Subordinated Lenders under the Subordinated Financing Agreements, then such provisions should not be acceptable to the Authority, but rather explicitly defined in the Contract.

[4] See Section 35 (Refinancing).

34.3 SUB-CONTRACTS

34.3.1 Without prejudice to any agreement in respect of market testing of soft services, the Authority should review the Contractor's sub-contractual arrangements prior to financial close to ensure that the Contractor is providing a solution to the Authority that is reasonably likely to meet the performance requirements set out in the Contract and that the price set out in the financial model is that set out in the relevant sub-contract. As discussed above, the Contractor should be permitted to manage his delivery of the Service but best practice is for the Authority to not sign the Contract until the sub-contracts are agreed and ready for execution. In particular, the Authority should review the terms of the sub-contracts for the following:

- **Term of contract** – without prejudice to any market testing mechanism set out in the Contract, if the term of the relevant sub-contract does not reflect the period that the Service is required to be provided for under the Contract, the Authority should consider the level of protection it has in the Contract relating to controlling the identity of any sub-contractors[5].

- **Liquidated Damages** – if the Contract requires the Contractor to pay liquidated damages to the Authority for late delivery of the Service, the Authority should ensure that the Contractor is sufficiently financially robust so as to meet such obligations, taking account of terms of sub-contracts and claims of the Senior Lenders. This is essential because if the terms are materially different, the Authority could be exposed (i.e. if the Contractor is unable to claim from the sub-contractor then the Contractor will be unable to pay the Authority).

- **Collateral Warranties** – if the Authority has the benefit of collateral warranties from Sub-Contractors then it will need to ensure that it is comfortable with the terms of the relevant Sub-Contract. To the extent that the Authority is able to pursue the sub-contractor under the collateral warranty for failure to perform the sub-contract, the Authority will, by definition, only be able to pursue the sub-contractor for non-performance of the sub-contract, and not non-performance of the Contract by the Contractor. Accordingly, the Authority should consider the consequences the extent of any risks which are not passed to a sub-contractor by the Contractor and ensure that the Contractor is sufficiently financially robust so as to meet any liabilities that may occur if such risks occur.

[5] See Section 15.1 (Control over Sub-Contractors).

35 REFINANCING

35.1 INTRODUCTION

35.1.1 The key principles underlying the Government's approach to Refinancing are as follows:

- Refinancings carried out in accordance with this 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.
- A refinancing will normally constitute a material change to the financial and economic structure of a PFI project as originally agreed at Financial Close between the Authority and the Contractor. An Authority should therefore have the right to be fully informed of any refinancing, and approval rights over refinancings other than those which were part of the original Financial Close Base Case financing plan or do not lead to a gain for investors compared to the original Base Case.
- A long term contractual commitment by an Authority to purchase a service, at a pre-determined price, with contractual certainty for financiers through, for example, the operation of termination provisions, is likely to be central to the original financing of the Project and to any refinancing gain arising. The Contractor could not itself achieve such fine terms of finance, particularly as regards gearing and pricing, without such contract terms. The Authority has a natural right to share in gains which are made possible by the strength of this contractual credit.
- An increase in returns to investors in the Contractor due to improved efficiency or performance, over and above what was anticipated when the contract was let should be for the investors' account unless it falls within the scope of benchmarking, market testing, upside sharing or similar provisions of the Contract. However, improvements to loan margins, and beneficial changes to the term and leverage of any debt finance raised to fund the project are not viewed as mainly due to efficiency improvements and, consequently, any benefits that arise from such changes should be shared between the Authority and investors.
- As the PFI/PPP market matures and its stability is assured, finer terms have and should continue to become available. In the broadest sense, both the public sector and the private sector will contribute in bringing about this improvement. Through refinancings, projects are able to gain access to these finer terms as they become available and, given their joint contribution to this state of affairs, both the public sector (in this case the Authority) and the private sector (in this case investors in the Contractor) should share in the benefits arising. The Public Accounts Committee has highlighted the importance of the public sector sharing equitably in "windfall gains" associated with a PFI project. This has particular relevance to changes in available terms of finance which are often heavily influenced by factors external to the Project.

