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The Limits of Market-Based Governance and Accountability - PFI Refinancing and the Resurgence of the Regulatory State

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Abstract

The refinancing of PFI (Private Finance Initiative) projects currently represents one of the most contentious aspects of Public Private Partnership in the UK. The negative publicity associated with UK PFI refinancing deals is associated with two main factors, namely evidence of massive private sector profit making in connection with past refinancing deals, and the 'failure' of private sector financiers to share refinancing profits with public sector organisations in line with government recommendations. This paper examines the ongoing 'dance of non-regulation' associated with PFI refinancing on the basis of traditional Marxist notions of 'contradictions of capitalism'. Our analysis commences with the argument that PFI represents a prototypical case of an alliance between finance capital and the state, which has been created with the principal purpose of establishing a new source of profits for the private sector. A Marxist analysis of state-business relationships would predict such an alliance to show tendencies towards instability which could arise from a number of factors. These include, among others, the inherent lack of legitimacy of such an alliance vis a vis established policy goals and the stakeholders associated with them; a lack of a credible regulatory framework which, as a systemic prerequisite of private sector profit making, further exacerbates existing problems of legitimation; and, perhaps most importantly, the potentially self-defeating attempt by capital to

maximise gains from the exploitation of the existing alliance without concern for the possibility of a political or regulatory backlash. Examining the recent history of PFI refinancing we find evidence of most of these destabilising tendencies which we expect to trigger calls for a greater regulation of PFI projects in the future.

Introduction

The establishment of PFI as a form of infrastructure financing is closely linked to the emergence of neo-liberal policy agendas in the early 1980s; albeit that PFI based procurement in the UK itself has only taken on significant proportions in the late 1990s. Accordingly, several researchers have argued that PFI is linked to a process whereby governments, which themselves have created fiscal pressures, adopt PFI as a means of tapping into global surplus capital (Cohn, 2004). This interpretation of a state-led financial transformation of public service provision, however, leaves much to be desired, because it fails to explain why this transformation is occurring at this late stage of neo-liberal policy making and it does not explain important features of PFI arrangements, such as the lack of financial accountability.

An alternative, and perhaps more credible, explanation for the emergence of PFI is one in which finance capital is itself seen as the driver for the creation of PFI with the state acting as facilitator and broker (Asenova and Beck, 2006). This explanation for the evolution of PFI assumes that this form of procurement emerged primarily as a response to the desire of global finance capital to balance its portfolio with lower risk/ lower return investments in relatively stable regions. Accordingly, PFI's principal function is not merely to provide infrastructure, but to act as a state-sponsored investment opportunity for surplus capital. As a consequence both state and finance capital face several problems, investigated below, of instability, legitimation and accountability.

Examining the recent history of PFI refinancing, this paper argues that, as one of the most controversial aspects of PFI procurement, refinancing illustrates the latent tendency of business state alliances towards instability. Specifically, we argue that refinancing highlights the lack of feasibility of a market-based form of governance, in which the state abrogates part of its traditional responsibilities in order to create new profit opportunities for the private sector. Our argument proceeds in four stages. Section one develops a theoretical framework and propositions for the purposes of assessing the evidence. Section two briefly discusses the mechanics of PFI refinancing. Section three analyses the contradictory attitudes of the UK government toward refinancing. Section four examines the tendency of private financiers to maximize profits from refinancing despite government appeals for moderation. Section five discusses two case studies of PFI refinancing which illustrate the dominance of private sector interests in these transactions. Section six concludes by examining the possibility of greater PFI regulation in the UK.

The theory of finance capital and the Private Finance Initiative

According to Kolko (1963, p.3) corporate behaviour towards the political sector is conditioned by a demand for economic 'rationalisation', which creates long run opportunities for stable profit making. Miliband's (1969) analysis of imperfect competition and monopoly regulation, for instance, notes that much regulation designed for this purpose, both in the UK and US, was not conducted in an adversarial context, but had rather developed into loose alliance monopoly capitalists and monopoly regulators. What is interesting in Miliband's analysis, however, is not so much the suggestion that business regulation tends to serve business, but rather the notion that, like capitalism itself, such alliances tend to suffer from contradictions which manifest themselves in the form of several sources of instability. Specifically, the stability and profitability imperatives are impeded by the dynamic instability of the social structure of accumulation, global surplus capital and the related imposition of hard capital rationing on government expenditure. Each of these instabilities explains the origins and character of privatisation programmes in general, and the experience of the public finance initiative in Britain in particular. Each, discussed in turn below, leads to research propositions concerning the experience of PFI.

