

Standardisation of PFI Contracts

Version 4

March 2007



HM TREASURY



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HM Treasury contacts

This document can be found on the Treasury website at:

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For general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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CONTENTS

	Page No
Chapter 1 INTRODUCTION	1
1.1 Background	1
1.2 Purpose	1
1.3 Assumptions	2
1.4 Application and Implementation	2
1.5 Use of Advisers	3
1.6 Terminology	3
1.7 Interpretation	4
Clause 1.7.1 Definitions	4
Clause 1.7.2 Interpretation	13
Chapter 2 DURATION OF CONTRACT	15
2.1 Introduction	15
2.2 Factors to Consider	15
Clause 2 Duration of Contract	16
Chapter 3 SERVICE COMMENCEMENT	17
3.1 Introduction	17
3.2 Authority's Role - General	17
3.3 Critical Dates	19
3.4 Submission of Designs and Information to the Authority	19
3.5 Quality Management Systems	20
3.6 Acceptance and Service Commencement	20
3.7 Existing Services	22
3.8 Range of Services to be Provided	24
3.9 Capital Contributions	24
3.10 Early Works Agreements	25

Chapter 4	PROTECTIONS AGAINST LATE SERVICE COMMENCEMENT	27
4.1	Introduction	27
4.2	Liquidated Damages	27
4.3	Performance Bonds	29
4.4	Parent Company Guarantees	29
4.5	Long-Stop Date	29
4.6	Bonus Payments for Early Service Commencement	29
Chapter 5	SUPERVENING EVENTS	31
5.1	Introduction	31
5.2	Compensation Events	32
5.2.1	Purpose and Scope	32
5.2.2	Consequences	33
5.2.3	Calculation of Compensation	34
	Clause 5.2 Delays in Service Commencement due to a Compensation Event	37
5.3	Relief Events	39
5.3.1	Purpose	39
5.3.2	Scope of Relief Events	39
5.3.3	Consequences	40
	Clause 5.3 Consequences of a Relief Event	41
5.4	Force Majeure Events	43
5.4.1	Scope of Force Majeure	43
5.4.2	Consequences of Force Majeure	44
5.4.3	Relief Events, Force Majeure Events and Insurance	44
Chapter 6	WARRANTIES	45
6.1	Introduction	45
6.2	Due Diligence	45
6.3	Authority Warranties	45
	Clause 6.3 Exclusion from Warranty	46

6.4	Benefit of Surveys and Reports	46
6.5	Latent Defects Risk	47
Chapter 7	PRICE AND PAYMENT MECHANISM	48
7.1	Introduction	48
7.2	Features of the Payment Mechanism	48
7.3	Structuring the Payment Mechanism	50
7.4	Usage-based Systems	51
7.5	Calibration	53
7.6	Financeability	58
7.7	Flexibility	58
7.8	Other Remedies for Poor Performance	59
7.9	Qualitative Factors and User Satisfaction	61
Chapter 8	AVAILABILITY REQUIREMENTS	64
8.1	Introduction	64
8.2	Definition of Availability	64
8.3	Examples of Unavailability	65
8.4	Payment for Availability and Weighting of Critical Areas	65
8.5	When does Availability Commence?	66
8.6	When does Unavailability Commence?	66
8.7	Rectification of Unavailability	67
8.8	Service Unavailable but Used	67
8.9	Restoration of Availability	68
8.10	Planned Maintenance	68
Chapter 9	PERFORMANCE REQUIREMENTS	69
9.1	Introduction	69
9.2	Setting the Performance Level	69
9.3	Replacement of Sub-Contractors	70
9.4	Monitoring of Sub-Contractors	70
9.5	Consequences of Poor Performance	71

Chapter 10	PAYMENT MECHANISM MANAGEMENT AND MONITORING	73
10.1	Contract Management	73
10.2	Monitoring against the Payment Mechanism	74
10.3	Commencement of Monitoring	75
10.4	Who does the Monitoring?	75
10.5	Who pays for the Monitoring?	76
10.6	Reporting the Results of Monitoring	76
Chapter 11	MAINTENANCE	78
11.1	Introduction	78
	Clause 11.1 Maintenance	78
11.2	Sinking Fund	78
11.3	Expiry of the Contract	79
11.4	Transfer of Assets at End of Contract	79
11.5	Surveys	80
	Clause 11.5 Surveys	80
Chapter 12	PAYMENTS AND SET-OFF	82
12.1	Introduction	82
12.2	Scope of Authority's Right to Set Off	82
12.3	Timing of Set-off	83
	Clause 12 Set-off	83
12.4	VAT on Payments	83
	Clause 12.4 VAT	83
Chapter 13	CHANGE IN SERVICE	84
13.1	Introduction	84
13.2	A Typology of Changes	85
13.3	Change Protocols	88
13.4	Transparency of Pricing and Value for Money	93
13.5	Incentivisation	98

Chapter 14	CHANGE IN LAW	99
14.1	Introduction	99
14.2	Contractor's and Authority's Concerns	99
14.3	Definition of Change in Law	99
14.4	Allocation of Risk of Change in Law	100
14.5	Mitigation	100
14.6	Discriminatory, Specific and General Changes in Law	101
14.7	General Change in Law at Contractor's Risk	101
14.8	General Change in Law as a Shared Risk	102
	Clause 14.8 Qualifying Change in Law	104
14.9	Changes in Tax Law	106
14.10	Changes in VAT	106
	14.10.1 Changes in the VAT Rate	106
	14.10.2 Changes in VAT Scope	106
	Clause 14.10 Payment of Irrecoverable VAT	107
Chapter 15	PRICE VARIATIONS	108
15.1	Introduction	108
15.2	Inflation Indexation	108
15.3	Value Testing of Operating Costs	109
	15.3.1 Introduction	109
	15.3.2 Choice of Value Test – Preference for Market Testing	110
	15.3.3 Planning and Management	111
15.4	Market Testing	112
	Clause 15.4 Market Testing	113
15.5	Benchmarking	115
Chapter 16	SUB-CONTRACTING, EMPLOYEES AND DOCUMENTARY CHANGES	117
16.1	Control over Sub-Contractors	117
16.2	Control over Employees	118
16.3	Consequences of Control	118

16.4	Changes to Project Documents and Financing Agreements	119
	Clause 16.4.1 Delivery of Initial and Changed Project Documents and Financing Agreements	119
	Clause 16.4.2 Changes to Project Documents	119
	Clause 16.4.3 Changes to Financing Agreements	120
Chapter 17	ASSIGNMENT	121
17.1	Introduction	121
17.2	Restrictions on the Contractor	121
17.3	Restrictions on the Authority	121
	Clause 17.3(A) Restrictions on Transfer of the Contract by the Authority in Central Government Projects	121
	Clause 17.3(B) Restrictions on transfer of the Contract by the Authority in Non-Central Government Projects	122
17.4	Restrictions on the Senior Lenders	122
Chapter 18	CHANGE OF OWNERSHIP	124
18.1	Introduction	124
18.2	Authority's Concerns	125
18.3	Shareholders' Concerns	126
18.4	Transfer of Interests: Flexibility and Restrictions	126
18.5	Related Issues	127
18.6	Ownership Default	127
Chapter 19	LAND, EQUIPMENT AND OTHER PROPERTY INTERESTS	128
19.1	Introduction	128
19.2	Property Transfer	128
19.3	Property Purchase and Disposal and Residual Value	129
19.4	Capital Allowances Act, 2001	131
19.5	Composite Trader	131

Chapter 20	TREATMENT OF ASSETS ON EXPIRY OF SERVICE PERIOD	133
20.1	Introduction	133
20.2	Assets where the Authority retains Residual Value on Expiry	133
	Clause 20.2 Treatment of Assets at Expiry Date	134
20.3	Preserving the Condition of the Assets on Expiry	135
20.4	Handover Provisions for Assets which transfer to the Authority	135
20.5	Transfer of Residual Value Risk	136
	Clause 20.5 Assets with an Alternative Use	137
20.6	Valuation of Terminal Payments on Expiry where Residual Value Risk has been Transferred	138
Chapter 21	EARLY TERMINATION	139
21.1	Termination on Authority Default	139
21.1.1	Introduction	139
21.1.2	Contractor's Rights to Terminate for Authority Default	139
	Clause 21.1.2 Termination on Authority Default	140
21.1.3	Compensation on Termination for Authority Default	140
	Clause 21.1.3 Compensation on Termination for Authority Default	142
21.2	Termination on Contractor Default	145
21.2.1	Introduction	145
21.2.2	Events Leading to Termination	145
21.2.3	Termination for Persistent Breach by the Contractor	147
	Clause 21.2.3 Persistent Breach	148
21.2.4	Rectification	148
	Clause 21.2.4 Rectification	148
21.2.5	Compensation on Termination for Contractor Default	150
21.2.6	Market Value	151
21.2.7	Retendering Election and Liquid Market	152

		Clause 21.2.7 Retendering Election	153
	21.2.8	Retendering Procedure	153
		Clause 21.2.8 Retendering Procedure	157
	21.2.9	No Retendering	160
		Clause 21.2.9 No Retendering Procedure	163
	21.2.10	Transfer of Assets on Contractor Default	164
21.3		Termination on Force Majeure	164
	21.3.1	Failure to agree	164
		Clause 21.3.1 Termination on Force Majeure	164
	21.3.2	Compensation on Termination for Force Majeure	166
		Clause 21.3.2 Compensation on Termination for Force Majeure	166
21.4		Termination on Corrupt Gifts and Fraud	167
	21.4.1	Introduction	167
	21.4.2	Scope of Corrupt Gifts and Fraud	168
		Clause 21.4.2 Corrupt Gifts and Fraud	169
		Clause 21.4.3 Termination for Corrupt Gifts and Fraud	169
	21.4.3	Compensation on Termination for Corrupt Gifts and Fraud	170
		Clause 21.4.4 Compensation on Termination for Corrupt Gifts and Fraud	170
21.5		Voluntary Termination by Authority	171
	21.5.1	Introduction	171
	21.5.2	Consequences of Voluntary Termination	171
	21.5.3	Compensation for Voluntary Termination	171
		Clause 21.5.1 Voluntary Termination by the Authority	171
		Clause 21.5.2 Compensation on Voluntary Termination	172
	21.5.4	Authority Break Points	172
		Clause 21.5.4 Termination on an Authority Break Point Date	172
		Clause 21.5.5 Compensation on Termination on an Authority Break Point Date	173

21.6	Termination for Breach of the Refinancing Provisions	173
21.6.1	Introduction	173
21.6.2	Compensation on Termination for Breach of the Refinancing Provisions	173
	Clause 21.6.1 Termination by the Authority for Breach of the Refinancing Provisions	174
	Clause 21.6.2 Compensation on Termination for Breach of the Refinancing Provisions	174
Chapter 22	CALCULATION AND PAYMENT OF EARLY TERMINATION PAYMENTS	175
22.1	Introduction	175
22.2	Gross-Up of Termination Payments	175
22.3	Certainty of Compensation Payment Amounts and Changes to Financing Agreements	175
	Clause 22.3 Changes to Financing Agreements and Project Documents	177
22.4	Set-off on Termination	177
	Clause 22.4 Set-off on Termination	178
22.5	Method of Payment	178
	Clause 22.5 Method of Payment	179
22.6	Retention of Assets by Contractor on Termination	181
22.7	Exclusivity of Remedy	181
Chapter 23	SURVEYS ON EXPIRY AND TERMINATION	183
23.1	Introduction	183
23.2	Timing of Survey on Expiry	183
23.3	Retention Fund	183
23.4	Guarantees or Bonds	184
23.5	Surveys on Early Termination	184
	Clause 23 Surveys on Termination	184

Chapter 24	INDEMNITIES, GUARANTEES AND CONTRACTUAL CLAIMS	186
24.1	Introduction	186
24.2	Guarantees	186
24.3	Indemnities	187
	Clause 24.3 Indemnity	188
24.4	Collateral Warranties	189
24.5	Financiers' Security	189
24.6	Damages Claims	190
Chapter 25	INSURANCE	192
25.1	Introduction	192
25.2	Authority's Requirements	193
	Clause 25.2 Insurance	195
25.3	Mechanism to increase Insured Amounts	197
25.4	Ensuring the Quality of the Insurances	197
25.5	Reinstatement and Change of Requirement after Insured Event	198
	Clause 25.5 Reinstatement	198
25.6	Application of Insurance Proceeds	200
	Clause 25.6 Economic Test	201
25.7	Control of the Defence on Litigation of an Insured Event	202
25.8	Insurance Premium Risk Sharing Schedule	202
25.9	Risks that become Uninsurable	212
	Clause 25.9 Uninsurable Risks	214
25.10	Terms and Conditions that become Unavailable	216
	Clause 25.10 Uninsurable Risks	216
25.11	Standard Required Insurance Schedule	218
Chapter 26	INFORMATION AND CONFIDENTIALITY	220
26.1	Introduction	220
26.2	Contractors Records and Provision of Information	220
	Clause 26.2 Contractor's Records and Provision of Information	220

26.3	Personal Data	222
	Clause 26.3 Personal Data	222
26.4	Public Relations and Publicity	223
	Clause 26.4 Public Relations and Publicity	223
26.5	Confidentiality	223
26.6	Government Openness	223
26.7	Recommended Approach	223
26.8	Nature of Commercially Sensitive Information	224
26.9	Related Matters	224
	Clause 26.9 Confidentiality	225
26.10	Freedom of Information	228
	Clause 26.10 Freedom of Information	228
Chapter 27	INTELLECTUAL PROPERTY RIGHTS	231
27.1	Introduction	231
27.2	Infringement of IPR by the Contractor	231
27.3	Infringement of IPR by the Authority	231
27.4	Rights to IPR on Expiry or Termination	232
Chapter 28	DISPUTE RESOLUTION	233
28.1	Introduction	233
28.2	Dispute Resolution Procedure	233
28.3	Joinder of Sub-Contract Disputes	233
28.4	Housing Grants, Construction and Regeneration Act 1996	234
28.5	Delays caused by Disputes	234
	Clause 28 Dispute Resolution	235
Chapter 29	AUTHORITY STEP-IN	240
29.1	Introduction	240
29.2	Step-In—General	240
	Clause 29 Authority Step-in	240
29.3	Step-In without Contractor Breach	241

29.4	Step-In on Contractor Breach	241
29.5	Related Issues	242
29.6	Rights of Access	243
Chapter 30	MISCELLANEOUS PROVISIONS	244
	Clause 30.1 Waiver	244
	Clause 30.2 Severability	244
	Clause 30.3 Counterparts	244
	Clause 30.4 Law of the Contract and Jurisdiction	244
	Clause 30.5 Third Party Rights	244
	Clause 30.6 Interest on Late Payments	244
	Clause 30.7 Continuing Obligations	244
Chapter 31	DIRECT AGREEMENT AND SENIOR LENDERS	246
31.1	Introduction	246
31.2	Liability of Senior Lenders	246
31.3	Required Approach	247
31.4	Performance Point Accrual when Stepped In	248
31.5	Liability for Indemnity Claims or Claims for Damages	249
31.6	Direct Agreement	249
	Clause 31.6 Direct Agreement	249
31.7	Subordination and Related Provisions	257
	Clause 31.7 Authority Rights under Direct Agreements [and Appointments]	258
Chapter 32	COMPETITIVE DIALOGUE AND COMMITMENT LETTERS	261
32.1	EU Procurement Law	261
32.2	Ensuring Commitment	262
32.3	Required Approach	263

Chapter 33	DUE DILIGENCE OVER SUB-CONTRACTS AND FINANCING DOCUMENTS	265
33.1	Introduction	265
33.2	Financing Documents	265
33.3	Sub-Contracts	266
Chapter 34	REFINANCING	268
34. 1	Introduction	268
34.2	What is a Refinancing?	269
34.3	Authority Consent	269
34.4	Exemptions	270
34.4.1	Junior Capital	270
34.4.2	Base Case Refinancings	271
34.4.3	Corporate Finance	271
34.4.4	Interest Rate Hedging	271
34.4.5	Taxation and Accounting Policies	271
34.4.6	Qualifying Bank Transactions	272
34.5	Method of Calculating, Sharing and Paying Benefits	272
34.5.1	Calculation	272
34.5.2	Discount Rate	273
34.5.3	Sharing	273
34.5.4	Payment	274
34.6	Audit Rights and Transaction Costs	274
34.7	Joint Venture PFI Projects	274
34.8	Model Refinancing Provisions	274
	Clause 34 Refinancing	275
Chapter 35	FINANCIAL ROBUSTNESS: CONTRACTOR DISTRESS	281
35.1	Structural Protection from the Consequences of Contractor Distress	281
35.2	Financial and Structuring Robustness	282
35.3	Contractual Protection	283
35.4	Recognising Contractor Distress	284
35.5	Managing Contractor Distress	286

Chapter 36	BOND FINANCE	288
36.1	Introduction	288
36.2	Principal Changes to the Contract for Bond Finance	289
Chapter 37	CORPORATE FINANCE	295
37.1	Introduction	295
37.2	Project and Corporate Finance	295
37.3	Corporate Finance – Procurement Implications	297
37.4	Corporate Finance – Evaluation Implications	297
37.5	Amendments to Standard Drafting	298
37.6	Changes between Project and Corporate Finance	304
	37.6.1 Change from Project to Corporate Finance	304
	37.6.2 Change from Corporate to Project Finance	305
37.7	Variant Structures	306
ANNEX 1		307
	Guidance Note - Standard Required Insurance Schedule	307

1 INTRODUCTION

1.1 BACKGROUND

1.1.1 In July 1999 the first edition of Standardisation of PFI Contracts ("SoPC") was published. The aim was to provide guidance on the key issues that arise in PFI projects in order to promote the achievement of commercially balanced Contracts and enable public sector procurers to meet their requirements and deliver best value for money. Second and third editions have followed in September 2002, and April 2004, together with an Addendum in December 2005. This Version 4 updates the guidance to take into account new legislation and developments in the PFI market, incorporates the changes and derogations contained in the Addendum and provides new guidance on certain matters identified in HM Treasury's ("HMT") March 2006 document entitled "PFI: Strengthening Long-Term Partnerships".¹

1.1.2 Version 4 contains new or updated material (beyond that contained in the Addendum) in relation to the following primary areas:

- the range of Services to be supplied under the Contract (Section 3.8);
- Price and Payment Mechanism (Section 7);
- Contract Management (Section 10.1);
- Change in Service (Section 13);
- Price Variations (Section 15);
- Changes to Project Documents and Financing Agreements (Section 16.4);
- Change of Ownership (Section 18);
- Land, Equipment and other Property Interests (Section 19);
- Authority Break Points (Section 21.5.4)
- Contractor's Records and Provision of Information (Section 26.2);
- Competitive Dialogue and Commitment Letters (Section 32);
- Refinancing (Section 34);
- Financial Robustness: Contractor Distress (Section 35);
- Bond Finance (Section 36); and
- Corporate Finance (Section 37).

See further HMT's document entitled "SoPC4: An Outline of Principal Changes" dated March 2007.

1.2 PURPOSE

1.2.1 The three main objectives of the guidance remain unchanged. First, to promote a common understanding of the main risks which are encountered in a standard PFI project; secondly, to allow consistency of approach and pricing across a range of similar projects; and thirdly, to reduce the time and costs of negotiation by enabling all parties concerned to agree a range of areas that can follow a standard approach without extended negotiations.

¹ See HMT web site at www.hm-treasury.gov.uk

1.3 ASSUMPTIONS

1.3.1 The following assumptions apply to the guidance, unless otherwise indicated:

- the party contracting with the public sector is a special purpose company² with Sub-Contractors providing the actual performance on its behalf;
- the project involves some development or a construction phase, followed by an operational phase during which the full Service is provided; and
- the project is wholly or partly financed by limited recourse debt.

1.3.2 These assumptions are relevant because: (a) that is how the majority of PFI transactions continue to be structured and (b) such a contractual structure is inherently complicated and thus large parts of the guidance will be particularly helpful to users.

1.3.3 Use of these assumptions does not mean however that one financial structure is inherently preferable to another. The suitability of various structures, including trade-offs between cost, complexity and risk, should naturally form part of the public sector's overall appraisal of bidders' proposals. Accordingly, no conclusion may be drawn in advance of such appraisal as to which form of financial structure is most appropriate, including whether a special purpose company will be required.

1.3.4 Where a project does not fall within the standard assumptions in Section 1.3.1, adjustments will be needed to required drafting provisions and Authorities should seek guidance at an early stage.

1.4 APPLICATION AND IMPLEMENTATION

1.4.1 The guidance continues to use a range of approaches to issues from explanatory text to specific drafting. Significant parts of the standard drafting are now sufficiently well established to be included in transaction documents without amendment. The Clauses specified in the following Sections should not be amended (except as envisaged by its accompanying footnotes and guidance notes): 1.7.1, 1.7.2, 2.2.4, 5.2.1.2, 5.2.3.9, 5.3.2.1, 5.3.3.5, 5.4.1.2, 6.3.3, 11.1.4, 11.5.2, 12.4.1, 12.4.2, 12.4.3, 14.3.1, 14.6.1, 14.6.2, 14.8.10, 17.3.2, 21.1.2.1, 21.1.2.4, 21.1.3.9, 21.2.2.1, 21.2.3.3, 21.2.4.1, 21.2.7.6, 21.2.8.9, 21.2.9.11, 21.3.1.1, 21.3.2.2, 21.4.1.3, 21.4.2.3, 21.4.3.4, 21.5.3.3, 21.6.2.2, 22.3.8, 22.4.1, 22.5.3.3, 22.5.4, 22.7.2, 23.5.1, 25.5.4, 25.6, 25.8.14, 25.9.3, 25.9.5, 25.9.9, 25.10.3, 26.2, 26.9.4, 28.5.3, 29.2, 29.3.3, 29.4.4, 29.6.2, 31.6, 32.3.1, 34.8.1.

1.4.2 In certain circumstances (e.g. on large, complex or novel deals), Authorities will still need to consider making changes to standard drafting, in order to address project-specific issues. In such circumstances, which should be limited, HMT and Partnerships UK plc ("PUK") can offer advice.

1.4.3 This guidance applies to all PFI contracts in England and Wales but does not apply to IT projects, for which separate guidance is applicable (see *ICT Model Services Agreement and*

² If the Contractor is a limited partnership this will necessitate a number of project -specific changes to standard drafting. The drafting affected will include:

- definition of "Contractor Default", to recognise partnership insolvency provisions (Section 21.2.2.1);
- definition of "Distribution", to recognise partnership equity (Clause 34);
- "Change of Ownership" provisions and definition, to recognise the structure of the partnership (see comments below and see Section 18); and
- tax provisions (to ensure that the Contractor maintains its UK tax residence).

If any of the holders of equity in the Contractor are limited partnerships or other funds, particular attention will need to be given to the Change of Ownership provisions during any lock-in period. To ensure that the intention of any lock-in is achieved, provisions should be considered requiring that the fund/limited partnership is at all times during the lock-in managed and advised by a member of the relevant bank's or Sub-Contractor's group (if they are a part of a bank or Sub-Contractor group and if the identity of this group is important to the Authority). See further Section 18.1.5

Guidance published for OGC on the PUK website). The PFI is not suitable for Projects with a capital value of less than £20 million.

1.4.4 The HMT letter entitled “Implementation of Standardisation of PFI Contracts”, published on the HMT web site sets out the requirements for the implementation and enforcement of this SoPC Version 4.

1.4.5 Where the Authority entering into the Contract is a local authority, some additional considerations apply (see generally in this respect the *Local Authority Supplement to SoPC* published on the 4ps website and dated July 2004). It is important that, in entering into any Contract, a local authority is not fettering itself in the performance of its normal public duties. Guidance on a suitable provision to achieve this may be obtained from 4ps and reference should be made to Section 4.2.10 of 4ps *Local Authority Supplement to SoPC*. Equally however, the Contractor will want to know that if the Authority expressly agrees to do something in the Contract and fails to do it, then (without seeking to fetter the local authority in the exercise of its public duties) the Contractor should enjoy his contractual rights and remedies (which may be by way of relief or compensation). The obligations of the Authority in any Contract should be limited (normally being confined to payment and perhaps some access and co-operation provisions) and clearly stated in any event. If there is any doubt around the relationship of any of these provisions with any statutory duty, the position should be clarified in the Contract. On any local authority project the Authority should always ensure that it does not undertake any obligations in the Contract which could conflict with its statutory duties and powers.

1.5 USE OF ADVISERS

1.5.1 Experience of delivering PFI Contracts continues to demonstrate that early appointment of suitably qualified advisers by the public sector is vital to success. These advisers should be required to work with this Version (subject to Section 1.4.4 (Implementation)) of SoPC as the basis for development of the Contract.

1.5.2 Where Authorities need help in relation to this guidance they can also contact HMT or PUK. In particular, PUK operates a helpline service for the public and private sectors, free at the point of use. Parties with questions about this edition are encouraged to make use of this service, details of which can be found on PUK’s website at www.partnershipsuk.org.uk. Authorities should continue to seek advice from relevant Private Finance Units, or 4ps.

1.6 TERMINOLOGY

1.6.1 In this guidance, the public sector party buying the Service is referred to as the “Authority” and its counterpart as the “Contractor”, with the overall scheme referred to as the “Project”. The agreement entered into between the Authority and the Contractor is referred to as the “Contract”. When all those with a financial stake in the Project are referred to then the expression “financiers” is used. Accordingly, the term “financing” refers to all types of financial interest in the Project. There is a Section containing definitions at the start of this guidance (see Section 1.7 (Interpretation)). These definitions are used both in the text and the drafting. Definitions specific to a particular Clause are set out with the Clause concerned. Where drafting is provided, it is set out in Clauses.

1.6.2 Three different forms which the provisions can take are (a) the standard drafting of a whole subject with guidance notes, (b) standard drafting of parts of a subject, with the rest of the subject being dealt with by explanatory notes and (c) guidance explaining how a subject should be dealt with in broad terms with a recommended approach to the issue. Where Clause drafting is provided it can be either required drafting (see Section 1.4.1) or suitable drafting.

1.6.3 The following acronyms and abbreviations are used in this guidance:

Addendum: HMT's "Further Guidance and Permitted Derogations and Clarifications" dated December 2005.