- A 50:50 sharing of refinancing gains between the Authority and the Contractor gives a reasonable balance between these factors.
- Refinancing gains should be measured by reference to the Project as it is performing at the time of refinancing, to enable the investors to benefit from improvements in efficiencies achieved by the Contractor to date and forecast to be achieved in the future; but if the Project is performing below the levels projected in the original Financial Close Base Case financial model, the investors are entitled to apply the benefits of refinancing to restore this Base Case projected performance prior to sharing with the Authority.

35.1.2 This Section takes account of the NAO report "The Refinancing of the Fazakerley PFI Prison Contract" published in June 2000, as well as subsequent recommendations of the House of Commons Public Accounts Select Committee.

35.2 WHAT IS A REFINANCING?

35.2.1 During the life of the Project, the Contractor may wish to replace, augment or change the structure, nature or terms of the financing solution that it put in place at Financial Close for the purposes of financing the Project. Where such restructurings or changes will have the effect of increasing or accelerating distributions to investors or of reducing their commitments to the Project, these effects are individually and collectively referred to as Refinancing Gains.

35.2.2 A non-exclusive list of transactions which could be undertaken by the Contractor following financial close and which could give rise to a Refinancing Gain is set out below:

- reduction in interest margins;
- reduction or release of reserve accounts;
- release of contingent junior capital;
- extension in the maturity of debt;
- increase in the amount of debt; and
- refinancings undertaken without the direct involvement of the Contractor, for example through a special purpose holding company, but which rely upon rights being granted in respect of the cash flow, assets or contracts of the Contractor.

35.2.3 Authorities should ensure that they review all finance documents prior to Financial Close and are provided with conformed copies of these at Financial Close. Authorities should further ensure that, if the Project is financed through an intermediate holding or associated company structure, the contractual restrictions on Refinancing are drafted to reflect this.

35.2.4 Refinancing is likely to be a matter for consideration by the Authority at different times during the life of a Project, notably when developing Contract terms in advance of the competition, when appraising bids submitted in response to the ITN and during the Contract period itself. The complexity of refinancings means that it is important that Authorities seek appropriate advice when considering the subject and they should consult with their

respective sponsoring Departments, Private Finance Units or HMT if there is any doubt about how the principles can best be applied in individual projects. It is also very likely that Authorities will need to seek the assistance of appropriate external advisers in respect of the financial and legal issues arising from refinancings both to ensure that this Guidance is properly reflected in project documentation and in any negotiations with the private sector on proposed refinancings.

35.3 AUTHORITY CONSENT

35.3.1 General

35.3.1.1 An Authority should have approval rights for refinancings other than those which were part of the original Financial Close Base Case financing plan or which do not lead to a gain for investors compared to the original Base Case. The latter will include refinancings undertaken to rescue a Contractor from financial difficulty – so called “rescue refinancings”.

35.3.1.2 Refinancing of PFI projects is one way in which both the Authority and investors in the Contractor can share in the benefits of a successful project. Accordingly, Authorities should be receptive to proposals from the Contractor to refinance, and are encouraged to consent to such proposals. However, when evaluating a refinancing proposed by the Contractor, an Authority should consider carefully whether the effects of such proposal could:

- increase the risk facing the Authority without conferring on it commensurate reward;
- reduce incentives for the Contractor to achieve sustained service standards, particularly in later years;
- undermine the financial stability of the Contractor, thereby endangering the provision of services.

35.3.1.3 When considering a request for consent to a refinancing the Authority should assess the Contractors’ proposals objectively. There may be occasions where, for good reasons, the Authority refuses to consent to a refinancing, despite the Contractor offering to share the gain arising in line with the principles set out above. In this situation, the Authority should be prepared to give its reasons to the Contractor for not consenting in a transparent manner. The Authority should also not unduly delay its response to any proposal.

35.3.1.4 A refusal to consent might arise, for example, where the Contractor proposes a new financing structure that the Authority perceives to be inherently much less flexible than the structure it replaces and the Authority places a high value on flexibility.

35.3.1.5 Generally, refinancings which increase the risks borne by the Authority (for instance, by replacing equity with debt) will also result in greater gains for sharing. The Authority’s consent to a refinancing should be forthcoming if its 50% share of the gain arising from the refinancing is reasonable compensation for the increased risks it is being asked to bear as a result of the new financing structure, for example through contracting with a more highly geared counter-party.