The social structure of accumulation (Gordon et al 1982) is explained in terms of phases of exploration, growth and decay. It is during the decay-exploration phase that firms lobby governments most heavily and, where successful, increase the prominence of the state but reduce its autonomy, so that lobbyists are able to access the bureaucratic elements of the state rather than work through its political institutions

(Prechel, 2000, pp.173-74). The consequence of these interactions is that, in the first phase, corporations are able successfully to exploit knowledge asymmetries associated with commercial practice at the expense of bureaucrats trained in state planning functions. In the subsequent phase the bureaucrats themselves are commercialised in their attitudes and priorities.

The invasion of the state bureaucracy by the dictates of commercialism has its most recent origins in the creation of global surplus capital. Rapid accumulation of financial capital as a ratio to GDP since the collapse of Bretton Woods in 1971, the oil price shock of 1973 and the subsequent removal of almost all significant limitations on international movements of capital threaten to depress the rate of return, unless institutional arrangements can be secured to guarantee higher rates of return. Simultaneously, the requirement for stability against a backdrop of instable international financial markets (Strange, 1998) leads to a search for low risk investments. It is precisely such investment opportunities that characterise privatisation deals in under-developed countries and elsewhere as well as the activities of large multinational corporations, whose activies are associated with high return low risk contractual arrangements and the possibility of an intense political backlash (Toms, 2006).[1] High return low risk investment opportunities are a characteristic of market failure consistent with a Ricardian model of rent appropriation, in this case at the expense of the state and ultimately the taxpayer. At the same time, contradictions associated with disequilibria in the rate of profit (Hilferding, [1910] (1981)) are deepened by the negotiation of bilaterally based contracts between corporations and the state. In the absence of a regulatory framework to protect the interests of total social capital from the actions of individual capitalist, such disequilibria create the risk of a destabilising political opposition.

[1] For example the case of the privatisation of the Bolivian water industry, in which the risk of a new dam project in Bolivia risk was transferred from the shareholders of Bechtel onto the Bolivian people via increased water charges (Palast, 2003, pp.173-81).

At the same time the prospects of such a political backlash are increased by the financially constrained position of governmental organisations. The rise of financial capitalism has imposed strict limits on levels of direct investment conducted by the state itself (Pilling, 1996). As a consequence, the infrastructure of public service provision enters the decay phase and governments face political pressure to respond to investment requirements under conditions of capital rationing. It would be expected that under such conditions, the cost of capital to the borrower increases, thereby creating a problem of legitimation for the state, which has the opportunity to use its own resources and raise money at a cheaper risk free rate, and for the corporate investor, which stands to be accused of profiteering. In the former case, the state can mitigate legitimacy problems by using the taxation and public finance system to prevent increased financing charges impacting on the direct cost of services at the point of use. Nonetheless, as a consequence it has an interest in disguising the underlying financial fundamentals of off-balance sheet deals. As far as the private sector is concerned, there are potentially very serious legitimacy problems which can be overcome only by avoiding disclosure of profits on very lucrative contracts, or by exaggerating the level of risk associated with the investment.

Summarising the above arguments in terms of PFI, specific, these sources of instability are threefold. First, problems of legitimation which result directly from the state prioritising business interests over those of the public, and in so doing externalises additional costs of private sector activity to the public (an example of this being the excessive costs of some PFI projects). Second, a lack of regulatory consistency which arises from the fact that private sector profit making in such ventures crucially depends on the absence of appropriate control and regulation (which is applied elsewhere to public sector activities). Third, the inherent tendency of the private sector to exploit the newly created profit opportunities beyond what is politically and economically feasible in the long run (thus creating the possibility of a political and/or regulatory backlash). Each of these propositions is investigated empirically below.