BSF: Building Schools for the Future. The Government's programme for rebuilding or refurbishing schools

HMRC: HM Revenue & Customs

HMT: HM Treasury

ISO: International Standards Organisation

IP: Intellectual Property

IPR: Intellectual Property Rights

IT: Information Technology

ITPD: Invitation to participate in the dialogue (i.e. the invitation to bidders who have pre-qualified to take part in a competitive dialogue under Regulation 18 of the Public Contracts Regulations 2006 (SI 2006 No. 5))

MOD: Ministry of Defence

NHS: National Health Service

NPV: Net Present Value

OGC: Office of Government Commerce

PUK: Partnerships UK plc

SLTP: HMT's "PFI: Strengthening Long-Term Partnerships" publication of March 2006.³

SPV: Special Purpose Vehicle

VfM: Value for Money

1.7 INTERPRETATION

1.7.1 Set out below is required wording for the following general definitions which are used at various stages in the guidance:

1.7.1 Definitions⁴

In this Contract, unless the context otherwise requires:

"Additional Permitted Borrowing"

means on any date, the amount equal to any amount of principal outstanding under the Senior Financing Agreements (as the same may from time to time be amended, whether or not with the approval of the Authority) in excess of the amount of principal scheduled under the Senior Financing Agreements at Financial Close to be outstanding at that date,

but only to the extent that:

- (a) this amount is less than or equal to the Additional Permitted Borrowings Limit;
- and

³ See HMT website www.hm-treasury.gov.uk

⁴ Certain definitions exclusive to the Direct agreement between the Authority and the Senior Lenders are contained in Section 31 (Direct Agreement and Senior Lenders).

- (b) in respect of any Additional Permitted Borrowing the Agent is not in material breach of its obligations under Clause 10(d)(iii) of the Direct Agreement as it applies to such Additional Permitted Borrowing

and provided further that any such excess amount of principal which is: (i) invested as part of any Qualifying Variation or (ii) outstanding from time to time as a result of any drawing under the Senior Financing Agreements as entered into at the date of this Contract, disregarding any subsequent amendment or (iii) outstanding from time to time as a result of any amendment to the Senior Financing Agreements in respect of which the Authority has agreed that its liabilities on a termination may be increased pursuant to Clause 22.3 (a), shall not be counted as Additional Permitted Borrowing;

“Additional Permitted Borrowings Limit”

means an amount equal to:

- (a) 10% of the Original Senior Commitment for any Additional Permitted Borrowing subsisting in the period from the date of Financial Close to the date on which the amount outstanding under the Senior Financing Agreements is reduced to 50% or less of the Original Senior Commitment, and thereafter;
- (b) the higher of:
 - (i) 5% of the Original Senior Commitment; and
 - (ii) the amount of any Additional Permitted Borrowing outstanding on the last day of the period referred to in (a);

“Affiliate”

means in relation to any person, any holding company or subsidiary of that person or any subsidiary of such holding company and “holding company” and “subsidiary” shall have the meaning given to them in Section 736 of the Companies Act 1985;

“Agent”⁵

means [] in its capacity as agent for the Senior Lenders under the Senior Financing Agreements;

“APB Distribution”

means, for the period during which the Additional Permitted Borrowing subsists, an amount equal to the aggregate of all Distributions made during that period up to an amount equal to the principal of the Additional Permitted Borrowing on the first day of that period;

“Assets”⁶

means all assets and rights to enable the Authority or a successor contractor to own, operate and maintain the Project in accordance with this Contract, including:

- (a) any land or buildings;
- (b) any equipment;
- (c) any books and records (including operating and maintenance manuals, health and safety manuals and other know-how);
- (d) any spare parts, tools and other assets (together with any warranties in respect of assets being transferred);

⁵ In the context of a bond financing, this definition may be substituted by a definition of “Credit Provider” (or similar), being the finance party that controls the rights of the financiers.

⁶ The precise nature of the assets involved and any exclusions will, of course, depend on the project concerned.

- (e) any revenues and any other contractual rights; and
- (f) any intellectual property rights,

but excluding any assets and rights in respect of which the Authority is full legal and beneficial owner;

“Associated Company”

means in respect of a relevant company, a company which is a subsidiary, a Holding Company or a company that is a subsidiary of the ultimate Holding Company of that relevant company, and in the case of the Contractor shall include [Holdco and] each of the Shareholders;

[N.B. If a fund or limited partnership or “50:50” owned vehicle (which is not a “subsidiary”) or similar is in the relevant ownership chain of the Contractor, this definition will need to be expanded to cover it. See further footnote 2 and Section 34].

“Base Case”

means the financial model agreed between the parties prior to the date of this Contract (as updated from time to time in accordance with the terms of this Contract)⁷ for the purpose of, amongst other things, calculating the Unitary Charge;

“Base Senior Debt Termination Amount”

means, subject to Clause 22.3 (Changes to Financing Agreements and Project Documents):

- (a) all amounts outstanding at the Termination Date, including interest and Default Interest accrued as at that date, from the Contractor to the Senior Lenders in respect of Permitted Borrowing⁸ (other than in respect of Additional Permitted Borrowing); and
- (b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs,⁹ payable by the Contractor to the Senior Lenders¹⁰ as a result of a prepayment in respect of Permitted Borrowing (other than in respect of Additional Permitted Borrowing), or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract, subject to the Contractor and the Senior Lenders mitigating all such costs to the extent reasonably possible;

less, to the extent it is a positive amount, the aggregate of (without double counting in relation to the calculation of the Base Senior Debt Termination Amount or the amounts below):

⁷ For example, following a benchmarking or market testing exercise, a Qualifying Change in Law or an Authority Change. The model should cover payments in respect of the Contractor and any other relevant company (e.g. Holdco).

⁸ This assumes a check has been made by the Authority’s advisers that the provisions of the Senior Financing Agreements do not include unusual provisions that could artificially inflate amounts beyond those provisions that are market standard (such as specific pre-payment fees). A judgement will have to be made, for example, on whether prepayment fees (in excess of market standard breakage costs) should be included. In most cases it is recommended that they should not be. See Section 33 (Due Diligence over Sub-Contracts and Financing Documents) and see also footnote 27 below.

⁹ This is intended to cover net breakage costs if the compensation is not paid on an interest payment date. Authorities may consider whether they should exclude any future profit element from the calculation of costs of early termination of interest hedging arrangements where the termination is for force majeure, breach of refinancing, corrupt gifts and uninsurability. See also *HMT Guidance “Interest rate and Inflation risks in PFI Transactions” of April 2006*.

¹⁰ This assumes the Senior Lenders are the only parties to any interest rate hedging agreements (this will not necessarily be the case) and are compliant with the agreed hedging policy. See also footnote 35 below.

- (i) all credit balances¹¹ on any bank accounts (but excluding the Joint Insurance Account)¹² held by or on behalf of the Contractor¹³ on the Termination Date;
- (ii) any amounts claimable on or after the Termination Date in respect of Contingent Funding Liabilities;
- (iii) all amounts, including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the Senior Lenders to the Contractor as a result of prepayment of amounts outstanding¹⁴ in respect of Permitted Borrowing (other than in respect of Additional Permitted Borrowing), or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract; and
- (iv) all other amounts received by the Senior Lenders on or after the Termination Date and before the date on which any compensation is payable by the Authority to the Contractor as a result of enforcing any other rights they may have;

“Business Day”

means a day (other than a Saturday or Sunday) on which banks are open for domestic business in the city of London;

“Capital Expenditure”

means any expenditure which falls to be treated as capital expenditure in accordance with generally accepted accounting principles in the United Kingdom from time to time;¹⁵

“Consents”

means all permissions, consents, approvals, certificates, permits, licenses and authorisations of a Relevant Authority required for the performance of any of the Contractor’s obligations under this Contract;¹⁶

“Construction Sub-Contractor”

means the [person performing the construction or development obligations];¹⁷

“Contingent Funding Liabilities”

means []:¹⁸

¹¹ Such references should also cover such credit balances whether they are held as cash (as with revenue accounts) or in the form of investments (as with reserve accounts) and should extend to letters of credit of other instruments if these are used instead of cash.

¹² Any proceeds standing to the credit of the Joint Insurance Account will continue to be used for reinstatement after the Termination Date. See Section 25.5.4 (Reinstatement and Change of Requirement after Insured Event).

¹³ This recognises that these balances will, in the ordinary course, be charged to the Senior Lenders as security and so on a termination can be set off by them against outstandings. It is sensible, therefore, not to pay such amounts, rather than to pay and subsequently recover such amounts. To the extent any such accounts are not charged to Senior Lenders, they may be excluded from (i). If a Holdco is used and the Senior Lenders have security over Holdco’s bank accounts, then Holdco should also be referenced here.

¹⁴ See footnote 27.

¹⁵ For “composite trader” projects this definition may be amended to read “Works Expenditure” or “Relevant Expenditure”. See Section 19.5 (Composite Trader).

¹⁶ These will include, for example, planning consents.

¹⁷ In transactions that do not involve construction work (for example, some defence contracts) other terminology will be required.

¹⁸ These will be any contingent liabilities of the shareholders in respect of financial obligations owed to the Contractor and/or lenders under the Financing Agreements in relation to the Project which are triggered as a result of or in relation to the termination of the Contract (see Section 33.2 in relation to due diligence). For example, guarantees or letters of credit in respect of deferred equity, subordinated debt or

“Default Interest”

means any increased margin that is payable to the Senior Lenders or which accrues as a result of any payment due to the Senior Lenders not being made on the date on which it is due;

“Direct Agreement”¹⁹

means the direct agreement dated on or about the date of this Contract and made between the Authority, the Contractor and the Agent;

“Effective Date”

means [the date on which any conditions precedent have been satisfied];²⁰

“Estimated Change in Project Costs”

means in relation to Clause 5.2 (Compensation Events), and Clause 14 (Change in Law), the aggregate of any estimated increase in construction costs, operating costs and financing costs less the aggregate of any estimated reduction in construction costs, operating costs and financing costs;

“Expiry Date”

means the [xth] anniversary of [the Effective Date] [the date of this Contract];

“Financial Close”

has the meaning given to it in the Senior Financing Agreements;

“Financing Agreements”²¹

means all or any of the agreements or instruments entered into or to be entered into by the Contractor or any of its Associated Companies relating to the financing of the Project (including the Initial Financing Agreements and any agreements or instruments to be entered into by the Contractor or any of its Associated Companies relating to the rescheduling of their indebtedness or any Refinancing);

“Guidance”

means any applicable guidance or directions with which the Contractor is bound to comply;²²

equity bridge loans or obligations to fund reserve accounts. This will not include any guarantees or letters of credit issued in support of the Sub-Contractors' obligations under the relevant Sub-Contracts.

¹⁹ The form of direct agreement that should be used is set out in Section 31 (Direct Agreement and Senior Lenders).

²⁰ Conditions precedent will often not be necessary in a Contract. They can be used as a checklist of what needs to be delivered on or prior to signing (e.g. the Senior Financing Agreements). Such issues can be dealt with in separate ways, for example, by having a checklist of tasks that must be completed or documents signed prior to the Contract being signed. Conditions precedent are strictly only needed if they relate to things which must be done after signing. One example would be planning consents in projects in which it is necessary to have a signed document prior to a planning application being made. See also Clause 2(a).

²¹ This definition assumes that the project is being financed using Senior Debt and equity and would cover subordinated debt and any mezzanine debt. This definition is used in Section 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements) and 16.4 (Changes to Financing Agreements) and Section 34 (Refinancing)). This guidance does not deal specifically with the provision of mezzanine debt to a project and its treatment (e.g. in terms of the compensation payable on termination for Authority Default, refinancing and force majeure), although this has been used in some PFI projects. How mezzanine financing is treated is an issue for specific projects, although this will naturally depend upon the particular funding structure, the rate of return on the mezzanine and the nature of the project concerned. Where mezzanine finance is used, it should be determined whether it has more the nature of senior debt or equity and treated accordingly, and advice should be sought from departmental Private Finance Units and/or HMT to ensure that it is classified correctly.

²² Whether this definition is needed will depend on the sector (i.e. whether the introduction of Guidance can have the same effect as a change in law (see Section 14 (Change in Law)).

“Holding Company”

has the meaning given to it in Section 736 of the Companies Act 1985, as amended by Section 144 of the Companies Act 1989;

“Holdco”

means [insert details of the Contractor’s 100% holding company if any];²³

“Initial Financing Agreements”

means the Financing Agreements put in place upon signature of this Agreement as follows:

[]

copies of which have been initialled by the parties for the purposes of identification;

“Joint Insurance Account”

means the joint bank account in the names of the Authority and the Contractor, having account number [] and held with [];

“Junior Debt”

means all amounts outstanding at the Termination Date under the Subordinated Financing Agreements;

“Operating Sub-Contractor”

means [the person performing obligations to provide the Service during the Service Period];²⁴

“Original Senior Commitment”

means the amount committed under the Senior Financing Agreements as at Financial Close (as adjusted to take into account any Qualifying Variation);

“Permitted Borrowing”

means, without double-counting, any:

- (a) advance to the Contractor under the Senior Financing Agreements,²⁵ provided that such advance is not made under any Committed Standby Facility;
- (b) Additional Permitted Borrowing;
- (c) advance to the Contractor under any Committed Standby Facility which is made solely for the purpose of funding any cost overruns, increased expenses or loss of revenue which the Contractor incurs, provided that such funds are not used in substitution for other sources of committed funding designated for those purposes; and²⁶

²³ If there is no 100% holding company used as part of the project structure then this definition should not be used and reference to Holdco in the definition of the Associated Company or elsewhere should be deleted. References to “Holding Company” however, must remain.

²⁴ In the absence of a single Service provider assuming all such obligations, this definition should be amended to refer to persons contracting directly with the Contractor to provide the constituent elements of the Service.

²⁵ If the Senior Lenders are not committing a Committed Standby Facility at Financial Close, the Authority should conduct due diligence over the sizing of the facilities that are committed, so as to ensure that they have not been inflated in such a way that the effect is to create a facility which by its very nature, also acts as a “Committed Standby Facility”.

²⁶ This will need to be defined and will be any standby facility that is committed by the Senior Lenders at Financial Close for the purposes of funding any unforeseen cost overruns, increased expenses or loss of revenues incurred by the Contractor, and the Authority should conduct due diligence over the size and terms of the facility prior to Financial Close to evaluate its potential liability under Clause 22.3. The protection given to the Contractor under Clause 22.3 (Changes to Financing Agreements and Project Documents) should only take effect if the purpose of the advance under the Committed Standby facility is to fund genuine unforeseen costs and not, for example, to

(d) interest and, in respect of the original Senior Financing Agreements only (as entered into at the date of this Contract, prior to any subsequent amendment), other amounts²⁷ accrued or payable under the terms of such original Senior Financing Agreements,

except where the amount referred to in paragraphs (a) to (d) above is or is being used to fund a payment of Default Interest on any Additional Permitted Borrowing;

“PFI”

means the Government’s Private Finance Initiative or any similar or replacement initiative;

“PFI Contractor”

means a person that has contracted with the Government, a local authority or other public or statutory body to provide services under the PFI;

“Planned Service Commencement Date”²⁸

means [fixed date by [on] which Service Commencement is planned to occur] or such other date as the parties may agree;

“Project”

means [];²⁹

“Project Documents”

means the agreements entered into by the Contractor for the performance of the obligations under this Contract which are listed in [] copies of which have been initialled by the parties for the purposes of identification;³⁰

“Qualifying Variation”³¹

means,

either:

- (a) a change in [the Works and/or]³² the Service in respect of which either an [Authority Notice of Change] or a [Contractor Notice of Change] has been served and, in the case of

prepay amounts owed by the Contractor under the Subordinated Financing Agreements.

²⁷ It is vital that the Authority’s advisers satisfy themselves as to the appropriateness of the senior finance terms (especially any possibly unusual fees or indemnities) in the light of this potential liability. If the Authority is not so satisfied, it should either ask the Senior Lenders to revise their terms or alternatively restrict the Authority’s exposure under Sub-Clause (d) of Permitted Borrowings above to those fees which it is willing to pay on a relevant termination.

²⁸ Whether this concept (and definition) is required will depend on:
(a) the attitude taken to early Service Commencement (See Sections 3.7 (Existing Services) and 4.6 (Bonus Payments for Early Service Commencement)); and
(b) whether any dates need to refer to the date on which the Service is due to commence (for example, a default long-stop date or liquidated damages for failure to complete on time).

²⁹ This term should be defined on a project-specific basis.

³⁰ These will usually be listed in a schedule and include contracts the Contractor has with its main Sub-Contractors, usually:

- (a) the Construction Sub-Contractor; and
- (b) the Operating Sub -Contractor.

The definition should not, however, be extended to include contracts between the main Sub-Contractors and their sub-contractors (i.e. those without a direct contractual relationship with the Contractor) or Finance Documents.

³¹ See definition of Original Senior Commitment.

³² References to Works should only be included if variations in the build phase are to be allowed and an appropriate definition should be used. Definitions of “Authority Notice of Change”, “Contractor Notice of Change” and “Estimate” should all relate to the relevant drafting in the Change Protocol developed pursuant to Section 13 (Change in Service).

- (i) an [Authority Notice of Change], the Authority has confirmed the [Estimate] and, where the Contractor is not funding all or part of the required Capital Expenditure, the Authority has agreed to meet all or the remaining part (as appropriate) of such Capital Expenditure; and
- (ii) a [Contractor Notice of Change], the change has been accepted by the Authority; or

(b) a Qualifying Change in Law

and in respect of which any documents or amendments to the Project Documents which are required to give effect to such change in [the Works and/or] Service or Qualifying Change in Law have become unconditional in all respects;

“Relevant Authority”

means any court with the relevant jurisdiction and any local, national or supra-national agency, inspectorate, minister, ministry, official or public or statutory person of the government of the United Kingdom or of the European Union;

“Revised Senior Debt Termination Amount”

means, subject to Clause 22.3 (Changes to Financing Agreements and Project Documents):

- (a) all amounts outstanding at the Termination Date, including interest and (other than in respect of Additional Permitted Borrowing) Default Interest accrued as at that date, from the Contractor to the Senior Lenders in respect of Permitted Borrowing; and
- (b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs,³³ payable by the Contractor to the Senior Lenders as a result of a prepayment in respect of Permitted Borrowing, or, in the case of early termination or interest rate hedging arrangements only, as a result of termination of this Contract, subject to the Contractor and the Senior Lenders mitigating all such costs to the extent reasonably possible,

less, to the extent it is a positive amount, the aggregate of (without double counting in relation to the calculation of the Revised Senior Debt Termination Amount or the amounts below):

- (i) all credit balances on any bank accounts (but excluding the Joint Insurance Account) held by or on behalf of the Contractor³⁴ on the Termination Date;
- (ii) any amounts claimable on or after the Termination Date in respect of Contingent Funding Liabilities;
- (iii) all amounts, including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the Senior Lenders to the Contractor as a result of prepayment of amounts outstanding in respect of Permitted Borrowing, or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract;
- (iv) all other amounts received by the Senior Lenders on or after the Termination Date and before the date on which any compensation is payable by the Authority to the Contractor as a result of enforcing any other rights they may have; and
- (v) all APB Distributions;

³³ See footnote 27 above.

³⁴ See footnote 13 above.

“Senior Debt”

means the financing provided by the Senior Lenders under the Senior Financing Agreements;

“Senior Financing Agreements”

means []³⁵ as at the date of this Contract or as amended with the prior written approval of the Authority pursuant to Clause 22.3 (a);³⁶

“Senior Lender”

means a person providing finance to the Contractor under the Senior Financing Agreements;³⁷

“Service”

means [the services required to satisfy the services specification of the Authority contained in Schedule []];

“Service Commencement”

means the commencement of the Service;

“Service Commencement Date”

means the date³⁸ on which Service Commencement occurs in accordance with [Section 3 (Service Commencement)];

“Service Period”

means the period specified in Clause 2(b);³⁹

“Shareholders”

means any person from time to time holding share capital in the Contractor or its Holding Company;

³⁵ These are all documents relating to the Senior Debt and may include:

- (a) a credit agreement;
- (b) interest rate hedging agreements; and
- (c) security documents.

Where bond financing is used the definition will include the bond trust deed, the terms and conditions of the bond, as well as security documents. A monoline insured deal will also include reference to the monoline's Policy and Endorsement and its Insurance and Indemnity Agreement (each of which will be defined in the Contract). See Section 36 (Bond Finance) Other financing structures will require reference to other documents. See Section 37 (Corporate Finance). As regards mezzanine finance, see footnote 36 above.

The Authority should place limits on hedging agreements to allow only those agreements that comply with an agreed hedging policy and details of which have been notified to and acknowledged by the Authority to be included in the definition of Senior Debt (Base Senior Debt Termination Amount or Revised Senior Debt Termination Amount, as appropriate). The hedging policy may, or course, change over time, which the parties should agree to as necessary.

³⁶ Where referred to in the Contract, Senior Financing Agreements should mean those agreements as at the date of the Contract as they may be amended with the approval of the Authority pursuant to Clause 22.3(a). This is particularly important if Senior Debt is paid on early termination of the Contract. On signature of the Contract, the Authority has an assumed exposure to termination liabilities (based on the financing structure in place at financial close); the Authority should therefore have the right to approve any amendments to its termination liability (see Section 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements)). If the Contractor makes changes to the Senior Financing Agreements which have not been approved by the Authority for the purposes of Clause 22.3 they will be disregarded for the purposes of calculating termination sums unless they qualify as Additional Permitted Borrowing.

³⁷ Reference may be made to approved hedge counter-parties if relevant. This and related definitions will need to be carefully reviewed for projects whose financial structures include a mixture of Senior Debt and mezzanine debt in addition to subordinated debt and equity.

³⁸ This assumes a single Service Commencement Date. To the extent a project has more than one Service Commencement Date (see Section 3.6 (Acceptance and Service Commencement)), this will need amendment to recognise that partial provision of the Service may commence prior to the main Service Commencement Date. See Section 3 (Service Commencement).

³⁹ That is the period from the Service Commencement Date to the Expiry Date, unless the Contract is terminated early (see Sections 2 (Duration of Contract) and 21 (Early Termination)).

“Sub-Contractors”

means each of the counterparties of the Contractor to the Project Documents or any person engaged by the Contractor from time to time as may be permitted by this Contract to procure the provision of the Works and/or Services (or any of them). References to sub-contractors means sub-contractors (of any tier) of the Contractor;

“Sub-Contracts”

means the contracts entered into between the Contractor and the Sub-Contractors;

“Subordinated Financing Agreements”

means []⁴⁰ as at the date of this Contract or as amended with the prior written approval of the Authority;

“Subordinated Lender”

means a person providing finance under a Subordinated Financing Agreement;

“Suitable Substitute Contractor”

means a person approved by the Authority (such approval not to be unreasonably withheld or delayed) as:

- (a) having the legal capacity, power and authority to become a party to and perform the obligations of the Contractor under the Contract; and
- (b) employing persons having the appropriate qualifications, experience and technical competence and having the resources available to it (including committed financial resources and sub-contracts) which are sufficient to enable it to perform the obligations of the Contractor under the Contract;

“Tax”

means any kind of tax, duty, levy or other charge (other than VAT) whether or not similar to any in force at the date of the Contract and whether imposed by a local, governmental or other Relevant Authority in the United Kingdom or elsewhere;

“Termination Date”

means any date of early termination of this Contract in accordance with Section 21 (Early Termination);

“Unitary Charge”

means the payment calculated in accordance with [Section 7 (Price and Payment Mechanism)];

“VAT”

means any value added taxes.

1.7.2 Along with the definitions, a Clause dealing with interpretation of the drafting and definitions should be included, as follows:

1.7.2 Interpretation

- (a) In this Contract, except where the context otherwise requires:⁴¹
 - (i) the masculine includes the feminine and vice-versa;

⁴⁰ These are the debt financing documents signed at Financial Close, through which the equity investors will often invest 'equity' in the Project in the form of subordinated debt.

⁴¹ This clause may be extended as appropriate (e.g. to deal with the meaning of "day" and "month").

- (ii) the singular includes the plural and vice-versa;
 - (iii) a reference in this Contract to any Clause, Sub-Clause, paragraph, Schedule or Annex is, except where it is expressly stated to the contrary, a reference to such Clause, Sub-Clause, paragraph, Schedule or Annex of this Contract;
 - (iv) save where stated to the contrary, any reference to this Contract or to any other document shall include any permitted variation, amendment, or supplement to such document;⁴²
 - (v) any reference to any enactment, order, regulation or other similar instrument shall be construed as a reference to the enactment, order, regulation or instrument (including any EU instrument) as amended, replaced, consolidated or re-enacted;
 - (vi) references to any documents being “in the agreed form” means such documents have been initialled by or on behalf of each of the parties for the purpose of identification;
 - (vii) a reference to a person includes firms, partnerships and corporations and their successors and permitted assignees or transferees; and
 - (viii) headings are for convenience of reference only.
- (b) This Contract is entered into under the PFI.⁴³ This Contract is excluded from Part II of the Housing Grants, Construction and Regeneration Act 1996 by operation of paragraph 4 of the Construction Contracts (England and Wales) Exclusion Order 1998. The Contractor acknowledges that the operation of the Housing Grants, Construction and Regeneration Act 1996 upon any Project Document shall not affect the parties’ rights or obligations under this Contract.⁴⁴
- (c) References to amounts expressed to be “indexed” are references to such amounts multiplied by
- $$\frac{\text{Index}_1^{45}}{\text{Index}_2}$$
- where Index₁ is the value of [index/indices selected] most recently published prior to the relevant calculation date. Index₂ is the value of [index/indices selected] on []⁴⁶

⁴² The Authority may wish to limit the Contractor’s ability to make material changes to Project Documents. See Section 16.4 (Changes to Project Documents and Financing Agreements).

⁴³ See paragraph 4 of the Construction Contracts (England and Wales) Exclusion Order 1998, SI No. 648.

⁴⁴ The underlying justification for this Clause is outlined in Section 28.4.2. The Clause may, if appropriate, be omitted from Contracts for projects without a construction phase (i.e. those outside the scope of the Housing Grants, Construction and Regeneration Act 1996).