35.3.1.6 Where a proposed refinancing involves an increase in termination liabilities, Contractors will need to secure the Authority's consent both to the refinancing itself and to the change in termination liabilities as these rights are separate and distinct.[1] In practice, many Authorities are likely to consider the Contractor's proposals on both a refinancing and any changes in termination liabilities concurrently. 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.

35.3.1.7 Increases in Senior Debt arranged for a PFI project, whether through the Contractor or otherwise having security (or other rights) over and/or recourse to the assets, contracts or cash-flow of the Contractor, beyond the original capital value of the Project should not be approved by the Authority without it first seeking appropriate professional advice.

35.4 EXEMPTIONS

35.4.1 The following transactions should not be subject to Authority consent or gain sharing:

35.4.1 Junior Capital

35.4.1.1 Disposals of investments or commitments of junior capital in the Contractor which are equity or equivalent, such as shareholder subordinated debt, which in terms of rights is equity in all but name[2]. Similarly exempt, are transactions involving dividends paid on equity and debt service on shareholder subordinated debt, once such dividends and payments have left the security net of all creditors having rights in relation to the cash-flow, assets or contracts of the Contractor.

35.4.2 Base Case Refinancings

35.4.2.1 Authorities should, as always, be seeking to generate strong competition in their procurements. Since successful PFI projects are more likely to generate refinancing opportunities, the effect of this competition should be to encourage the Contractor to anticipate the gain from some refinancings within its original bid price. Such refinancings which are clearly and fully included within the original Financial Close Base Case financial model and taken into account in the calculation of the Unitary Charge should therefore be exempt from Authority consent and gain sharing up to the amount included in the Financial Close Base Case.

[1] See Section 21.3 (Certainty of Compensation Payment Amounts).

[2] It is common practice however that the Authority will have some degree of approval rights over changes in ownership of the Contractor, particularly during the construction phase of a project. These are important where the shareholder has expertise which is relevant to that phase of the project (for example, a construction company which is also associated with construction being undertaken through the Contractor). The Authority should also consider the credit worthiness of providers of shareholder subordinated debt and equity in relation to restrictions on transfers before this capital is fully paid.

35.4.2.2 To guard against the Contractor seeking to use this exemption to bypass the Refinancing Gain sharing provisions, the Authority and its advisers should conduct due diligence over the Base Case prior to financial close so as to clarify and agree any refinancing assumptions that have been demonstrably taken into account in the Unitary Charge bid at the time of BAFO, i.e. that a reasonable return on equity will only be achieved if and to the extent that these refinancings take place[3]. If an Authority receives a bid that claims to take into account future refinancings, the Authority should consult with its Department, relevant Private Finance Unit or HMT before selecting a preferred bidder.

35.4.3 Corporate Finance

35.4.3.1 Transactions originally undertaken on a strictly corporate finance basis should not be subject to the Refinancing provisions contained within this Section. The Authority (and its advisers) will need to conduct due diligence over the structure and nature of a bid being put forward on a "corporate finance" basis to satisfy itself that the funding solution being proposed is a corporate financing and not a structure designed to bypass the Refinancing provisions. Although bids should be reviewed on a case by case basis, the following represent features of a corporate financed bid:

- the bidding vehicle is a prime contractor with credible financial standing or the bidding vehicle is supported by credible guarantees from a member of its group;
- no direct agreements between the Authority and the bidder's funders;
- no assignments, acknowledgements or other documentation is given by the Authority in favour, or for the benefit of the bidder's funders;
- no reference to third party finance, or associated features such as interest rate hedges (whether equity, debt or other forms of finance) appear within the Contract, or other documents or letters entered into by the Authority;
- there is no third party creditor due diligence process;
- there is no movement in bid price once the bid is submitted following ITN for reasons of terms of finance.

35.4.3.2 This exemption from Refinancing Gain sharing applies only to the extent that such corporate finance arrangements are implemented at Financial Close, since the benefits to an Authority of a corporate finance approach (e.g. in terms of the Authority not bearing risk on terms of finance after receipt of bid) cannot be retrospectively introduced and are fundamental to the justification of this exemption. If the Contractor subsequently seeks to introduce limited recourse finance to a Project which has initially been corporate financed, it is likely that at least one of the features above will cease to apply and a renegotiation of the relevant terms of the Contract to reflect the new financial structure, financial model and allocation of benefits will be necessary at the time. The Authority should seek appropriate professional advice in such circumstances.