The Mechanics of PFI Refinancing

PFI projects are financed through a large proportion of bank debt or bonds (typically around 90% of the capital requirement) and equity finance, primarily in the form of subscription to shares in the project company. The precise financial structure of these projects is usually shaped by private sector companies and the party which acts as the project's loan arranger or financial advisor to the project company. The objective of these arrangements is to ensure such financial arrangements which will guarantee that the project's financial requirements will be met and the shareholders will receive profits. The financing costs of the PFI projects are determined by various factors such as the project's scope and scale, the economic and market conditions, the credit reputation and rating of the borrower, etc. and are closely associated with the project's risk profile.

The key risks involved in a PFI project include the risk of the project collapsing before the debt repayment and the risk of inaccurate revenue forecasts (Allen, 2001). Due to a less than obvious interplay of factors and difficulties in measuring these risks, cost evaluations associated with different methods of borrowing can be very imprecise, which is one of the factors which gives rise to the possibility of refinancing.

As a financial transaction, refinancing has become popular in the UK primarily on account of the willingness of government organizations to make it work. However, the very fact that refinancing exists paradoxically raises concerns about the nature of PFI contracts. Among other things, the large investor returns which were generated by the refinancing of some early PFI projects indicate that such basic fundamentals of PFI transactions as the pricing structure are frequently inaccurate (HM Treasury, 2007).

Today, refinancing is considered particularly suitable for projects where the construction phase has been completed and the operational phase is demonstrably successful. The risk profile of such projects is significantly less critical and revenues can be forecast more accurately. Refinancing, however, often increases the risk borne by the public sector, for example, in situations where equity is replaced by debt. This has led several observers to argue in favour of equal sharing of the financial gains.

During the recent decade it has become obvious that PFI is not necessarily the cheapest procurement option available to the government departments (Robinson, 2000). The UK government can borrow money at lower cost compared to private firms (Allen, 2001), on account of its access to the National Loans Fund (NLF)[2] which is maintained by tax contributions and is a cheap, virtually risk free, financing option. Following the introduction of the new Prudential Borrowing Framework in 2003, local authorities have been encouraged to borrow money in a more flexible way and to repay capital expenditure borrowing from their future revenue streams. Currently both forms for financing local authorities capital expenditure exists in parallel.

Apart from questions about the efficacy of PFI as a borrowing tool, the financing and refinancing aspects of PFI continue to attract a lot of controversy, mainly due to the often disproportionate refinancing gains made by the private sector companies and, by implication, damage to the public interest. Some commentators and government watchdogs have been referring to refinancing as the "unacceptable face of the capitalism" (HM Treasury, 2006; Settle, 2006). While refinancing is a common practice for long-term public sector projects, in non-PFI finance the public sector is the single beneficiary. By contrast, in the case of PFI refinancing, the main beneficiary so far has been the private sector. In other words, many PFI refinancing deals appear to have been little more than a vehicle for a direct transfer of money from the public purse to the private investors.

UK Government Attitudes towards PFI Refinancing

The refinancing of PFI projects involves a reconsidering of the project features according to which the loan was initially provided. The HM Treasury's

[2] The NLF is a government account opened in 1968 through which pass most of the government borrowing transactions and some domestic lending transactions.

Standardisation of PFI Contracts (Version 3) (2004: 254) defines refinancing as follows:

> 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 restructuring changes will have the effect of increasing or accelerating distribution to investors or of reducing their commitment to the Project, these effects are individually or collectively referred to as Refinancing Gains.

The same document provides explicit encouragement to the authorities to approve and endorse such arrangements (HM Treasury, 2004: 255):

> 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.

An earlier version of this guidance (TTF, 1999: 85-86) had gone even further in supporting refinancing by advising that "restricting the ability of the Contractors to refinance will severely limit their ability to innovate at the bid stage". These 'encouragements' have to be seen in the light of the public sector authorities' right to refuse consent for refinancing in situations where the proposed financial structure is perceived as being potentially restrictive and reducing the flexibility of existing arrangements. As many well-publicised cases indicate, this has rarely happened but it appears that given its continuing commitment to PFI, the UK government is actively seeking to prevent activities which could dampen the private sector's enthusiasm for this type of investment.

Increasing the level of senior debt is crucial for ensuring the involvement of the private sector companies in refinancing activities. Treasury guidance documents have been discouraging, but not prohibitive, of such practices (HM Treasury, 2004: 256):

> Increases in Senior Debt 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-flows 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.

The key components of refinancing can include alterations in financial parameters such as interest rates, repayment dates, margins and/or the level of senior debt, at which the loan was provided in the original contract as well as the release of contingent junior capital (TTF, 1999; HM Treasury, 2004).