⁴⁵ If RPIX is the index used (see Section 15.2 (Inflation Indexation)), then this can be defined as the index published in Table RPO5 (RPI all items – excluding Mortgage Interest Payment (RPIX) reference CHMK published by the Office for National Statistics or failing such publication or in the event of a fundamental change to the index, such other index as the parties may agree, or such adjustments to the index as the parties may agree (in each case with the intention of putting the parties in no better nor worse position than they would have had the index not ceased to be published or the relevant fundamental change not been made) or, in the event that no such agreement is reached, as may be determined in accordance with Section 28 (Dispute Resolution). See Section 15 (Price Variations) as other indices may be relevant. See HMT’s Application Note “Interest Rate & Inflation Risks in PFI Contract” May 2006.

⁴⁶ This is the date by reference to which the prices expressed in this Contract to be indexed are fixed, often the bid date.

2 DURATION OF CONTRACT

2.1 INTRODUCTION

2.1.1 The Contract must specify its duration. It will usually also specify a Service Commencement Date to distinguish the time (if any) from the signing of the Contract and before the Service Period from the Service Period itself. The choice of duration should be considered in the light of the issues set out in Section 2.2 (Factors to Consider).

2.2 FACTORS TO CONSIDER

2.2.1 The Authority will wish to specify a duration which is expected to result in the best value for money solution for the Project. Factors to be taken into account when deciding on the duration of the Contract will include:

- the Service requirements of the Authority (see Section 7 (Price and Payment Mechanism)) and the Authority's ability to forecast quality and quantity outputs in the longer term;
- the expected life of the assets underpinning the Service and any possible residual value (see Sections 2.2.2 and 20 (Treatment of Assets on Expiry of Service Period)) and the need for and timing of major refurbishment or asset refreshment programmes during the Contract (see Section 11 (Maintenance));
- the importance of continuity in the delivery of the Service, including the degree of transition difficulties and inefficiencies that might be caused by changing Contractors;
- the importance of maintaining performance incentives over time;
- the viability of recompeting the Contract regularly, including private sector capacity and bidders' likely willingness to bid against the incumbent;
- the ability of the Contractor accurately to forecast its base cost; and
- the possibility of an option to extend the term of the Contract by entering into a further contract period with the initial Contractor (this can equally be structured as a no cost early termination option – see Sections 20.2.5 and 20.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been transferred)) even if there is no alternative use.

See further paragraph 3.10 of HMT's *Value for Money Assessment Guidance* November 2006.¹

2.2.2 Some assets (e.g. vehicles or property) may have an alternative use which means that they can generate revenue for the Contractor after the Contract expires (see Section 20 (Treatment of Assets on Expiry of Service Period)). If this is the case, the Contractor should not expect to recover the full cost of financing its investment (i.e. debt and equity return) over the life of the Contract, as it will be able to recover the balance by putting the assets to such alternative use after the Contract expires (e.g. selling them). The price the Contractor charges to the Authority can therefore be lower and the Contract duration shorter than would be the case if the Contractor needed to recover all of its costs over the life of the Contract (see Section 20.2 (Assets where the Authority retains Residual Value on Expiry)).

¹ See HMT website www.hm-treasury.gov.uk.

2.2.3 Given the rapid pace of both technological change and Authority functions (particularly in projects such as hospitals), the Authority should ensure that the Contract is sufficiently flexible to allow changes to the Service over time (see Section 13 (Change in Service)). If, however, the Authority is concerned that changes will be so radical that the Service in its present form may become redundant it may wish to retain some flexibility by having shorter Contract periods, consistent with an affordable financing plan, or break points (see Section 21.5.4 (Authority Break Points)).

2.2.4 The impact of certain events on the duration of a Contract is dealt with in the Sections on Compensation Events (see Section 5.2 (Compensation Events)), Relief Events (see Section 5.3 (Relief Events)) and Force Majeure (see Section 21.3 (Termination on Force Majeure)). A delay in the Service Commencement Date should not lead to an extension of the Contract (see Section 5 (Supervening Events)).

Required drafting is as follows:

2 Duration of Contract²

- (a) This Contract and the rights and obligations of the parties to this Contract shall take effect on the [date of this Contract][Effective Date].
- (b) The Service Period will commence on the Service Commencement Date³ and terminate on the earlier of:
 - (i) the Expiry Date; and
 - (ii) the Termination Date.

² It is often possible for contract signature and financial close to be simultaneous. If there are project specific reasons for conditions precedent being required (i.e. a condition such as planning must be satisfied), then the concept of conditions precedent and "Effective Date" will be needed (and the effect of pricing of interest rate fluctuations, between the date of contract signature and financial close, will need to be addressed). If conditions precedent do exist, the obligation to use reasonable endeavours to satisfy these (to the extent this is needed) should take effect prior to the conditions precedent being met. Other obligations (such as those of confidentiality) may also come into effect prior to the satisfaction of any condition precedent.

³ See footnote 2 above.

3 SERVICE COMMENCEMENT

3.1 INTRODUCTION

3.1.1 After the Contract is signed and in force, there is usually a construction or development period during which the Contractor carries out its construction or development obligations and puts in place the operational procedures which it believes will meet the Service requirement.

3.1.2 During this period, the Authority naturally wants to know if the Contractor is going to deliver the Service on time and in a way which meets all the Authority's contracted requirements. The Contractor will not wish to be unnecessarily hampered by the Authority, but it will also want to be reassured that what it is developing will meet the Authority's requirements.

3.1.3 The key issue here is the extent to which the Authority should be involved during this period and what rights, if any, the Authority should have to approve or monitor the Contractor's progress prior to and on Service Commencement.

3.1.4 There must be a clear limit to the extent of Authority participation as involvement to a greater extent than is appropriate may lead to the Authority taking back both a risk it is paying the Contractor to accept and a management role it is paying the Contractor to deliver. It will not be appropriate for the Authority to adopt the type of overseeing role it might traditionally expect to have when procuring stand-alone construction or development services.

3.2 AUTHORITY'S ROLE – GENERAL

3.2.1 The design, construction, integration, installation, testing, commissioning, operation, maintenance and ultimate performance of any asset procured or developed for the purposes of meeting the requirements of the output specification are all the Contractor's responsibility and the Authority should not (save in exceptional circumstances) take any responsibility for this risk. Correspondingly, the Contractor should be afforded the freedom to manage its activities without interference from the Authority. It is the Contractor's risk whether the design and development it has carried out and the operational procedures it has put in place are capable of satisfying the Authority's service requirements. The Authority should not, save in exceptional circumstances (for example, those giving rise to Authority step-in (see Section 29 (Authority Step-In)), agree to any role before or following Service Commencement which involves the Authority taking back any part of the Contractor's risk. In this context, the issues referred to in Section 3.3.2 are important.

3.2.2 The Authority's role prior to signature of the Contract includes:

- defining the output requirements and any constraints within which the output requirements must be achieved;
- reviewing the Contractor's proposals for achieving the outputs in terms of approach, methods, resources, timetable, management and organisation (including design, maintenance and operational procedures and method statements); and
- negotiating and agreeing with the Contractor all contractual terms, including the procedure for either party proposing and implementing a change in Service (see Section 13 (Change in Service)), the consequences of a failure to meet the Service Commencement Date (see Section 4 (Protections Against Late Service Commencement)), and the procedure for accepting the Service Commencement (see

Section 3.6 (Acceptance and Service Commencement)). See generally Section 32 (Competitive Dialogue and Commitment Letters).

In accordance with the principle outlined in Section 3.2.1, the Authority should not confirm to the Contractor that the Contractor's proposals will meet the Service requirement. In practice, however, the Authority should be confident before signing the Contract that the Contractor's proposals (including method statements) will be capable of delivering the Service once fully developed and implemented.¹ The Authority should also ensure that the Contractor's basic design proposal is incorporated into the Contract (see Section 3.4 (Submission of Designs and Information to the Authority)).

3.2.3 The Authority's role after signature of the Contract and prior to Service Commencement will normally include:

- reviewing and commenting upon the Contractor's designs, maintenance and operational procedures and method statements as they are developed (see Section 3.4 (Submission of Designs and Information to the Authority));
- viewing and observing tests of any equipment being developed;
- administering the agreed process for either the Contractor or itself to propose and implement changes to the output requirements, constraints on inputs or the Contractor's proposals (see Sections 3.5 (Quality Management Systems) and 13 (Change in Service));
- following the agreed procedure by which the Contractor demonstrates to the Authority that Service Commencement can be accepted (see Section 3.6 (Acceptance and Service Commencement));
- following the agreed procedure in relation to a failure to meet the Service Commencement Date and agreeing with the Contractor the measures to be taken and the financial consequences (see Sections 4 (Protections Against Late Service Commencement) and 5 (Supervening Events)); and
- auditing the Contractor's activities in accordance with an acceptable Quality Management Systems regime (see Section 3.5 (Quality Management Systems)).

3.2.4 The Authority should require enough management information to be reassured that the delivery timetable is on track and any overriding safety issues are being satisfactorily addressed. This will involve having access to the site.

3.2.5 The principle outlined in Section 3.2.1 must be upheld to ensure the appropriate risk transfer during the pre-Service Commencement period. The Authority should not, for example, retain any rights to approve or accept interim stages such as practical completion of construction or detailed design prior to acceptance of Service Commencement, as this may dilute any risk transfer (unless, of course, the Authority takes the risk of commissioning as the NHS does for clinical services in relation to the technical interface in hospital projects). This is different to the point made in Section 3.6.4 in relation to accepting Service Commencement before all construction requirements are completed. In the case of certain defence projects involving very specialised or necessarily subjective requirements there may be a case for the Authority to accept some aspects of the design by agreeing a methodology for meeting such requirements in the Contract (see Section 3.6.2). This should only be contemplated where transfer of all aspects of the design risk would clearly not offer the best value for money.

¹ The Department of Health has issued guidance on how NHS Trusts should deal with design sign-off on PFI Projects (see The Design Development Protocol for PFI Schemes – Jan 2001).

3.3 CRITICAL DATES

3.3.1 In many projects the effects of late Service Commencement can be handled through the payment mechanism (see Section 7 (Price and Payment Mechanism)). In some cases, however, there will be a critical date beyond which the adverse consequences of non-provision of the Service are greatly magnified (see Section 4 (Protections Against Late Service Commencement)). Where failure to provide the Service by a critical date would be unacceptable, the Authority must develop a contingency plan (and this could be implemented at the Contractor's expense, for example temporary classrooms at a school).

3.3.2 As a last resort, the Authority would usually expect to have the ability to terminate the Contract (subject to the step-in rights of the Senior Lenders) so that it can use another Contractor (see Section 21 (Early Termination)). In Section 21.2.2.1 (Events Leading to Termination), paragraphs (j) and (k) of the definition of Contractor Default give the Authority the right to terminate during the construction or development period. Section 21.2 (Termination on Contractor Default) makes it clear that termination for failure to achieve a milestone during that period is not recommended.

3.4 SUBMISSION OF DESIGNS AND INFORMATION TO THE AUTHORITY

3.4.1 The key aspects of the Contractor's tender should be incorporated into the Contract schedules so as to ensure that the Contractor is bound to deliver the Project in accordance with its tender submission. However, the incorporation of the Contractor's tender submission in the Contract should not be interpreted as representing any form of approval by the Authority that the plan will satisfy the requirements of the output specification.²

3.4.2 The basic design proposal must be set out in the Contract and will be developed further by the Contractor after signature.³ The procedure for developing the design must also be specified in the Contract so that changes beyond the permitted parameters of further design development can be distinguished from permitted design developments. The Contract should also specify the extent (if at all) to which other minor changes⁴ may be made without triggering the change in Service mechanism (see Section 13 (Change in Service)).

3.4.3 Although the Contractor is responsible for the design development, the Authority knows its own service requirement and the means by which it has been delivered in the past and this should not be lost to the development process.⁵ Consultation with the Authority and subsequent adoption of any comment made by the Authority must, however, remain firmly at the Contractor's risk. The Contractor and its financiers should accept that it is not in the Authority's interests to watch without comment as a design is developed and implemented which it knows will not be able to deliver the Service. The procedure for submitting and commenting on design issues should be capable of giving all parties the reassurance they need.

3.4.4 The Contract should therefore set out a mechanism for:

² This can be achieved by setting out in the Contract that the output specification takes priority over the technical solution being provided by the Contractor. Under no circumstances should the output specification be amended to reflect the Contractor's solution.

³ Depending on the nature of the Contract, the Authority may also wish to include (amongst other things) the Contractor's operational procedures, key asset proposals or manpower and spares policies in the Contract.

⁴ Such changes will include, for example, changes which have no financial impact or which do not affect the pre-agreed risk allocation.

⁵ It may be acceptable for an Authority to accept a limited degree of design responsibility insofar as it relates solely to the ability of the Authority to carry out its functions in the project building.

- the Contractor to submit designs and information to the Authority and its representatives. Such designs should be in a package and format and submitted to a timetable to be agreed between the parties;
- the Contractor to submit minor design changes which do not have any impact on cost or the Service and which the Authority can accept without the change in Service mechanism having to be implemented (see Section 13 (Change in Service));
- the Authority to comment (if it wishes) on such submissions within an agreed time period⁶ (see Section 5.2 (Compensation Events)); and
- the discussion of and, if appropriate, adoption by the Contractor of any comments by the Authority.

3.5 QUALITY MANAGEMENT SYSTEMS

3.5.1 One central source of comfort for the Authority that assets and services are being provided in accordance with good industry practice should be the Contractor's quality management system (such as ISO 9000 or an equivalent standard).

3.5.2 The Authority should retain the right to audit the Contractor's quality management system which should include the right to examine or inspect works or activities on or off-site to establish the adequacy and accuracy of the system documentation. The Contract should provide for the Contractor and Sub-Contractors to provide such assistance and access as the Authority requires and include provisions setting out the obligations upon the Contractor and Sub-Contractors to respond to any recommendations which result from an audit. No other rights or remedies (e.g. rights to terminate for default) should arise from such an audit since deficiencies in the quality management system will manifest themselves through poor performance (see Section 9.5 (Consequences of Poor Performance)). The audit is essentially a due diligence tool available to the Authority.

3.6 ACCEPTANCE AND SERVICE COMMENCEMENT

3.6.1 Before Service Commencement and at points in the Contract where the Service changes significantly (for example on the introduction of a new asset or new operational procedures), the Contractor should be under an obligation to demonstrate that the arrangements put in place will meet the output specification in the Contract. The method of demonstration by the Contractor will be dependent on each situation but may take the form of:

- a completion inspection of any asset built or developed with demonstration of principal facilities and services;
- completion of acceptance trials for new services; and
- other performance tests or inspections.

3.6.2 The Contract should set out in detail:

- the form of the tests, inspections or demonstrations ("Tests") to be carried out by the Contractor;
- the timetable for the Tests – it may be appropriate to undertake partial Tests over a period rather than a single Test;

⁶ Irrespective of the Authority's comments (if any) on the minor design changes submitted by the Contractor which do not have any impact on cost, level of fit-out, quality of the scheme or the Service, the Contractor may choose to adopt such changes, albeit at its own risk, to ensure that it satisfies the Authority's service requirement.

- the consequences of a failure to pass a Test;
- the notice of the Tests to be given by the Contractor to the Authority – this is particularly important if the Authority has to roster staff and resources to participate. If it is essential for the Authority to attend the Tests, the Contract should specify a time period for the Authority to respond to the notice and, to the extent that the Authority does not respond in time, a Compensation Event will have occurred (see Section 5.2 (Compensation Events)) although the Authority can still attend once it has responded;
- the responsibility for the cost and organisation of resources for the Tests. Again this is particularly important if the Authority’s staff and resources are to be involved (also the responsibility for costs if Tests have to be repeated should be considered);
- the access for the Authority to witness the Tests (if the Authority does not control the site);
- the documentation required by the Authority as evidence of the results of the Tests;
- who is responsible for assessing satisfaction of the Tests – this should, in most cases, be done by joint assessment by the Authority and the Contractor or by an independent third party, although there will be cases where both parties accept that the Authority is the best judge (e.g. with defence equipment projects the best judge of whether the equipment behaves like it should are its users). The Authority should in no circumstances rely on any technical or other adviser appointed solely on behalf of the Senior Lenders, but may accept an adviser that has been jointly appointed and owes duties to all sets of interested parties; and
- the timing and procedure for acceptance of Service Commencement if the results of the Tests are satisfactory. Acceptance may be confirmed by the third party tester or by the Authority, in which case again the Compensation Event consequence of being late should be borne in mind if the Service cannot commence before any such confirmation is issued.

3.6.3 At the time of acceptance of the Service, there must be no “approval” of the means of delivery of the Service, as this may involve the Authority in taking back part of the Contractor’s risk. Rather, acceptance should be based as far as possible on satisfaction by the Contractor of objective Service Commencement based tests.

3.6.4 As stated in Section 3.2.5, the Authority should not generally accept stages of work (e.g. by signing off milestones) prior to the Service Commencement Date and delivery of the full Service as this dilutes risk transfer.⁷ In certain projects, however, it may be appropriate for the Authority to commence payment before a complete service is available. The principal examples of these are as follows:

- in roads projects, where the Highways Agency issues a permit allowing traffic to use the road once certain safety standards have been achieved, although construction may not be fully completed. Final acceptance of the road takes place once the Contractor has completed the outstanding construction works and the payment mechanism is structured to ensure that the Contractor is incentivised to do so;
- in accommodation projects, the Authority may accept Service Commencement where certain minor aspects of the construction works are incomplete but which are not integral to the Contractor’s ability to provide the main Service – this may be done by specifying particular areas (e.g. landscaping works) or through more generic descriptions (e.g. “de minimis defects, shrinkages or faults”). Whether this is agreed

⁷ Neither should the Authority seek to impose any milestones during the construction phase.

prior to or after signature of the Contract, the Authority must ensure that the Contractor remains incentivised through the payment mechanism to complete the outstanding works. The Authority's technical adviser should advise on what aspects of the works can be completed after Service Commencement;

- in light rail projects where milestones trigger payments of grant, or where a portion of the repayments are derived from fare box revenues;
- in certain projects there may be aspects of the project for which the Authority retains a part of the risk deliberately, as it will ultimately retain responsibility for a part of the overall Service; and
- in projects in which Service Commencement is phased (i.e. different buildings or pieces of equipment are brought into service at different times), then an appropriate phasing in the introduction of payments (again with built-in incentives) may be appropriate.

3.6.5 In projects where Service Commencement is phased, there are two clear alternatives available to the Authority:

- to stipulate that full Service Commencement will only be accepted when all phases in the scheme reach the required output specification level, which would incentivise the Contractor to bring them all up to the output specification standard as quickly as possible. This would mean, however, that the Authority would receive the full output specification level of service for some phases without paying for it; or
- to accept full Service Commencement as each phase reaches the output specification standard, so that payments reflect the service received. A slight variant to this that may be adopted in very large grouped schemes, where it would be administratively cumbersome to have phase by phase Service Commencement, would be to accept Service Commencement in batches as full service availability is confirmed. If this approach is adopted, some of the incentive effect of the first alternative above can still be achieved if payment is not increased pro rata as phases reach the output specification, so that there is in effect an amount retained or abated until the last phase reaches Service Commencement.

3.6.6 The overall time period until the planned completion and service commencement of the last phase is likely to have a significant impact on the relative value for money of these two alternatives - the longer the period, the more reluctant the Contractor is likely to be to accept the delayed payment involved in the first alternative above.

3.7 EXISTING SERVICES

3.7.1 The approval/acceptance procedure raises other issues if the Contractor is taking over existing services as well as undertaking additional services. The Authority should structure the payment mechanism and any termination compensation so as to incentivise the Contractor to commence delivery of the new service on time, so that it cannot simply choose to provide the existing service only. This is the case even where provision of the existing service is more important to the Authority from an operational perspective than provision of the new service.

3.7.2 The first question to address is, when does the Contractor take over full or partial responsibility for service delivery? Authorities should recognise that any TUPE transfers of staff that may arise out of the Contract are likely to take effect from the time at which the Contractor takes over provision of the relevant service. There are therefore three options open to the Authority:

- responsibility for all sites in the Contract is taken over by the Contractor following financial close, commonly after a brief mobilisation period. This provides a clean start

and minimises ambiguity about responsibilities between the Authority and the Contractor, and is therefore the recommended approach. However, in some cases, for example where there are particular concerns or uncertainty about the condition of the buildings, this approach may require the Contractor to take on risks that are unacceptable to it at a realistic price, and so not provide value for money;

- phase the handover so that the Contractor takes over responsibility for the sites when it has planned to start works on them to bring them up to the full output specification standard. This would leave the Authority responsible for some sites between financial close and the programmed start date of the Contractor's work on site. For a large grouped scheme this may well create some greater complexity in the management arrangements throughout the transitional phase from financial close to the point at which all of the sites have reached full Service Commencement, but is recommended where the first approach above does not provide value for money; and
- only hand the sites over to the Contractor once they have been brought up to the full output specification standard. This would cause an additional complexity as the pre-contract arrangements, involving in-house provision or a separate contractor, would continue in relation to facilities management (if relevant) and operation of the accommodation, whilst the Contractor was carrying out works to bring the sites up to the output specification standard. Scope for disputes over responsibility for problems that arise suggest that this would not be an attractive option, and it is therefore not recommended.

In some cases, the existing condition of buildings may be such that there is a risk (however remote) of criminal prosecution, for example under Health and Safety legislation. The output specification will generally require the buildings to be in a condition that complies with all applicable law. In some schemes prospective shareholders of a Contractor will be understandably nervous about taking on such a risk for the period before Service Commencement. In such circumstances, Authorities should consider retaining legal responsibility for the buildings until planned Service Commencement, and so any Existing Services provided by the Contractor may be in the form of a maintenance and/or FM contract.

3.7.3 In relation to the first two options, a specification will be needed for the service level that is expected for the period while the Contractor is responsible for each site, but has not yet reached full Service Commencement. The specification should include requirements in relation to individual FM services that the Contractor will be required to provide (if relevant), and a reactive and responsive maintenance and repair service that at least keeps the sites open to the standard they are when the Contract starts. It is important for all parties that there is a common understanding of the Service required during this period. This will assist in minimising dispute if under performance occurs. There are generally two options available to the Authority:

- use the output specification that will apply from Service Commencement for the transitional period as well, albeit with a relaxed payment and performance regime (including default termination thresholds). However, this may lead to regular performance failures due to the pre-existing condition of the buildings and cause disputes between the parties; or
- tailor a bespoke specification for the transitional period which sets out the Authority's requirements and is realistic in terms of delivery. In relation to some individual service requirements however, the Contract output specification may be relevant and sufficient for the transitional period (e.g. response and rectification periods, or if it is reasonable to expect individual "soft" FM services to be provided to the output specification standard from the award of the Contract). However, where the output specification for the Service Period cannot be met by the Contractor during the transitional period, bespoke outputs will need to be tailored.

3.7.4 In PFI projects, no payment should be made until the services are available and being delivered. This fundamental principle of “no service, no payment” is not compromised in instances where the Contractor takes over the delivery of existing services and is paid accordingly. There are two approaches that the Authority can take in relation to payment for delivery of services during the transitional period and the Authority should assess which of these approaches to adopt depending on the value for money they provide:

- many Authorities have based payments before full Service Commencement on their current expenditure, pre-contract, and then applied a performance regime so that, in accordance with the principles of the full payment mechanism, there would be no payment if, for example, a building was unavailable and could not be used, and deductions from the payments if there was poor performance, for example a failure to meet response or rectification periods that did not lead to non-availability. Payment for those parts of the services being delivered will not diminish the significance of full Service Commencement provided the Unitary Charge is structured to incentivise the Contractor to achieve this standard; or
- an alternative to the approach described above would be for the Authority to make no payment in relation to the services received during the transitional period. This would maximise the incentive on the Contractor to bring the facilities up to the Service Commencement level as quickly as possible, but the Authority may lose some influence over the standard of service during the transitional period. As the two approaches will lead to different funding requirements and cash flows for the Contractor, it may well have a significant impact on price.

3.8 RANGE OF SERVICES TO BE PROVIDED

3.8.1 Authorities should consider carefully, at an early stage in their procurement planning, the range of services which need to be provided through the Contract. In particular they should consider whether or not it offers value for money to include soft services as part of the range of services to be provided. HMT has updated its “*Value for Money Guidance*”⁸ as a tool to assist Authorities in this decision. Where hard services⁹ only are procured, adjustments will need to be made to the Contract and in particular (a) any benchmarking/market testing provisions are unlikely to be applicable, though some sort of value testing for the Contract could still apply (see Section 15 (Price Variations)), (b) the Sub-Contracting provisions (see Section 16 (Sub-Contracting, Employees and Documentary Changes) and Section 9.3 (Replacement of Sub-Contractors)) may need consideration, and (c) Authorities will need to give particular attention to any interface issues which might arise with the providers of other services.

3.9 CAPITAL CONTRIBUTIONS¹⁰

3.9.1 In the ordinary course of events, no public sector capital contributions should be made to the Project, and no Unitary Charge should be payable, until the Works have been completed and accepted. In certain exceptional circumstances however (for instance where the Project frees up surplus land and the Authority is able to sell this and use the proceeds) an Authority may want to make a capital contribution of its own to the Project or may have some other form of co-financing proposal. Authorities should always discuss any such proposal at an early stage with HMT. Any capital contributions, if approved, should be kept to a modest size. PFI is concerned with payments for Services rather than public sector capital financing. A large contribution may upset the risk transfer balance and incentives of the Project (especially where the Project gets into difficulty). Any contributions should be scheduled to, or towards, the end of the Construction period and linked to acceptance of the Service or other important milestones (e.g. completion of

⁸ See HMT website www.hm-treasury.gov.uk.

⁹ See Section 15.3 (Value Testing of Operating Costs).

¹⁰ For projects in Scotland, see Scottish Executive guidance at www.scotland.gov.uk.

whole schools on a grouped school project). In any event it is important that any Authority payments are not paid towards advisers' fees or working capital or other similar costs.

3.9.2 If there is a construction delay or cost over-run and there is any rescheduling of Senior Debt drawdowns, Authority capital contributions should be withheld until the Authority is satisfied that no draw-downs of Senior Debt or equity are retired behind those of the Authority and that the ratio of private capital to Authority capital is not adversely effected. Where there is an equity bridge facility (with debt being provided instead of equity on a temporary basis), Authorities should ensure that the full equity investment remains at risk on a termination (such that normal risk-allocation principles are maintained). Authorities should also ensure that levels of sub-contract security (bonds, liquidated damages, etc.) remain at the same levels regardless of any public-sector capital contribution (i.e. if there is a 10% Authority contribution, sub-contract security levels should still be gauged against 100% costs and not just against the 90% private sector contribution). No amendment of the core drafting listed in Section 1.4.1 should be made, except that an allowance may be made for future capital contributions as set out in the base case when calculating the amount of any termination payment under Section 21.2.9 where the "no retendering" termination route is used.