[3] In practical terms, a bid that includes a Unitary Charge that takes into account future refinancings will produce a higher Threshold Equity IRR than one that does not, as the equity risk is higher.

35.4.4 Interest Rate Hedging

35.4.4.1 Gains derived from fixing of interest rates for part or all of the Contract period at a lower rate than had been assumed at Financial Close, and hence used to calculate the Unitary Charge, should be exempt from Authority consent or gain sharing, subject to three conditions:

- if the Contractor wishes any interest rate hedging contracts to qualify as part of Senior Debt for the purposes of termination compensation under the Contract, these must be approved by the Authority;
- it is clear within the Contract that the Contractor bears all interest rate risks after Financial Close; and
- the Unitary Charge has been determined by reference to market interest rates for the full term of the Contract. If a Contractor elects not to hedge the interest rate on its Senior Debt over its full term from Financial Close, the interest rate at which it does partially hedge its Senior Debt will not necessarily be appropriate for determining the Unitary Charge, and Authorities must seek suitable financial advice on this matter at the time.

35.4.5 Taxation and Accounting Policies

35.4.5.1 Changes in taxation or in the Contractor's accounting policies, such as depreciation are not considered to be Refinancings[4]. However, Authorities and their advisers must take care to ensure that the tax and accounting assumptions within bids are not unduly conservative or likely to change, for example under codes of practice already announced by the professional accounting authorities, but not yet implemented or by reference to precedents already agreed with the Inland Revenue which may be applicable to the Contractor.

35.4.5.2 Whilst they are not regarded as refinancings, changes in taxation or in the Contractor's accounting policies which involve amendments to project agreements to which the Authority is a party, or otherwise require its consent under separate provisions of the Contract, will quite clearly be subject to the Authority's approval in their own right at the time and subject to the usual critical examination as to their likely impact on risk, incentives and value for money. If the Authority is any doubt about the implications of such proposed changes, they should consult their respective Departmental Private Finance Unit or HMT.

35.5 METHOD OF CALCULATING, SHARING AND PAYING BENEFITS

35.5.1 The Contract should include the provisions in Section 35.8 below which specify how the benefits of any refinancing will be determined and shared between the Authority and investors in the Contractor. These provisions do not set out the detailed basis and method of calculating the gains, as these will vary from project to project and so need to be agreed between the parties at the time of the refinancing[5].

[4] See Section 13.9 (Changes in Tax Law) for a discussion of how changes in taxation should be addressed in the Contract.

[5] See Annex 1 "Guidance Note – Calculation of the Authority's Share of a Refinancing Gain" for fuller guidance in this respect.

35.5.2 The high level principles for calculating, sharing and paying gains are set out below. It is mandatory that investors submit a bid which reflects these principles, however it may be appropriate in certain limited circumstances for the Authority to consider alternative bids as offering better value for money – for example where there is a substantial residual value or demand risk (e.g. tram projects), or where there is substantial third party income. In these situations the Authority should consider inviting bids on an alternative basis but should always ensure that a bid is also received on the basis of the provisions set out in this guidance. In such cases the Authority should always ensure that it evaluates both bids.

35.5.1 Calculation

35.5.1.1 The Refinancing Gain is derived from the changes in Distributions projected to take place after the refinancing, by comparison with the position immediately before the refinancing.

35.5.1.2 These changes can be both positive and negative. If, for example, the Contractor raises additional amounts of debt, the additional debt will probably be paid out as an immediate Distribution (e.g. to prepay amounts outstanding under Subordinated Financing Agreements), and hence will be an increase compared to the pre-refinancing position. Thereafter, however, as the amount of debt has increased, debt service payments will also be greater and hence future Distributions will be lower than the pre-refinancing position.

35.5.1.3 These positive and negative changes in the Distributions should be discounted to their net present value at the refinancing date: the result of this calculation is the Refinancing Gain.

35.5.1.4 Thus the Refinancing Gain is not necessarily an actual cash sum as at the refinancing date, and the payment of the Authority's share has to take this into account.

