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Calderdale and Huddersfield NHS Foundation Trust – PFI options appraisal

May 2013

Important notice

This report (the "Report") has been prepared solely in connection with and for the purpose of reporting to Calderdale and Huddersfield NHS Foundation Trust (the "Trust") in respect of the review and development of proposals to reduce the overall cost associated with the PFI arrangement that the Trust has through a contract with Calderdale Hospital SPC Limited (formerly Catalyst Healthcare (Calderdale) Limited) (the "PFI Arrangement"). The Report has been prepared on the basis set out in our engagement letter addressed to the Trust dated 16 April 2013 ("Engagement Letter"), and should be read in conjunction with the Engagement Letter.

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The Report aims to inform the Trust's decision making by indentifying the different alternatives available and recommending a preferred option based on a quantitative and qualitative analysis of the options identified, but it does not form and should not be construed as providing a decision as to the option that should be pursued by the Trust in relation to the PFI Arrangement.

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1 Executive Summary

1.1 Introduction

The aim of this Report is to identify the different possibilities available to the Trust in regards to reducing the overall cost associated with the PFI Arrangement. The analysis contained within this report is based on historical information only that may not represent an accurate forecast of future cash flows under the PFI. Whilst we have adjusted for some known areas in some places, this is unlikely to be comprehensive. The results of this report should be considered as indicative only for the purposes of suggesting where further analysis may be justified. No contractual decisions should be made on the basis of this report.

KPMG has performed a review of the following documentation received from the Trust related to the PFI Arrangement:

- Financial close model: *"REFINANCED CALDERDALE MODEL 155C AMENDED.XLS"*; and
- The contract between the Trust and Calderdale Hospital SPC Limited (formerly Catalyst Healthcare (Calderdale) Limited): *"CONCESSION AGREEMENT safe (3).rtf"*

In addition, KPMG has used the following supporting documentation from other sources:

- Accounts of Calderdale Hospital SPC Limited (formerly Catalyst Healthcare (Calderdale) Limited) (the "Project SPV") for the year ended 31 December 2011, obtained from the Companies House;
- Current swap base rates from www.ft.com; and
- Historical RPI data obtained from the Office for National Statistics

Based on the information contained in the documents provided by the Trust, we have identified four main alternatives for the Trust:

- Option 1: Do nothing
- Option 2: Early termination of agreement
- Option 3: Purchase of share capital
- Option 4: Refinancing
- Option 5: Renegotiating the operating specifications

1.2 Procedures

We have performed an appraisal of these four options. As part of this analysis, we have carried out a number of procedures for each of the options (except for option 4):

- Analysis of cash flows and Net Present Cost (NPC)
  - Estimation of the cash flows for the Trust from a given date, which for modelling purposes has been arbitrarily set as 1 June 2015, until the end of the concession agreement –i.e. 31 May 2031 as per the Financial Close model; and
  - Selection of an appropriate discount rate and discounting of cash flows to calculate the NPC for the Trust as at 1 June 2015.

- Analysis of affordability – this focuses on the cash outflows only. We have not performed any detailed analysis of the income and expenditure account impact of each option.

- Consideration of any other factors

For option 4 (Refinancing), a high level analysis has been done instead.

Finally, we have performed a comparison among the first three options and, based on the analysis, we have provided a recommendation.

1.3 Description of options

The Unitary Payment being made under the PFI contract pays for a number of things – continued facilities management and lifecycle services under the contract, repayment and interest on senior debt, equity and junior debt distributions and tax.

The options discussed are broadly variants on renegotiating different elements or bundles of these elements.

£m	Service contracts	Senior debt	Equity & junior debt	Tax
Option 1: Do nothing	×	×	×	×
Option 2: Early termination	?	✓	✓	✓
Option 3: Purchase of share capital	×	×	✓	?
Option 4: Refinancing	×	✓	×	×
Option 5: Renegotiate service specification	✓	×	×	×
✓ = renegotiated under this option × = not renegotiated under this option ? = potential to renegotiate				

Option 1: Do nothing – this is the base option where you continue to pay the Unitary Charge for the remainder of the concession.

Option 2: Early termination – under this option you reach a commercial agreement with the Project SPV to terminate the contract early. In the base option we assume that the Trust continue to provide the same service specification post termination for the same cost. This is for simplicity at this stage. This could be combined with Option 5 to renegotiate the service specifications if additional savings are forecast from that option.

Option 3: Purchase of share capital – under this option you reach a commercial agreement with the Project SPV to purchase the equity from them. You will continue to pay the Unitary Charge for the remainder of the contract but will receive equity and junior debt distributions from the SPV. These distributions will be at risk depending on the performance of the SPV. Under the base option we presume that the SPV continues to pay tax. Once in Trust ownership there may be potential to novate the Project Agreements and funding to a limited liability partnership to also reduce the tax payable and increase the value to the Trust. A sensitivity is provided on this as Option 3b.

Option 4: Refinancing – this option looks at whether there is potential for the Project SPV to reduce cost by renegotiating their senior financing arrangements.

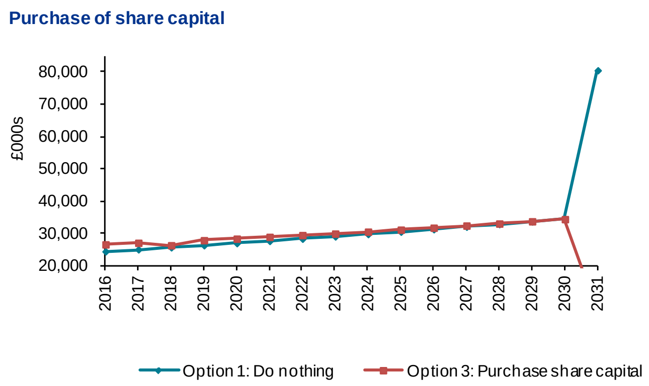
Option 5: Renegotiating service specification – we briefly look at the potential to make savings through renegotiation of the service specifications rather than the financing and ownership arrangements around the PFI SPV.