3.10 EARLY WORKS AGREEMENTS

3.10.1 In the ordinary course of events, for a well planned procurement exercise no agreements should be needed for the commencement of early works ahead of the parties signing the Contract. Such agreements would generally be considered bad practice for a number of reasons:

- there may be questions as to whether any such early works agreement had been procured in accordance with relevant procurement law and regulation (e.g is it covered in the relevant OJEU notice and has it been awarded to the winning tenderer);
- in the ordinary course, no payments would be made to the Contractor or any Construction Sub-Contractor prior to completion of the relevant facilities and commencement of the Services (see further Section 3.9 (Capital Contributions));
- in the ordinary course, Authorities should not be under any obligation to make any payments prior to Financial Close;
- negotiations on early works agreements tend to be a distraction for the negotiating teams on the main Contract and obstruct the completion process for the main Contract;
- project integration issues can arise;
- early works agreements can undermine the bargaining position of the Authority and adversely affect the balance of risk on the procurement; and
- to date, early works agreements tend not to have been factored into the original procurement programme and are often a sign that a procurement is in difficulty.

3.10.2 For all these reasons early works agreements are generally to be avoided. However, for certain projects where particular programming issues apply (such as schools who wish to avoid facility handovers occurring in term-time), basic enabling works may be needed prior to Contract signature, and for such projects the following rules should apply:

- the enabling works should be planned well in advance and as part of the overall procurement strategy (and alternatives to it should always be appraised);
- consideration should be given as to whether it is appropriate for the bidder to do such works or whether the Authority should independently commission a third party to do them;

- the works proposal should offer demonstrable savings to the project timetable and be value for money in its own right;¹¹
- the relevant Private Finance Unit should be consulted and approve the proposal;
- the works should only comprise essential early works which the Authority would wish to have done in any event. Examples may include certain surveys, “making safe” works, advanced purchase orders (in unusual markets where a market position is needed for timetable reasons), access roads or other pre-construction “enabling” works;
- the works should be of a general nature, and not specifically related to the specific project solution proposed by the bidder, such that they will be of value to the Authority whether or not the Contract is signed;
- the works completed should not impair the risk allocation in respect of work subsequently done under the Contract; and
- the scale/cost of such works should not be significant and the Authority should ensure it has funding for them.

¹¹ Although it is not recommended that an Authority make early payment for such works, if any payment is made, there must be a commensurate reduction in the Unitary Charge.

4 PROTECTIONS AGAINST LATE SERVICE COMMENCEMENT

4.1 INTRODUCTION

4.1.1 The Contract must ensure that the Authority is protected against late Service Commencement by the Contractor in a way which gives the Authority value for money, taking into account the type of loss the Authority may suffer and the need for (and cost of) any contingency plans that are put in place (see Section 3.3.1). This Section deals with the level, types and combinations of protections appropriate in relation to a particular project.

4.1.2 In considering the issue of late Service Commencement, the Authority should acknowledge that the Contractor is likely to be at least as concerned as the Authority to commence Service delivery on time due to significant financial pressures. The Contractor's financing will often be structured with limited contingency to deal with a delay in Service Commencement (particularly where Senior Debt is involved), and the Contractor risks suffering a cash flow drain because its Senior Debt obligations are not being met by payments of the Unitary Charge by the Authority. For every day the Contractor is late in commencing Service delivery, not only does it lose revenue, but its revenue earning period is also reduced. The longer the construction period is, relative to the Service Period, the greater the concern for the Contractor.

4.1.3 If the Authority will not suffer any significant loss as a result of late Service Commencement, then it is unlikely to need specific protections. In exceptional cases, however, the Authority may need protections from the Contractor (in addition to the non-payment of the Unitary Charge) such as liquidated damages, performance bonds and/or parent company guarantees. These types of protections are, however, likely to increase the price and affect the project timetable, so the Authority must consider carefully their effect on value for money (see Sections 4.2 (Liquidated Damages), 4.3 (Performance Bonds), 4.4 (Parent Company Guarantees) and 4.5 (Financiers' Security)).

4.1.4 The Authority should also protect itself against prolonged uncertainties arising from late Service Commencement by having a cut-off date after which it may terminate the Contract if the Contractor has not commenced Service delivery by such a date (see Section 4.5 (Long-stop Date)). As stated in Section 3.3.2 and elsewhere throughout this guidance, termination should be a last resort.

4.1.5 The Authority should also consider the issue of early Service Commencement and whether the Authority should accept and reward early delivery (see Section 4.6 (Bonus Payments for Early Service Commencement)).

4.2 LIQUIDATED DAMAGES

4.2.1 Liquidated damages for delayed Service Commencement are an ascertained payment representing a genuine pre-estimate of the losses or damages the Authority will suffer if the Contractor fails to fulfil its obligation to commence Service delivery on time. If the Authority will not suffer any losses in excess of the payment of the Unitary Charge (taking into account the cost of procuring the Service itself), liquidated damages are not appropriate or recoverable. If the Authority will suffer such losses, liquidated damages may be appropriate but only where they offer the Authority value for money, taking into account the effect of any other protections being required by the Authority, the Contractor or its financiers.

4.2.2 To protect against late Service Commencement, Senior Lenders will usually require the Sub-Contractors to cover debt service for any period of delay through liquidated damages paid to the Contractor (secured to the Senior Lenders) as the finance plan will assume Service Commencement and so finance costs being recovered in accordance with a particular timetable. The Construction Sub-Contractor will price this requirement into the price it charges the Contractor (for example, by increasing its construction costs to ensure completion will be achieved on time) and may also require a longer build period to allow itself more contingency time. This cost is then likely to be passed on to the Authority through the Unitary Charge and the Project timetable is likely to be longer. If the Authority requires liquidated damages to be paid by the Contractor to itself in addition to those already required by the Senior Lenders, this is likely to further increase the Unitary Charge and the build period. Liquidated damages payable to the Authority may therefore prove bad value for money unless circumstances such as those outlined in Section 4.2.3 exist.

4.2.3 Liquidated damages may prove value for money in situations where the costs the Authority incurs as a result of the delay are so great as to justify the increased expense (e.g. a higher Unitary Charge) to which such liquidated damages give rise. This could be the case where there are critical dates (see Section 3.3 (Critical Dates)) and the Authority's contingency plan to cope with such dates has a significant quantifiable expense associated with it.¹ Liquidated damages may also be justified where:

- the Authority has contributed a valuable asset to the Project which could otherwise have been used by the Authority during the period prior to Service Commencement, so an "opportunity cost" is incurred; or
- there are no prior claims on liquidated damages paid by a Sub-Contractor (for example, from Senior Lenders) and liquidated damages give value for money.

4.2.4 If liquidated damages are considered worthwhile and value for money, the Authority should specify the level of liquidated damages, and any cap,² early on in the bidding process (i.e. in the ITPD) to enable the bidders to price the risk of incurring liquidated damages.³ Bidders could also be invited to submit alternative bids without liquidated damages and/or using higher or lower caps. The Authority's technical or financial adviser should advise on an appropriate level.

4.2.5 The Authority should note that any assessment of the appropriate rate of liquidated damages must be a genuine pre-estimate of the losses the Authority is likely to incur as a result of the delay in Service Commencement. If this is not the case, the rate may be judged to be a penalty and the liquidated damages provision will not be legally enforceable against the Contractor.

4.2.6 If the Contractor is not going to be able to deliver the Service on time, but is able to find some form of alternative which is acceptable to the Authority and which can commence on the Planned Service Commencement Date (or will reduce the delay in Service Commencement), the Authority may agree that this alternative service may be provided for a certain period for a reduced Unitary Charge. Any liquidated damages liability will be deferred for the period in question and the Contractor's revenue stream will commence. The Unitary Charge will be reduced appropriately to reflect the fact that the Service is not being provided as contracted. This

¹ For example, in school projects the Authority may have to purchase temporary classrooms to replace school accommodation that is not available; in prison projects, the Authority may have to pay to house prisoners in police cells because a prison is not ready on time; and in training projects involving flight simulators, the Authority may incur costs in providing training by alternative means if the simulator-based training is not available on time.

² A cap will be a key issue for financiers.

³ It will assist the evaluation of any bids submitted if the cost of providing liquidated damages could be identified separately within such bids.

is not an issue which needs to (or necessarily can) be agreed prior to signature of the Contract, so it may need to be negotiated at the time.

4.3 PERFORMANCE BONDS

4.3.1 In the construction industry, performance bonds are generally given by Construction Contractors as a form of guarantee of completion (the amount guaranteed is usually a percentage of the construction price). They can be called by the recipient when, for example, the Planned Service Commencement Date is missed. Accordingly, the Contractor and its financiers may well require a performance bond from the Construction Sub-Contractor. The Construction Sub-Contractor will pass through the cost and timing effects of providing such a bond to its customer (i.e. the Contractor), who will in turn pass them on to the Authority. As with liquidated damages, the consequences of the Authority itself requiring a performance bond – in addition to any bond required by the Contractor and its financiers – is likely to be an increased Unitary Charge and longer build period. Again, this may not give the Authority value for money.⁴

4.4 PARENT COMPANY GUARANTEES

4.4.1 In traditional procurement, the Authority may expect to obtain parent company guarantees from the parent companies to the Contractor and/or the Sub-Contractors (in particular, the Construction Sub-Contractor) to support the obligation to deliver the Service on time. This is not, however, normally appropriate in PFI Contracts and should not be a pre-condition to acceptance of a tenderer's bid.

4.4.2 Rather, the necessary comfort and protection for the Authority can be provided through the Project Documents, the use of collateral warranties and or direct agreements between the Sub-Contractors and the Authority (see Sections 24.5 (Financiers' Security) and 29 (Authority Step-In)). Further discussion of this issue takes place in Section 24 (Indemnities, Guarantees and Contractual Claims).

4.5 LONG-STOP DATE

4.5.1 Service Commencement should not generally be allowed to be delayed indefinitely due to Contractor default. The Authority may impose a long-stop date after which the Contract may be terminated by the Authority if the Service has not yet been commenced (see Section 21.2.2 (Events Leading to Termination)).

4.5.2 The long-stop date is often fixed by reference to the Planned Service Commencement Date. The date chosen should be reasonable, taking into account the nature of the Project and the length of time the Contractor and its Senior Lenders should reasonably be allowed to remedy the situation. The Planned Service Commencement Date and, therefore, the long-stop date should be extended to the extent of any delay caused by any Compensation Event, Relief Event or Force Majeure Event (see Sections 5 (Supervening Events) and 21.3 (Termination on Force Majeure)).

4.6 BONUS PAYMENTS FOR EARLY SERVICE COMMENCEMENT

4.6.1 It is sometimes proposed that "bonus payments" should be paid for early Service Commencement, particularly where the Authority has required protections of the types described above against late Service Commencement. The term "bonus payment" can be misleading,

⁴ The reasons for not requiring parent company guarantees (see Section 4.4.2) are equally relevant when considering Authority demands for performance bonds. However, for corporately financed projects see Section 37 (Corporate Finance).

however, so it is important to understand what is envisaged and how it ties in with the implications of early Service Commencement.

4.6.2 The key point for the Authority is that it should not be under an obligation to accept early Service Commencement (unless it has agreed to be). It should only accept early Service Commencement and payment of any relevant bonus if it offers value for money. Early Service Commencement may clearly prove good value for money if there is a critical demand for the Service or if it would benefit the Authority financially. This might be the case, for example, if the early start date meant the Project generated additional third party revenue, or the Contractor made savings, in which the Authority shared. Any benefit to the Authority should be assessed on a case by case basis.

4.6.3 There may be budgetary problems for some Authorities (such as local authorities) in accepting and paying for early Service Commencement. These should generally be surmountable, however, if sufficient warning is given by the Contractor of early commencement, particularly as the Authority would in many cases be sharing in extra revenue or savings.⁵

4.6.4 If the Authority decides to accept early Service Commencement, the Contractor's revenue stream will commence earlier than originally planned. The Authority will have the choice between bringing the Expiry Date of the Contract forward to retain the length of the original Service Period or retaining the original Expiry Date, thereby extending the original Service Period. This is where the "bonus payment" concept is relevant since:

- if the Authority retains the original Expiry Date, the Contractor will receive a "bonus" amount of revenue through the Unitary Charge payable in respect of the extra Service Period;
- if the Authority brings the Expiry Date forward, the Authority may either simply pay the Unitary Charge for the same length of Service Period (i.e. essentially what it would have paid originally), which involves a "bonus" element (as payment is being received earlier) or it may pay the Contractor a "bonus payment" equivalent to the additional amount the Contractor would have received if the original Expiry Date had instead been retained. The difference between this approach and the alternative outlined in the first bullet point is that this bonus would not be subject to deductions as a result of unavailability or poor performance. It would also be likely to be paid as a lump sum;
- the Authority may alternatively simply opt to make a "bonus payment" which is unrelated to the length of the Service Period or any additional amounts of revenue which the Contractor may expect to receive due to its early Service Commencement. Such a bonus would typically be an agreed fixed amount.⁶

⁵ See also Section 8.5 (When does Availability Commence?).

⁶ If "bonus payments" are to be made for early Service Commencement then the parties will need to consider what, if any, further compensation should be paid to the Contractor in circumstances where the occurrence of a Compensation Event prevents early Service Commencement (see Section 5.2 (Compensation Events)).

5 SUPERVENING EVENTS

5.1 INTRODUCTION

5.1.1 The Contractor undertakes to ensure Service Commencement usually by a particular fixed date¹ and to continue to provide the Service for the duration of the Contract. There may, however, be circumstances in which the Contractor should fairly be relieved from liability for failure to commence or provide the Service. A balance must be struck between encouraging the Contractor to manage the risk and protecting the Authority from non-performance.

5.1.2 Supervening events for which some relief is appropriate should be divided into three categories:

- Compensation Events – i.e. events which are clearly at the Authority’s risk and in respect of which the Contractor should be compensated (see Section 5.2 (Compensation Events));
- Relief Events – i.e. events which are best managed by the Contractor (although not necessarily in its control) and for which the Contractor bears the financial risk, but in respect of which no rights of termination should arise (see Section 5.3 (Delays Due to a Relief Events)); and
- Force Majeure Events – a limited set of events which arise through no fault of either party, which are best managed by the Contractor (although not in its control) and in respect of which rights of termination can arise (see Section 5.4 (Force Majeure Events)).

5.1.3 The distinction between Compensation Events and Relief Events is sometimes expressed as being the difference between the Contractor being given ‘time and money’ and ‘time’ only.

5.1.4 Certain events may be dealt with differently in specific projects, depending on the nature of the Project, the likelihood of the event occurring and the value for money obtainable if the Contractor prices the risk of such event occurring into its price. Given the effect on the Authority of adding risks to Compensation Events, this should only be done after careful consideration in specific cases. For example, in a project in which Government use means that delays during the construction phase are a high risk, the Authority may accept that the event leading to such increased risk should be a Compensation Event. In a project where such risks do not exist, the parties may agree that a Relief Event is the way to deal with that risk. An alternative way of dealing with the risk of discovery of fossils or antiquities during the construction period, which lies somewhere between the Compensation Event and Relief Event approach, is for the Contractor to bear a pre-determined initial level of loss (both financial and in terms of delays to the construction timetable), as defined in the Contract, with further losses above that prescribed level being shared by the parties in accordance with an agreed formula.²

¹ The typical structure will require the Contractor to ensure Service Commencement either by a scheduled date for completion of construction (i.e. the Planned Service Commencement Date) or at any time from the date of the Contract or the Effective Date (depending upon the presence of conditions precedent) but by a pre-agreed long-stop date (see Section 4.5 (Long-Stop Date)).

² This alternative approach may be applied in a wide range of projects, but should only be used ordinarily when dealing with the risk of discovery of fossils or antiquities and not other risks. A different approach is justified here because of:

- (a) the potential impact of such risk being greater than is the case with other possible Relief Events; and
- (b) the public benefit that is derived from the discovery of fossils and antiquities.

5.1.5 Similarly, the risk of planning delays may require different treatment in different projects. For example, the Authority may accept some planning delay risk in order to obtain value for money if it wants the Contract to be signed before full detailed planning consent is obtained or challenge-periods in respect of such consents have expired.³ As far as the discovery of adverse ground conditions and historic contamination is concerned, this should not usually be at the Authority's risk as the Contractor should have carried out appropriate surveys in relation to such matters prior to signing the Contract and can often assess and accept such risks more economically than the Authority. The situation may be different in specific circumstances such as where the Contractor has been prevented from carrying out appropriate surveys or it is not reasonable or good value for money for surveys to be undertaken (e.g. because of the number of sites involved in the project).⁴ For instance, normal practice on a grouped schools scheme would be for the Authority to organise surveys itself and ensure that the bidders (who would ultimately bear the risk) could rely on them.

5.2 COMPENSATION EVENTS

5.2.1 Purpose and Scope

5.2.1.1 Compensation Events are designed to cater for events which arise before the Service Commencement Date which are at the Authority's risk and which result in a delay to Service Commencement and/or increased costs to the Contractor, although the concept can be extended to the Service Period (see Section 5.2.1.4). Such events are more appropriately dealt with by compensation methods than by being an Authority Default (see Section 21.1.2.1 (Contractor's Right to Terminate for Authority Default)) as termination should in all circumstances be a last resort (although if an event renders the parties' contractual relationship untenable the Authority may choose to exercise its voluntary termination rights). In fact, even a delay is not strictly necessary for the occurrence of a Compensation Event (see Clause 5.2(a)) as cost increases can arise without any timetable changes.

5.2.1.2 Events which can arise before the Service Commencement Date and which are at the Authority's risk (i.e. for which compensation should be paid to the Contractor) are:

- Authority breach of an obligation⁵ (which includes a breach occasioned by third parties for whom the Authority is responsible,⁶ such as teachers or doctors);
- Authority changes (see Section 13 (Change in Service)); and
- discriminatory or specific changes in law (see Section 14.6 (Discriminatory, Specific and General Changes in Law)).

The Authority should bear the effects of Authority changes and Qualifying Changes in Law in accordance with the principles set out in Sections 13 (Change in Service) and 14 (Change in Law) respectively. The only significant difference in relation to how the approaches are dealt with during the Service Period is referred to in Section 5.2.3 (Calculation of Compensation).

As mentioned in Section 5.1.4, it may, after careful consideration in certain projects (or sectors), be appropriate to add other specific events. As Authority changes and Qualifying Changes in Law are dealt with in Sections 13 and 14 respectively, the required definition of Compensation Event is as follows:

³ In these circumstances the Authority should consider very carefully how its liabilities in the event of planning failure can be mitigated.

⁴ See Section 6 (Warranties).

⁵ Authorities should ensure that their obligations under the Contract are both limited and specific.

⁶ Compensation claims should be very much the exception. Particularly where the Works are to be carried out on buildings that remain in use, the Contract should require the Contractor to co-operate with and work around other third party contractors wherever possible, and the effects should be anticipated and factored into the programme up-front.

“Compensation Event”

means a breach⁷ by the Authority of any of its obligations under this Contract.⁸

5.2.1.3 It is of course possible that Authority changes and changes in law will occur during the Service Period. The Authority should bear the risk of these events in accordance with the principles set out in Section 13 (Change in Service) and Section 14 (Change in Law).

5.2.1.4 The Authority may be faced with a request by the Contractor and its financiers to give compensation for Authority breaches which occur during the Service Period. This will not always be appropriate and the Authority should consider carefully the nature of its obligations during the Service Period.⁹ If its sole obligation is to make payment, then there is no need to give compensation as non-payment in the Service Period is addressed through the provisions dealing with interest on late payment (see Section 7.2.3 and Clause 30.6 (Interest on Late Payments)) and, in extreme cases, through termination for Authority Default (see Section 21.1 (Termination on Authority Default)). During an insurance reinstatement, however, the concept of Compensation Events would apply irrespective of the position for the treatment of Compensation Events in the Service Period, as the construction period will effectively be starting again until reinstatement is completed. The issues relating to reinstatement are dealt with in depth in Section 25.5 (Reinstatement and Change of Requirement After Insured Event). Compensation is relevant if the Authority fails to release surplus land at the required date.

5.2.1.5 If, however, the Authority has significant ongoing obligations and breach of such obligations would seriously adversely affect the Contractor's ability to perform (e.g. if the Authority failed to carry out procedures for certifying operating matters) or materially affect the cost of performance, then it may be appropriate to give compensation if such breach occurs. This can most easily be addressed by extending the scope of the Compensation Event concept.

5.2.2 Consequences

5.2.2.1 A practical consequence of a Compensation Event occurring is that the Planned Service Commencement Date may have to be postponed, usually by the length of any delay caused (and any long-stop date will be similarly put back). This means that the start date of the Contractor's revenue stream is also delayed and/or additional costs¹⁰ are incurred (see Section 5.2.2.6). As a result, the Contractor may incur finance charges and additional costs which could involve the Contractor in significant expense.¹¹

5.2.2.2 The Contractor should be compensated for any delay to Service Commencement resulting directly from a Compensation Event. The original Expiry Date should be retained and the Contractor compensated for its loss. This does not mean that payment of the Unitary Charge is made for a month in which no Service has been provided although the monetary value of the compensation may be the same as the Unitary Charge.

⁷ This is a breach that will not normally lead to an Authority Default (which can lead to termination - see Section 21.1 (Termination on Authority Default)), but which will nevertheless cause delay and put the Contractor to material expense, including, for example, a failure to allow the Contractor appropriate access to an Authority provided site.

⁸ To the extent that the Authority is contracting on behalf of others (such as school governing bodies in school projects), then these should be included. Other persons responsible to the Authority can, by failing to act, also trigger Compensation Events.

⁹ If it is appropriate for the Authority to give the Contractor compensation for Authority breaches arising during the Service Period, the Contract will need to incorporate an appropriate compensation mechanism.

¹⁰ A Compensation Event may not affect the Contractor's ability to achieve the Planned Service Commencement Date but increase the Contractor's costs.

¹¹ If “bonus payments” are to be made for early Service Commencement (see Section 4.6 (Bonus Payments for Early Service Commencement)) the parties will need to consider what, if any, further compensation should be paid to the Contractor where early Service Commencement has been prevented by the occurrence of a Compensation Event.

5.2.2.3 If the Contract contains liquidated damages provisions (see Section 4 (Protections Against Late Service Commencement)), then the Contractor's liability for liquidated damages will also be relieved for the period of delay caused by the Compensation Event. The Contractor should, of course, also be relieved of any other liability for the Authority's losses in respect of the Compensation Event. This should be taken into account in determining the consequences for the Authority of a Compensation Event.

5.2.2.4 The main advantages of this approach are first, simplicity and second, it will be preferable to financiers, since the senior debt loan life cover ratio and equity return can be preserved. This approach also means that the Authority has an incentive to manage its rights and obligations in the construction period in a way that does not result in delay. The detail of how this approach should work in practice can be seen by reference to Section 5.2.3 (Calculation of Compensation).

5.2.2.5 Some early projects sought to compensate the Contractor by paying up-front for its additional Sub-Contractor's costs, but dealt with financing costs by extending the Expiry Date. This is unlikely to be financeable and so should not be pursued. If the Contractor is fully compensated for the delay, there is no need to extend the Expiry Date and a danger exists of unnecessary complication by doing this. Provided compensation has been paid as set out below, extension of the Expiry Date is not appropriate.

5.2.2.6 The Contractor should be obliged to use reasonable endeavours to mitigate its losses and costs (for example, by rescheduling its works timetable or by redeploying staff). Such mitigation may result in there being no delay in the Planned Service Commencement Date (although extra costs may result from steps taken to mitigate).

5.2.3 Calculation of Compensation

5.2.3.1 The Unitary Charge may need to be adjusted if the Compensation Event concerned involves an additional cost or a time delay which has cost or loss of revenue implications. The Contract must contain an appropriate method for dealing with any changes that arise as a result of a Compensation Event. Section 5.2.3.3 below sets out the required drafting. The treatment of issues here is equally applicable to costs arising as a result of an Authority change in Service (see Section 13.2 (A Typology of Changes)) and a Qualifying Change in Law (see Section 14.8 (General Change in Law as a Shared Risk)).

5.2.3.2 One common way of dealing with such events is to rely on the financial model to deal with the issue and for both parties to use this to calculate how and when compensation should be paid. Typically this would require the Authority to agree that the senior debt loan life cover ratio¹² and equity return are to remain unchanged. Whilst there is no objection in principle to the parties referring to a financial model (provided both parties fully understand all of its various aspects), there are three principal problems that can arise in using a financial model to calculate compensation payable for Compensation Events (and for that matter the effects of an Authority change in Service (see Section 13.2 (A Typology of Changes)) and Qualifying Changes in Law (see Section 14.8 (General Change in Law as a Shared Risk)):

- the financial model may obscure the process being followed in reaching the answer, unless there is clarity on all sides on how the relevant formulae used in the model

¹² If this is being calculated during the Service Period and no further drawings are possible, then this is arrived at by dividing:

(a) forecast net revenues until the final maturity date of the loan (including any payments from the Authority, any business interruption insurance receipts, as well as other similar payments (such as additional shareholder contributions) that any person is obliged to pay to the Contractor), discounting back future revenues to the date of calculation (at the interest rate payable under the Senior Debt (including hedging)),

by

(b) the Senior Debt outstanding (having deducted credit balances on bank accounts) on the date of calculation. If further drawings are possible, then the above calculation will have to take into account the forecast level of Senior Debt up to the maximum committed debt.

work. For example, if something has happened which was not originally modelled for and audited, there could be conflict arising on how to model it, which could impact on the calculation concerned;

- if the Authority has access to a financial model in sufficient detail and to all of the internal costs, returns and other assumptions (to the level of detail required), then more information than is relevant simply to value the consequences of the event may have to be provided by the Contractor, which may not be acceptable to it (and, in addition, certain of the assumptions may need to be updated); and
- the result of preserving the ratios and equity return can be achieved in a number of different ways (these are referred to in Section 5.2.3.4).