35.5.1.5 Insofar as payment of the Authority's share of the Refinancing Gain is tax-deductible, the benefit of this to the Contractor should be taken into account in the calculation.

35.5.2 Discount Rate

35.5.2.1 The discount rate to be used in the calculation set out in 35.5.1 is the original base case equity internal rate of return (IRR),[6] since:

This is the Threshold Equity IRR used for sharing the Refinancing Gain (cf. Section 35.5.3);

if the investors did not undertake the Refinancing, this is the rate they would be earning from capital invested in the project, so the benefit of refinancing should be evaluated against that benchmark; and

it is the effect of the Refinancing on equity returns which is being measured.

35.5.2.2 It is not appropriate to use alternative discount rates such as:

the Equity IRR expected by investors in the project at the time of refinancing;

[6] This should be the "blended" equity IRR – i.e. including both share capital and shareholder subordinated debt. If projects are calculated on a nominal basis then the IRR used should also be a nominal rate. The IRR used should be on the post-tax basis (cf. Annex 2 "Guidance Note on the Use of IRRs in PFI Contracts").

the Project IRR;

Senior Debt interest rate.

35.5.2.3 The equity IRR which an investor in the project at the time of the refinancing would expect (i.e. the then current market for investment returns) should not be used because it is not feasible to find an objective way of determining this rate in advance, and would provide opportunities to construct a rate at the time which is unduly favourable to one party or the other.

35.5.2.4 The project IRR should not be used because the purpose of the discount calculation is to look at the effect of changes in the debt structure or terms, which were not considered in the original project IRR calculation.

35.5.2.5 Similarly, using the debt interest rate as a discount rate is also inappropriate, because in many cases this would lead to an artificial reduction of the Refinancing Gain to zero.[7]

35.5.3 Sharing

35.5.3.1 The Refinancing Gain should be shared 50:50 between the Authority and the Contractor. But 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.

35.5.3.2 In consequence, the original Base Case investor rate of return is of key significance to the Authority which, during the course of its due diligence, must satisfy itself of the reasonableness of this figure as the key threshold above which Refinancing Gain sharing applies. This may be a critical issue if competition has been weak, such that either the Base Case return is higher than can be justified or, conversely, the return is artificially depressed by the use of overly conservative assumptions (for example in relation to accounting policies, changes to which are exempt from gain sharing (see Section 35.4.5 above)).

35.5.4 Payment

35.5.4.1 The Authority's share should be taken either as:

(i) a cash sum at the time of Refinancing; and/or

(ii) by a reduced Unitary Charge.

35.5.4.2 In determining the appropriate form of Refinancing Gain sharing, the Authority should take note of the form and timing of Refinancing Gain obtained by the investors (i.e. if investors receive their return through prepayment of subordinated debt, the Authority should (other than in exceptional circumstances and cleared by the Authority's sponsoring Department or Private Finance Unit) also receive its share of Refinancing Gain through an initial cash sum).

35.5.4.3 Often, Refinancing Gains will be both immediate (e.g. by release of a reserve which can then be paid out as a Distribution) and long-term (e.g. by increasing the debt repayment period or reducing interest margins). In these cases, a mixture of cash lump sum and reduced Unitary Charge may be appropriate.

[7] Because the NPV of a series of future debt interest and principal payments, discounted at the debt interest rate, and deducting the original debt amount, is zero.

35.5.4.4 An Authority may elect (having discussed with its sponsoring Department or PFU) to receive its share of a Refinancing Gain through increased scope of services, subject to suitable value for money tests and the application of any relevant procurement procedures.

35.5.4.5 Where the Authority's share of Refinancing Gains is to be paid by way of a reduced Unitary Charge, the reduction in Unitary Charge should not be at risk to project performance even though the investors' share, which may well be projected to come through future dividend distributions, will be at risk.

35.6 AUDIT RIGHTS AND TRANSACTION COSTS

35.6.1 The Authority will need to ensure it has the right of access at any time (either before or after the Refinancing) to audit the financial model used by the private sector for the Refinancing and calculation of the Refinancing Gain, the underlying assumptions for the data and projections used in the model and to review documentation resulting from the refinancing, whether or not a refinancing appears to be subject to Authority consent and gain sharing.