1.4 Summary of findings

	Investment required	Estimated return on investment %	NPC saving/(cost) pre finance @ 6.09% discount rate	NPC saving/(cost) if financed through FTFF at a rate of 2.5%	Deliverability
Option 1: Do nothing	-	-	-	-	High
Option 2: Early termination	£195.3m	4.7%	(£10.0m)	£23.9m	Low due to high investment requirement and return lower than 6.09%.
Option 3: Purchase of share capital	£53.2m	7.1%	£9.5m	£18.7m	Some concerns over commercial negotiations required with the SPV and the requirement for funder consent.
Option 3b: Purchase of share capital with tax saved	£53.2m	10.1%	£30.7m	£39.9m	Low due to need to amend the Deed of Safeguard.
Option 4: Refinancing	-	-	-	-	Low
Option 5: Renegotiate service specification		Further work required to quantify			Medium

- Both termination options and purchasing the share capital of the Project SPV have the potential to generate a positive return on investment. Only the share capital purchase option generates a return in excess of the Treasury Green Book rate of 6.09%, although as a Foundation Trust you are not constrained by Treasury guidance on required returns (unless DH or Treasury approval is required, which is discussed further below). The return on investment represents the savings from each option relative to the total cost under the Do Nothing option, pre any Trust cost of finance to fund the investment.
- If the return on investment presented exceeds the Trust's cost of capital for financing the investment requirement, the option has the potential to generate an affordability advantage.
- The return on investment is higher under the purchase of share capital option, with a forecast 7.1% base return. This return is higher than under the termination option because under termination you would also be required to break the senior debt interest rate swap. As base interest rates have plummeted since the financial close of this project, the interest rate swap is currently 'in-the-money' for the swap provider, meaning that significant compensation would have to be paid to break this swap. We have estimated this compensation to be £40.2m based on current base rates and the swap profile at financial close. If possible, it would be better to leave the current senior debt in place. For the same reason, refinancing the senior debt does not look a viable option. The purchase of share capital option further benefits from a lower upfront investment requirement, which may be easier for the Trust to raise.
- Despite the overall NPC benefit and return on investment from purchasing the share capital, there would be no cash flow benefit for a number of years. Under the current PFI arrangements, a Terminal Payment of £42.7m is due to be made at the end of the concession. A significant portion of the equity return to shareholders of the Project SPV from the project is generated by this payment. As such, whilst this option generates a positive return on investment overall it does not generate sufficient cash savings in year 1 to 15 to cover the cost of repaying any capital raised over the project term, i.e. the Trust is essentially getting its benefit solely through saving the Terminal Payment on expiry of the project. . If an FTFF loan was obtained at a rate of 2.5%

(estimated based on National Loan Fund rates) to fund the estimated £53.2m purchase cost of the equity, and this loan was repaid based on annuity profile (which is the base position for the FTFF), then cash out flows would actually go up over the next 15 years but be reduced by the Terminal Payment on expiry. This is presented graphically below.



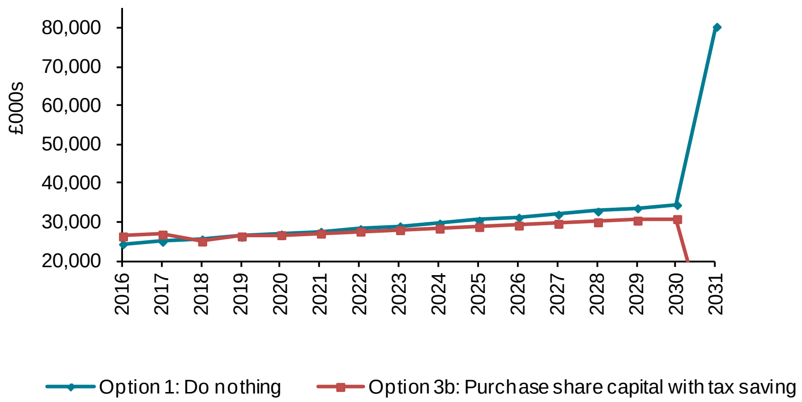
- The Income and Expenditure Account profile may not follow this profile – the profit on the investment in the subsidiary, which will probably need consolidating into the Trust accounts (although we have not performed a detailed accounting review), will be recognised sooner due to net profits being made within the SPV in advance of the equity and junior debt distributions being made at the end of the contract, i.e. profits will be recognised in the SPV broadly in line with service provided, not on the profile of cash paid by the Trust. This may result in the overall saving being recognised through the I&E account over the course of the remaining contract. This will require further analysis.
- We have also assumed the Trust fund 100% of the share capital purchase costs through FTFF debt. Should the Trust have cash resources to fund some or all of the purchase then this would lead to a favourable position.
- Whilst the Purchase Share Capital Option may look attractive, there are a number of constraints that would need to be overcome. These represent a considerable hurdle to the deliverability of this option:
  - Negotiating a purchase price: The Trust has no mechanism to force the current equity holders to sell their equity. This would be subject to a commercial negotiation. We have estimated a market value based on the data available to us, which is mostly historical. Should the actual forecast trading performance of the SPV be very different to this, it could have a material impact on the value of the equity. We have allowed a 10% premium to our estimated market value to reflect the fact that the SPV are not currently looking to sell the equity.
  - Obtaining funder consent: The senior funders to the SPV must provide their consent to any change in shareholding. Whilst they must act reasonably, a funder may consider there is a potential conflict of interest for the Trust to be both the customer of the SPV and its owner. For example, the funder could have concern that the Trust could levy deductions on the SPV as, although this would hurt equity return, it is ultimately cash neutral to the Trust (or even a cash saving to the extent this also reduces tax payable in the SPV). However, this would increase the risk of default under the financing arrangements and therefore reduce funder security. The Trust will need dialogue with funders on this issue, and they may require some additional protection under the financing arrangements. It is possible that they would use this as an opportunity to renegotiate the financing rates and increase margins, which would undermine the affordability advantage of this option.
  - Obtaining funding: We have assumed that the share capital purchase price would be funded through FTFF funding. Whilst as a Foundation Trust you do not formally require approval from DH or Treasury for such a transaction, where an application for FTFF is required this gives them a de facto approval. In our experience with other trusts, obtaining this approval can be

cumbersome and, at times, difficult. The Treasury will seek to see a full business case supporting the transaction. As well as the cash benefits of the transaction (and meeting at least a 6.09% return threshold to meet Green Book requirements), they will require a full assessment of the levels of commercial risk re-absorbed by the Trust by taking on ownership, as well as neutralisation of any of the benefits that are driven through lower tax. It will also help if the rationale for the change is driven by aspects other than a financial return on the equity. Examples may include a need for greater flexibility over use of the facilities and easier negotiations for variations if there is not a private party at the table, or efficiencies that can be gained by combining service contracts with other contracts the Trust has.

  - Vires: The Trust may wish to seek a legal opinion to confirm they would be acting within vires to purchase the share capital of the SPV. We have worked with other Foundation Trusts who have confirmed this is within vires.

- A higher potential gain is possible if, post purchasing the equity, the trade and activities of the Project SPV is novated from the Limited Company to a Limited Liability Partnership. As a Limited Liability Partnership has flow through tax status, the tax payable within the SPV would be saved. This would increase the return from the investment to 10.1%. Importantly, it would also change the cash profile of the investment such that the cash savings exceeded the cost of FTFF funding after just 2 years, giving an annual saving as well as an NPC benefit.