The guidance requires that as simple an approach as possible is followed as the only concern of this Section is to ensure fair compensation for a limited number of events which can be calculated in a straightforward manner. If the Unitary Charge is to change, then financial advice is likely to be needed.

5.2.3.3 The approach taken in the drafting to the various events that may lead to a change in the Unitary Charge is as follows:

- if the event concerned requires Capital Expenditure (whether before or during the Service Period), then in most cases, it will be more practicable to deal with this by a lump sum reimbursement (subject of course to the possibility of staged payments)¹³ (see Clause 5.2(c)(ii)); and
- if the event concerned requires a change in operating costs, then an alteration in the Unitary Charge is the appropriate means of payment (see Clause 5.2(c)(iii)).

Although the issue is dealt with in this way in the drafting, it is important to stress that for Authority breach it is also perfectly acceptable for the Authority simply to reimburse the Contractor on the basis of costs incurred (for example, as a result of any delay in giving an approval).

5.2.3.4 The approach referred to in the drafting and Section 5.2.3.3 ensures that a minimum of additional financing costs are incurred. Other reasons, including affordability constraints may, however, mean that an Authority wishes to reserve the right to ask the Contractor to use reasonable endeavours to finance the event where Capital Expenditure is required. If this is done¹⁴ then careful scrutiny of the value for money implications should be undertaken.

5.2.3.5 Where the compensation involves an increased obligation to incur Capital Expenditure, other possibilities¹⁵ to that referred to in the drafting and Section 5.2.3.3 include:

- a lump sum payment from the Authority paid immediately on Service Commencement, the amount payable to exceed the amount of the relevant increase in Capital Expenditure by any incremental increase in financing costs consequent on a more rapid drawdown of Senior Debt and/or Junior Debt than originally anticipated and the agreed costs incurred in arranging any such financing;
- an adjustment to the Unitary Charge to take account of the Contractor's additional funding outstanding for the event concerned. This adjustment would reflect the actual

¹³ Significant Authority changes are likely to be acceptable to the Contractor only if compensation is paid by the Authority, so as to match the timing of the agreed costs of the change.

¹⁴ As stated in Section 5.2.3.3 this approach should not be used for Authority breach, but will be a common option to include, for example, for Authority changes and Qualifying Changes in Law (see Sections 13 (Change in Service) and 14 (Change in Law)).

¹⁵ Particularly to avoid the time and expense of engaging advisers for what may be minor compensation sums (if this approach is used), it is recommended that the parties agree and record in the Contract the incremental impact on Unitary Charge of minor capital expenditure and operational expenditure changes.

terms and conditions of the funding, which would have been agreed between the parties at the outset, and be applied on the basis that the financiers are no worse and no better off, from the perspective of risk and return, than they would have been had the increase in Capital Expenditure not arisen. As stated above, in practice this generally means that an increase is made to the Unitary Charge (over the term of amortisation of the additional dedicated funding) to restore the senior debt loan life cover ratio and equity return to their values had the additional funding not been required. This calculation can only be made by using the financial model (as to which see Section 5.2.3.2 above). The Authority should not seek a grace period on paying higher Unitary Charge even if this would satisfy the senior debt loan life cover ratio and equity return (as this could cause inappropriate distortion to the cash flow profile); or

- particularly if the Authority cannot afford to pay compensation in the form of a lump sum but wishes to avoid having to use a financial model, it may offer to pay a supplementary Unitary Charge over a period of its choosing as an annuity equivalent of the Capital Expenditure. If this approach is adopted, the discussion can be reduced to a single issue, namely the annuity rate to be applied. In this case, the Authority need not be concerned with how and at what cost the Contractor has arranged additional dedicated funding, if any.¹⁶

5.2.3.6 If the event concerned involves a Capital Expenditure reduction (e.g. cancellation of a wing of a building), this would involve:

- a reduction in Unitary Charge. The size of reduction will depend upon not only savings in Capital Expenditure but also consequent savings in finance and operating costs. The decision on whether or not to cancel any excess committed finance prior to project completion (if this is possible with the financing structure concerned) will be taken jointly with the Contractor and its financiers. The concept of lump sum payment (or refund), whether single or by instalment, does not arise as a possibility in this context.
- there are two alternative approaches to determining the appropriate reduction in Unitary Charge: either to use the financial model (see Section 5.2.3.2 above); or to determine the annuity equivalent reduction. With an annuity equivalent reduction the term of the annuity should be the term of the Contract, unless the parties otherwise agree.

5.2.3.7 If the compensation arises only because of a change in operating costs then appropriate changes in the Unitary Charge should be by negotiation and may be possible without reference to the financial model, even where the impact on operating costs is periodic or irregular over time. The change in Unitary Charge should be made at the time of the Compensation Event to reflect forecast operating costs changes, as to amount and timing. The use of lump sum compensation payments or annuity equivalents are also inappropriate for changes in operating costs.

As many of the above issues have complicated financial consequences, financial advisers should be consulted as to the most appropriate approach for a particular project.

5.2.3.8 In any event, (even if this approach is taken in relation to Authority changes and Qualifying Changes in Law) it is not appropriate in any circumstances for breach by the Authority

¹⁶ If the original Unitary Charge over the chosen annuity payment period is profiled, then the supplementary Unitary Charge should similarly be profiled. Annuities being based upon nominal discount rates would be excluded from any indexation provisions of the Unitary Charge.

of its obligations to give rise to an obligation on the Contractor to finance any Capital Expenditure consequences.¹⁷

5.2.3.9 In assessing the consequences of a Compensation Event, other causes of delays to the Service Commencement Date will be relevant as to whether the Contractor will receive relief from its obligations and/or compensation. The Contractor's losses should be calculated as accurately as possible at the time and payment made as appropriate.

Required drafting is as follows:

5.2 Delays in Service Commencement Due to a Compensation Event

(a) If, on or before the Service Commencement Date,¹⁸ as a direct result of the occurrence of a Compensation Event:¹⁹

- (i) the Contractor is unable to achieve Service Commencement on or before the Planned Service Commencement Date, or, following the Planned Service Commencement Date, the Long Stop Date;
- (ii) the Contractor is unable to comply with its obligations under this Contract; and/or
- (iii) the Contractor incurs costs or loses revenue,²⁰

then the Contractor is entitled to apply for relief from its obligations and/or claim compensation under this Contract.

(b) Subject to sub clause (d) below, to obtain relief and/or claim compensation the Contractor must:

- (i) as soon as practicable, and in any event within [21] days after it became aware that the Compensation Event has caused or is likely to cause delay, breach of an obligation under this Contract and/or the Contractor to incur costs or lose revenue, give to the Authority a notice of its claim for an extension of time for Service Commencement, payment of compensation and/or relief from its obligations under the Contract;
- (ii) within [14] days of receipt by the Authority of the notice referred to in paragraph (b)(i) above, give full details²¹ of the Compensation Event and the extension of time and/or any Estimated Change in Project Costs and/or loss of revenue claimed;²² and
- (iii) demonstrate to the reasonable satisfaction of the Authority that:
 - (A) the Compensation Event was the direct cause of the Estimated Change in Project Costs and/or loss of revenue and/or any delay in the

¹⁷ See Section 13 (Change in Service) and 14.8 (Qualifying Change in Law) which provides for the approach set out in the second bullet point to Section 5.2.3.5.

¹⁸ This provision may also be applied during work of a construction nature (such as on an insurance reinstatement following total or partial destruction of an asset) (see Section 5.2.1.4). The concept can also be extended in respect of an Authority obligation to be performed during the Service Period, particularly if there are non payment obligations on the Authority (again see Section 5.2.1.4). Subject to the reinstatement point, however, the principal obligations in the Service Period will be payment related and can often be dealt with through provisions dealing with interest on late payment (see Clause 30.6 (Interest on Late Payments))

¹⁹ In the event of a delay to the Planned Service Commencement Date the construction costs will most likely increase, due to a longer financing period. The Contractor is under a duty to mitigate its other costs associated with any delay (for example, by delaying recruitment, if this can be done) (see Clause 5.2(b)(iii)).

²⁰ This loss means not only out of pocket costs but also a claim for loss of profits (including a lost completion bonus) caused directly by the Compensation Event.

²¹ The Authority and the Contractor may wish to specify in the Contract precisely what details are required.

²² This figure will not calculate the compensation payable, but it gives an indication of the seriousness of the breach and so what should be taken by way of mitigation.

achievement of the Planned Service Commencement Date and/or breach of the Contractor's obligations under this Contract, or, following the Planned Service Commencement date, delay in achieving Service Commencement before the Long Stop Date; and

- (B) the Estimated Change in Project Costs and/or loss of revenue, time lost, and/or relief from the obligations under the Contract claimed, could not reasonably be expected to be mitigated or recovered by the Contractor acting in accordance with good industry practice.²³
 - (c) In the event that the Contractor has complied with its obligations under paragraph (b) above, then:
 - (i) in the case of a delay, the Planned Service Commencement Date or, following the Planned Service Commencement Date, the Long Stop Date, shall be postponed by such time as shall be reasonable for such a Compensation Event, taking into account the likely effect of delay;²⁴
 - (ii) in the case of an additional cost being incurred or revenue being lost by the Contractor:
 - (A) on or before the Service Commencement Date; or
 - (B) as a result of Capital Expenditure being incurred by the Contractor at any time
- the Authority shall compensate the Contractor for the actual Estimated Change in Project Costs as adjusted to reflect the actual costs reasonably incurred and, without double counting, for revenue actually lost (to the extent it could not reasonably have been mitigated), within [30] days of receipt of a written demand by the Contractor supported by all relevant information;²⁵
- (iii) in the case of a payment of compensation for the Estimated Change in Project Costs and/or without double counting, loss of revenue that does not result in Capital Expenditure being incurred by the Contractor referred to in paragraph (B) above but which reflects a change in the costs being incurred by the Contractor after the Service Commencement Date, the Authority shall compensate the Contractor in accordance with paragraph (f) below by an adjustment to the Unitary Charge; and /or
 - (iv) the Authority shall give the Contractor such relief from its obligations under the Contract, as is reasonable for such a Compensation Event.
- (d) In the event that information is provided after the dates referred to in paragraph (b) above, then the Contractor shall not be entitled to any extension of time, compensation, or relief from its obligations under the Contract in respect of the period for which the information is delayed.²⁶

²³ This will depend on the industry concerned.

²⁴ Since the Long Stop Date is linked to the Planned Service Commencement Date, where (prior to the Planned Service Commencement Date), the Planned Service Commencement Date is put back, the Long Stop Date will automatically be put back too. If the Contractor is required to pay the Authority liquidated damages for failure to achieve Service Commencement by the Planned Service Commencement Date, the Authority and its advisers should consider how the Contractor's obligation to pay will be relieved if a Compensation Event occurs after the Planned Service but prior to actual Service Commencement.

²⁵ This payment can be in the form of a monthly payment as expenditure is incurred (or staged payments against milestones) and invoiced if the delay is for a significant period of time. In the event that the Authority wishes the Contractor to increase its financing to pay for the consequences of a Compensation Event (other than an Authority breach), then Section 5.2.3 (Calculation of Compensation) should be reflected.

²⁶ Some early Contracts provide that to the extent procedures are not followed here that no extension of time, payment or relief is given. This approach should not be used for new projects.

- (e) If the parties cannot agree the extent of any compensation, delay incurred, relief from the Contractor's obligations under the Contract, or the Authority disagrees that a Compensation Event has occurred (or as to its consequences), or that the Contractor is entitled to any relief under this Clause, the parties shall resolve the matter in accordance with Clause 28 (Dispute Resolution).
- (f) Any payment of compensation referred to in paragraph (c) (iii) above shall be calculated in accordance with [Section 5.2.3 (Calculation of Compensation) above].²⁷

5.3 RELIEF EVENTS

5.3.1 Purpose

5.3.1.1 Relief Events are events which prevent performance by the Contractor of its obligations at any time, in respect of which the Contractor bears the financial risk in terms of increased costs and reduced revenue but for which it is given relief from termination for failure to provide the full Service. The events listed in Section 5.3.2 (Scope of Relief Events) may be outside the Contractor's control, but that is not the appropriate measure of whether an event should appear on the list, as many events beyond a person's control at the time they occur could in fact have been prevented by proper precautions (e.g. fire). In fact, the list of events has been arrived at because the risk of the events concerned occurring is better borne by the Contractor as it is in a better position than the Authority to mitigate and manage the consequences. In some cases this will be with insurance, in others with a combination of insurance and proper planning and in others still, by risk management and planning (i.e. the events can be worked around for the period they exist).

5.3.1.2 It is clear in most cases that termination should not follow a Relief Event. This is because any replacement Contractor would be similarly affected and so the Authority's position would not be improved by termination. Relief Events do not, however, require the same treatment as Force Majeure Events (see Section 5.4 (Force Majeure Events)) as their consequences are not likely to be as severe and will usually only last for a finite period.

5.3.1.3 In the past it has been argued that a right to terminate should exist for the prolonged occurrence of a Relief Event. Other than in certain defence projects,²⁸ this is not appropriate for two reasons. First there is a risk of there being no proper incentive on the Contractor to manage the risk (depending on any compensation payable on termination) and secondly the occurrence of such an event is likely either to be short-lived (e.g. strikes by a supplier) and/or lead to an alternative sourcing of the supply concerned by the Contractor (e.g. any shortage of fuel). In any event, the appropriate measure for a termination payment in such circumstances (i.e. Contractor Default – see Section 21.2.5 (Compensation on Termination for Contractor Default)) would be unlikely to be agreed by Contractors.

5.3.2 Scope of Relief Events

5.3.2.1 The required drafting for Relief Events is as follows:

²⁷ Authorities should not enter into arrangements whereby after the relevant effects of the Compensation Event has been calculated there is a reconciliation if the costs are greater or lesser than those agreed or estimated.

²⁸ In the interests of certainty in particular defence projects, for example where the Service is needed by the MOD for military or operational reasons, a right to terminate may be allowed for both parties in the event of prolonged occurrence of a Relief Event. See MOD Standard Form Contract.

“Relief Event”

means:²⁹

- (a) fire, explosion, lightning, storm, tempest, flood, bursting or overflowing of water tanks, apparatus or pipes, ionising radiation (to the extent it does not constitute a Force Majeure Event),³⁰ earthquakes, riot and civil commotion;
- (b) failure by any statutory undertaker, utility company, local authority³¹ or other like body to carry out works or provide services;
- (c) any accidental loss or damage [to the development³² or any roads servicing it];
- (d) any failure or shortage of power, fuel or transport;
- (e) any blockade or embargo which does not constitute a Force Majeure Event,³³ and
- (f) any:
 - (i) official or unofficial strike;
 - (ii) lockout;
 - (iii) go–slow; or
 - (iv) other dispute,generally affecting the [] industry³⁴ or a significant sector of it,

unless any of the events listed in paragraphs (a) to (f) inclusive arises (directly or indirectly) as a result of any wilful default or wilful act of the Contractor³⁵ or any of its sub-contractors.

5.3.2.2 The Contract will have similar provisions during both the construction/development phase and the Service Period. In addition, as mentioned in Section 5.1.5, the above list of events may be extended to include other similar events if the circumstances warrant. Force majeure delays should be excluded (see Section 5.4 (Force Majeure Events)) as they are treated separately. In addition, in circumstances where the Contract imposes a long–stop date for Service Commencement (see Section 4.5 (Long–Stop Date)) the scope of Relief Events may be extended to cover further events (e.g. unforeseen ground conditions) given that the financial risks associated with such events will remain with the Contractor, though in ordinary circumstances allowance will already have been made for such contingency when setting the Long–Stop Date.

5.3.3 Consequences

5.3.3.1 The financial effects of delays caused by Relief Events are borne by the Contractor, so no compensation should be paid by the Authority on the occurrence of such delays. If a Relief Event occurs prior to Service Commencement any long–stop termination date will be put back by a period equal to the relevant delay. In most cases the only relief given will be relief from

²⁹ This list can be extended or tailored for specific sectors (e.g. the unintentional introduction of a virus in an IT project) provided that the commercial risk of the occurrence of such events clearly still lies with the Contractor. Authorities should be aware that the issues relating to termination rectification should restrict the list to events (other than those set out above) over which the Contractor has no control. There will also be circumstances in which the uninsurability of particular risks may require relief treatment in order to prevent either party from terminating the Contract (see Section 25.9 (Risks that become Uninsurable)).

³⁰ Force Majeure Events are defined in Section 5.4.

³¹ In the context of a local authority project please see Section 1.4.4.

³² More specific reference may, as appropriate, be used (such as Facilities or Works).

³³ See footnote 30 above.

³⁴ This will be the principal industry relating to the project concerned. For example, in an accommodation project this will include the building maintenance or facilities management industries.

³⁵ See also Section 21.2.4.3 in relation to Relief Events occurring during rectification periods for Contractor Default.

termination (i.e. Relief Events are separate and distinct from Compensation Events and Force Majeure Events).

5.3.3.2 There should be no extension to the Contract owing to a Relief Event. The Authority should not regard an extension of the Contract as a concession without significant cost. This is because if an extension is given, then although the Contractor does not receive the Unitary Charge during a Relief Event (save to the extent the Service is delivered), the Contractor's revenue period would be kept whole. If this occurs, then there is a reduced incentive on the Contractor to manage the effects of the Relief Event and restore the Service as soon as possible. In addition, the Authority's exposure to any risks it bears under the Contract is extended indefinitely as the Expiry Date may be continually extended. By extending the Contract, therefore, the Authority can be taking a large element of the risk of the occurrence of Relief Events (as the economic effects of an extension can be substantial).

5.3.3.3 The parties should consider, on a project specific basis, whether or not the Contractor should be relieved of any liability for liquidated damages, although availability and performance deductions should continue to be made where necessary in respect of the period of delay caused by the Relief Event (see Sections 4 (Protections Against Late Service Commencement) and 7 (Price and Payment Mechanism)). Liquidated damages prior to Service Commencement (to the extent they exist) are designed to compensate the Authority for specific losses due to late Service delivery so that if the Contractor fails to commence provision of the Service due to a Relief Event, the Authority will still suffer this loss. Depending on the nature of the Project, however, the Authority may feel that it will obtain better value for money if it allows any liability of the Contractor for liquidated damages to be postponed by the period of the delay.

5.3.3.4 When a Relief Event has occurred and the Authority has been informed, the parties should consult to discuss relevant issues, such as the likely duration of the Relief Event and the action to be taken to mitigate its effects.

5.3.3.5 The Authority should not normally expect to exercise any step-in rights it has during a Relief Event (see Sections 29 (Authority Step-In)). If the Contractor is not using reasonable endeavours to rectify matters and mitigate the consequences, it will not obtain the relief afforded by Relief Events and will be at risk of termination for default (see Clause 5.3(b) (Delays due to a Relief Event)). This should provide a sufficient spur for the Contractor to perform (depending, in part, on the approach taken to relief from other obligations under the Contract).

Required drafting to deal with Relief Events is as follows:

5.3 Consequences of a Relief Event

(a) If and to the extent that a Relief Event:

- (i) is the direct cause of a delay in Service Commencement; and/ or
- (ii) adversely affects the ability of the Contractor to perform any of [its obligations under this Contract],

then the Contractor is entitled to apply for relief from any rights of the Authority arising under Clause 21.2 (Termination on Contractor Default) [and its obligations³⁶ under this Contract].

(b) To obtain relief, the Contractor must:³⁷

³⁶ In most contracts Relief Events should give only relief from the risk of termination for failure to complete or failure to perform (see Section 5.3.3.1). In cases in which liquidated damages are payable to the Authority there will be an issue of the extent to which relief can be given from claims for damages or liquidated damages (see Sections 5.3.3.3 and 24 (Indemnities, Guarantees and Contractual Claims)). The performance regime should still apply and this should be made clear, to the extent there is potential for relief from liquidated and other damages.

- (i) as soon as practicable, and in any event within [14] days after it became aware that the Relief Event has caused or is likely to cause delay and/or adversely affect the ability of the Contractor to perform its other obligations give to the Authority a notice of its claim for relief from its obligations under the Contract, including full details of the nature of the Relief Event, the date of occurrence and its likely duration;
- (ii) within [7] days of receipt by the Authority of the notice referred to in paragraph (b)(i) above, give full details of the relief claimed; and
- (iii) demonstrate to the reasonable satisfaction of the Authority that:
 - (A) the Contractor and its sub-contractors could not have avoided such occurrence or consequences by steps which they might reasonably be expected to have taken, without incurring material expenditure;
 - (B) the Relief Event directly caused the delay to the Planned Service Commencement Date or, following the Planned Service Commencement Date, delay in achieving Service Commencement by the Long Stop Date or [the need for relief from other obligations under the Contract],³⁸
 - (C) the time lost and/or relief from the obligations under the Contract claimed could not reasonably be expected to be mitigated or recovered by the Contractor acting in accordance with good industry practice,³⁹ without incurring material expenditure; and
 - (D) the Contractor is using reasonable endeavours to perform its obligations under the Contract.
- (c) In the event that the Contractor has complied with its obligations under paragraph (b) above, then:
 - (i) the Planned Service Commencement Date or, following the Planned Service Commencement Date, the Long Stop Date shall be postponed by such time as shall be reasonable for such a Relief Event, taking into account the likely effect of delay; and/or
 - (ii) the Authority shall not be entitled to exercise its rights to terminate the Contract under Clause 21.2 (Termination on Contractor Default)⁴⁰ [and, subject to paragraph (d) below, shall give such other relief as has been requested by the Contractor].⁴¹
- (d) [Nothing in paragraph (c) above shall affect any entitlement to make deductions⁴² or any deductions made as a result of [Section 9 (Payment and Performance Mechanism)]] during the period in which the Relief Event is subsisting.⁴³

³⁷ The approach here is to set out a quick procedure so that relief can be given or refused on a sensible timescale without additional delays.

³⁸ See footnote 36 above.

³⁹ This will depend on the industry concerned.

⁴⁰ See Section 21.2 (Termination on Contractor Default).

⁴¹ This wording is only appropriate where additional relief beyond relief from termination (for instance for liquidated damages) are offered. See Section 5.3.3.3 and footnote 36 above.

⁴² If the termination levels under the Contract for non-performance are connected to the deductions made under the Contract or the award of performance points, the Contract should ensure that deductions or points arising due to non-performance caused by Relief Events are not taken into account in the termination provisions of the Contract. This is best dealt with in the performance regime.

⁴³ See footnote 36 above.

- (e) In the event that information required by paragraph (b) above is provided after the dates referred to in that paragraph, then the Contractor shall not be entitled to any relief during the period for which the information is delayed.
- (f) The Contractor shall notify the Authority if at any time it receives or becomes aware of any further information relating to the Relief Event, giving details of that information to the extent that such information is new or renders information previously submitted materially inaccurate or misleading.
- (g) If the parties cannot agree the extent of the relief required, or the Authority disagrees that a Relief Event has occurred or that the Contractor is entitled to any extension of the Planned Service Commencement Date or the Long Stop Date [and/or relief from other obligations under this Contract],⁴⁴ the parties shall resolve the matter in accordance with Clause 28 (Dispute Resolution).

5.4 FORCE MAJEURE EVENTS

5.4.1 Scope of Force Majeure

5.4.1.1 The purpose of force majeure provisions is to give the Affected Party relief from liability and, if the event continues for a certain period, to give the parties an opportunity to terminate the Contract. The definition of Force Majeure Events (see Section 5.4.1.2) should only include events which, unlike Relief Events, are likely to have a catastrophic effect on either party's (although usually the Contractor's) ability to fulfil its obligations under the Contract. In practice, such events are highly unlikely to occur. As neither party is likely to be in a better position than the other to manage either the occurrence or the effects of force majeure, and the events may continue for a long period of time, such events are given a different treatment from Relief Events and the financial consequences shared.

5.4.1.2 The following is the required definition of Force Majeure Events:

“Force Majeure Event”⁴⁵

means the occurrence after the date of Contract of:

- (a) war, civil war, armed conflict or terrorism; or
- (b) nuclear, chemical or biological contamination unless the source or the cause of the contamination is the result of the actions of or breach by the Contractor or its sub-contractors; or
- (c) pressure waves caused by devices travelling at supersonic speeds,

which directly causes either party (the **“Affected Party”**) to be unable to comply with all or a material part of its obligations under this Contract.

5.4.1.3 Relief for Force Majeure Events applies only to the extent that the Contractor or the Authority is unable to comply with all or a material part of its obligations under the Contract and the parties cannot agree within a limited period (say 6 months) how to resume the Project.

5.4.1.4 The Authority should not be obliged to pay the Contractor any amount simply to service the Contractors' debt obligations in whole or in part, but the parties should recognise that the

⁴⁴ See footnote 36.

⁴⁵ This definition should not be expanded without a very careful consideration of the specific issues on the Project concerned, as the effect can be to dilute or undermine agreed areas of risk transfer. It is recognised, however, that there are some obvious sector specific changes that may be needed (for example, certain MOD projects might exclude some of paragraph (a) if it is intended to operate during times of war). The definition may also be narrowed to cope with the fact that paragraph (b) may be inapplicable to environmental projects or projects involving chemical treatment which may be designed to deal with a certain degree of chemical contamination. The NHS has specific provisions dealing with chemical and biological contamination.

Contractor may wish to include certain tolerances into its Contract to allow for this. If termination occurs, the Authority will in any event compensate the Contractor for outstanding Senior Debt.⁴⁶ If termination does not occur, then the parties will be discussing continuation of the Contract against a back drop of such a compensation payment.

5.4.2 Consequences of Force Majeure

5.4.2.1 On the occurrence of a Force Majeure Event, the parties should consult to attempt to find a way to continue the Project, such as agreeing how it can be reinstated if destroyed (although neither party will be obliged to do this). The solution will depend on the nature of the event and its effects, but may involve altering the service requirement, amending the payment mechanism or even extending the term of the Contract. The required drafting for dealing with the effects of Force Majeure Events is set out in Section 21.3 (Termination on Force Majeure).

5.4.3 Relief Events, Force Majeure Events and Insurance

5.4.3.1 Contractors may take out advance loss of profit or business interruption insurance against certain of the Relief Events (see Section 25 (Insurance)) to provide a replacement revenue stream for financiers and others reliant on the revenue of the Project for the duration of the event and/or the duration of a rebuild. Such insurances will often be subject to an excess for a number of days and so the occurrence of any such event may still involve the Contractor in substantial cost. Such insurance may not be available in respect of all types of Relief Event and, generally, will only pay out where there is physical damage to the Project.

