MEETING: Cabinet DATE: 09/01/2018

Title: Refinancing Hengrove Leisure Centre PFI	
Ward(s): *Hengrove & Whitchurch Park*	
Author: David Tully	**Job title: Finance Business Partner**
Cabinet lead: Cllr Craig Cheney	**Director lead: Denise Murray**
Proposal origin: *BCC Staff*	
Decision maker: Mayor **Decision forum:** *Cabinet*	
Timescales: Financial close on this proposed refinancing would take place when a decision to proceed comes into effect during January 2018.	
Purpose of Report: The Cabinet approval is sought to a refinancing of the existing Private Finance Initiative contract for the Hengrove Leisure Centre in January 2018. The council would share in the proceeds from this refinancing, estimated to be up to £2.3m as a lump sum. The refinancing cannot proceed without this agreement.	

Evidence Base:

Appendix A sets out in **Table 1** the current income and expenditure associated with managing the Hengrove Leisure Centre PFI**.** As part of the Council's budget setting for 2017/18, it was agreed that a target saving -£0.126m in a full year would be delivered through refinancing the PFI contract and sharing in the consequent financial gain with the PFI contractor.

It is a common feature of PFI contracts that they are refinanced once the construction phase is over (and, therefore, the construction risks have passed). For Hengrove PFI there is the added incentive to refinance because the contract was signed when interest rates were high in 2010. While the precise amount of the council's gain share will only be known when the financial deal is closed, the indicative total gain from the refinancing is up to £3.9m, with the council's share being £2.3m.

It is proposed that the council's share is received as a lump sum, rather than as a reduction to the monthly invoice from the contractor. There is no difference between the net present value of the benefit of a monthly reduction for the next 20 years and the indicative lump sum of £2.3m. Given the council's current financial position, however, officers believe that it is better to have cash on the balance sheet now, rather than lower costs in the future.

The refinancing is proposed to take place in January 2018 (when the decision comes into effect).

Appendix D, includes some information on the following risks and sensitivities identified by the Local Partnerships, the Council's financial advisors:

Pre-financial close

a) Impact of not proceeding with the refinancing at this stage;
b) Increase in underlying financial costs and margins;
c) Contract breach;
d) Incorrect calculation of Refinancing Gain;

Post financial close

e) Robustness of the SPV (commentary);
f) Sensitivities of changes in credit terms

Some exempt information has been included in **Appendix H** to this report on the basis that it is Information relating to the financial or business affairs of any particular person (including the authority holding that information).(Part 1 Schedule 12A of the Local Government Act 1972 as amended). This has been extracted from advice provided by Local Partnerships and it includes:

Appendix H1	**The costs of advisors and a commentary on their suitability for this work**. It is concluded that advisor costs are generally higher than might normally be the case for a PFI Refinancing, but the original plan two years ago was for Equitix (the shareholder of the SPV) to refinance 5 projects together. Such an exercise required companies with sufficient experience and standing to undertake that work. In the end, the refinancing is a stand-alone exercise. Officers challenged the level of fees, but ultimately accepted that advisors had been appointed on the basis of tendering processes or with reference to commercial benchmarks. Retendering for advisors at this late stage in the process was not practical. It is also accepted that the advisors are appropriate for their roles.
Appendix H2	**The funding terms of the refinancing deal**. This sets out the commercial funding terms offered by SMBC Bank. The gain from the refinancing deal is a combination of changing expensive loans for less expensive loans, but also changing the profile of funding requirements over the full-term of the contract. This has the effect of bringing forward the consequent gain, such that both the Council and the SPV are able to draw the financial benefit from the refinancing immediately.
Appendix H3	**Termination Liabilities.** A consequence of the refinancing is that the termination liabilities under different scenarios of the PFI contract increase. In the event that the PFI contract were terminated under different scenarios (eg voluntary decision by the Authority, contractor default, force majeure) the PFI contract specifies that the Authority would be liable for a combination of the senior debt, penalties for terminating loans and any outstanding equity in the SPV. Generally, this amount increases (eg in the event of an authority voluntary termination, without refinancing termination would be £24.2m and after termination this would rise to £30.0m). These figures reduce over time, but they are a natural feature of refinancing deals.
Appendix H4	**Considerations of the robustness of the SPV**. This provides details of the financial structure of the SPV to allow the conclusions set out in Appendix D on the risk of SPV failure.