Purchase of share capital with tax saved



- There are some considerable further constraints that would need to be overcome in order for this additional saving to be realised, including:
  - Deed of Safeguard Issues: The current SPV benefits from a Deed of Safeguard from the Secretary of State standing behind the obligations of the Trust under the contract. Should the contract need to be novated into a new contract vehicle, this Deed of Safeguard would need to be updated. An approval for this is likely to be time consuming, particularly if the case for the change is purely driven by a desire to reduce tax. In due course you may wish to seek legal advice on whether this could be achieved without updating the Deed of Safeguard.
  - Further funder consent would be required as the 'borrower' for the loan would be a new entity. We don't envisage any objections in principle to this aside from the Deed of Safeguard, but this would need to be confirmed. It would also lead to a higher transaction cost.

2 Detailed findings

2.1 Introduction

Based on a review of the concession agreement and the Financial Close model provided by the Trust, we have identified four main alternatives for the Trust:

- Option 1: Do nothing
- Option 2: Early termination of agreement
- Option 3: Purchase of share capital
- Option 4: Refinancing
- Option 5: Renegotiating the service specifications

Refer to sections 2.2 to 2.6 for the assessment of each of them.

2.2 Option 1: Do nothing

2.2.1 Description

The "Do nothing" option consists in maintaining the status quo, i.e. the Trust continues to pay the unitary charge related to the PFI Arrangement until the end of the concession agreement and takes no further action.

This option will serve as a benchmark when assessing the other 3 alternatives.

2.2.2 Cash flow and NPC analysis

The Trust will have a periodic cash outflow corresponding to the Unitary Charge paid to the Project SPV. This is in line with the payments the Trust currently makes in relation to this project.

The Unitary Charge for the period 2015 to 2031 has been estimated based on the Financial Close model and has been adjusted to account for differences between estimated RPI indexation per the FC model and actual indexation for the period 1997 to 2013. We have made no adjustment for forecast inflation post April 2013, i.e. we assume RPI inflation at 2.5% for the remainder of the contract.

£m	Total nominal cash cost of the remainder of the contract	NPC of pre Trust finance costs	NPC of post Trust finance costs	Additional Trust capital required
Do nothing option	517.8	305.3	305.3	0.0

A nominal discount rate of 6.09% has been used for all cash flows, in accordance with the HMT Green Book guidance. The Trust may wish to substitute this rate with a more appropriate rate to reflect the Trust cost of capital or a deemed opportunity cost of capital.

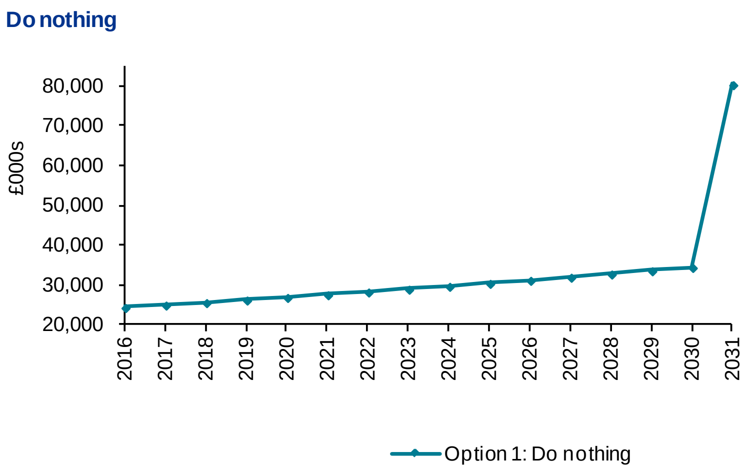
No additional Trust finance is required for this option.

Below we set out a breakdown of the component cash flows that the Unitary Charge pays for. This is helpful in understanding the other options set out.

Component	£m NPC @ 6.09%	*% of Unitary Charge*
Service costs, overheads less other income	121.1	*40%*
Lifecycle costs	7.5	*2%*
Senior finance	94.4	*31%*
Equity and junior finance	57.8	*19%*
Tax paid	24.5	*8%*
Total	305.3	*100%*

2.2.3 Affordability analysis

The cash flows under this option would be the payments to the PFI SPV only.



Note that under the current arrangements a lump sum Terminal Payment of £42.7m is payable at the end of the contract, in addition to the Unitary Charge for that year. This enables a lower Unitary Charge up to this point as equity payments are limited over the contract.

2.2.4 Other factors

Not applicable.

2.3 Option 2: Early termination of agreement

2.3.1 Description

The second option to be considered is the termination of the PFI Arrangement. In this case, the Trust will need to pay the PFI SPV a compensation on termination fee and make alternative arrangements for the provision of the service elements of the project – whether in house or through a subcontracted service. It may be possible to novate the subcontracts of the PFI SPV to the Trust.

Option to terminate

The first matter to consider is whether the Trust can unilaterally terminate the PFI Arrangement. Per clause 64.1.1 of the concession agreement signed in 1998 between the Trust and the Project SPV, one of the conditions for the Trust to be able to exercise the option of early termination of the contract is that "the Board of Directors of the Trust has passed a resolution to discontinue the provision of clinical services at the Trust's Premises". As this is not the case, the Trust does not have the contractual option to terminate the scheme unilaterally.

In the absence of any of the events listed in the contract as termination triggers (e.g. concession co default, Trust default, etc.), it appears that this concession agreement can only be terminated upon the mutual agreement of the parties and with the approval of the Senior Lenders and Mezzanine Lenders.

In the analysis that follows, we estimate what a reasonable amount of compensation on termination may be to get the PFI SPV to agree to a termination.

Financing the compensation on termination

We have assumed that if a termination option was pursued, the Trust would approach the Foundation Trust Financing Facility (FTFF) to obtain funding for 100% of the termination cost. Based on current rates available from the FTFF, we have assumed a 2.5% rate of finance. Lower rates may currently be available.

The availability of finance from the FTFF to fund a termination is by no means certain. As a Foundation Trust the DH will have not have any formal right to approve or veto a termination. However, they can exert some control over the availability of FTFF funding, hence exerting de facto right of veto. HM Treasury may also intervene at this stage, in our experience. Whilst the Trust may wish to base its decision to terminate on affordability comparisons with the Do Nothing Option, DH and HM Treasury are likely to require more formal value for money analysis. This is discussed further at 2.3.4.