5.4.3.2 The issue of allocating the risk of Relief Events and Force Majeure Events should be treated separately from the issue of whether or not insurance is available. The primary factor in allocating risk is who is best placed to manage the risk and its consequences and, in the case of Relief Events, this is the Contractor. Whether it can insure against such risk is a matter for the Contractor as it is essentially the Contractor's decision to manage the risk (to the extent the insurances are not required) in a satisfactory manner. Authorities should therefore not accept the argument that uninsurable events should inevitably fall within the definition of force majeure or an equivalent. This would significantly extend the definition of Force Majeure Events (see Sections 25 (Insurance) and 21.3 (Termination on Force Majeure)). Force Majeure is specifically given a different treatment in this guidance as the occurrence of the events listed in Section 21.3.2.2 are judged to be risks which the Contractor is not necessarily best placed to manage, and so should be shared by the Authority.

⁴⁶ See Section 21.3.2 (Compensation on Termination for Force Majeure).

6 WARRANTIES

6.1 INTRODUCTION

6.1.1 Tenderers base their bids on information provided by the Authority in the tender documents and the Authority should make it clear whether or not such information has been verified.¹

6.1.2 The Contract should determine who should bear the risk if information on which a Contractor relies in its bid subsequently proves to be incorrect. This includes determining who should bear the risk of latent defects appearing in assets transferred from the Authority to the Contractor.

6.2 DUE DILIGENCE

6.2.1 A common approach in the past has been for the Authority to assume automatically that it should hand over full responsibility to the Contractor for verifying information. This involves the Contractor (and other bidders) in due diligence expense in ascertaining what is being bid against and what contingencies to include. Contractors have accepted this risk in Projects in which the due diligence is small in relation to the rest of the Project, particularly where the Project involves only the provision of a new service.

6.2.2 Contractors may be reluctant, however, to bear this risk where the Project involves a great deal of costly due diligence (relative to the size of the Project) or where the Authority is the sole source of information which cannot otherwise be verified. This is usually the case where the Authority is handing over a service (and possibly employees) which has been provided in-house for an extended period and/or a range of assets in uncertain condition.

6.2.3 If the Contractor bears the risk of information being inaccurate, then its bid price may increase to reflect the level of risk assumed. The Authority should consider whether it can obtain better value for money (taking into account the overall risk allocation) if it is able to bear some of this risk itself or transfer some of this risk to a third party. If the risk is sufficiently large it will affect the ability of some or all bidders to submit bids.

6.3 AUTHORITY WARRANTIES

6.3.1 The Authority should be very careful in warranting any information it provides. Warranties, to the extent given, should not extend beyond information on which the Contractor must rely for its bid. Accordingly, the Authority should seek to minimise the extent of any warranties, unless:

- the Authority is the sole source of such information or such information cannot be verified by the Contractor at reasonable cost;
- the Authority is confident in the accuracy of such information or is able to confirm its accuracy without significant expense (e.g. through surveys, in-house checks or inspections); and
- the Authority will obtain better value for money as a result (taking into account the overall risk allocation).

¹ The Authority will assist its position, obtain quicker contract signature and secure better value for money, if it ensures that, prior to the bid phase, all assets to be contributed by the Authority to the Project are properly vested in the Authority.

6.3.2 If the criteria listed in Section 6.3.1 are satisfied and the Authority gives certain warranties, this will help reduce the Contractor's costs. The Contract could then either contain a price variation mechanism to be employed if the information turns out to be inaccurate (rather than giving rise to a right to terminate) or give rise to a damages claim. An example of where warranties are likely to be appropriate is where employees are being transferred by the Authority to the Contractor or particular known risks exist in relation to a building (such as asbestos content).

6.3.3 Required drafting for warranty exclusion for Contracts in which warranties are not given by the Authority is as follows:

6.3 Exclusion from Warranty

- (a) The Contractor shall be deemed to have:
- (i) satisfied itself as to the assets to which it will acquire rights and the nature and extent of the risks assumed by it under this Contract; and
 - (ii) gathered all information necessary to perform its obligations under this Contract and other obligations assumed, including:
 - (A) information as to the nature, location and condition of the land (including hydrological, geological, geo-technical and sub-surface conditions);
 - (B) information relating to archaeological finds, areas of archaeological scientific or natural interest,² local conditions and facilities and the quality of existing structures; and
 - (iii) [other relevant information (e.g. environmental contamination)].³
- (b) The Contractor shall not in any way be relieved from any obligation under this Contract nor shall it be entitled to claim against the Authority on grounds that any information, whether obtained from the Authority or otherwise (including information made available by the Authority) is incorrect or insufficient and shall make its own enquiries as to the accuracy and adequacy of that information.

6.4 BENEFIT OF SURVEYS AND REPORTS

6.4.1 There are other means by which the Authority can help reduce the Contractor's due diligence costs. It may, to the extent possible, disclose the contents of or assign the benefit of any reports or surveys it commissions from third party consultants direct to the Contractor (or the bidders) or share the benefit of such reports or surveys with them having reached an agreement on cost sharing. If the Authority wants to follow this route, it must ensure that when it appoints the relevant consultant that it agrees to take on the work on the basis of such assignment or sharing of the benefit.⁴ In addition, if this approach is to be of value to the Contractor, the relevant report or survey must be up-to-date and address the issues of particular concern to the Contractor and, where possible, its financiers.

6.4.2 A practical option for bidders to consider is to share the cost of carrying out expensive aspects of due diligence by jointly appointing a consultant.

² See Section 5.1.4 above for the treatment of fossils and antiquities in certain projects.

³ The value of environmental warranties/indemnities will need to be reviewed on a project specific basis, taking into account the considerations outlined in Section 6.3.1 (Authority Warranties). In certain circumstances, for example, it may prove better value for money for the Authority to provide environmental indemnities where a low probability but high impact risk is present, e.g. where part of the site was previously used as gasworks.

⁴ See, for instance, the BSF schools programme.

6.5 LATENT DEFECTS RISK

6.5.1 The issue of who should bear latent defects risk in assets transferred to the Contractor by the Authority should be addressed on a project specific basis as it depends on the type of assets involved.

6.5.2 In transferring latent defects risk from the Authority to the Contractor in respect of existing buildings, particular issues will arise where:

- the relevant building is large and/or complex;
- there is any significant doubt as to the building's structural stability; or
- the Project involves minor additions to an existing building.

Where land is concerned, however, ground conditions risk should be borne by the Contractor unless exceptional circumstances apply (e.g. the Contractor is prevented by the Authority from carrying out all relevant surveys).⁵

⁵ This is of general application in that it may not prove value for money for the Authority to seek to transfer this or latent defects risk in respect of any asset which the Contractor is not afforded the opportunity to survey (see Section 5.3.2.2). Fossils and antiquities are dealt with in Section 5.1.4 above.

7 PRICE AND PAYMENT MECHANISM

7.1 INTRODUCTION

7.1.1 The payment mechanism lies at the heart of the Contract. It puts into financial effect the allocation of risk and responsibility between the Authority and the Contractor. It determines the payments which the Authority makes to the Contractor and establishes the incentives for the Contractor to deliver the Service required in a manner that gives value for money.

7.1.2 Many PFI payment mechanisms involve two key determinants of payment – availability of the Service and performance of Service. This Section is an introduction to the wide range of concepts which can be used in payment mechanisms. These two concepts are discussed in more detail in Sections 8 (Availability Requirements) and 9 (Performance Requirements).

7.1.3 When procuring services through PFI contracts, Authorities should assess not only their current requirements but also their requirements into the future. In many projects, demand or usage will be a key risk over the life of the Contract, regardless of whether or not this risk is passed to the Contractor through the payment mechanism. In drawing up a specification for the Services required, Authorities should be confident that there will be long-term demand for the Service.

7.1.4 The design and calibration of the payment mechanism requires input from the Authority and its advisers, including financial, legal and technical advisers. The payment mechanism should be tailored to the individual project. Where more detailed guidance has been issued by departmental Private Finance Units or organisations such as Partnerships for Schools, this should be followed.

7.2 FEATURES OF THE PAYMENT MECHANISM

7.2.1 The key features of a payment mechanism are:

- no payments should be made until the Service is available;
- there should be a single Unitary Charge for the Service which is not made up of separate independent elements relating to availability or performance;
- the level of payment should be linked to the level of Service. For a payment mechanism based on availability with an overlay of performance deductions, this will mean linking payment to both the availability and the quality of the Service;
- the Unitary Charge should never be paid in advance of the period to which it relates;¹
- the payment mechanism should adjust for sub-standard performance, and deductions should reflect the severity of failure. Thus no Service should lead to no payment, but proportionality is important and therefore a minor failure should cause a minor deduction (except in the case of persistent failure where ratchet mechanisms may increase the level of deduction);
- the mechanism should not only incentivise the Contractor to remedy service failures but should also take into account the importance of that failing Service to the Authority;

¹ Projects may appear more affordable if payments are made in advance (on the first day of a monthly, or other, period rather than after the end of the period). This is bad practice and not to be adopted.

- a balance should be struck amongst the variables in the payment mechanism, such as the initial “weighting” of deductions for failures, response / rectification periods, and the “ratcheting up” of deductions for repeated failures over time;
- the performance and payment regime should not be made up of sub-elements which relate to delivery of inputs (e.g. completion of stages of construction, cost of materials or labour) but should be based on outputs (e.g. the availability of facilities or standard of Services); and
- the payment mechanism should never contain a fixed element which the Contractor always receives irrespective of performance (e.g. which covers the Contractor’s debt service obligations).

7.2.2 It is not generally appropriate to “sculpt” the Unitary Charge (i.e. through an uneven or irregular payment profile) other than for relevant general price changes² or to ensure consistency with any ramp-up in services in an initial period or project phasing. The reason for this is that sculpting the Unitary Charge is contrary to the principle of paying for Services rather than inputs; moreover it is orientated towards affordability rather than value for money concerns and can undermine the effectiveness of the risk transfer to the private sector.³ “Ramp-up” can happen, for example, where a project involves a mixture of new construction and refurbishment of existing facilities, with the latter becoming available before completion of construction.

7.2.3 The Authority should pay for Services on time and payment should not be unreasonably withheld. The Authority should comply with Government policy on late payment (e.g. agreeing payment of interest if payment is late), so Contracts should take into account the relevant provisions of the Late Payments of Commercial Debts (Interest) Act 1998. The Authority should also take steps to ensure that the Contractor complies with best practice in this area. In accordance with Government policy the Contractor should pay its Sub-Contractors ordinarily within 30 days, unless a different period is specified in the relevant Sub-Contract.

7.2.4 The choice of payment mechanism should be a positive decision by Authorities, informed by advice from their advisers. The Authority should also involve relevant stakeholders (e.g. end-users) as appropriate.

7.2.5 The payment mechanism must be properly applied in practice. There have been occasions where Authorities have been wary of imposing deductions for fear of threatening their relationship with the Contractor, or because they are concerned that deductions will damage the ability of Sub-Contractors to rectify problems. Authorities should regard the payment mechanism as an important part of their Contract and should enforce it.

7.2.6 The Authority’s requirements and payment mechanism are designed to deliver the required Services identified in the business case and accordingly out-performance (i.e. performance to a higher standard) by the Contractor should not ordinarily warrant further payment. However, for some projects (for example, where the performance by the Contractor can affect the financial position of the Authority, such as rent collection in some housing projects) Authorities may consider that there is value for money in including scope for additional payments. In such cases Authorities may wish to cap payments for out-performance (e.g. at the level of previous deductions or by awarding ‘bonus points’ which can only serve to offset ‘negative’ points for poor performance). Such payments will, however, only offer value for money if they are valued by bidders and Senior Lenders in their pricing for the Project.

² The payment mechanism will often include provisions relating to changes in the general price level (i.e. as a result of inflation) during the Contract (see Section 15.2 (Inflation Indexation)). Benchmarking and market testing can also lead to changes in the Unitary Charge (see Section 15 (Price Variations)).

³ The May 2006 HMT Application Note “*Interest-Rate and Inflation Risks in PFI Contracts*” (see section 3.2 in particular) discusses this issue and addresses the related question of ‘over-indexing’ the Unitary Charge.

7.3 STRUCTURING THE PAYMENT MECHANISM

7.3.1 Authorities should consider the following principles in structuring their regime:

- where the mechanism measures both availability and Service performance, the distinction between points to be included as part of the definition of availability and those to be part of a performance measurement system is important.⁴ Occasionally there is an overlap, for example, in a hospital cleanliness is an important element of availability, especially for operating theatres, but lack of cleaning can also constitute a performance failure. In this example the distinction is ultimately one of degree; it may be appropriate for such items to feature in both the availability definition and the performance measurement system so long as the arrangement is clear and double-counting is avoided,⁵
- the mechanism might involve (a) direct cash deductions for failure, whether in terms of unavailability, poor performance, or other terms appropriate to the mechanism for a specific project, or (b) a two-stage system whereby failure leads firstly to points which in turn lead to cash implications (e.g. once a certain number of points are reached). If the definition of availability omits key requirements – these being instead covered by the performance measurement system – the latter could include both immediate payment deductions and a system of performance points;
- the payment for a given period, e.g. a month, might be structured as (a) starting from zero, with payment increased in response to availability and performance, or (b) increasing for availability but subject to deductions for poor performance, or (c) a base case figure for the Unitary Charge for that period which is subject to deductions for both unavailability and poor performance;
- a number of performance regimes amongst early projects have been over-elaborate and, as a result, ineffective, and some have not been designed with enough consideration of the practicability of day-to-day procedures. As a rule, simple is best. The payment mechanism should seek to “measure less but measure well”;
- unnecessary complexity can also arise where the movement from specification of inputs to specification of outputs has not been endorsed by the Authority. The mechanism should concentrate on measuring “outputs” not measuring “inputs”;
- Authorities should first build their model from the bottom up, ensuring that for any particular area, or service failure, there is an appropriate potential deduction. The model should then be reviewed from the top down, considering the cumulative effect of all types of deduction. If it is “over-weighted” in terms of the scale of likely deductions, it will encourage excessive risk pricing and cash reserving by bidders. If it is “under-weighted”, bidders will not be sufficiently incentivised to rectify Service failures.

7.3.2 The key objectives are value for money and effective incentivisation; the Contract should contain sufficient incentives for the Contractor to rectify any default.

⁴ For example, if prison cells or classrooms are in practical terms un-usable, it may be most appropriate for them to be regarded as unavailable, with direct consequences in terms of the Unitary Charge. Alternatively, some problems with prison cells or classrooms might not make the room un-usable and instead the shortcoming might be better described as a performance failure. The bar in terms of ‘usability’ need not be set so high as “not able to be used” – the concept of “unavailable-but-used” can provide a compromise position (see Section 7.5.12).

⁵ The split between ‘availability’ and ‘Service performance’ is not itself a requirement of this guidance, however, in most sectors this distinction has been found to be helpful. The underlying principles set out here apply even where this split is not observed.

7.3.3 A variety of payment mechanism structures have been used across various sectors and project types. Models A to C below illustrate alternative features of a payment mechanism. They are not intended to be prescriptive:

- Model A – the Unitary Charge is built up from the number of available places or units, so only places or units that are available are paid for. The definition of available places or units incorporates the provision of ongoing services that are core to the requirements of the Authority to carry out its functions. On top of this, a performance regime is imposed to address levels of performance that do not impact on the availability of places and/or Services that are outside the definition of the core Service. Sub-standard performance leads initially to “performance points” accruing and, only indirectly, to deductions from the Unitary Charge once a certain level of points has accrued. A ratchet increases the deduction for repeated performance failings.
- Model B – the Unitary Charge (before any deductions) is based on a full provision of the overall requirement and the payment mechanism determines deductions both for unavailability and sub-standard performance, i.e. both are represented in the calculations as deductions from the 100% level. Availability is defined in terms of being usable and accessible and different deductions are made depending on which area is unavailable. There is a system of weightings whereby each section of accommodation is divided into units and given a weighting depending on its importance; for each failure to provide an available unit there is initially a payment deduction equal to the Unitary Charge multiplied by the relevant weighting. The deduction can be based on an escalating tariff so that subsequent days of unavailability of the same space may lead to progressively higher deductions.
- Model C – the Unitary Charge is based both on availability and usage, for example in the context of a training service with payment per training place. There is a minimum take-or-pay level (i.e. if usage by the Authority is below that level it must nonetheless pay for usage at that level) in order to assist with the financeability of the Project and to strike a balance between flexibility and the cost implications of greater risk transfer. There is still a requirement for availability to be defined, as the Authority will not pay above its actual usage if the units of Service are not available. There can in addition be scope for payment deductions for poor performance of Services.

7.4 USAGE-BASED SYSTEMS

7.4.1 An alternative to availability-based payment is for the level of the Unitary Charge to be determined by usage (also referred to as ‘volume’ or ‘demand’), or to combine these approaches within a single payment mechanism. The early road projects relied on usage payments (where payment was based on a shadow toll – payable by the Highways Agency).⁶ Normally, where usage is relevant the Unitary Charge is only partly dependent on usage (for example, some waste and MOD projects). Payments linked to usage can bring advantages when the Contractor’s performance can influence the level of usage, since customers can “vote with their feet” on the availability and quality of the Service; in this way payment will be linked to performance through this automatic feedback.

7.4.2 It is important to differentiate between regimes where the Unitary Charge itself (payable by the Authority) is adjustable by reference to usage, and regimes where the Unitary Charge is based on availability and performance principles, but the Contractor separately takes the risk on the amount of “third party revenue” which can be generated from the facilities (and in respect of which the Authority may seek some gain share). Third party revenue may range from relatively

⁶ The Highways Agency now in most cases uses an availability-based mechanism, since the Contractor is not able to control demand, neither is demand clearly linked to the level of service.

small amounts, e.g. on schools projects, to larger amounts which may be generated on light rail,⁷ waste⁸ or housing⁹ projects. Third party revenue may be derived from the core service or peripheral activities such as a canteen or car-parking, and can exist alongside a predominantly availability-based payment mechanism.

7.4.3 Third party revenue should be assessed as part of the value for money evaluation of the proposed structure as a whole; if it provides a benefit to the Contractor this should in principle reduce the required return from other activities. The Unitary Charge may be reduced as a result of Contractor access to third party revenue, with a revenue-sharing arrangement for revenue above the amount assumed in the Unitary Charge reduction. The value for money benefit of allowing third party revenue to fall to the Contractor will depend on the Contractor's ability to forecast and influence it (and Authorities should be wary of over-optimistic assumptions on these points). In many projects the scope for recognising significant third party revenue in the financial model, and thus reducing the Unitary Charge, is limited as the demand is difficult to predict; in these cases upside sharing is particularly important.

7.4.4 In some projects (for example training projects) a measure of usage risk may be transferred such that profitability is only affected at the margins. Where there is a mixture of availability and volume-based principles, some "take-or-pay" minimum volume amounts may be used. Authorities must ensure that these structures do not mutate into structures which simply ring-fence senior debt, since underwriting any significant part of the Contractor's costs, such as senior debt, is contrary to basic PFI risk transfer principles.¹⁰ Where take-or-pay arrangements exist, the mechanics of availability are likely still to be required, since the Authority should not pay for the minimum level of usage where the facilities are unavailable. Take-or-pay principles should not protect payment streams where Services are unavailable because of Relief Events, Force Majeure events or Contractor failures.

7.4.5 In some circumstances performance regimes which are dependent on levels of usage may not in fact transfer true usage risk to the Contractor. This is the case where the increase in payments corresponding with an additional unit being used is equal to the marginal cost to the Contractor of providing the unit. For example, where an extra tonne of waste will cost a Contractor an extra £10 to process, increasing the payment by £10 per tonne will not affect the Contractor's profitability.¹¹

7.4.6 The factors which determine whether it is value for money to transfer usage risk tend to be project-specific or sector-specific, and the transfer of usage risk has in practice tended to focus on certain sectors, e.g. roads, leisure centres. Genuine transfer of all usage risk to the Contractor,

⁷ Light rail projects have to date tended to pass the fare box revenue to the Contractor, although in practice the level may only suffice to cover operational costs.

⁸ Waste projects can include a range of sources of third party revenue, including sales of electricity generated from 'energy from waste' plants, sale of excess capacity to users other than the Authority, and sale of recyclates (products from a recycling process which can be used in industrial or agricultural processes, for example). See "*Standardisation of Waste Management PFI Contracts: Guidance on SoPC Derogations*", May 2006, from the Department for Environment Food and Rural Affairs for further details.

⁹ Non-Housing Revenue Account housing projects tend to involve the rental income as part of the Contractor's revenue; this is in effect third party revenue and a transfer of usage risk.

¹⁰ In certain circumstances, however, underpinning an element of Senior Debt may offer value for money, but HMT approval must always be obtained for any such scheme.

¹¹ Authorities should also consider their approach to energy usage. For energy usage the general principle is for the Authority to take pricing risk and the Contractor to take volume risk since this is largely dependent on design. However, the Authority therefore has an interest in the price so the selection of service provider should not be entirely for the Contractor, moreover the Authority may have greater purchasing power than the Contractor. On the other hand the Contractor may not be entirely in control of volume and in any event it may not be value for money to ask the Contractor to price volume over a long period of time. One approach, which has been developed in detail by the Department of Health, is to derive a mechanism for generating a central volume expectation, and pay the Contractor on the basis of that volume with a sharing mechanism should volume be lower or greater than that central expectation. This is also an important element of street lighting contracts, and the street lighting standard form has detailed provisions whereby an electricity charge is usually paid by the Authority to the Contractor in addition to the Unitary Charge (and can be as large as the Unitary Charge). Detailed provisions have been developed to deal with, for example, savings derived from technological advances.

making its profit (i.e. revenue less costs) dependent on usage, is rarely appropriate and should only be considered in cases where the Contractor can forecast and influence future usage. Usage risk transfer may be appropriate where the Contractor is satisfied with predictions of the level of demand for the Service, or where reductions in Authority usage can be offset by third party revenue. A part of usage risk can be transferred in some cases, but many Projects cannot transfer any usage risk, even where services such as catering facilities are being provided. Transferring usage risk in inappropriate cases is likely to result in poor value for money. Senior Lenders tend to have strong concerns over the transfer of usage risk, and “take-or-pay” or other devices such as a reduction in gearing or increase in lender protection ratios may be required.

Evaluation and other implications of transferring usage risk

7.4.7 Where the Unitary Charge is sensitive to usage or there is third party revenue, bid evaluation (i.e. in terms of the potential costs of alternative proposals) is made more complex. Moreover it may be difficult to predict the likely level of termination payments which would result should the Project in due course be terminated. From the perspective of flexibility for the Authority, this is particularly relevant to Authority voluntary termination (where equity investors look for some compensation for their lost opportunity to make returns from future revenues). Areas of the Contract which may require special attention where volume-based payments are significant are Compensation Events, Qualifying Change in Law, Authority Step-in, Authority change in Service, Force Majeure, the setting of the Threshold Equity IRR in the refinancing Clauses, and the various different termination scenarios. The basis for compensation may vary according to the type of event leading up to loss and whether the compensation has any sensitivity to future revenue expectations.¹² For example, following Qualifying Change of Law and in other no-fault scenarios the appropriate measure should be the lower of base case (i.e. the original forecasts) and actual usage levels, and Authorities may also wish to seek to apply this principle to compensation on termination for Contractor Default where there is no liquid market and/or Authority voluntary termination.

7.4.8 The volume of usage (demand) risk is, where the risk is material, the key determinant of the accounting treatment of the underlying asset. Authorities should consider, as part of their Business Case prior to commencing procurement, the likely materiality of demand risk, and the allocation of it. Where they have a high level of certainty in the need for the asset, and the volume of usage in relation to it (for example, the number of pupils expected to attend a school, or the throughput of a hospital, over a number of years ahead) is predictable, Authorities may often demonstrate that the risk in relation to demand is immaterial. As transfer of usage risk is rarely appropriate, as described above, Authorities should generally retain this risk but, it will commonly be immaterial for the reasons described. Where this is not the case, and the Authority is planning to retain material demand risk, Authorities should consult their Private Finance Unit prior to commencing procurement to ensure that the accounting implications are appreciated.

7.5 CALIBRATION

7.5.1 The economic characteristics and detailed design of the payment mechanism are central to the achievement of value for money. There are a large number of points of detail involved in assigning numbers to the various parts of the payment mechanism. This process is referred to as “calibration”. The remainder of this section assumes an availability-based payment mechanism but the principles have wider application.

7.5.2 Authorities and their advisers should consider how to approach this issue during the procurement process, and how much input to seek from Contractors and at what point. An over-

¹² See Section 21 (Early Termination). In the case of third party revenue and the termination of the Project, the facility may continue to be operated by the Authority and this may mean that the Authority’s exposure to higher-than-expected costs of termination is offset by higher-than-expected future revenue.

rigid approach during negotiations will reduce the scope for innovation by the bidders and so reduce the potential for best value for money to be achieved.¹³ However, it is normally appropriate to include a significant level of detail relatively early in the process so that the maximum benefit is taken for development while under competitive tension. Under the Competitive Dialogue procedure there is no scope for making significant alterations to the payment mechanism after completion of the dialogue (though fine tuning is still permitted). Where final calibration is still to be completed at the time of appointment of the winning bidder, the winning bidder's letter should include an obligation to recalibrate with the final details. It is essential that the process is not undermined by last-minute re-calibration following lender due diligence (as has sometimes happened in the past).

7.5.3 The Authority should understand how the various responsibilities relating to the drafting and calibration of the output specification and payment mechanism are allocated amongst its advisers, and ensure that all issues have a clear allocation of responsibility.

7.5.4 There are many variables in a payment mechanism, including the following:

- the definitions of availability and performance standards (i.e. how demanding the requirements are);
- response and rectification periods (i.e. how quickly problems have to be addressed);
- the scope (in practical terms and under the contract) for the Contractor to provide (temporary) alternative services/locations instead of having deductions applied, giving them greater flexibility to avoid deductions, or for allowing 'unavailable' facilities to continue to be used;
- levels/weightings of deductions for unavailability or poor performance;
- ratchet mechanisms for repeated or widespread failures; and
- caps on performance deductions.¹⁴

7.5.5 The degree of risk transfer depends on all of these parts; heavy deductions for poor service might not imply a harsh mechanism if the Service requirements are not overly demanding, there are long periods in which the Contractor can respond, the Contractor can provide alternative accommodation or the unavailable accommodation is likely to continue to be used with lower deductions applying. On the other hand a scheme with small cash deductions might provide strong incentives to perform and significant risk transfer if the definitions give tightly-defined high standards and the time requirements are short or ratchet up.