Following bad publicity in relation to some earlier refinancing arrangements (Anon, 2006; Hencke, 2007; Rozenberg, 2006; Russell, 2007; Settle, 2006; Timmins, 2006, HM Treasury, 2006), the government has attempted to provide guidance on how these transactions should be structured. References to refinancing were first made in the publication 'Guidance on the Standardisation of PFI Contracts' (OGC, 1999) and subsequently revised (OGC, 2001). As a minimum, this early guidance recommends that the client's consent be gained prior to refinancing. At the same time, the guidance maintains that, even in the absence of formal provisions, the public sector should share benefits. According to the Office of Government Commerce (OGC, 2001), refinancing profits should compensate parties for risks taken during the construction phase. Therefore the benefits should be shared on equal basis between the public and the private sectors.

The requirement for equal shares (50:50) has been disputed by many private sector companies, which believed that they should receive higher proportion from the profits (e.g. 75:25) as a reflection of the actual risk distribution. It is easy to see the lack of logic in this argument. The risk of a project is embedded in its underlying cash flows, not in how those cash flows are shared between contributing classes of finance, a view shared by Marx, (1984, ch XII) and Modigliani and Miller (1958). In other words the lobbying process can be seen as an attempt to establish differential profit rates to the advantage of the private sector. It is also a process in which the private sector havs experienced considerable successes. In 2001, when an attempt was made to establish new regulations regarding the conditions for refinancing, approval by private sector parties became subject to intensive negotiations. In July 2002 the body commissioned with this task, the OGC, published for the first time its revised guidance to the public sector authorities stipulating that in all new PFI contracts the refinancing gains should be equally distributed between the public and the private sector partners (HM Treasury, 2003).

The second important outcome of these consultations was that the private sector agreed to adopt a voluntary code for sharing the gains from earlier PFI contracts (i.e. contracts signed up to 30 September 2002) which otherwise did not contain explicit arrangements regarding the refinancing. The introduction of this voluntary code was considered an important achievement in light of the fact that early PFI projects were likely to have the greatest potential for refinancing (NAO, 2006). According to this voluntary code, the public sector was entitled to no more than 30% share of the refinancing gains, which was considered "the best it [OGC] could have achieved" (HM Treasury, 2003: 7). The argument put forward for this decision reflects the government's own perception that the balance of power within the PFI scene is distributed overwhelmingly in favour of the private sector (HM Treasury, 2003: 7):

> To have sought more would have increased the risks that the private sector would not agree to the code or would seek to avoid complying with it.

Overall the UK government's approaches to the regulation of refinancing have been characterised by a continued unwillingness to recognise the failure of voluntary approaches to as well as a readiness to sacrifice public gains to private profiteers. It can be argued that this 'dance of non-regulation' is a direct reflection of the contradictions which have arisen in connection with the invasion of the state bureaucracies by the commercial interests of PFI financiers. Thus, there is an imperative for the state to benefit from the gains of PFI refinancing, yet there is also the currently more powerful imperative to allow private sector financiers to draw extraordinary profits from the venture, so as to ensure their future involvement in PFI projects. These two goals are difficult to resolve, and probably are only likely to receive a resolution when sufficient political, or fiscal, momentum is mobilised to stop the existing pattern of collusion.

The Reality of PFI Refinancing

Notwithstanding the adequacy of the 30% share, it has to be noted that, prior to the introduction of the voluntary code and the new guidance on refinancing, the private sector companies showed very little concern for the interests of the taxpayer. Table 1 shows the proportion of contracts allocated with reference to the thresholds discussed above in the periods before and after June 2000.