The Refinancing Documentation listed in Appendix G is described more fully in the exempt Appendix H5 which is exempt Information on the grounds of legal professional privilege. This has been provided by CMS Cameron McKenna Nabarro Olswang LLP.

Appendix H5	**Refinancing Documentation**. This provides a commentary from the legal advisors on the purpose, key issues and status of each of the components of the Refinancing Documentation. Any issues arising from this are reflected in the comments of the Council's Legal Officers.

Cabinet Member / Officer Recommendations:

Cabinet is recommended to proceed with the refinancing of the Hengrove Leisure Centre PFI by:

a) **agreeing that the council's share of the financial gain should be received by the council as a lump sum following financial close of the refinancing;**

b) approving the terms of the following Refinancing Documents (as further defined and listed in Appendix G):

a. deed of variation of the Hengrove Leisure Centre PFI Project Agreement (the "Deed of Variation");

b. the Authority Direct Agreement;

c. certificates issued in accordance with the Local Government (Contracts) Act 1997;

d. any and all other contractual documentation which may be necessary or desirable to conclude the negotiations and achieve financial close of the refinancing of Hengrove Leisure Centre PFI;

c) in consultation with the Deputy Mayor and Cabinet member for Finance, Governance and Performance, authorising the Service Director of Finance (Chief Finance Officer and s151 officer), or Service Director: Legal and Democratic Services (Monitoring Officer), to approve, sign and issue certificates in accordance with section 3 of the Local Government (Contracts) Act 1997 in relation to the Deed of Variation and the Authority Direct Agreement and to take any such other steps in relation thereto as may be necessary or desirable; and

d) authorising the duly authorised legal officers under the council's Scheme of Delegation to:

a. affix the council's seal to the Deed of Variation and the Authority Direct Agreement; and

b. approve, sign and or execute any and all other documentation which may be necessary or desirable to conclude the negotiations and to achieve financial close of the refinancing.

Revenue Cost: £ £3.6m on-going with a potential one-off saving in the region of £2.3m.	**Source of Revenue Funding:** PFI Grant (£2.8m), General Fund Budget (£0.7m), shortfall (£0.1m) funded by PFI reserve.
Capital Cost: £ Nil	**Source of Capital Funding:** *N/A*
One off cost ☒ Ongoing cost ☐	**Saving Proposal ☐ Income generation proposal ☐**

Finance Advice:

1. This is a financial report and the main text includes the financial context and implications.

2. Officers have commissioned specialist legal advisors (CMS – Cameron McKenna) and financial advisors (Local Partnerships) to assist with preparing the advice to Members on the implications of entering into the refinancing of the Hengrove Leisure Centre PFI contract.

3. A refinancing proposal has been put forward by the contractor which would, in accordance with the refinancing mechanism in clause 37 of the PFI contract, produce a saving on the contract of £3.9m (net present value of the cash flows through to 2037, discounted at the Internal Rate of Return on the project of 12.7%). The contract specifies that the council's share of £3.9m would be £2.3m and the contractor's would be £1.6m. The council has an option of taking their £2.3m as an annual reduction of £0.184m on the contract cost for the remainder of the contract term, instead. In net present value terms, the cash flows are equivalent, so receiving the funding up front is preferred.

4. The Medium Term Financial Plan already includes a saving achieved through looking at the costs at Hengrove Leisure Centre of -£126k. The Refinancing of the PFI would deliver this saving, albeit that budgets would need to be reflected differently if the saving is received as a lump sum, rather than a reduction in annual payments.

5. This is a technically complex exercise and the council has engaged specialist legal and financial advisors to undertake due diligence and to protect the council's interests up to financial close. On the basis that the refinancing reaches financial close (i.e. the deal is done), each party's costs would be charged to the deal. Provision has been made within the costs of the refinancing for such costs to be reimbursed on financial close. If the deal does not proceed, each party would have to bear their own costs.

6. A key factor in deciding on whether to refinance or not is the impact it has on the cost the council would be required to pay if it chose to voluntarily terminate the PFI contract. At present, before refinancing, the council would have to pay £24.2m to terminate the contract and this would pay for the outstanding debt on the contract, penalties to the lenders for settling those debts early and the valuation of the equity held by the shareholders of the SPV. After refinancing, this would rise to £30.0m because the new loan would include the repayment of the original loan, the penalties for paying that loan off early, the costs of the refinancing, the gain-share for both parties, then much smaller future penalties of paying the new loan off early and the smaller valuation of the equity held by the shareholders of the SPV. Voluntary termination, however, is a major exercise in itself, which would only happen if the Department of Media Culture and Sport and the Treasury were persuaded that it was demonstrably better value for the public purse overall (i.e. not just cheaper for the council) to end the PFI contract. The contractor is generally performing well, so termination costs are currently less of an issue.