We present the NPC of the termination option below both before and after FTFF funding. The before financing NPC that is most relevant to Treasury in assessing proposals (although as no risk adjustment is made, this does not strictly follow Green Book methodology). The post FTFF NPC may be most relevant to the Trust. As the rate of finance on FTFF funding (assumed at 2.5%) is lower than the discount rate used (6.09%) the FTFF finance provides a positive NPC impact. Should FTFF not be available then the Trust may seek to raise finance from other sources. Where the cost of finance is lower than the investment return presented by the option, the option will generate an overall positive NPC saving. We have not commented further on appropriate additional sources of finance, but commercial loans and local authority loans have all been explored by other trusts.

Service costs post termination

We have assumed that the service costs post termination continue at the same levels as pre termination, i.e. there is no efficiency or inefficiency for bringing these services in house. This simple assumption reflects that the current subcontracts could be novated to the Trust. There may be further opportunities to reduce these costs that the Trust could explore.

Compensation payable on termination

We have estimate the compensation payable to the Project SPV as follows:

£m	Compensation payable	
Outstanding senior debt	97.3	Note 1
Less reserve accounts	(10.7)	Note 2
Swap breakage costs	40.2	Note 3
Equity compensation (pre tax)	53.2	Note 4
Subcontract breakage costs	1.0	Note 5
Transaction costs	1.0	Note 6
Tax gross up	13.3	Note 7
Total estimated compensation	**195.3**	

Note 1: Outstanding senior debt

This is the outstanding senior debt balance as at 1 June 2015 as per the financial close model. The balance per the latest published SPV accounts differs from the value slightly, but not sufficiently to be material to this analysis.

Note 2: Reserve accounts

This is balance to the credit of reserve accounts within the Project SPV, as per the financial close model. This consists of £5.1m in a debt service reserve account, £5.3m in a lifecycle reserve account and £0.3m in a working capital reserve. Upon termination, these amounts will set off against either the senior debt balance or the equity valuation.

Note 3: Swap breakage costs

Interest rate swap:

We understand that at financial close, the Project SPV entered into an interest rate swap. This effectively fixes the interest rate on the senior debt loan over the life of the contract. The senior debt interest rate at financial close was made up of a base swap rate of 5.6% and margins totalling 1.10%, giving a total rate of 6.7%. Under the terms of the swap agreement, the Project SPV will pay interest to the senior lender based on variable day to day LIBOR rates (or similar) + the 1.10% margin. However, the Project SPV will also pay the swap provider (which we assume to be the same party as the senior lender, although we have not confirmed this) a fixed rate of 5.6% on the financial close senior debt profile, and receive variable LIBOR in exchange. The net effect for the Project SPV is that it pays a fixed rate of 5.6% + 1.10%.

Upon termination the interest rate swap would need to be terminated. Upon termination, the 'value' of the swap would either have to be paid to the swap provider as compensation if the swap is in-the-money or received from the swap provider if the swap is out-of-the-money. Since the signing of the contract, swap rates have reduced significantly. We have estimated current market swap rates, for the remaining term of the contract, to be 1.19% (based on GBP interest rates swaps taken from the Financial Times on 3 May 2013. This means that once terminated, the swap provider will only be able to reinvest its money in a new swap earning 1.19%, rather than the 5.6% currently paid by the Project SPV. The Project SPV will need to pay compensation to the swap provider calculated broadly as the difference between 5.6% and 1.19% interest over the remainder of the concession, discounted at current rates (1.19%). Given the current historically low swap rates, this means a significant compensation sum of £40.2m.

RPI swap:

The financial close model also shows that the Project SPV took out an RPI swap at financial close. As the Trust pay a fully inflation linked Unitary Charge, the Project Co would have wanted to 'swap' some of this inflation linked income for fixed income to cover fixed debt repayments. Based on the numbers in the financial close model it does not look like the RPI swap is in-the-money, hence we have not included any compensation for the termination of the RPI swap. The terms of the RPI swap arrangement would need to be further investigated to confirm this is the case.

Note 4: Market value of equity

We have included a simple valuation of equity based on a discounted cash flow of expected future equity and junior debt returns. As there is no right to terminate, the valuation of equity will be subject to commercial negotiation and will ultimately be whatever the Project SPV requires in order to persuade them to terminate.

The valuation of equity is subject to a number of assumptions. We set out the main ones here:

Valuation discount rate:

We have assumed a market discount rate of 8.0%, being a reasonable assumption for current required returns in the secondary market (post construction) for a social infrastructure project such as this. We have not performed detailed valuation advice, which would be needed before proceeding. Any valuation of equity has an element of subjectivity and is difficult to estimate.

Equity distributions:

We have taken the forecast equity distributions per the financial close model, but adjusted them in a number of ways. These are set out below.

£m	PV	
Equity distributions per FC model	**36.7**	
Margin on SPV mgt	1.0	We assume that the SPV management costs within the financial close model include some profit margin that the equity holders would want compensating for on termination. We assume the FC costs include a 15% margin.
Lifecycle savings	0.6	In many older PFI schemes, there has been considerable upside in lifecycle cost estimates as the FC estimates have turned out to be prudent. This would result in extra profit to equity. We have assumed a 10% saving in lifecycle costs over the remainder of the concession.
Overhead savings	0.5	Likewise we assume some minor savings in overheads based on current SPV accounts.
Inflation adjustment	2.1	Actual RPI has run at a higher rate, on average, over the concession to date than the 2.5% forecast at FC. We adjusted equity returns upwards to reflect this historical increase in RPI. Please note we make no

		adjustment for RPI running higher than 2.5% in the future, although the Project SPV may seek to introduce this into negotiation.
Tax impact of above items	(0.8)	This represents a simple 20% corporation tax saving on the items above.
Decrease in corporation tax	8.3	At financial close a 30% corporation tax rate was assumed. The subsequent drop in tax rates to 20% and the resulting lower forecast tax charge for the Project Co has a direct benefit to equity holders and valuation.
Revised distributions	**48.4**	

Equity premium:

As there is no right for the Trust to require a termination, the Project SPV may require a premium to the equity value to incentivise a termination. We have allowed a 10% premium for this purpose, increasing the equity valuation to £53.2m.

Note 5: Subcontract breakage costs

It is likely that the Project SPV will have to compensate subcontractors for loss of profits under the terms of their subcontracts on termination. We have allowed £1.0m for this, which is based on approximately 2 months subcontractor charges. This will require further analysis should you decide to proceed with this option.

As discussed above, it is possible on termination for the subcontracts to novate to the Trust. If this was to happen then there is every chance that these subcontract breakage costs would be saved. However, for prudence, we have retained them in the termination sum at this stage.

Note 6: Transaction costs

We have included a lump sum of £1m to cover the transaction costs of all of the Trust, Project SPV and subcontractors in negotiating a termination. We have no real basis to determine this figure and it will require further analysis.