Table 1 about here

Despite increased voluntary regulation of refinancing deals, they continue to be, by the government's own admission, riddled with problems. One of the most important recent allegations relates to the level of disclosure of the precise scale of the refinancing benefits. Information in the press quotes Edward Leigh, Chairman of the Commons Public Accounts Committee referring to "obscene" rates of return (Timmins, 2006) as well as his concern that due to the lack of transparency and full disclosure the real profits can be "even more grotesque". Leigh warned that some contractors may have to be called to provide an explanation of controversial refinancing deals to the members of the Parliament. Some of the key PFI players that have failed to provide their refinancing figures including Balfour Beatty, Barclays Capital, Jarvis, Laing Investment, etc. Perhaps unsurprisingly, some public sector authorities have been equally reluctant to provide details on refinancing deals. For example, in November 2006, NHS Lothian refused to disclose the financial details related to the refinancing of one of its early flagship PFI projects - the Edinburgh Royal Infirmary, which has been surrounded by controvery over the recent years. In response to critics pointing out the possibility that the costs of the new deal are likely to exceed the original (already high) costs of the project, the Trust responded with vague reassurances that the deal was "commercially confidential" and will "deliver multi-million pound gains" for the local users (Settle, 2006).

The most recent Report of the Committee of Public Accounts (HM Treasury, 2007) indicates that, while the Treasury had been aware for some time of the potential problems with excessive private sector gains, it was reluctant to intervene with measures which "might affect the private sector's interest in bidding for the early PFI contracts" (HM Treasury, 2007: 7). According to a report produced by the Comptroller and Auditor General, the four projects with the highest rates of increase in their investors' internal rate of return on refinancing include the Debden Park School, the Norfolk & Norwich Hospital, the Bromley Hospital and the Darren Valley Hospital (see **Table 2**). Those, and other, examples indicate that the voluntary code has effectively failed to generate the expected benefits for the public purse (Russell, 2007).

Table 2 about here

In the absence of proper sharing arrangements, the favourable conditions introduced through the refinancing of some projects have often resulted in excessive rates of return to the shareholders, which even key government sources have described as undermining public interest and jeopardising the achievement of value for money VFM (HM Treasury, 2007; NAO 2006). Thus the NAO's most recent report specifically notes that the large refinancing gains, combined with the increased risk taken by the public sector, put to question the VFM even in cases when some sharing of the gains takes place (NAO, 2006).

Following the transfer of responsibility for the PFI policy from OGC to the Treasury in April 2003, there has been a decline of the debt refinancing activities, which is largely due to the increased emphasis on the observance of the VFM requirement. While some earlier, as well as more recent, guidance documents envisage the need for auditing of the project companies' financial models in relation to the refinancing (TTF, 1999; HM Treasury, 2003; HM Treasury, 2004), so far, there is no published evidence that such audits have been conducted and that any sanctions have been implemented.

The intricacy and complexity of the refinancing deals provide an excellent illustration of the shift in private sector liaison away from the more open political process and towards unaccountable asymmetrical bilateralism with the state bureaucracy. In itself this is sufficient for a significant transfer of additional risks to the public sector. In this context, the Committee of Public Accounts Report (HM Treasury, 2003) quotes the results of a survey conducted by the National Audit Office in 2001 revealing that alarming 21% of the public sector project teams were completely unaware of their current contractor's financial arrangements including any "improvements" of the financing arrangements as well as possible additional risks. The NAO noted that of 107 audited PFI transactions only about 25% contained profit-sharing clauses (Bowman, 2001). The failure to negotiate such clauses was explained by different factors. Firstly, it has been assumed that the public sector client was negligent, and that the advice received from the advisers to the public sector was inadequate. Secondly, it has been argued that, due to unfamiliarity and the uncertain risk profile of earlier projects, the banks would not have been willing to accept any contractual conditions including profit-sharing clauses. It has also been argued that, since the introduction of PFI in 1992, interest rates have fallen considerably and current gains could be merely reflecting that unforeseen fall (HM Treasury, 2003).

The lack of experience of the public sector has been recognized as another key factor contributing, not only to unsound commercial contracts, but also to allowing for the disproportionate private sector profits. The scale of the problem becomes apparent in the light of the fact that at present there are around 750 approved PFI projects with total costs amounting to £54.5 billion (Hencke, 2007). The lack of commercial awareness of the public sector has been highlighted in the most recent refinancing report produced by the Commons Public Accounts Committee. The first recommendation of this report identifies the lack of commercial awareness of public sector local level officials as an important problem, while the second recommendation stipulates that the Treasury should approve any refinancing deal which can result in substantial private sector gains (HM Treasury, 2007: 5). The Chairman of the Public Accounts Committee has also highlighted the problem with the public sector officials "painfully lacking commercial expertise" (Hencke, 2007: 21).