35.6.2 These rights are important to enable the Authority to confirm whether the Refinancing is subject to its consent, to verify any calculations in respect of the sharing of Refinancing Gains, and to assess the impact (if any) of the refinancing on the Authority's termination liabilities and other considerations highlighted above, including any adverse impact on the private sector's incentive to sustain service standards throughout the term of the Contract, particularly in later years.

35.6.3 The Authority should be reimbursed by the Contractor for its reasonable costs of engaging suitable advisers to review refinancing proposals and to support the Authority in connection with implementing an agreed refinancing. The Refinancing Gain available for sharing will be calculated after deducting the reasonable third party costs incurred by the Contractor and the Authority in connection with the transaction.

35.7 JOINT VENTURE PFI PROJECTS

35.7.1 In some PFI projects, the Authority may elect to take equity in the Contractor by way of a shareholding and/or as a provider of subordinated debt. In the context of refinancing, the Authority has interests in the Project both as an investor in the Contractor and as counterparty to the Contract. Accordingly, the Authority will potentially take the benefit of any Refinancing Gain in both capacities, through a payment to it as Authority under the Contract and by way of an increase in Distributions to investors.

35.8 MODEL REFINANCING PROVISIONS

35.8.1 Required drafting (including definitions) is as follows:

35 Refinancing

35.1 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.[8]

[8] The Authority may terminate the Contract for a wilful breach of this clause. 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 20.5 (Termination on Corrupt Gifts or Fraud). See Section 20.6 (Termination for Breach of the Refinancing Provisions).

35.2 The Authority shall be entitled to receive a 50 per cent share of any Refinancing Gain arising from a Qualifying Refinancing.

35.3 The Authority shall not withhold or delay its consent to a Qualifying Refinancing to obtain a greater than 50 per cent share of the Refinancing Gain.[9]

35.4 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).

35.5 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[10] made on or about the date of the Refinancing;

(b) a reduction in the Unitary Charge over the remaining term of the Contract; or

(c) a combination of any of the above.

35.6 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 35.5 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 27 (Dispute Resolution)[11].

35.7 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.

"Distribution"

means:

(a) whether in cash or in kind, any:

(i) dividend or other distribution in respect of share capital;

(ii) reduction of capital, redemption or purchase of shares or any other reorganisation or variation to share capital;

(iii) payments under the Subordinated Financing Agreements (whether of principal, interest, breakage costs or otherwise);

[9] Please see Section 21.3 (Changes to Financing Agreements) in relation to requests made to the Authority for increases in its termination liabilities.

[10] 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 into account for the purposes of paragraph (a).

[11] Any dispute should be determined under the fast-track dispute resolution process (see Section 27.2.3).

(iv) payment, loan, contractual arrangement or transfer of assets or rights to the extent (in each case) it was put in place after Financial Close and was neither in the ordinary course of business nor on reasonable commercial terms;

(v) the receipt of any other benefit which is not received in the ordinary course of business and on reasonable commercial terms, or

(b) the early release of any Contingent Funding Liabilities, the amount of such release being deemed to be a gain for the purposes of any calculation of Refinancing Gain;

"EEA"

means from time to time the European Economic Area as created by The Agreement on the European Economic Area 1992 or any successor or replacement body, association, entity or organisation which has assumed either or both the function and responsibilities of the European Economic Area;

"Equity IRR"

means the projected blended rate of return to the Relevant Persons over the full term of the Contract, having regard to Distributions made and projected to be made.

"Exempt Refinancing"[12]

means:

(a) any Refinancing that was fully taken into account in the calculation of the Unitary Charge[13];

(b) a change in taxation or change in accounting treatment;

(c) the exercise of rights, waivers, consents and similar actions which relate to day to day administrative and supervisory matters, and which are in respect of:

(i) breach of representations and warranties or undertakings;

(ii) movement of monies between the Project Accounts in accordance with the terms of the Senior Financing Agreements as at Financial Close;

(iii) late or non-provision of information, consents or licences;

(iv) amendments to Sub-Contracts;

(v) approval of revised technical and economic assumptions for financial model runs (to the extent required for forecasts under the Financing Agreements);

(vi) restrictions imposed by the Senior Lenders on the dates at which the Senior Debt can be advanced to the Contractor under the Senior Financing Agreements and/or amounts released from the [Escrow Account] during the [Initial Availability Period], each as defined in the Senior Financing Agreements[14] and which are given as a result of any failure by the Contractor to ensure that the construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;

[12] To the extent a HoldCo is used, an equivalent exemption will need to be reflected in the drafting.