Note 7: Tax gross up

We have included an allowance in our calculation for compensating the Project SPV for additional tax payable on the compensation on the termination amount. We have assumed that the compensation payable to the Project SPV will be treated as taxable income within the Project SPV. The corresponding repayments of senior, subordinated debt and equity would not be treated as tax deductible; hence a large tax charge would arise. Where this is the case, we would expect the Project SPV to require an increase to the compensation amount to pay for this tax. Based on our recent experience we identify a strong likelihood of the compensation received by the Company being treated as taxable income with the Company.

We have roughly calculated the impact on this as the Lenders Market Value of Equity *and* Subordinated Debt *all multiplied* by 20%/(1-20%). We have not sought detailed advice from our tax colleagues at this stage to verify this calculation. Specifically, we have not allowed for a tax gross up on the payment to repay senior debt, on the basis that the Project SPV has adopted (to the best of our knowledge) a composite trader tax treatment.

We would strongly advise that the Trust seeks specialist tax advice on this calculation prior to proceeding with any termination. Whether this payment is required or the extent of payment can depend on specific clauses within the Project Agreement and the tax treatment adopted by the Project SPV. Given the materiality of the tax gross up allowance in our analysis, we provide a sensitivity later on the impact of whether an additional tax gross becomes payable on the repayment of the outstanding senior debt amount as well.

With the co-operation of current Project SPV shareholders and funders, it may be possible to avoid this tax gross up. This could be achieved by purchasing the equity only first (which wouldn't be treated as taxable income), and then repaying the debt and terminating subcontracts once the Trust is the owner. For prudence, a straight termination payout has been assumed in our analysis showing this tax gross up as being due.

We have not assumed that the Trust will incur any irrecoverable VAT on the compensation amount, but would also advise the Trust seeks specialist advice in this area before proceeding.

2.3.2 Cash flow and NPC analysis

A summary of the nominal cash flow and NPC over the remainder of the PFI contract term under the termination option and comparison to the Do Nothing option is provided in the table below.

£m	Additional Trust capital required	Return on investment	Total nominal cash cost of the remainder of the contract	NPC of pre Trust finance costs	NPC of post Trust finance costs
PFI termination option	195.3	4.7%	409.7	315.3	281.4
Do nothing option	-	-	517.8	305.3	305.3
Saving / (cost)	(195.3)		108.1	(10.0)	23.9

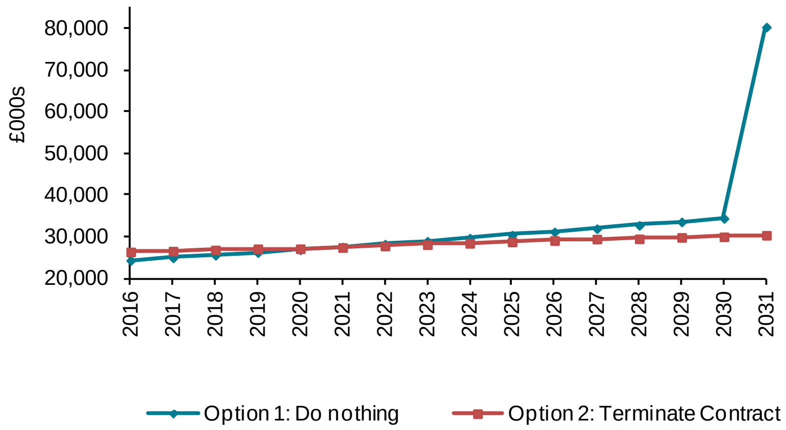
This shows that if the Trust can obtain a FTFF loan to fund the cost of the PFI termination, it will lead to an overall affordability saving over the remainder of the concession. However, as the NPC of pre Trust finance costs is higher under the termination option, driven by the investment return being lower than the Green Book rate of 6.09%, we consider a high likelihood of DH and Treasury intervening in the process and making obtaining a FTFF loan of this magnitude difficult.

Given the potential for an overall affordability advantage from termination, it may be worth preliminary exploratory conversations with DH (through PFU) and/or Treasury about this course of action.

2.3.3 Affordability analysis

We show the total cash profile, post FTFF financing, of the termination option below compared to the Do Nothing option.

Termination



Note that the termination option shows higher cash outflows for the first five years post termination, requiring an extra £6.1m of cash over this period. This is driven by the fact that we have assumed the FTFF require a flat/annuity repayment profile rather than the inflation linked payment under the Unitary Charge with a £42.7m terminal payment at the end of the concession. Should this short term increase negate the affordability benefits of termination, it may be possible to negotiate a different repayment profile of FTFF funding. Much of this short term increase is a result of quicker repayment of the FTFF loan than the repayment of finance under the PFI contract – as such this £6.1m cash increase is not likely to represent a £6.1m I&E account increase, although this would need confirming.

From October 2013, and in shadow form from now, Monitor risk ratios are changing to reflect capital servicing and liquidity ratios rather than the old FRR tests. It is likely that a loan of £195.2 million will exceed the value of the liability for the project currently held in the Trust's accounts,although we have not confirmed this. As such, funding termination through an FTFF loan would increase the Trusts overall borrowing. However, due to lower interest rates the total debt service per annum is likely to be lower, hence improving capital servicing ratios. Further analysis would be required to confirm this.

2.3.4 Other factors

Value for money analysis

This affordability position is different to a value for money assessment that may be required if HM Treasury approval is needed.

When assessing the whole of government position, HM Treasury guidance would require the following additional requirements:

- Ignoring the FTFF finance benefits (as noted above) and replacing the Trust cost of finance with a Green Book interest rate of 6.09% nominal.
- Adding a value of the cost of increased risks to the Trust as a result of taking over the service contracts. We have not considered this further here, but it is likely to result in a worse value for money presentation than noted in this analysis.
- Neutralising the tax revenue differential between different options. We assume a cost of £13.3m in our compensation of termination calculations for tax. This compares to the net present cost of tax assumed to be payable by the bidder in the financial close model of £30.3m. This means an additional value for money hurdle of £17.0m.

This means there is likely to be a hurdle to termination from a value for money perspective of at least £27m, and likely to be higher once the value of risks reabsorbed by the Trust are taken into account. Considerable further work will need to be undertaken to prove a value for money case using HM Treasury guidance should central approvals be required, which is likley if FTFF funding is required.

Inflation exposure

By terminating the contract the Trust will have lower exposure to index linked payments, as index linked costs would only be for the service, lifecycle and administrative expenses rather than the whole UC. It is assumed that any new finance charges would not be index linked. This may provide an additional benefit to the Trust in reducing inflation exposure.