> Staff negotiating the fine print of the refinancing clauses in contracts, where the risks to the public sector can be high, must be trained so that they can are not outwitted by their commercially sophisticated private sector counterparts.

Overall, in the PFIs refinanced so far, the private sector has been the primary beneficiary to the extent that some official earlier forecasts for the potential benefits of the public had to be revised. According to the OGC's 2003 analysis, the estimated public sector gains from refinancing were between £175 and £200 million. In December 2006 these figures were revised down to around £93 million, where the latter figure includes £60 million from hospital deals with augmented, i.e. increased, transfers of risk to the public sector (HM Treasury, 2003: 8). This reduction of the actual gains is attributed partially to the possible reluctance of the private to enter into new refinancing deals, and partially to the 30% limitation introduced by the voluntary code, which does not necessarily take into account the excessive returns realized in some cases (HM Treasury, 2007).

The reduction in the actual amount of gains from refinancing and the transfer of additional risks back to the public sector represent only one side of the coin. Additional losses for the public can be accrued due to the method of payment of the public sector share. According to the existing regulation the public sector can acquire the refinancing gains in three possible ways including a) as a lump sum, b) through a reduction of the unitary charge over the life of the contract, or c) by a combination of the first two options (HM Treasury, 2003; HM Treasury, 2004; HM Treasury, 2007). While the private sector always takes its share as a lump sum, the public sector typically accepts the added uncertainty associated with long-term payments. Therefore, in case of financial difficulties experienced by the private sector contractors, which is not unlikely considering the long duration of the contacts, or in case of complete failure of private companies to honour their contractual commitments, the public sector will not only have the ultimate responsibility for the service provision, but it will also lose partially or entirely its refinancing gains. Similarly, if over time the service becomes obsolete and the project is terminated early, the public sector will be unable to materialize the expected gains. In addition, it remains uncertain whether accelerated investors gains occurring early on during the life of the contract will act as a disincentive, which will be affect the quality of the services provided to the public (NAO, 2006). There is no doubt that this whole arrangement contains a myriad of loopholes with potentially damaging consequences for the public interest.

Apart from reflecting the previously discussed fundamental contradictions of PFI as a form of commercial invasion of the state bureaucracy, the current practise of refinancing reveals another dimension of this interaction, namely, the tendency of the private sector to obfuscate its profits and the willingness of the state to collude with these actions at least in the short run. Again, there is reason to argue that such a strategy itself carries significant potential towards instability, primarily because it is unlikely, as recent events already illustrate, that excessive private sector profits can be hidden from the public gaze for any length of time.

Case Studies

The following brief case studies of refinancing deals illustrate the mechanisms by which private sector investors have multiplied their benefits by achieving increased profits for a project with a lower risk profile, while the public sector has been forced to accept higher risks and higher costs. Additionally they illustrate the contradictory attitude of government agencies who have taken a critical attitude towards these deals while failing to create an adequate regulatory framework for preventing undesirable outcomes.

Case one – the refinancing of Fazakerley Prison

One early refinancing deal which highlighted the lucrative potential of the PFI was related to the Fazakerley Prison PFI contract in Liverpool. The contract between the Prison Service and Fazakerley Prison Services Ltd (Carillon and Group 4) was signed in 1995 and included 25 years concession period. According to the report produced by NAO (NAO, 2000: para 2.1):

> The refinancing of the Fazakerly prison contract is one example of how shareholders can extract financial benefits both earlier and in greater quantity than the expected benefits originally disclosed in their consortium bid.

The project was initially financed through a loan of £92.5 million, arranged by ABN Auto and Halifax. In November 1999, following successful construction, early completion (four months ahead) and two years of operation, the prison contract was refinanced. The refinancing resulted in significant benefits to the shareholders in terms of early debt repayment and higher dividend flows (Allen, 2001). The terms of the refinancing (NAO, 2000) included i) a decreased lending loan margin[3], ii) an extension of the initial re-payment period from 19 to 22 years, iii) the arrangement of fixed rate of interests for the full period of the loan and iv) the early repayment of the subordinated debt to the shareholders.