[13] See Section 35.4.2 above.

[14] These definitions should follow those contained in the Senior Financing Agreements – the Initial Availability Period being the construction phase drawdown period. These will need to be checked.

(vii) changes to milestones for drawdown and/or amounts released from the [Escrow Account] during the [Initial Availability Period] set out in the Senior Financing Agreements and which are given as a result of any failure by the Contractor to ensure that construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;

(viii) failure by the Contractor to obtain any consent by statutory bodies required by the Senior Financing Agreements; or

(ix) voting by the Senior Lenders and the voting arrangements between the Senior Lenders in respect of the levels of approval required by them under the Senior Financing Agreements;

(d) any amendment, variation or supplement of any agreement (other than any Subordinated Financing Agreement) approved by the Authority as part of any Qualifying Variation under this Agreement;

(e) any sale of shares in the Contractor by the shareholders or securitisation of the existing rights and/or interests attaching to shares in the Contractor;[15]

(f) any sale or transfer of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements or securitisation of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements; or[16]

(g) any Qualifying Bank Transaction.

"Financial Close"

shall have the meaning given to it in the Senior Financing Agreements.

"Insurance Undertaking"

has the meaning given in the rules from time to time of the Financial Services Authority;

"Net Present Value"

means the aggregate of the discounted values, calculated as of the estimated date of the Refinancing, of each of the relevant projected Distributions, in each case discounted using the Threshold Equity IRR;

"Pre-Refinancing Equity IRR"

means the nominal post-tax[17] Equity IRR calculated immediately prior to the Refinancing.

"Project Accounts"

means accounts referred to in and required to be established under the Senior Financing

[15] This Clause therefore means that any grant of new rights over the Contractor's assets, cashflows or contracts in conjunction with this transfer would not be exempt.

[16] See footnote 15.

[17] I.e. post-tax with respect to the Contractor, pre-tax with respect to the Shareholders in the Contractor.

Agreements

"Qualifying Bank"

means a bank that is authorised by the Financial Services Authority to accept deposits in the United Kingdom.

"Qualifying Bank Transaction"

means:

(a) the syndication by a Senior Lender, in the ordinary course of its business, of any of its rights or interests in the Senior Financing Agreements;

(b) the grant by a Senior Lender of any rights of participation, or the disposition by a Senior Lender of any of its rights or interests (other than as specified in paragraph (a) above), in respect of the Senior Financing Agreements in favour of (i) any other Senior Lender (ii) any institution which is recognised or permitted under the law of any member state of the EEA to carry on the business of a credit institution pursuant to Council Directive 2001/12/EC relating to the taking up and pursuit of the business of credit institutions or which is otherwise permitted to accept deposits in the United Kingdom or any other EEA member state (iii) a local authority or public authority (iv) a trustee of a charitable trust which has (or has had at any time during the previous two years) assets of at least £10 million (or its equivalent in any other currency at the relevant time) (v) a trustee of an occupational pension scheme or stakeholder pension scheme where the trust has (or has had at any time during the previous two years) at least 50 members and assets under management of at least £10 million (or its equivalent in any other currency at the relevant time) (vi) an EEA or Swiss Insurance Undertaking (vii) a Regulated Collective Investment Scheme (viii) any Qualifying Institution or (ix) any other institution in respect of which the prior written consent of the Authority has been given;

(c) the grant by a Senior Lender of any other form of benefit or interest in either the Senior Financing Agreements or the revenues or assets of the Contractor, whether by way of security or otherwise, in favour of (i) any other Senior Lender (ii) any institution specified in paragraphs (b)(ii) to (vii) above (iii) any Qualifying Institution or (iv) any other institution in respect of which the prior written consent of the Authority has been given.[18]

[18] Any attempt by banks to attempt to conceal refinancings behind elaborate avoidance structures will be regarded as a serious breach of these provisions and dealt with accordingly.