Financial flexibility

An additional benefit to terminating may be that the termination loan is more flexible and more easily renegotiated over time than the PFI contract or extra control can be exerted over service subcontracts. This extra flexiblity may have value where Trust finances are under pressure in the future. Flexibility may be particularly apparant in areas like building lifecycle and maintenance, whereby the Trust could manage, defer or bring forward expenditure to suit affordability constraints in any given year.

2.4 Option 3: Purchase of share capital

2.4.1 Description

As an alternative to full termination, the Trust could acquire the equity of the Project SPV and hence becomes the beneficiary of any distributions made by the Project SPV to equity holders from that point onwards. In parallel, the Trust continues to make Unitary Charge payments to the Project SPV for the provision of services.

This option has similarities to the termination option in that, as equity holder, the Trust reabsorb responsibility and risk of service provision, but the senior debt is left in place. This reduces the termination payout required and avoids having to pay extensive breakage costs on the senior debt swap.

2.4.2 Constraints

Right to purchase

Similar to the termination scenario, there is no right for the Trust to purchase the equity. This would be a commercial negotiation between the parties to agree a value based on whatever premium over market value is required to make the current equity holders sell.

Funder consent

Under the terms of the Project Agreement, the consent of senior funders is required for any change in shareholding. Generally speaking, senior lenders do not like the position where a Trust plays the role of both the customer of the SPV and the owner. This gives rise to potential concerns of conflict of interest leaving the lender stuck in the middle, e.g. the Trust could levy higher deductions on the SPV, which would reduce equity returns but be otherwise cash neutral (as it is an in and an out for the Trust), but leave the lender exposed to greater risk of default on the debt. In fact, the Trust could be perceived as being incentivised to do this to reduce the 'profit' in the SPV and hence reduce the tax charge, leading to an overall affordability saving.

Should you decide to pursue this course of action, we would suggest early dialogue with funders.

2.4.3 Cash flow and NPC analysis

In terms of cash flows, the Trust would have to pay a consideration to acquire 100% of the equity and junior debt at the start of the period. After that, the Trust would have to pay the Unitary Charge periodically as it currently does but, on the other hand, it would also receive periodic distributions from the Project SPV (e.g. dividends).

The equity consideration used in the cash flow analysis for this option is based on the market value of equity calculated as part of the appraisal of Option 2. The estimated consideration to be paid consists of two elements: the estimated market value of equity and an estimated equity premium element (refer to section 2.3.2 for further details).

A summary of the nominal cash flow and NPC over the remainder of the PFI contract term under the purchase of share capital option and comparison to the Do Nothing option is provided in the table that follows.

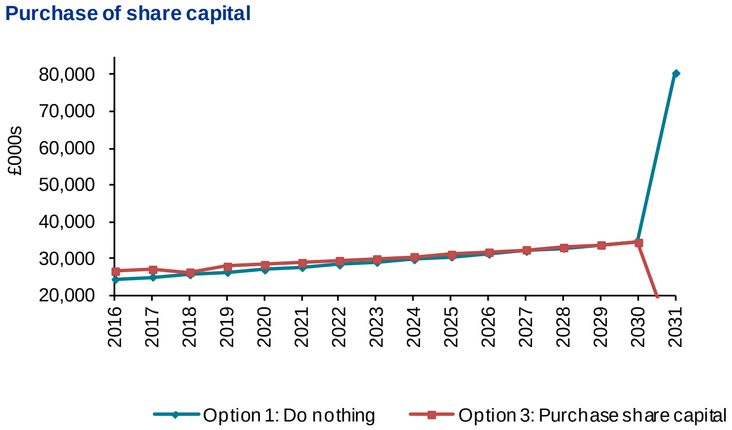
£m	Additional Trust capital required	Return on investment	Total nominal cash cost of the remainder of the contract (pre finance)	NPC of pre Trust finance costs	NPC of post Trust finance costs
Purchase of share capital	53.2	7.1%	445.0	295.8	286.6
Do nothing option	0.0	-	517.8	305.3	305.3
Saving / (cost)	(53.2)		72.8	9.5	18.7

This shows that if the Trust can obtain a FTFF loan to fund the cost of the share capital purchase, it will lead to an overall affordability saving over the remainder of the concession. It will also lead to a lower net present cost of savings using a 6.09% discount rate, meaning there is greater potential to get a positive response from DH and Treasury – meaning an FTFF loan may be easier to obtain.

Given the potential for an overall affordability advantage from purchasing the share capital, it may be worth preliminary exploratory conversations with DH (through PFU) and/or Treasury about this course of action.

2.4.4 Affordability analysis

We show the total cash profile, assuming FTFF financing at 2.5%, of the equity purchase option below compared to the Do Nothing option.



The share capital purchase option shows higher annual cash outflows than the Do Nothing Option right up to the last two years of the concession. This is driven by the fact that the PFI Unitary Charge has a £42.6m terminal payment included, meaning debt and equity payments are very back-ended – whilst under an FTFF option the debt would need to be repaid under more or less an annuity profile. Under a the share capital purchase option the terminal payment would still need to be made, but most of this would then be returned to the Trust as an equity distribution, meaning there is no spike in net payment at the end of the concession. The equity returns that the Trust would get from being the PFI SPV owner are back-ended towards the end of the concession, so for initial years the Trust needs to pay the Unitary Charge plus the cost of servicing the FTFF debt without a corresponding cash return from the SPV being due.

The Trust may consider that this increased initial payment profile negates the NPC benefit over purchasing the share capital overall. Should this short term increase negate the affordability benefits of termination, it may be possible to negotiate a different repayment profile of FTFF funding. The I&E impact of purchasing the share capital may be less adverse than the cash position, as the accelerated payments would reduce the total debt interest costs more quickly.

2.4.5 Other factors

Tax payable by the SPV post purchase

The analysis above assumes that once the PFI SPV has been bought by the Trust, it will continue to operate as a limited company and pay corporation tax. There may be the opportunity, with the consent of senior funders, to novate the activities and debt of the SPV into a limited liability partnership owned by the Trust. This partnership would then not pay any tax, leading to an additional affordability benefit for the Trust. Further work would be required to confirm whether this was possible.

The restated position assuming all tax could be saved would be as follows:

£m	Additional Trust capital required	Return on investment	Total nominal cash cost of the remainder of the contract (pre finance)	NPC of pre Trust finance costs	NPC of post Trust finance costs
Purchase of share capital	53.2	10.1%	403.8	274.6	265.4
Do nothing option	-	-	517.8	305.3	305.3
Saving / (cost)	(53.2)		114.0	30.7	39.9

Control of SPV

Purchasing the share capital will give the Trust greater level of control over the activities of the SPV. This may lead to a greater opportunity to realise further value from the project. As SPV owner, it would be easier for the Trust to renegotiate service subcontracts. If there are opportunities to reduce the required specification for the project whilst still meeting an acceptable standard, this may realise further savings.