The new financing terms inevitably increased the risk to the public sector as in certain contract terminations circumstances the Prison Service had to pay off the debt. While the original project contract did not include provisions for sharing refinancing benefits, the private sector lenders required the formal consent from the client. The consent was backed up by a recognition of the private sector's successful project management as well as being seen as an incentive for future private sector involvement in projects PFI. Post refinancing, the rate of return for the consortium increased from 12.8% to 39%, raising cash profit by 80% (NAO, 2000). In order to compensate for the increased risks associated with the refinancing, the client (the Prison Service) received £1 million from a total of £10.7 million refinancing revenue. This compensation was negotiated only after the previous lower private sector offers (for £100,000 and £300,000) had been rejected.

Notably, while this PFI contract did not require the agreement of the public sector for refinancing, it did require its consent for changes which could potentially increase the termination liabilities, i.e. the payments which the client had to make if the contract was terminated prematurely. According to the NAO, the financiers were also concerned that, if the private sector proceeded with the refinancing without the explicit agreement of the Prison Service, this could potentially jeopardize the payment of the termination liabilities (NAO, 2000).

The NAO (2000) inquiry identified a number of lessons, which could be drawn from this refinancing deal. The included:

- At the project planning stage, the client should consider the potential for refinancing gains and their right to share them.
- The refinancing profit should benefit the parties according to the degree of their risk bearing.

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[3] The loan margin was decreased from 150 basic points to 70 basic points for the initial five years, and 90 basic points for the rest of the time (Bowman 2001).

- The VFM needs to be preserved in refinancing transactions.
- The contractual terms have to stipulate under what circumstances the client's consent for refinancing should be required.
- Expert legal and financial advice should be sought, with the experts' payments being linked to the outcome of the negotiations.
- The long-term contractual relations between the parties should be maintained.

Despite its criticism of the Fazakerley deal, the NAO's analysis failed to recognise the need for an improved regulatory framework which would ensure a better articulation of the public sector's financial interests. This was particularly surprising in light of a series of government papers (Bates, 1997; Bates, 1999; Gershon, 1999) and academic studies (Asenova and Beck, 2003) which have highlighted the difficulties public sector clients encounter when negotiating complex financial arrangements.

Partly as a consequence of this lack of regulation, the press has reported a series of refinancing deals in which the private sector has been able to achieve significant windfall profits. These include the Norfolk & Norwich hospital project, with estimated windfalls to the private sector in the range of £70 million; the Dartford and Graveshend hospital, with gains around £20 million; and the Bridgent prison in South Wales, with smaller gains of £5 million (Bowman, 2001).

Case two – the refinancing of the Norfolk & Norwich hospital

This brief case study looks in more detail at the refinancing of one of the first PFI hospitals, the Norfolk & Norwich hospital. The PFI contract between the NHS Trust and the private consortia Octagon was signed in January 1998. It included the provision of the hospital buildings as well as their maintenance and facilities management over a period of 30 years. In 2003, two years after the opening of the new hospital, Octagon refinanced the project on such terms which trebled the investors' rate of return, i.e. from 19% in the initial contract to 60% (HM Treasury, 2006). The accelerated benefits achieved by Octagon became possible through 'optimised' financing arrangements which included increased borrowing by 53% (from £200 million to £306 million) as well as the replacement of the senior bank debt repayable in 2018 with bond finance repayable by 2035.

There were three main factors which resulted in improved financing terms for the private sector. These included, firstly, the reduction of the project risk following the successful completion of the construction phase, secondly, the stabilization of the PFI market, and thirdly, the fall of the commercial interest rates. A report produced by the Committee of Public Accounts (HM Treasury, 2006) highlighted the fact that, despite the two-year delay before reaching financial closure and the availability of newly emerging bond finance, the Trust had failed to request funding competition which could have reduced the costs of the finance. Despite vastly improved financing opportunities, the Trust's gains from this refinancing deal were a rather modest 29% or £34 million. Perhaps not surprisingly, a Treasury report pointed out that in this deal the private sector's profits were objectionable by any standards (HM Treasury, 2006; 4):

> The refinancing produced a balance of risks and awards between the public and private sectors which, even for an early PFI deal, is unacceptable.