7. The financial advisors worked with the Council's accounting team to consider the Council's treatment of the PFI contract on the balance sheet and the conclusion was that the current basis of reporting would not be affected by the refinancing by the SPV.

8. The Authority has had written confirmation from the Department for Digital, Media, Culture and Sport that they do not need to sign off the refinancing because there is no effect on the payments. (Email from Heman Vyas, DDMCS to Simon Johnson, Local Partnerships 17th November 2017).

9. The precise amount of gain from the refinancing will depend on base interest rates at the time of financial close, how long it takes to reach financial close and the actual costs of advisors, compared to estimates. SMBC's funding terms offer in July 2017 has been reconfirmed. SMBC obtained its credit committee approval in early December 2017. The standard formal policy is that credit committee approval remains valid for 3 months, so the period would last until early March 2018. However, credit committee approval was sought and obtained on the understanding that all parties were working to reach financial close as soon as possible in the new year.

Finance Business Partner: David Tully

Corporate Strategy alignment: This initiative helps deliver the Medium Term Financial Plan.

Legal Considerations: The refinancing process has followed the proper process in accordance with the PFI Project Agreement. The Refinancing Documents (as defined in Appendix G) produced by the parties' advisers and the approach taken to the refinancing are typical of a transaction of this nature and do not expose the council to inappropriate contractual terms or risk. There are no legal restrictions preventing the council from entering into the Refinancing Documents.

Detailed legal advice has been provided by the council's external legal advisers CMS (Cameron McKenna Nabarro Olswang LLP) and is included in exempt **Appendix H5**. The report summarises the main legal risks and issues in relation to the refinancing and concurs with the comment above. The advice is exempt on the basis that it is Information in respect of which a claim for legal professional privilege could be maintained in legal proceedings. (Part 1 Schedule 12A of the Local Government Act 1972 as amended.)
Legal Team Leader: Richard Bakewell, Solicitor, Legal Services (20/12/2017)
City Benefits: Provision of leisure services / Improving the efficiency of contracts
Consultation Details:

DLT Sign-off	Alison Comley	16/08/2017
SLT Sign-off	Nicky Beardmore	22/08/2017
Cabinet Member sign-off	Cllr Cheney	20/12/2017
For Key Decisions - Mayor's Office sign-off[	[name]	[date]

Appendix A – Further essential background / detail on the proposal	**YES**
Appendix B – Details of consultation carried out - internal and external	**NO**
Appendix C – Summary of any engagement with scrutiny	**NO**
Appendix D – Risk assessment	**YES**
Appendix E – Equalities screening / impact assessment of proposal	**NO**
Appendix F – Eco-impact screening/ impact assessment of proposal	**NO**
Appendix G – Refinancing Documentation	**YES**
Appendix H – Exempt Information	**YES**

Appendix A

Further detailed background information on the proposal

1. Context:

1.1 Hengrove Leisure Centre PFI has been operational for 5 years. The contractor built, operates and maintains the facility and is contractually bound to continue doing so until 2037. To assist with the affordability of the contract, the council injected £4m of capital into the project at the start, which was financed through prudential borrowing and that is being repaid at £161k per year for the duration of the contract. The finances of the contract for 2017/18 are summarised in Table 1.

Table 1: Expected costs on Hengrove PFI 2017/18 and sources of funding.

Component	**Expected 2017/18 £'000**
Prudential Borrowing costs	161
Unitary Charge (Fixed element)	2,813
Unitary Charge (Indexed to RPIx)	183
Utilities (Indexed to annual tariff changes)	410
Total costs	**3,567**
Funded from	
PFI Grant	-2,786
General Fund Budget	-662
Contribution from PFI Reserve	-119
Total income	**-3,567**

1.2 The PFI reserve was £1.140m at the end of March 2017. It exists because PFI grant was payable in full before the facility was fully operational and this generated a surplus. This funding may be used to meet the costs of the PFI contract until it is spent. If all the costs were fixed, the contribution from the reserve would be sufficient to bridge the gap between costs and income for around ten years, but the contract has twenty years to run and the indexation of costs will widen that gap. The precise amount of General Fund budget to cover the costs of the contact in the long-term depends on levels of indexation. If indexation were 2.5% per year for the next twenty years, the General Fund contribution would need to increase by around £80k from its current level. That General Fund budget would then also need to be increased by the same rate of indexation (2.5% in this illustration) every year and all of the PFI reserve would have to be used to end the contract in 2037 on a break-even basis. This is not the immediate issue at hand and could be resolved once the refinancing is in place or as part of this or a future Medium Term Financial Plan.

