FINANCIAL STATEGY & Private Finance Initiative

Risks and Money

NATALIE NORMINTON
The pricing of the risks inherent in a PFI project is actually by far and away the most complicated feature within PFI, predominantly because you don't have any history, because if you take the case of a prison, or you take the case of a hospital, you don't have twenty, twenty-five years' worth of history there that you can actually evaluate how likely it is that the activities within this kind of hospital or prison will change, and then from that be able to price that risk up front.

DAWN STEPENSON
So it was quite, it was quite a detailed process and I think it is more an art than a science. At the end of the day we demonstrated in percentage terms the PFI gave better value for money by about two or three percent, which doesn't sound a lot, but when you actually look at the millions that we spend over a thirty year period, two or three percent is actually something around fifty of sixty million pounds difference. But that's including the risk transfer and this is obviously subject to financial close and what we actually pay at the end of the day.

NICK CLARKE
As with Altcourse, the PFI route has only a marginal cost advantage, and being the only means open to them to get the hospital built, this was enough to persuade the Trust to push ahead.

HADYN COOK
Frankly, though, some of this is quite scary because we're making a thirty year, at least, commitment through private finance. Now if it was public sector capital spent on a hospital tomorrow you know you can't get it back that day after if it was a bad investment, but it almost feels more painful to be thinking you'll be paying for it in thirty years' time.

NICK CLARKE
The deal they re currently negotiating at their lawyers' offices in London looks as if it will cost the Trust fourteen million pounds a year.

HADYN COOK
It's in line with what we're spending presently on capital and other services on the three sites so, if you like, for us it's a kind of level transfer from three relatively inefficient buildings to one more compact arrangement. It's not a cheap solution by any means but the kind of complexities are, with private finance, the building will actually be properly maintained. With lots of the public sector options you tend to get behind on maintenance and that looks cheap. This way looks a bit more expensive but in some ways can be better value and, overall, I think it is a reasonable deal.

NICK CLARKE
To ensure that it is a reasonable deal the public sector needs the private sector to accept the risks it wants to transfer to them but this isn't always straightforward. The private sector only wants to accept risks it can control. For example, the Prison Service originally planned to pay the consortium chosen to run Altcourse a fee per prisoner and thus transfer what's known as volume risk, but the prison population is controlled by Government policy and crime levels, not by the consortium. As a result, the bidding consortia asked for unacceptably high compensation to accept this risk, and the idea was quickly dropped. It's the banks that exert the strongest influence on the level of risk consortia take on as they're the primary source of finance for PFI projects.

BILL ROBINSON
Generally investment projects are difficult in the sense that someone, some financier, parts with millions, tens of millions of pounds of your savings, and mine probably, in the expectation of some rather distant return, and those people want to be persuaded that there's absolutely no risk, that this is a sure-fire thing. And so you have this almost catch-22 whereby the private sector wants to be told there's no risk, and the public sector insists on being told that there is some risk, and it's the same project.

NICK CLARKE
The bank Deutsche Morgan Grenfell is an advisor and lender to a number of PFI projects. Their Project Finance Division is headed by Colin Berry.

COLIN BERRY
It's important to understand that the perspective of a bank lender in project financing is that he has exposure to certain risks and he has downside, and if all goes well he gets paid, if things go wrong he may not be paid, but he does not share in the upside that the equity providers share in so lenders get, understandably, very focused on and preoccupied with assessing risk.

NICK CLARKE
So how do PFI projects manage to satisfy both the public sector and the risk-averse financiers? To answer this we need to look at how these deals are structured financially, and in the main this has been along class project finance lines.

COLIN BERRY
From a banking perspective the thing that makes project financing different from normal corporate lending is that we are looking for the debt to be repaid only from the revenue or the proceeds of the individual project and, in that sense, we are relying partly on assets, although assets that are locked into a project have perhaps got limited value, but particularly for the future cash flow that comes out of that particular project. This is usually referred to a 'limited recourse' project financing, meaning that the banks have either none or, in any case, very limited recourse to the equity shareholders, or the other companies standing behind the project.

NICK CLARKE
At Altcourse these companies are Tarmac Plc, and Group 4. They created a holding company to build, operate and own the prison, and it is this company which has been lent ninety-five million pounds by the banks. Tarmac and Group 4 have themselves invested around four million pounds each for their fifty percent stakes. As they stand to lose all of this if the business should fail, this money acts as a form of surety, both to the banks and to the Prison Service.

CAMPBELL BOYLE
Both the parent companies have contributed equally to the equity and the amount of equity has been determined by discussion with the banks and that, in turns, rests on the transfer of risk and how much the banks are willing to carry, and how much reassurance they need from equity contributed by the parent companies.

NICK CLARKE
The financiers also need to be convinced that the holding company they're actually lending to is carrying a minimum of risk.

CAMPBELL BOYLE
It is a matter of convincing these people that when they go to the credit committees that we have thought about all the risks and that they have been packaged in the most appropriate way. The approach that we had to risks was that you should either design them out, or you should manage them out, or you should pass the risk to someone who was willing to take it, or you should insure against it. So none of the risks are left as open-ended, everything is closed off from the point of view of our owning company that we don't have any residual risks

in the owning company, because those which have not been passed on to the sub-contractors have been insured against.

NICK CLARKE
So at Altcourse the Prison Service transferred design, construction and operating risks to the holding company. The holding company then passed on the operating risk to Group 4's subsidiary, Prison and Court Services, whilst the design and build risk went to the construction arm of Tarmac, with any residual risk going to insurers. Thus emptied of risk, the holding company becomes essentially a conduit for cash flows, receiving revenue from the Prison Service, and paying it out to the operator, to the equity providers and, of course, to the banks.

COLIN BERRY
In a narrow sense of bank providing debt to a project, we look very carefully at the cash flow availability to service the debt so that the main preoccupation of banks in assessing a project is the adequacy and the certainty that cash flow will be available to service debt.

NICK CLARKE
The banks' cash flow concerns can have a significant impact on projects, and at Altcourse this cash flow is the fee from the Prison Service, which is reduced if fewer than a certain number of prison cells are available for use.

CAMPBELL BOYLE
The banks were concerned that some of the accommodation might go out of service, either through mechanical failure, or damage, and therefore the revenue stream would be prejudiced. And how we dealt with that is that we built a number of extra cells so the total number of cells available is not the number required by the Prison Service, it is in fact a number which we agreed with the bank, which is in excess of the number required in the contract, so there's a little bit of a cushion there on the revenue stream.

NICK CLARKE
The public sector, too, has to reassure the banks. They must satisfy the financiers that they can afford the project, that they have enough secure income to be able to pay the consortium's fees for the duration of these long contracts.

DAWN STEPHENSON
One of the things that we did as part of the financial analysis was we actually looked at income profile. We did a market analysis, we looked at who our main purchasers were, and where they lied within the district, how secure that income was, and actually looked at our contract structure. We at Calderdale are quite fortunate that eighty-five percent is from our main purchaser and is a cost and volume contract, which has been one of the things that the bankers have been assured about as to their risk exposure. So we did a risk analysis around that and were fairly confident, other than anything that comes out from the Government about us being merged or wiped off, that our income stream is fairly robust.