When the initial contract was signed the conditions for refinancing had not been negotiated by the Trust, although all parties were aware about this possibility. This resulted in disadvantageous starting point during the subsequent refinancing negotiations. The accumulation of errors continued as the Trust failed to avoid the increase of the termination liabilities to £257 million. Considering the increase of the concession period by five years and the difficulty to predict future service needs, this failure can be very costly to the Trust in the future. The report described the Trust officials as “too readily agreeing with refinancing proposals” (HM Treasury, 2006; 5) and was highly critical of the demonstrable lack of commercial approach among the public sector officials (HM Treasury, 2006; 4):

> It is wholly inappropriate that, in the event of termination, the Trust’s liabilities could now include not just the cost of the hospital, but all the additional borrowing Octagon took on to boost investor’s returns. It is unacceptable that, in the event of termination, the Trust could be left with liabilities incurred simply to make it easier for the investors to achieve high returns.

Considering the fact that the early PFI hospital deals were generally characterized by high financing costs, the Trust should obviously not have accepted the increased termination liabilities (Rozenberg, 2007; Russell, 2007). However, it is probably inappropriate to blame the public sector alone for an outcome which was ostensibly the product of negotiation with its private sector ‘partners’.

In the case of the refinancing of this hospital, the benefits of the Trust were further undermined by the methods of payment of the refinancing benefits. While the investors took their benefits immediately, the Trust accepted a process whereby payments to them would be to spread over 35 years as a reduction of the unitary charge. If for any reason there is a decline for some hospital services and the contract is terminated early there is a strong possibility that these gains will be lost (Anon, 2006).

Overall, there is evidence that, as a result of refinancing, private sector investors have been able to multiply their benefits by getting increased profits for a project with lower risk profile, while the public sector has accepted higher risks and higher costs. While it is apparent that the government has not been happy with these outcomes, it appears to have failed to create an effective regulatory framework for preventing such outcomes, beyond guidance which advises public sector clients to include clauses regarding profit-sharing in PFI contracts, should the possibility for refinancing arise in the future. This situation is likely to result in future refinancing deals with similarly inequitable outcomes, and carries with it the potential of a political backlash, not just against the refinancing of PFI, but also against private sector involvement in infrastructure financing in general.

Conclusion

This paper has argued that the current collaboration of the UK government and private financiers around PFI has resulted in contradictory outcomes which endanger the stability of this state-business collaboration in the long run. In reviewing current practices of, and government attitudes to, PFI refinancing, we have noted that this instability has become particularly pronounced in connection with the question as to how gains from refinancing should shared between the public and private sectors.

Specifically, the issue of PFI refinancing has given rise to serious problems of legitimation, which are related to a situation where the state appears to prioritise business interests over those of the public and, in so doing, externalises the costs of private sector activity to the public. This situation has been aggravated by a lack a of regulatory consistency by the UK government itself, where, one the one hand, a preference is given to largely ineffective voluntary arrangements, while, on the other hand, public sector clients are blamed for 'undesirable' outcomes. One of the principal reasons why voluntary arrangement have proven unsatisfactory, meanwhile lies in the fact that the private sector appears to lack the foresight to curb its desire for short-term financial gain in order to ensure the sustainability of the existing collaboration.

Given the combination of private sector short-sightedness and public outrage, there is every possibility that the status quo of voluntary ‘regulation’ of PFI refinancing cannot be maintained in the in the future. Whether this will result merely in a renewed cycle of PFI regulation, or a more fundamental re-consideration as to how the private sector financing of infrastructure can be conducted in a politically and socially sustainable manner, however, is difficult to predict.

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Table 1: Proportion of the early PFI contracts with arrangements to share refinancing gains.

Contracts let:	Prior to June 2000	Year to June 2001
Contracts with at least 50% share	4%	4%
Contacts with a share of 30%	4%	23%
Contacts with a share of less than 30%	18%	27%
Total with some share of refinancing gains	**26%**	**54%**

Source: HM Treasury (2003), House of Commons, Committee of Public Accounts, PFI Refinancing Update, Twenty-second Report of Session 2002-3.

Table 2: PFI projects with high investor returns following refinancing.

	Investor rate of return prior to refinancing	Investor rate of return after refinancing	Multiple increase in investor rate of returns on refinancing
Debden Park School	15.5%	71.3%	4.6
Norfolk & Norwich Hospital	16.0%	60.0%	3.75
Bromley Hospital	27.1%	70.5%	2.6
Darren Valley Hospital	23.0%	56.0%	2.44

Source: HM Treasury (2007) House of Commons, Committee of Public Accounts, Update on PFI Debt Refinancing, Twenty-fifth Report of Session 2006-7.