Calibration methodology

7.5.6 Authorities should consider the following calibration issues:

- the level of deductions should be considered in the light of the importance of the Services to the Authority (i.e. large deductions for the unavailability of important parts of the Service). The incentives on the Contractor are also important (i.e. large deductions for types of failure which could be expensive to remedy and therefore require a strong incentive);

¹³ In establishing a suitable system, the Authority should be aware of the effects a particular system has on the solution offered by a bidder. For example, a bid solution that is capital intensive up-front with reduced life-cycle costs may have one optimum approach and one with lower initial costs but higher life cycle costs another, because the financial structure of the Contractor will be different. It is crucial for the Authority to understand what system will best achieve the result it seeks.

¹⁴ This is not a complete list of every potential feature of a payment mechanism and other features may be appropriate to particular projects.

- the Authority should determine what level of performance is required, and this should then serve as the benchmark at which 100% or close to 100% payment is achieved; and
- there are a range of approaches available to an Authority to improve its understanding of how a proposed system might work. These approaches range from consideration of a limited number of specific potential scenarios to the construction of complex models or Monte Carlo simulations. A calibration model can be used to suggest what levels of deduction might result from a given specification and payment mechanism, give an insight into the economic incentives they give rise to, and also help an Authority understand the level of contingency which a Contractor might incorporate in its price.

7.5.7 Where the Authority is seeking to simulate how the mechanism is likely to work, it might seek information from other successful projects, and also consider the use of historical data from existing services run by itself.

Standards

7.5.8 The payment mechanism should give clear economic incentives to the Contractor to perform to the required standards. Availability and performance standards should be defined to meet the requirements of the Authority, but should also be set at a realistic and achievable level to avoid unnecessary risk pricing by the Contractor and Sub-Contractors.

7.5.9 Given that a key element of the expression of the Authority's requirements in a PFI Contract is the output specification, significant parts of the output specification frequently feature in, or are linked to, the payment mechanism. The Contract will be easier to manage, and to change in the event of Contract variations, if these relationships are clearly laid out, and the role of any output specification requirements which do not feature in the payment mechanism should be challenged (or they should be brought into the payment mechanism). The use of specification requirements in the payment mechanism must be clear. Units should be provided where appropriate – for example, a requirement for maintenance to be performed, together with a deduction of £10 for service failure, requires a clear linkage in terms of how many poorly-maintained rooms, over what period, attract a single deduction of £10.

Time periods for repair/rectification

7.5.10 Time periods for repair and/or rectification are not applicable to all types of failure (for example, they do not apply to staff being recruited without required qualifications). Where a period is applicable, such as for the repair of a broken window, the Authority should ensure that repair periods are challenging but realistic, without entailing costs to a level which does not represent value for money (for example, by requiring excessive standby provision of labour and resources). An Authority might consider what resources may be available on-site and thus at short notice, and what types of problems might most cost-effectively require outside resources and thus perhaps warrant longer periods for repair. For significant problems, "rectification plans", to be agreed on a case by case basis and to include agreed rectification periods, may be used.

7.5.11 For some failures a concept of "temporary repair" can be appropriate, and some payment mechanisms make a distinction between a response period, being the time within which a temporary solution should be found (for example, a temporary window repair), and a rectification period, being the time within which the problem should be properly remedied (for example, a new window). Immediately at the start of operations, an Authority may allow slightly longer periods for "bedding in" the regime.¹⁵

¹⁵ Some projects also make additional allowances regarding deductions and/or termination during a bedding-in period. The use of such arrangements should be considered carefully and a balance should be struck between the reasonable expectations of the Authority and

“Unavailable but used”

7.5.12 The use of a definition of “unavailable but used” (see Section 8.8), dealing with the situation where the Authority wishes to continue using a facility which is technically “unavailable”, can be appropriate (for example, a classroom which is needed for teaching). In some projects it will be common for elements to be unavailable but used so this can be a significant part of the regime.

Weightings

7.5.13 In many payment mechanisms the maximum notional deduction for unavailability exceeds 100% of the Unitary Charge. The maximum financial deduction is however capped at 100% of the Authority’s payment (e.g. the total Unitary Charge for a given month), so the Contractor may receive zero payment before the facility becomes entirely unavailable (or when it is entirely unavailable but only for part of the period e.g. month), but should not be obliged to make payments to the Authority when notional deductions are higher than the Unitary Charge payment.¹⁶ High weightings clearly strengthen the incentive on the Contractor to perform but also increase the risk on the Contractor and may encourage higher pricing.^{17 18} If the weighting is too heavy, perverse incentives may arise. For example, if the Contractor is receiving zero payment for only one-quarter of service provision there is little incentive to increase to one-half service provision if payment will remain zero at that level.

7.5.14 There is little point in using weightings so low that it is cheaper overall to the Contractor to under-perform. Deductions in respect of poor performance of services need not significantly exceed the estimated cost of those services, so long as the many elements of performance are appropriately weighted. The calibration of deductions in respect of the physical fabric of a building is more complex as the causes of unavailability can vary from causes which the Contractor could fix at relatively little cost (thus requiring relatively little incentive) to wider failures requiring significant expense. Authorities should consider the overall weighting in the light of the detail of the output specification, the other variables of the mechanism and the facility/facilities in question.

7.5.15 A benchmark for standard accommodation projects is that the overall weighting of unavailability deductions should be in the range 150-200% (assuming a standard approach to the overall construction of the payment mechanism). For non-accommodation projects such as equipment projects (most of which have been in the defence sector) it is more difficult to generalise. Factors suggesting a lower level, even below 150%, include a project having a range of separate project outputs which are not interdependent (such as geographically-dispersed social housing provision or equipment projects with a number of independent and independently-useful vehicles).¹⁹ Factors suggesting a higher level within that range, or above 200%, are complexity

the potential for unnecessary risk-pricing.

¹⁶ Some payment mechanisms have allowed Authorities to “carry forward” any deductions greater than 100% to apply in the following period. This is unlikely to be value for money and is not recommended. The scope for retrospective deductions (where the Authority later discovers a performance failure has existed undetected for a period) should be subject to a cap, as the Contractor and the Senior Lenders may not have been aware of the failure and therefore not have taken steps to remedy it.

¹⁷ As an example, the Department of Health has in December 2006 issued guidance on performance mechanisms stating that the total notional deduction should not exceed 200%, having previously seen much larger maximum deductions in some projects (e.g. 500%). There is a two-stage approach in the standard health payment mechanism, with the Project being split into “Functional Areas” each comprising of a number of “Functional Units”. The unavailability of all Functional Areas can provide a maximum notional deduction of 200%, capped at a 100% actual deduction. The unavailability of all Functional Units in one Functional Area could provide a notional deduction of 150% for that area, again with a 100% actual deductions cap. Therefore, if two-thirds of the units in one area were unavailable, there would be zero payment for that area. If this occurred in half the areas, the Unitary Charge payment would be zero.

¹⁸ Another example is the standard BSF calibration guidance, which states that the weighting should be in the region 100-200%. For housing projects it tends to be at the lower end e.g. 100%.

¹⁹ Thus a lack of inter-connectedness, from the perspective of the utility of a facility, suggests a lower impact on the Authority of a single element being unavailable. Note that this is not the only driver of weighting – the deductions must still suffice to incentivise the Contractor. At the same time, if the elements are independent from the perspective of the service provider, there can be a “portfolio effect” meaning that a higher weighting might be tolerable by the Contractor. For example, in a street lighting project the Contractor can plan and price for the risks of individual lanterns being damaged in accidents in a sophisticated way, and might tolerate a higher

and interdependence of outputs, for example a large hospital where a number of rooms or areas have interdependencies and each requires an appropriate deduction regime, or a training project where a piece of equipment and a classroom facility each requires the other in order for the project to deliver the desired outcome. A project which excludes soft facilities management services may require heavier weighting for failures as a percentage of the whole Unitary Charge, as the Unitary Charge will be lower through the exclusion of soft facilities management services.

7.5.16 The payment mechanism should not however be designed simply on the basis of broad economic assumptions such as these. These weighting recommendations are designed as a sense check for the regime. Performance regimes should be constructed initially from the bottom-up with weightings for the different output components designed to incentivise good performance. The aggregate figure should then be given a top-down sense check to ensure that the overall economics of the Project offer value for money.

7.5.17 Potential Contractors and Sub-Contractors will model the behaviour of the payment mechanism in order to examine the risks they will face, and base their pricing on the results (noting that for Sub-Contractors the deductions for unavailability may be regarded as of less day-to-day significance than deductions relating to the performance measurement system). Similarly, the riskiness of the Contract will affect the level of interest from funders and the terms they offer. An onerous output specification and payment mechanism may lead to higher pricing or put off credible bidders and funders. Some early regimes were over-rigorous and overcomplicated when they were constructed, and were not then fully enforced. An over-rigorous Contract combined with weak enforcement offers poor value for money. Authorities should strive to produce fair regimes and diligently enforce them. Section 8.4 (Payment for Availability and Weighting of Critical Areas) provides further comment on this area of the calibration.

Ratchet mechanisms

7.5.18 Many payment mechanisms include “ratchets” whereby a long delay in fixing a problem, or its repeated recurrence, or its widespread occurrence in a number of areas across a project, leads to higher deductions. Ratchets help ensure that systematic problems are properly dealt with. See further Section 9.5 (Consequences of Poor Performance). The use of ratchets should be considered carefully: a low initial deduction together with a ratchet may simply encourage a reactive rather than pro-active approach to performance management, but on the other hand, without ratchets the incentives may not be effective (for example it may turn out that without a ratchet the deduction is not heavy enough to give an economic incentive to good performance). Ratchets are likely to be useful in most payment mechanisms.²⁰

Performance deduction caps

7.5.19 In some sectors it is common for there to be a cap on the amount of deductions which can be made in respect of poor performance.²¹ The Sub-Contractor’s maximum exposure in any year may be limited to receiving zero payment from the Contractor (i.e. they may lose all their income but they do not reimburse the Contractor for deductions which exceed their fee but are due to their failings as a Sub-Contractor). The risk of additional availability deductions then stays with the Contractor. It is important for the Authority always to preserve the principle of no-service no-fee and in an availability-based payment mechanism there should be no payment if the facility is unavailable. The capping of deductions for poor performance of Services may be acceptable if

weighting because the chance of substantial numbers of accidents is low. If greater risk transfer can be achieved with relatively little cost impact then in principle that should be pursued.

²⁰ The ratchet should be triggered by repeated performance failures even if they had different causes.

²¹ For example the standard BSF payment mechanism uses a cap set at a level equating to the value of Services (as opposed to capital works), including soft facilities management, insurance costs and Contractor administration costs. This cap does not apply to deductions for unavailability.

the Authority considers that there is little further benefit from further performance deductions which cannot be either passed down or absorbed by the Contractor on a value for money basis. However, any cap should not be used simply to insulate equity investors from risk. In any event, if a Sub-Contractor is losing a significant portion of its fee for poor performance it is likely to be in default of its own Sub-Contract and the Contractor has a clear motive to replace it before it puts the availability of the facilities and hence the full Unitary Charge at risk. Authorities should ensure that the Contractor is incentivised to manage Sub-Contractors effectively, and should not concede a cap on deductions without advice from their advisers. Any performance deduction cap must always be justified on value for money grounds.

7.6 FINANCEABILITY

7.6.1 A payment mechanism should not ring-fence or guarantee the Contractor's finance charges.

7.6.2 Senior Lenders will test deductions against their financial model runs in order to assess their risk as lenders. Experience has shown that the payment mechanisms outlined in this guidance are capable of being financed provided the payment mechanism is sufficiently objective, reasonable rectification periods are included and it is appropriately calibrated.

7.7 FLEXIBILITY

7.7.1 Authorities should consider how far their payment mechanisms are able to accommodate change in Authority requirements, whether in terms of additional capital works or changes to Services. This is partly a matter of payment mechanism design, but Authorities should also consider including in the payment mechanism a process for annual review of weightings, rectification times, etc.²² Such a review may only provide for changes to be made where both parties agree, but the Contract can nevertheless set out a framework for discussions and provide a formal opportunity to consider the workings of the mechanism in the light of emerging guidance and best practice for the sector, and experience of the practical application of the mechanism to the particular project. Such a review might be appropriate at the end of any bedding-in period.

7.7.2 For those payment mechanisms where the payment varies with usage or volume (see Section 7.4 (Usage-based Systems)), the payment mechanism allows (subject to any minimum take-or-pay level or the limitations of design capacity) for the payment to be adjusted in response to changes in throughput (e.g. waste or street-lighting). In accommodation-based schemes (e.g. schools and hospitals), it can be more difficult to design such flexibility into payment mechanisms, partly because the Service is not easily divided into discrete units (i.e. there are large common areas like corridors and halls), and partly because the cost structure is largely fixed relative to usage.²³ As a result, it is more common in these sectors to have payment mechanisms which are designed based on a given aggregate capacity and a given schedule of areas required, with each area receiving an "area weighting" according to which its corresponding availability and performance deductions can be computed. This typically means that as changes occur (e.g. new classroom spaces are added), the payment mechanism needs to be re-calibrated. The weighting of the original facilities as a proportion of the total post-variation Unitary Charge will need to be amended in order to preserve the incentive effect of the original calibration. Particularly where the changes are small to medium-value, the transaction costs of re-calibration can be quite high relative to the cost of the changes.

²² This approach has been adopted as standard in the health sector; see Part D of the standard Department of Health payment mechanism issued in December 2006.

²³ However, housing PFI schemes are one example of accommodation-based schemes where the service is divided into discrete units (i.e. flats or houses), and because of the ability of tenants to exercise their right to buy their properties, it is increasingly common in housing PFI payment mechanisms to include a method of adjustments to the Unitary Charge payment as a result of changes to the number of housing units, based on calculations of fixed, variable and semi-variable costs.

7.7.3 A relatively straightforward way of dealing with this issue is to design the payment mechanism in such a manner that it can automatically be extended to cover changes up to a limit, with only a periodic review (say once a year, perhaps part of the general annual review suggested above) required of the overall calibration. An example of this approach is provided in the BSF programme, where the deduction values are stated in monetary amounts for different areas, with the implication that as new areas are added on the corresponding deduction levels can automatically apply to them. So, for instance, if the deduction value for an unavailable classroom is £x, new classrooms can be added on to the school, each carrying a deduction level of £x without re-calibration. An annual review would provide an opportunity to examine the overall balance of incentives. For large variations (e.g. in excess of £100,000), it is quite likely that re-calibration will be required each time.

7.7.4 Further flexibility can be gained if Authorities agree with the Contractor and its Senior Lenders that below certain volume and value thresholds, change orders will be regarded as normal churn in the Project and will not have to go through detailed due diligence. Instead the Contractor can simply certify, in quarterly/annual reports to the funders, what changes have been put through the Contract with automatic extensions of the payment mechanism. Annual reviews can be carried out as above to check that the calibration is still in balance. This will save technical and legal due diligence fees as well as management time.

7.8 OTHER REMEDIES FOR POOR PERFORMANCE

7.8.1 The payment mechanism provides a mechanism through which the Authority can calibrate the financial consequences of Service failures. The Authority should not seek compensation in damages in addition to levying its deductions for Service failures. Please note that this does not limit the Authority from pursuing other rights expressly given to it in the Contract (such as, for instance, termination rights, step-in rights or specific indemnity rights, or rights to require the replacement of a sub-contractor if certain levels of poor performance are reached) and does not limit any claim for specific performance or injunctive relief.²⁴

7.8.2 Suitable drafting is as follows:

7.8 Payment Mechanism: No double remedy

(a) Subject to:

- (i) any other express right of the Authority pursuant to this Contract, and
- (ii) the Authority's right to claim, on or after termination of this Contract, the amount of its reasonable costs, losses, damages and expenses suffered or incurred by it as a result of rectifying or mitigating the effects of any breach of this Contract by the Contractor, save to the extent that the same has already been recovered by the Authority pursuant to this Contract or has been taken into account to calculate any compensation payable by the Authority pursuant to Clauses 21.3.2 (Compensation on Termination for Force Majeure), 21.2 (Compensation on Termination for Contractor Default), 21.1.3 (Compensation on Termination for Authority Default), 21.4.4 (Compensation Termination for Corrupt Gifts and Fraud), 21.5.2 (Compensation on Voluntary Termination), [21.5.4 (Compensation on Termination on an Authority Break Point Date)], or 21.6.2 (Compensation on Termination for Breach of the Refinancing Provisions),

the sole remedy of the Authority in respect of a failure to provide the Services in accordance with this Contract shall be the operation of Schedule [] (Payment Mechanism).

²⁴ See further Section 24.6 (Damages Claims).

(b) Nothing in this Clause 7.8 (Payment Mechanism: No Double Remedy) shall prevent or restrict the right of the Authority to seek injunctive relief or a decree of specific performance or other discretionary remedies of the court.

7.8.3 Contractor Default is discussed in Section 21.2 (Termination on Contractor Default). The Authority must ensure that adequate termination rights exist, for example, in terms of the levels of unavailability or Service failure which constitute a termination event, or in terms of alternative definitions where the payment mechanism is not availability-based.

7.8.4 The calibration of payment mechanisms is discussed in Section 7.5. The thresholds for Contractor Default and potential precursors thereto should be determined as part of the overall calibration process. Such precursors typically include:

- warning notices to the Contractor;
- increased monitoring of performance, normally at the Contractor's expense;
- a requirement for the Contractor to produce a remedial plan;
- replacement of the sub-contractor; and
- Contractor Default (noting that termination remains at the Authority's discretion).

7.8.5 There is no need to use all of these steps or to be limited to them. Authorities should choose a route to potential termination which will provide a meaningful framework for discussions about how to address the poor performance. These steps can be linked to a given level of payment deduction, for example, a deduction greater than x% of the Unitary Charge in some/each of y successive months or a series of short and longer-term thresholds, or to a system of "termination points" which might be linked to the other elements of the payment mechanism or might run in parallel.²⁵

7.8.6 Authorities should primarily consider what constitutes an unacceptable level of performance to themselves when setting the Contractor Default threshold and related thresholds. As a secondary matter, they may also consider the impact which the threshold level of deductions has on the financial position of the Contractor (and even where thresholds are not expressed in simple financial terms it should be possible to consider the relationship between the levels of performance leading to Contractor Default and the level of deductions likely to accompany that performance).²⁶

7.8.7 A different approach might be required for non-availability-based payment mechanisms; a low level of usage and hence of payment does not necessarily mean that the Contractor is failing, although it may do.

7.8.8 Sub-Contracts will typically have termination arrangements which are linked to the wider arrangements for Contractor Default (see Sections 9.3 (Replacement of Sub-Contractors) and 9.4 (Monitoring of Sub-Contractors)). When calibrating its remedies, the Authority should also bear in mind that the Senior Lenders will similarly be calibrating their own remedies (of step-in, replacement, default etc). The Authority should understand how these relate to the Authority's position and ensure that the overall structure appropriately incentivises the Senior Lenders to exercise their remedies in advance of the Authority exercising its remedies.

²⁵ So, for example, deductions in a single month of greater than 25% or deductions in each of three successive months of greater than 20% each could earn the Contractor a 'termination point' the accumulation of which leads to Contractor Default. In terms of actual drafting, projects can involve a range of different triggers, and some projects have different thresholds for deductions relating to unavailability and deductions relating to poor performance of services.

²⁶ If a Contractor is suffering deductions which are sufficient to entirely erode profit margins and allowances for contingency throughout the supply chain, including the risk premium element of the equity return, its position may prove unsustainable. The level at which all contingency and profit margin is eroded might be in the region of a 15-20% deduction from the Unitary Charge over a period of several months, however this can vary in accordance with the overall structure of the payment mechanism.

7.9 QUALITATIVE FACTORS AND USER SATISFACTION

7.9.1 The specification even of relatively straightforward requirements such as those relating to heating or lighting can be difficult and subject to dispute after Contract signature; the appropriate level of contractual detail reflects considerations of practicability and clarity, and Authorities should consider these issues carefully for all elements of the payment mechanism. Objective and well-defined performance criteria should always be used as far as practicable, but other methods of measuring performance may be considered and may offer complementary requirements within the overall mechanism.

7.9.2 In some projects there may be qualitative aspects of performance which it may be difficult to measure objectively but which are nevertheless important to the users of the Service, such as the helpfulness of staff or the quality of catering. More generally, the quality of service in a complex setting such as a hospital or school cannot easily be wholly reduced to a practical set of availability and performance criteria.

7.9.3 The most straightforward mechanism to measure this is a regular customer satisfaction survey with deductions for a low or falling score. It is commonly argued that it is difficult to base financial compensation on customer satisfaction surveys because they are based on individuals' perceptions rather than hard measurable facts and so the results may be variable; moreover they may be vulnerable to manipulation. However, surveys are a useful way of monitoring performance, and have been used successfully in a number of projects in a variety of sectors albeit that the maximum deduction is generally a relatively small element of the overall Unitary Charge. Examples include deductions for poor satisfaction by head teachers in schools projects, deductions for low scores on user satisfaction surveys in housing projects, and requirements for the Contractor to carry out a performance audit and prepare a remedial plan in the event of low user satisfaction. The main advantage of such a system is that the feedback obtained can be very useful as an incentive to good Service provision.

7.9.4 In this context, local authorities are already under a statutory duty to secure continuous improvement in the way they exercise their statutory functions; this is commonly known as the "Best Value duty".²⁷ This would commonly involve the making of periodic user satisfaction surveys to compare the quality of service under the Contract against the quality of comparable services elsewhere. 4ps have published guidance on the Best Value duty, and suggested provisions for inclusion in local authority PFI Contracts.²⁸ The following recommendations are designed to sit alongside the 4ps guidance for local authority transactions and would apply independently for central government PFI Contracts.

7.9.5 A variety of mechanisms have been used successfully in the past to reflect the importance of qualitative factors in the payment mechanism.²⁹ All projects³⁰ should as a minimum include the following points:

- provision for regular user satisfaction surveys (at least annual albeit that they may be conducted on a rolling basis), to be paid for by the Contractor. These would usually be carried out by the Contractor, or an independent third party (under contract to the Contractor).³¹ In the former case, the Authority should have the option to commission its

²⁷ See the Local Government Act 1999.

²⁸ See 4ps "Local Government Supplement to Standardisation of PFI Contracts Version 3", July 2004.

²⁹ The use of user satisfaction is, however, not intended to cut across use of the Authority change procedure where real service specification changes are needed.

³⁰ Unless they are of an exceptional nature, where the Authority is satisfied that there is no meaningful way in which a customer satisfaction survey can be created.

³¹ These options both assume that the respondents will be the actual users. Another suggestion is to use "mystery shoppers". A mystery shopper is a qualified independent individual used to test aspects of the Service; this reduces subjectivity as they will apply the same standards throughout. The routine use of external organisations, including mystery shoppers, is likely to have cost implications which

own survey from an independent third party in the event of its dissatisfaction with the Contractor's own survey, such option to be exercised at the expense of the Authority and such survey to take precedence over the Contractor's survey unless the Authority agrees otherwise. The intention is that even if the results of the survey have no direct financial impact, this information is useful management information for both the Authority and Contractor. Failure to carry out the survey should itself trigger a penalty under the payment mechanism;

- a requirement for production of a remediation plan, by the Contractor at their expense, in the event of low satisfaction. This plan should set out the Contractor's view of why satisfaction is measured as low in the survey, their planned actions to improve it insofar as it (in their view) relates to their performance, and their proposals for assessing the effectiveness of these actions (for example, inclusion of related questions in the next survey). "Low" satisfaction should be defined in the Contract where possible, but it is acceptable to set it for an initial period and provide for review after, say, five years of operations. The production of a plan clearly requires some management time and therefore it is a form of indirect financial cost for the Contractor, but it is intended primarily as a device to ensure that issues with user satisfaction are taken seriously by the Contractor; and
- the findings of user satisfaction surveys should be regarded as legitimate evidence, insofar as they relate to the relevant service provider, in the evaluation of incumbent Service providers for market testing of soft facilities management services.³²

7.9.6 As regards sanctions for poor user satisfaction, Authorities should consider the following potential approaches:

- immediate direct financial deduction (for example, a set amount per percentage point short of a pre-agreed base-line, which might remain constant or be adjusted to reflect obligations for continuous improvement). The design of such deductions should be subject to value for money evaluation and are likely to be fairly modest;
- the award of performance points, to be treated in a similar way to points for other types of performance failure where such a system is used;
- the remediation plan discussed above could be connected to deductions should its adoption have no effect on user satisfaction;
- low satisfaction could require the Contractor to carry out a performance audit (at the Contractor's expense) in relation to the mechanism more widely. In effect, this represents using poor satisfaction ratings as a tool to ensure rigorous application of the "standard" elements of the payment mechanism, and it is an indirect approach to giving financial effect to poor user satisfaction; and/or
- linking deductions to complaints or to calls to a help-desk.

7.9.7 Authorities should consider whether to deduct from the Unitary Charge for poor satisfaction or reward for out-performance, or both. Payments linked to user satisfaction might be an area where reward for out-performance does have merit (see Section 7.2.6) in which case the incentive could work both ways.

may undermine value for money in all but the largest projects.

³² It is important that the incumbent is not faced with an "additional" test in the market testing which outside parties will not be assessed against, being the test of receiving positive user satisfaction results. Rather, the incumbent and outside parties will all be assessed against their ability to deliver the Service, and for new potential providers references would normally be sought; in relation to the incumbent the Authority is in a position to provide direct evidence against such assessment criteria. Authorities should make clear in the market testing provisions that user satisfaction survey results might be used in this way.

7.9.8 As with other elements of the payment mechanism, Authorities should agree the detail of the measurement process and the financial implications before the appointment of the winning bidder (for example, they should agree the design and content of any questionnaire, required scores, sample size/identification process, and the details of who is going to carry out the survey, how and when).