1.3 While the contractor is generally performing well, there have been some contractual difficulties encountered in the first five years of operation. There have been disputes about the application of a 'ratchet' (multiplier) mechanism in relation to the calculation of performance deductions in the contract, which the contractor successfully challenged through the contractual adjudication process. There remain some contractual ambiguities (and a number of errors in the drafting) of the Specification and Payment mechanism which both parties have been trying to resolve through a Deed of Variation. Such a deed has not yet been agreed on and negotiations are currently suspended as the SPV has asked the council to bear its legal costs (or to permit such costs to be included as part of the refinancing costs), which was neither agreed nor considered equitable by the council. It may be that the decision to refinance will bring a new impetus to reach a decision, but whether an agreement can be reached on the deed or not, it need not hold up the refinancing.

2. **Proposal**:

2.1. Refinancing of PFI contracts is common and the Hengrove contract allows for it, if both parties give their consent. In simple terms, the contractor had to borrow to pay for the capital works at high interest rates. Now that the capital works are complete, the facility is operational and interest rates are much lower. The contractor will repay the original loans and take out a new loan which will cover the costs of:

- The value of the outstanding original loan
- The penalties associated with terminating those loans early
- Each party's advisor costs in preparing the refinancing options, arranging the new loans and undertaking due diligence.
- The upfront costs of the gain-share for both parties.
- Impact of any other cash flow changes through refinancing

2.2. The net present value of the changed cash-flows in the PFI base model, agreed in 2010, would be an estimated £3.9m improvement (the precise amounts are dependent on the position at financial close). The contract requires that the gains from refinancing should be shared on the basis set out in **Table 2**.

Table 2: How £4.3m would be shared, as per the PFI contract

Band	Local Authority	SPV	Total
Up to £1m (50:50)	£0.5m	£0.5m	£1.0m
Between £1m and £3m (60:40)	£1.2m	£0.8m	£2.0m
Over £3m (70:30)	£0.6m	£0.3m	£0.9m
Total	**£2.3m**	**£1.6m**	**£3.9m**

2.3. The costs of the Council's legal and financial advisors will be met from the Refinancing deal.

3. Time Line

3.1. The issue of refinancing was originally proposed by the contractor in 2015, so much time has elapsed during which a refinanced contract could have been in place. The financial information was refreshed in June 2017 and the bank (SMBC) has held its offer open on the basis of financial close before the end of December 2017. The broad timetable being worked to is set out below. Financial close cannot proceed without Cabinet approval as this is a key decision.

Phase	Activity	Completed by
Preparation	• Appointment of specialist advisors • firm up timetable • Start the process	End September 2017
Due Diligence	• Funder credit committee approval • Preparation of Due Diligence reports • Circulation of Due Diligence reports to funder (SMBC)	Mid November 2017
Documentation process	• Funding documentation drafting • Funding documentation	End November 2017

	negotiations	
Closing	• Funding documentation agreed • Commencement of Dry-runs • Project Agreement Deed of Variation (DOV) agreed • Facility Management DOV agreed • Financial close	Mid December 2017 to end January 2018

Appendix D

Risks and Sensitivities advised by Local Partnerships (financial advisors)