Negotiation with senior debt providers

One of the bid hurdles to changing the financing structure of the Project SPV whilst it is in private ownership is that any negotiation has to go through the equity holders, who are the borrower. Once the Trust is SPV owner, it is in a better position to have open dialogue with senior lenders. Many senior bank lenders are looking to exit long term lending arrangements such as PFIs. Notwithstanding our conclusions in section 2.3 about the high cost of terminating the senior lending, which stand, with open dialogue with lenders there may be more scope to cut a deal. This is difficult while you are negotiating through a PFI SPV, who, to be frank, have limited incentive to help.

2.5 Option 4: Refinancing

2.5.1 Description

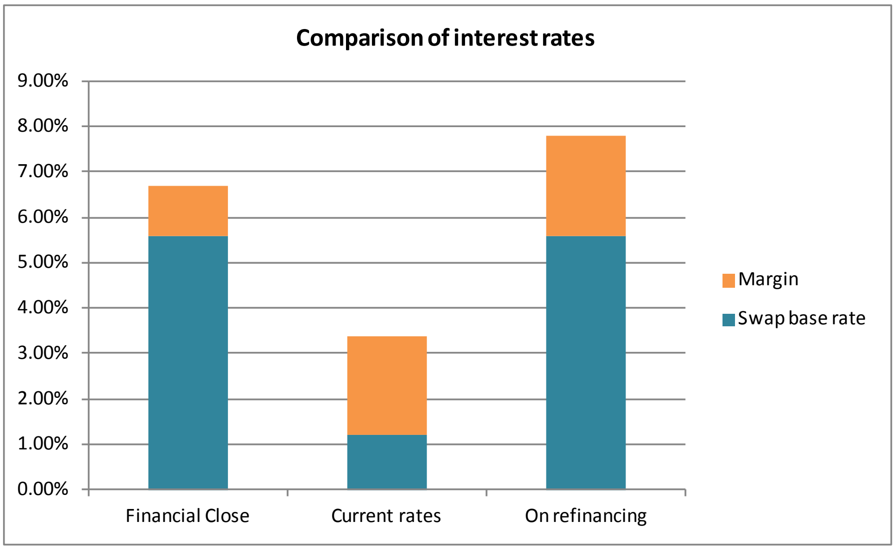
The Trust could ask the current SPV owners to refinance the existing debt within the Project SPV to a rate currently seen in the market. However, there is no clause in the Project Agreement requiring the SPV owners to respond to the Trust's request, so the Trust would be dependent upon the SPV's co-operation.

Under the terms of the Project Agreement, the Project SPV is entitled to keep the lion's share of any refinancing gain. As a result they are incentivised to refinance if this was shown to provide a benefit.

We have provided some analysis below of the current rates that may be able to be obtained on a refinancing. These are indicative only and based on our broad understanding of rates that are available in the current market. It is worth stressing that the current project finance markets are very volatile and these rates are subject to material change over short periods.

2.5.2 Analysis

	Financial Close	Expected rates In today's market	Rates available on refinancing
Swap base rate	5.60%	1.19%	5.60%
Margin	1.10%	2.20%	2.20%
Total	6.70%	3.39%	7.80%



The senior debt interest rates are broadly made up of two components – the base swap rate and a margin. Since financial close, base rates have fallen significantly from 5.60% to an estimated 1.19%. However, the margin charged by lenders has increased from 1.10% to an estimated 2.20%. As a result, the total rates of finance that are available in the market for a new project are significantly less than they were are financial close, as the fall in base rates exceeds the increase in margin.

However, an interest rate swap was taken out at financial close to fix the base rate for the life of the contract. Upon refinancing, this means that the gain from the reduction in base rates would not be realised – either the current interest rate swap would be left in place, meaning the 5.60% base rate would continue, or compensation would need to be paid the current swap provider of circa £40.2m (as set out in 2.3.2) which is broadly equivalent. This means that upon refinancing the total cost of finance would be equivalent to the current base rate of 5.60%, plus the new higher margin. This would lead to an increase in the total cost of finance and hence we consider that at the current time refinancing would not be a viable option to pursue.

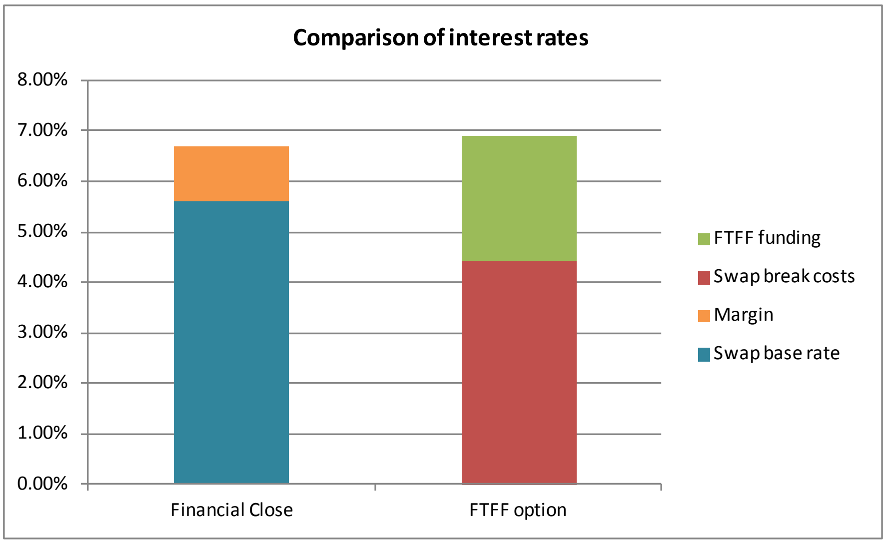
2.5.1 Other factors

FTFF refinancing of the project SPV

Rather than refinancing the project debt with new commercial debt, it may be possible to refinance the SPV with public debt, such as through the FTFF.

Our recent conversations with the FTFF suggest this would be very difficult and we consider this unlikely to be viable, but we discuss here for completeness.

	Financial Close	FTFF option
Swap base rate	5.60%	-
Margin	1.10%	-
Swap break costs	-	4.41%
FTFF funding	-	2.5%
Total	6.70%	6.91%



This shows that at a rate of 2.5%, FTFF funding would not offer any affordability advantage due to the high swap break costs. Current FTFF rates over this term are somewhere between 2.0% and 2.5%. At a rate of 2.29% then refinancing the commercial debt with FTFF would break even.

Given the perceived difficulty in obtaining approval to proceed with this option and obtaining FTFF funding with little gain, we have not explored this option further.