"Qualifying Institution"

means:

[ ][19]

"Qualifying Refinancing"

means any Refinancing that will give rise to a Refinancing Gain greater than zero that is not an Exempt Refinancing".

"Refinancing"

means:

(a) any amendment, variation, novation, supplement or replacement of any Financing Agreement (other than any Subordinated Financing Agreement);

(b) the exercise of any right, or the grant of any waiver or consent, under any Financing Agreement (other than any Subordinated Financing Agreement);

(c) the disposition of any rights or interests in, or the creation of any rights of participation in respect of, the Financing Agreements (other than the Subordinated Financing Agreements) or the creation or granting of any other form of benefit or interest in either the Financing Agreements (other than the Subordinated Financing Agreements) or the contracts, revenues or assets of the Contractor whether by way of security or otherwise; or

(d) any other arrangement put in place by the Contractor or another person which has an effect which is similar to any of (a)–(c) above or which has the effect of limiting the Contractor's ability to carry out any of (a)–(c) above.

"Refinancing Gain"

means an amount equal to the greater of zero and [(A – B) – C], where:

A = the Net Present Value of the Distributions projected immediately prior to the Refinancing (taking into account the effect of the Refinancing and using the Base Case as updated (including as to the performance of the Project) so as to be current immediately prior to the Refinancing) to be made to each Relevant Person over the remaining term of the Contract following the Refinancing;

[19] If there are particular institutions which for particular reasons do not come within the other heads of Qualifying Bank Transaction, bidders may propose to the Authority that such institutions be included as Qualifying Institutions. In the light of the broad drafting of the other provisions in the definition of Qualifying Bank Transaction, the Authority would expect any such proposal to be specific and limited. Broad group definitions will not be entertained. For a listed bond transaction, however, the following may be inserted:

"(a) any holder in due course of any security arising under or constituted by the Senior Financing Agreements in respect of which an application has been made for such security to be admitted to listing, either:
  (i) on the Official List of the Financial Services Authority in its capacity as competent authority for the purposes of Part IV of the Financial Services and Markets Act 2000 (and to trading on the London Stock Exchange); or
  (ii) to the competent authority in any other EEA state; or
(b) in a situation where any security arising under or constituted by the Senior Financing Agreements is no longer admitted to listing as described in paragraph (a) above, any person whose ordinary activities involve them in acquiring, holding or disposing of investments (as principal or agent) for the purposes of their business where the acquisition of the rights of a Senior Lender in the Senior Financing Agreements takes place in accordance with all applicable securities legislation other than where such acquisition, grant or disposition is made in concert with the Shareholders and/or the Subordinated Lenders for the purpose of giving rise to a Refinancing Gain; or
(c) a trustee for any other entity listed in paragraph (b)(ii) to (viii) or (c)(ii) or (iii) of the definition of Qualifying Bank Transaction other than a trustee whose acquisition, grant or disposition is made in concert with the Shareholders and/or the Subordinated Lenders for the purpose of giving rise to a Refinancing Gain."

B = the Net Present Value of the Distributions projected immediately prior to the Refinancing (but without taking into account the effect of the Refinancing and using the Base Case as updated (including as to the performance of the Project) so as to be current immediately prior to the Refinancing) to be made to each Relevant Person over the remaining term of the Contract following the Refinancing; and

C = any adjustment required to raise the Pre-Refinancing Equity IRR to the Threshold Equity IRR.

"Regulated Collective Investment Scheme"

has the meaning given in the rules from time to time of the Financial Services Authority;

"Relevant Person"

means a Shareholder and any of its Affiliates.

"Shareholder"

means any person from time to time holding share capital in the Contractor or [HoldCo[20]].

"Threshold Equity IRR"

means [•]%[21].

[20] This definition should include any intermediate special purpose company between the Contractor and the investors in the Project. If the Contractor is a partnership or other legal entity, the definition should be revised so as to include all equity investors such as the General Partner and Limited Partner in the case of a Limited Liability Partnership.

[21] This is the nominal post-tax (i.e. post tax with respect to the Contractor, pre-tax with respect to the shareholders in the Contractor). Equity IRR set out in the Base Case, which excludes the effects of any anticipated refinancing.