Pre financial close

1. **Abort**
    1.1. In the event the refinancing transaction fails to reach financial close then abort costs will become due. Given we are near the end of the exercise, the fees incurred by advisers so far is likely to be approaching the full value, circa total £850-900k.
    1.2. The Council has minimised its risk related to abort costs by avoiding issuing a Refinancing Notice; therefore in contractual terms, the Council has not triggered the refinancing exercise.
    1.3. However, it is expected that, in the event the refinancing exercise is abandoned, each party would have to bear its own costs. In relation to the Authority, at this stage this would encompass the Authority's legal adviser and the Authority's commercial and financial adviser, Local Partnerships. Notwithstanding that position, if the Authority abandoned the refinancing at this stage without good reason, it may be anticipated that the Service Provider would attempt to procure compensation for its other costs from the Authority on the basis of 'good faith'.
    1.4. The officers at the Council have actively addressed the risk of failing to achieve the refinancing on the Council's part by engaging with senior members early in the process and then obtaining Cabinet approval to proceed with the refinancing transaction (including delegated powers to execute all related documents).
    1.5. The risk of abort due to a decision by the Council or the shareholders is considered to be very low given resource and cost commitment to the exercise already expended and the financing benefit to be shared by the public and private sector.
2. **Increase in underlying financing costs and margins**
    2.1. A key determinant of the quantum of Refinancing Gain is the overall cost of funding. This can be split into two areas:
    2.2. Debt margin and interest rate swap credit spread
    2.3. Underlying cost of funds (i.e. swap rate); and
    2.4. The debt margin of 2.00% and incremental credit spread of 0.40% bps has been agreed with SMBC.
    2.5. It is accepted however that the underlying cost of funds remains a risk to the Council's share of the gain until the point of financial close, and the Refinancing Gain will therefore vary dependent on final pricing. Unlike a primary PFI transaction however, the risk with regard to the swap rate is only applicable to the tranche of additional debt. Furthermore, there is some hedging of this risk as a consequence of the swap break cost – if rates decrease, the new debt will be cheaper, but the swap break cost will be larger, and vice versa if rates increase.
    2.6. The market rates for swap have been volatile in recent months. This risk is largely out of the control of the project parties and as such all parties consider it critical to proceed to financial close promptly in order to minimise exposure to the risk of increase in funding terms or non-availability of funding.

3. Contract breach

3.1. Risk associated with failing to follow the processes laid out in the Project Agreement should not impact on the Council. The Council's advisers will ensure that the Sponsor cannot gain undue advantage by avoiding the correct processes, but no opportunity has been identified to do so.

3.2. The consequences for contractual breach associated with refinancing are severe, the Council would have the right to terminate the PFI with only senior debt paid out in line with corrupt gifts and fraud.

3.3. Largely, the interests of the Council and the Sponsor are aligned in maximising the value achievable through improved funding terms.

4. Incorrect calculation of Refinancing Gain

4.1. As above, if a deliberate attempt to reduce the Authority's benefit from the refinancing was discovered, the consequences would be severe.

4.2. The most significant area of the refinancing exercise where the interests of the Council and the Sponsor are not aligned lies in the optimisation of the post-refinancing financial model, as money not identified as Refinancing Gain will remain in the project to the benefit of the Sponsor. The protocols for generating and solving the financial models at Financial Close will be understood and tightly defined in advance.

4.3. The Council's advisers have been fully involved in the process from start to finish. The Council's advisers have performed assurance work and reconciliation testing on the financial models and the refinancing gain calculations and will continue to do so through to Financial Close and finalisation.

Post financial close

5. Robustness of the SPV

The table setting out the financial indicators for the SPV is included in private Appendix H on the grounds of commercial confidentiality.

5.1. Risks relating to the original construction programme have now passed and an operational track record for the asset now exists.

5.2. While gearing has been increased slightly and ratios somewhat reduced due to the refinancing, the ratios are still healthy. Compared to a standard availability-based PFI project they need to be, due to the portion of the revenue that depends on payment from the facility operator and which is exposed to demand risk. However, the Council should have confidence that position of the SPV once the new financing structure has been implemented remains robust.

6. Sensitivity of the gainshare to changes

6.1. The financial advisor has looked at downsides for changes in the LIBOR reference rate element of the refinancing interest rate and found that the project is well hedged, such that the impact of movement in rates on the Authority's expected gain is limited. A large increase of 0.20% in the new LIBOR swap rate was forecast to result in a decrease in Authority gain of £50k. While the new interest costs increased considerably that effect is balanced by a decrease in the cost of breaking the old swaps.

Appendix G

Refinancing Documents

The refinancing documents include:

(a) Deed of Variation to the Hengrove Leisure Centre PFI Project Agreement to be entered into by the council and Bristol Active Limited;

(b) Authority Direct Agreement to be entered into by the council, Sumitomo Mitsui Banking Corporation Europe Limited and Bristol Active Limited;

(c) Certificates in accordance with the Local Government (Contracts) Act 1997 including in relation to documents a) and b) above;

(d) any and all other contractual documentation which may be necessary or desirable to conclude the negotiations and achieve the refinancing of Hengrove Leisure Centre PFI,

all such documents being subject to any and all further amendments arising in the course of negotiations and approved by any one or more of the persons authorised to sign and/or execute such documents on behalf of the council, (together all such documents being referred to as the “**Refinancing Documents**”).

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