2.6 Option 5: Renegotiating the operating specifications

2.6.1 Description

We understand that the current service specification has remained unchanged since the start of the contract. Although this service specification will have been determined to provide Value for Money at that time, recent Treasury reviews of health PFI contracts have concluded that:

- Many PFI contract service specifications were over-specified in relation to the standard that a Trust requires when managing contracts themselves, i.e. services are gold-plated; and
- The value for money of certain soft FM services is questionable and greater value may be gained from taking these back in house.

Whilst the Project Agreement contains benchmarking provisions that provide the Trust assurance that the cost for services to meet the current scope are competitive (provided the Trust has been enforcing these benchmarking provisions), it does not test whether the specification itself is suitable. Given service costs represent 42% of the cost of the remaining Unitary Charge, reviewing them for potential areas of saving may generate value.

We have not performed a detailed review of the service specification for opportunities to reduce scope, but this could be explored by the Trust as further avenue to look for savings.

Renegotiating the service specification would be a variation to the Project Agreement and be subject to commercial negotiation. However, provided their transaction costs are covered, the Project SPV are fairly well incentivised to negotiate this pragmatically as ultimately any reduction in service specification will reduce their equity risk.

Whilst we have not performed any detailed analysis of where there may be opportunities for service specification savings to be made, we set out below the potential benefit of savings made to help the Trust assess the order of magnitude and assess whether further work is justified.

	Total nominal cost over the concession	Annual saving	NPC @ 6.09%
1% service cost saving	£1.8m	£91k	£1.1m
5% service cost saving	£8.8m	£455k	£5.4m
10% service cost saving	£17.6m	£910k	£10.7m

Appendix 1 Cash flows under each option

The annual cash flow profile under each option from an assumed termination date of 1 June 2015 are shown below.

Option 1: Do nothing	Total	31-May-16	31-May-17	31-May-18	31-May-19	31-May-20	31-May-21	31-May-22	31-May-23	31-May-24	31-May-25	31-May-26	31-May-27	31-May-28	31-May-29	31-May-30	31-May-31
Current Unitary Charge		24,391	25,001	25,626	26,267	26,923	27,596	28,286	28,993	29,718	30,461	31,223	32,003	32,803	33,623	34,464	80,383
Total	517,762	24,391	25,001	25,626	26,267	26,923	27,596	28,286	28,993	29,718	30,461	31,223	32,003	32,803	33,623	34,464	80,383

Option 2: Terminate Contract	Total	31-May-16	31-May-17	31-May-18	31-May-19	31-May-20	31-May-21	31-May-22	31-May-23	31-May-24	31-May-25	31-May-26	31-May-27	31-May-28	31-May-29	31-May-30	31-May-31
Termination payment	195,329	195,329	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Variable costs of service	23,451	1,210	1,240	1,271	1,303	1,336	1,369	1,403	1,438	1,474	1,511	1,549	1,588	1,627	1,668	1,710	1,753
Fixed costs of service	152,948	7,892	8,089	8,292	8,499	8,711	8,929	9,152	9,381	9,616	9,856	10,102	10,355	10,614	10,879	11,151	11,430
Lifecycle expenditure	8,655	854	774	781	788	512	519	576	585	595	604	614	624	333	319	86	88
Overheads	29,345	1,514	1,552	1,591	1,631	1,671	1,713	1,756	1,800	1,845	1,891	1,938	1,987	2,036	2,087	2,140	2,193
Total before financing	**409,728**	**206,800**	**11,656**	**11,935**	**12,221**	**12,230**	**12,531**	**12,888**	**13,205**	**13,530**	**13,863**	**14,204**	**14,554**	**14,611**	**14,954**	**15,086**	**15,463**
Financing cashflows @ 2.5% rate	44,063	-180,367	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962	14,962
Total	**453,791**	**26,433**	**26,618**	**26,897**	**27,183**	**27,192**	**27,493**	**27,850**	**28,167**	**28,492**	**28,825**	**29,166**	**29,516**	**29,573**	**29,916**	**30,048**	**30,425**

Option 3: Purchase share capital	Total	31-May-16	31-May-17	31-May-18	31-May-19	31-May-20	31-May-21	31-May-22	31-May-23	31-May-24	31-May-25	31-May-26	31-May-27	31-May-28	31-May-29	31-May-30	31-May-31
Consideration paid for share capital	53,215	53,215	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Payment of Unitary Charge	517,762	24,391	25,001	25,626	26,267	26,923	27,596	28,286	28,993	29,718	30,461	31,223	32,003	32,803	33,623	34,464	80,383
Distributions to equity holders	(125,941)	-1,924	-2,045	-3,429	-2,511	-2,695	-2,807	-2,949	-3,196	-3,323	-3,450	-3,603	-3,720	-3,895	-4,025	-4,196	-78,172
Total before financing	**445,036**	**75,682**	**22,956**	**22,197**	**23,755**	**24,228**	**24,789**	**25,337**	**25,797**	**26,394**	**27,011**	**27,619**	**28,283**	**28,908**	**29,598**	**30,268**	**2,211**
Financing cashflows @ 2.5% rate	12,004	-49,139	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076
Total	**457,040**	**26,543**	**27,032**	**26,273**	**27,832**	**28,304**	**28,865**	**29,413**	**29,873**	**30,471**	**31,088**	**31,696**	**32,359**	**32,984**	**33,675**	**34,345**	**6,288**

Option 3b: Purchase share capital with tax savi	Total	31-May-16	31-May-17	31-May-18	31-May-19	31-May-20	31-May-21	31-May-22	31-May-23	31-May-24	31-May-25	31-May-26	31-May-27	31-May-28	31-May-29	31-May-30	31-May-31
Consideration paid for share capital	53,215	53,215	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Payment of Unitary Charge	517,762	24,391	25,001	25,626	26,267	26,923	27,596	28,286	28,993	29,718	30,461	31,223	32,003	32,803	33,623	34,464	80,383
Distributions to equity holders	(167,197)	-2,080	-2,207	-4,621	-3,956	-4,284	-4,555	-4,732	-5,064	-5,394	-5,725	-6,101	-6,441	-6,850	-7,236	-7,680	-90,269
Total before financing	**403,780**	**75,526**	**22,793**	**21,005**	**22,311**	**22,639**	**23,041**	**23,554**	**23,929**	**24,324**	**24,736**	**25,121**	**25,563**	**25,953**	**26,387**	**26,784**	**-9,886**
Financing cashflows @ 2.5% rate	12,004	-49,139	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076
Total	**415,785**	**26,387**	**26,870**	**25,081**	**26,387**	**26,715**	**27,117**	**27,630**	**28,006**	**28,400**	**28,812**	**29,197**	**29,639**	**30,030**	**30,463**	**30,860**	**-5,810**

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