7.9.9 The best approach to choice of user groups for satisfaction surveys will depend on the particular project. There are a range of different “users” in most projects, from the contract management function within the Authority (e.g. in a local authority), local management of the facility (e.g. head teacher), to operational staff (e.g. teachers) and wider stakeholders (e.g. pupils or their parents). Either party may be more comfortable with surveying some groups than others, depending on their relationships with the parties involved.

7.9.10 It may in some cases be value for money to measure outcomes from the Service as a whole, which reflect the performance of public-sector staff and Contractor staff together, e.g. health or educational outcomes compared to an appropriate comparator group. This moves away from a focus on the Contractor’s activities but is more objective, albeit that it may be more appropriate for payments for out-performance than deductions.

7.9.11 Authorities can calibrate user satisfaction requirements against pre-PFI performance where possible (e.g. for a refurbishment project), or results from similar projects (e.g. those run by the same project sponsors or Authority).

8 AVAILABILITY REQUIREMENTS

8.1 INTRODUCTION

8.1.1 The substance of a PFI deal should be the procurement of a Service. The payment mechanism is therefore often structured around the availability or unavailability of the Service, with unavailability resulting in a reduced payment by the Authority or, in certain circumstances, no payment. This Section applies to projects where the payment mechanism or an element thereof has been structured in this way. This Section should be read in conjunction with Section 7 (Price and Payment Mechanism).

8.1.2 Among the most obvious examples of projects in which payment depends on availability are those that involve the provision of a building-based Service (such as a hospital, school, prison or office accommodation). Such projects are looked at in particular detail as they give rise to many issues which do not occur in other sectors – for example, the issue of paying for space that is technically unavailable but which is still used by the Authority (see Section 8.8 (Service Unavailable but Used)).

8.2 DEFINITION OF AVAILABILITY

8.2.1 Contracts with availability-based payments must define what is meant by “available” (or, alternatively, what is meant by “unavailable”). The definition will typically specify certain conditions which must be met if the Service is to be treated as available. As payment depends on the definition being met, the Contractor and its financiers are naturally very concerned that the definition is objective, measurable, reasonable and does not contain criteria which are unachievable or immaterial in the context of the Service as a whole.

8.2.2 The definition of availability should therefore concentrate on the core functions of the Service and consist of objective, measurable criteria, so that it is clear to both parties whether or not those criteria have been satisfied. The criteria should not necessarily be limited to physical aspects (such as provision of a bed in a room), but should also include any “soft services” which are a core function of the Service. For example, services such as catering and delivery of meals are core requirements for prison and hospital accommodation to be usable and for the Authority to carry out its functions, but may not be in other projects. For such projects, the existence of a functioning catering service to an acceptable minimum standard may be appropriate to include in the definition of availability. Provided minimum standards are met, failure in performance of a catering service in such circumstances would not, however, make the whole Service unavailable.

8.2.3 The definition of availability is more straightforward in some sectors than in others. For example, a significant aspect of availability may depend on whether or not a piece of equipment works (as in a project involving simulator-based training or other Service that involves the provision of a major piece of equipment). Other projects are more difficult, as there may be scope for discussion about the appropriate availability criteria. For example, the appropriate levels of light, heat and access to be provided for the accommodation or other assets to be usable for its function must be agreed on a project-by-project basis.

8.2.4 In general terms, unavailability should be measured in as simple a way as possible. Accordingly, complex definitions that require excessive monitoring costs should be avoided, although definitions may have to be very specific. The precise measure will depend on the nature of the individual project, the particular times when the Service should be provided and the rectification periods allowed (see Section 8.7 (Rectification of Unavailability)). Possible examples of periods triggering unavailability include:

- for critical services, less than one hour;
- the remainder of a 12 or 24 hour period, i.e. measured in days or half days; or
- the remainder of normal working hours (say 8am to 6pm). Unavailability outside normal working hours will usually not affect payment (unless for a specific function).

8.3 EXAMPLES OF UNAVAILABILITY

8.3.1 Unavailability will occur if the relevant key objective criteria determining availability are not satisfied. These will need to be tailored to each individual project but in the case of an office accommodation project, for example, may include:

- non-provision of a specified level of access;
- non-provision of specified physical and environmental conditions;
- a failure in supply of power, gas, electricity, water or other utilities and services;
- non-provision of a specified level of ambient temperature;
- non-provision of a specified level of lighting;
- non-provision of fully functioning communications or information services infrastructure;
- non-compliance with a law which applies, affects or relates to the relevant area;
- specified threats to the safety or health of persons using or having access, including failure to provide fire detection and alarm systems; or
- failure to comply with any other specified factors (i.e. those which are likely to jeopardise continuing operations).

8.4 PAYMENT FOR AVAILABILITY AND WEIGHTING OF CRITICAL AREAS

8.4.1 Payment for availability of the Service will vary according to each project. In accommodation projects, for example, accommodation should be allocated into “units”; the availability test will be applied to each unit and payment of the Unitary Charge will vary according to the number of “units” available. In other types of project, this approach may not be feasible and there may be a single availability test applied to the whole Service.

8.4.2 Where the Service is divided into areas, the financial consequences of unavailability of an area should depend on its level of criticality, as some areas will be critical to the provision of the Service whilst others will be less so.

8.4.3 The Contract must therefore specify which areas are most important (i.e. core to the Service) and allocate them a higher weighting (i.e. make a greater deduction from the Unitary Charge if they are unavailable). For example, in hospitals, accommodation is often grouped into three areas: the most important area includes accident and emergency facilities and patient spaces including bathrooms, operating theatres and intensive care; the area of medium importance includes general waiting areas and clinical support areas such as pharmacy, physiotherapy and chiropody, and the least important areas are office areas and educational facilities.

8.4.4 The effect of weighting can also be achieved through or in conjunction with other means, for example, by allowing shorter rectification periods for key areas before the Contractor suffers deductions.¹

8.4.5 The calibration of the payment mechanism and weightings of deductions is discussed further in Section 7.5.

8.5 WHEN DOES AVAILABILITY COMMENCE?

8.5.1 The Contract must specify what happens if the Contractor is able to provide the Service earlier than the Planned Service Commencement Date. The Authority should not be obliged to make any payment of the Unitary Charge before the Planned Service Commencement Date unless it has agreed in the Contract to accept earlier Service Commencement (see Section 4.6 (Bonus Payments for Early Service Commencement)). If early commencement is practical and agreed, then the Contract should also provide for adequate notice to be given to the Authority of a possible early Service Commencement Date so that the Authority can make all necessary preparations for earlier Service Commencement.

8.6 WHEN DOES UNAVAILABILITY COMMENCE?

8.6.1 The Contract must specify precisely when unavailability starts so that any permitted rectification period can be measured by both parties. Both parties should therefore be notified as soon as practicable when unavailability is discovered. Possible triggers which should be considered are:

- when the Contractor (e.g. the “Help Desk” provided by the Contractor) receives a notice of unavailability from the Authority. This may take the form of a simple telephone call, an e-mail that is activated when opened by the Help Desk² or a paper based pro-forma sent to the Help Desk. The key issue is that there must be formal recognition and recording of receipt of the notice so that the time taken for rectification can be measured; and
- when monitoring indicates that the availability criteria are not being met. The Contractor will need to verify the reported unavailability if it has not carried out the relevant monitoring.

8.6.2 If the Authority detects the unavailability but is unable to notify the Contractor because, for example, there is a failure in access to the Help Desk³ then unavailability commences from the time when the failure is detected. If, however, the Authority fails to notify until later because of other duties (e.g. a teacher in a classroom), then unavailability and any applicable rectification period should not commence until the Contractor has been notified.

¹ By way of further example, subjecting every individual room in an accommodation project to an availability deduction will tend to lead to lower deductions than having the same overall weighting but arranging rooms in functional pairs and giving a deduction of twice the size for either (or both) member(s) of a pair becoming unavailable: the first occurrence of unavailability will in the latter case immediately lead to twice the level of deduction, although the subsequent unavailability of the other half of the pair will put the Contractor in the same position as had each room been assessed individually. A similar system is to define “consequential unavailability” where the unavailability of one room leads to that of another.

² To the extent such an e-mail is not opened within a certain time frame this will be dealt with through performance points and/or deductions.

³ Failure to provide a Help Desk Facility may give rise to deductions being made and performance points being awarded under the performance regime.

8.7 RECTIFICATION OF UNAVAILABILITY

8.7.1 The Contract should usually provide for a rectification period within which the Contractor has the opportunity to rectify the problem without triggering the start of a period of unavailability. How long the rectification period should be (e.g. one hour or twelve hours) will depend on the criticality of the area or function and the nature of the Project.⁴ A failure to meet certain availability criteria may not be capable of rectification. For example, a rectification period may be appropriate in the case of a requirement for constant light in a room where the light fuses can be quickly repaired, but is not appropriate in the case of a requirement for meals to be served regularly three times daily and only two meals have been served. In the event that the Contractor is able to supply the Service by other means (e.g. alternative office space or hotel accommodation) and where the Contract recognises this option, availability payments should continue in full (although deductions to reflect standards of performance of the Service may be made and the effects of any disruption should be dealt with).

8.7.2 If the Contractor rectifies the failure(s) within the relevant rectification period, the Service should be deemed to have been available throughout that period (i.e. from the commencement of unavailability determined in accordance with Section 8.6) and no availability deductions should be made.

8.7.3 If the Contractor fails to rectify the failure(s) within the relevant rectification period, the Service should be deemed to have been unavailable throughout that period and availability deductions should be made. Any performance points accrued during that period in respect of the relevant failure should be discounted to the extent the availability deduction represents the full agreed financial consequence of that failure to avoid double counting for the same failure.

8.7.4 As well as any rectification period(s), the payment mechanism will need to make clear what deduction an instance of unavailability for a given length of time will give rise to. Longer periods of unavailability may give rise to higher deductions than shorter ones.

8.8 SERVICE UNAVAILABLE BUT USED

8.8.1 The Contract should specify what happens if the Authority continues to use the Service (e.g. a prison cell or classroom) despite the defects which would otherwise render that part of the Service unavailable. If part or all of the Service is unavailable but used (for example, because operational reasons require it to be used even though the Service is significantly below what either party regards as adequate) then this may lead to either only a proportion of the availability fee being paid, based on what part of the Service is available, or appropriate deductions or performance points accruing in respect of the relevant failure. In either case, the Contractor should not receive a full Unitary Charge (with no availability or performance deductions) as it has not provided the Service at the required standard. The deduction should reflect the degradation in Service.

8.8.2 However, the Authority must ensure that where it is able to use any alternative service (e.g. provided by the Contractor or a third party), this is reflected in the deductions made. In addition, the Contractor should not be penalised if the Authority obstructs the Contractor from remedying the defect. Both the Contractor and the Authority should agree reasonable access times for remedial work to occur.

⁴ The Authority should consider carefully any requirement for rectification periods, taking into account tolerances already built into the Service levels and considering separately those events which lead to immediate unavailability and those which do not, but which provide an opportunity for rectification prior to failing to meet the availability criteria. When assessing whether or not to grant rectification periods to the Contractor, the Authority should ensure that the Contractor will continue to be incentivised to carry out maintenance during the planned maintenance periods and not as and when the Service becomes unavailable.

8.8.3 Unavailability should be excused if it is caused by Authority step-in and the Contractor is not itself in default (see Section 29 (Authority Step-In)). The effects of a Compensation Event on availability are set out in Section 5.2 (Compensation Events).

8.8.4 As availability is a factor in determining payment, the dispute resolution procedure should contain a mechanism to ensure a quick solution to any disagreements (see Section 28 (Dispute Resolution)).

8.9 RESTORATION OF AVAILABILITY

8.9.1 The Contract must include a mechanism for assessing when availability has been restored. This can be done by technology, for example in the case of unavailability due to high or low temperature, by reference to a building management system measuring temperature. Alternatively, the monitoring personnel on the Authority's project management team may simply submit a pro-forma confirmation to the Help Desk. There should be an agreed procedure for both parties to be notified, particularly so that the Authority can where necessary confirm such availability.

8.10 PLANNED MAINTENANCE

8.10.1 Maintenance is required in order to allow the Contractor to keep any facility at the appropriate standard in order to meet the output specification throughout the life of the Contract (see Section 11 (Maintenance)). The programme for planned preventative maintenance should be agreed in advance in the Contract between the parties so that the extent to which units or areas will be affected by the Contractor undertaking such maintenance is clear.

8.10.2 There should be no deduction for unavailability or performance deductions during periods when agreed preventative maintenance is taking place as planned. The Contractor will have to balance whether maintenance occurring at times other than those agreed will result in an improvement or worsening in its financial position (e.g. by postponing or accelerating maintenance).

8.10.3 Arrangements and contractual requirements in relation to planned preventative maintenance must be considered by the Authority and its advisers, including arrangements around the timing of work. What is reasonable will depend on the nature of the activities undertaken by the Contractor. For example, the maintenance of a school should be capable of being planned around holiday periods or outside school hours so there should, in most projects, be no maintenance planned during school hours or in term time.

9 PERFORMANCE REQUIREMENTS

9.1 INTRODUCTION

9.1.1 The level of Unitary Charge paid can be conditional upon the quality of the performance of services (see Section 7 (Price and Payment Mechanism)). Performance regimes normally work in conjunction with availability regimes (see Section 8 (Availability Requirements)).

9.1.2 Where this approach is used within the payment mechanism the Contract should set out:

- the level of performance required;
- the means by which the Authority is able to monitor the Contractor's performance against such required level; and
- the consequences for the Contractor of a failure to meet the required level.

9.2 SETTING THE PERFORMANCE LEVEL

9.2.1 In order to encourage innovation and optimise risk transfer, the Contract should specify the required performance level through output requirements (i.e. the Service standard required), rather than through prescriptive inputs (i.e. how the Service will be delivered). In some cases there may be no appropriate comparators or benchmarks available. In such circumstances a suitable performance regime will need to be carefully worked out by the Authority and the bidders during the competitive stages of the procurement. The performance regime will form a key element of the risk-transfer mechanism. The Authority should pay due attention to the principles set out in Section 7.5 (Calibration).

9.2.2 In setting the performance level, the Authority should focus primarily on the level of Service it requires and not, for example, on what it is familiar with. If, however, the Authority or a third party is already providing the same type of Service or part of the Service, this may provide a benchmark against which the Authority may compare the quality and price of the Contractor's bid.

9.2.3 Benchmarking against a comparator group of other providers of the same or similar Services may be useful where the Service to be delivered has not been measured before in the manner required by the performance monitoring regime in the Contract. An untested performance measurement system may by itself result in performance deductions being too high or too low, so a mechanism for setting the level by comparing similar services should avoid this problem.

9.2.4 As with availability (see Section 7.6 (Financeability)), financiers will be concerned that the performance level required is reasonable and objectively measurable. They will seek to establish that the Unitary Charge will not, save in circumstances which they have satisfied themselves are unlikely to occur, drop below a level that allows Senior Debt to be serviced and an equity return to be paid. In considering what a reasonable level is, the Authority should decide what the optimum 100% performance standard would be and whether it is achievable and essential (taking into account the nature of the Service), to set the required standard in the Contract at this level. For example, in some cases such as operating theatres in hospitals and custody suites in police stations, the optimum 100% standard will always be required and should always be achievable.

9.2.5 In other cases, however, the Authority may recognise that the optimum 100% standard is not, in practice, always essential (or necessarily always achievable). In such cases, the Authority may retain the optimum 100% level, but allow a certain leeway before the Contractor suffers for performing below such 100% level. For example, it may be acceptable for the Contractor to incur a certain number of performance points in any specified period before suffering financially where

the Service provided is adequate without being excellent and the under-performance does not materially affect the operation in that area (see Section 9.5 (Consequences of Poor Performance)).

9.3 REPLACEMENT OF SUB-CONTRACTORS

9.3.1 Some Contracts allow flexibility in the performance regime where a replacement Contractor or Sub-Contractor is being installed.

9.3.2 The Contractor should bear the risk of poor performance of its Sub-Contractors. The Authority should not be disadvantaged by any change in Sub-Contractors so the performance regime should not be interrupted. The Authority should, however, recognise that it should allow the Contractor the right to replace its Sub-Contractors in order to improve performance and avoid termination. To enable it to do so, the Contractor will normally set a stricter termination threshold (or trigger termination earlier in point of time) in its Sub-Contracts than that which applies in the Contract.

9.3.3 However, where there are one or two Sub-Contractors, the Contractor may find it impossible to find a replacement Sub-Contractor where the performance points accrued at Contract level are such that a further very minor default under the Sub-Contract could trigger termination of the Contract. In these circumstances, the Authority should consider whether it should:

- give relief from termination of the Contract on replacement of that Sub-Contractor for a limited period of time (e.g. two months) during which failures attributable to poor performance of the relevant Services provided by the replacement Sub-Contractor will not result in termination of the Contract. Financial deductions under the Contract should continue to be made for such failures to incentivise proper performance of that contract and to the extent that the performance regime includes any “ratchet” mechanisms for continued poor performance, these should not be relaxed; and/or
- cancel any performance points or warning notices, in so far as they count towards any termination threshold only, accrued by the Contractor under the Contract in relation to the relevant Services provided by the replaced Sub-Contractor on the appointment of the replacement Sub-Contractor.

9.3.4 The Contractor’s ability to benefit from the performance relief regime should be limited to twice in the life of the Contract.

9.3.5 As mentioned above, the Authority should not be disadvantaged by the replacement of any Sub-Contractor. Accordingly, the Authority should consider allowing itself the opportunity to approve the identify of any replacement Sub-Contractor if a request is made by the Contractor for temporary relief under the performance regime following the replacement of a Sub-Contractor. This approval right is consistent with the approach taken in the Direct Agreement (see Section 31 (Direct Agreement and Senior Lenders)) and similarly, any such approval rights should be limited to matters of technical competence and financial standing.

9.3.6 For Projects where there are a number of Sub-Contractors the Authority should not give this relief as failures attributable to a single Sub-Contractor in these circumstances are less likely to cause accrued penalty points under the Contract to approach termination thresholds.

9.4 MONITORING OF SUB-CONTRACTORS

9.4.1 An Authority may feel it needs to use the Contract to allow it to intervene at Sub-Contractor level to protect its interest if a Sub-Contractor is underperforming (e.g. the Authority may want the right to direct or require the replacement of the Sub-Contractor). This approach should only be allowed as a final resort, since ordinarily it should be for the Contractor to manage its Sub-Contractors and intervention by the Authority will affect the degree of risk transfer

achieved (see Section 16 (Sub-Contracting, Employees and Documentary Changes)). The Authority should instead rely on the payment mechanism and its termination rights to address sub-standard performance.

9.4.2 Deductions under the payment mechanism and, ultimately, the risk of the Authority terminating the Contract for under-performance, should be a sufficient incentive on the Contractor to manage its Sub-Contractors' performance. The Contractor will typically ensure it has the right under the Project Documents to replace its Sub-Contractors before the Authority's right to terminate arises under the Contract. Concerns regarding Sub-Contractors' performance may be further addressed in the Contract by requiring a temporary increase of monitoring at the Contractor's expense in specified circumstances as well as requiring the Contractor to provide an acceptable plan outlining how any defects in the Service will be put right. Both of these measures impose costs on the Contractor and are only acceptable if there has been a persistent and verifiable period of under-performance (see Section 7.8 (Other Remedies for Poor Performance) regarding termination arrangements and calibration).

9.5 CONSEQUENCES OF POOR PERFORMANCE

9.5.1 The Contract must set out clearly the consequences of any failure by the Contractor to perform to the standard required by the output specification.

9.5.2 The simplest approach is to categorise the various types of performance shortcomings and use a simple grid of monetary deductions. An alternative two-stage approach is for the Contractor to incur a specified number of performance points for each failure, with the number of points incurred varying according to the seriousness of the failure and for there to be then a mechanism for translating points to monetary deductions. The Contract would in this case include a schedule setting out in detail the level of points imposed for each failure to meet a specified performance output. The Contract may be structured so deductions only start once a certain threshold level of points is exceeded.

9.5.3 There should be a clear link between the seriousness of the failure, the number of points accrued where applicable, and the financial impact on the Contractor. For example, a failure to cut the grass outside a prison should not accrue as many points as a failure to carry out security checks. Similarly, the same type of failure may also incur different deductions depending upon the nature of the area in which it arises. For example, a failure to empty bins in a hospital ward is a more serious failure than a failure to empty bins in the hospital's office accommodation.

9.5.4 If performance deteriorates below a particular level then a range of other non-financial mechanisms can be implemented to encourage the Contractor to improve performance. These range from formal warnings to eventual termination for breach of the Contract (see Section 7.8 (Other Remedies for Poor Performance) and Section 21.2.2.1 (Events Leading to Termination)).

Ratchet mechanisms

9.5.5 It may be appropriate to have a ratchet mechanism to encourage the Contractor to improve performance if it is consistently poor in relation to a particular part of the Service or a particular failure is not rectified. This can be particularly useful where the financial cost of performance points which accrue is insufficient to provide an appropriate incentive on the Contractor to rectify the fault. Too complicated a regime can, however, be difficult to manage and including onerous measures in the pricing mechanism can lead to poor value for money. A key advantage of a ratchet mechanism is that poor performance that continues for a significant period of time will be more difficult for others interested in the Contract (e.g. lenders) to ignore, encouraging early action by the Contractor. It is recommended that ratchets be used in most payment mechanisms.

9.5.6 A simple ratchet mechanism will work by increasing the number of penalty points awarded for a particular failure in the Service which recurs too often within a specified period. For example, if x points are awarded for a failure to achieve a particular output then $(x+3)$ points may be awarded for each failure over and above a specified maximum number of failures within a pre-defined period.¹ It is of vital importance to tailor the ratchet mechanism to a particular project in a way that produces best value for money. Ratchets might also apply to failures which occur in a high proportion of areas within a large project, i.e. for repeated failures geographically rather than repeated failures over time.

9.5.7 There is an argument that performance points should not be capable of being “earned back” retrospectively by the Contractor performing above the standard required:² the required performance level should be set at what is considered reasonable and achievable, so if the Contractor is capable of performing at a consistently higher level then either the level is too low (i.e. the payment mechanism has been poorly calibrated) or the Contractor is simply performing very well and delivering a standard of service at a higher level than the Authority expected or required. However, for some projects it may be considered that the higher level of performance is of additional benefit to the Authority, in which case it may be appropriate for the Contractor to receive additional consideration over and above the usual Unitary Charge. See also Section 7.2.6.

9.5.8 The performance points regime should as far as possible cover every aspect of the Service. Where an all-encompassing performance regime is not feasible or does not sufficiently address persistent failures, the Authority should consider what recourse it has against the Contractor for sub-standard performance which is not covered under the performance regime (see Section 21.2.3 (Termination for Persistent Breach by the Contractor)).

¹ Alternatively, the number of points may increase for each failure over and above *de minimis* level.

² The performance points mechanism should after a certain time, however, disregard points accrued in circumstances where the relevant thresholds for warnings, deductions etc. have not been reached or, if reached, have been dealt with in accordance with the Contract. This is often achieved by using periodic test periods or rolling points-accrual periods.

10 PAYMENT MECHANISM MANAGEMENT AND MONITORING

10.1 CONTRACT MANAGEMENT

10.1.1 Robust contract management arrangements must be in place in respect of all areas of the Contract and payment mechanism. In many contracts the performance measurement system will be the most complex element of the payment mechanism, and the detail in the following Sections relates most directly to that element.

10.1.2 The following issues must be considered:

- the requirement for the monitoring system to be set out in the Contract so that all parties are clear where their responsibilities lie (see Section 10.2 (Monitoring Against the Payment Mechanism));
- when monitoring/transition arrangements should start (see Section 10.3 (Commencement of Monitoring));
- what to do where Sub-Contractors have been replaced (see Section 9.3 (Replacement of Sub-Contractors));
- who performs the monitoring function (see Section 10.4 (Who does the Monitoring?)). In many cases it will be appropriate for the Contractor to self-monitor, with Authority audit procedures and Authority rights to investigate complaints;
- who pays for monitoring against the payment mechanism (see Section 10.5 (Who pays for the Monitoring?)). The Contractor should normally pay for monitoring, and the ITPD should make this clear;
- what information must be communicated, to whom, when and in what format (see Section 10.6 (Reporting the Results of Monitoring)). Lack of adherence to information requirements needed to enable the payment mechanism to be applied should itself be subject to incentives on the Contractor;
- the relationship with other contracts or activities of the Authority, or dependencies of the Authority on the successful performance of the PFI Contract. This area is generally referred to as “interface risk”, but also includes the initial transition/handover of the Project; and
- the relationship between the requirements of the Contract and the Authority’s actual procedures in relation to such matters as invoicing and acceptance of completed works.

10.1.3 Authorities have developed a number of points of best practice, to help ensure that the desired performance level is achieved. These points include the following:¹

- Authorities should develop a “manual” or “user guide” to support effective monitoring. This manual should provide a plain English explanation of the payment mechanism, together with references to the Contract as appropriate, to facilitate effective management by individuals who may not have been involved with the original negotiation. It may be helpful to include worked examples in this;
- the manual should provide references to relevant guidance and contact details;

¹ Authorities should also refer to Operational Taskforce note 2, issued in March 2007, Procurement to Service Delivery, Guidance (see HMT website at www.hm-treasury.gov.uk).

- for complex payment mechanisms or complex elements of payment mechanisms, the manual should explain the desired incentive effects;
- successful Contract management has resource requirements for the Authority, which should be considered at the Project planning stage and during procurement. There must be adequate resourcing of suitably-qualified staff during the Project's operational phase. The individuals or groups who will be involved in Contract management should be brought into the procurement process prior to Financial Close;
- training should be provided on the payment mechanism to relevant staff, on both the Authority and private-sector side, and also involving users as appropriate. This is particularly important where the knowledge retained by relevant staff may be limited, for example, where the procurement has involved external advisers for project management or where the lead managers for the Authority have not been involved in the development of the Contract;
- Authorities should consider holding a “dry run” of the payment mechanism and monitoring system prior to Financial Close, by testing scenarios to see how the payment mechanism and monitoring staff would deal with these. Similarly, Authorities might also perform a “shadow” or “trial” run of the payment mechanism after Contract signature but prior to Service Commencement, in order to ensure its effective application once the Project is in operation and to ensure that the relevant staff have been trained adequately in its application;
- review mechanisms for the calibration of the payment mechanism can be appropriate (see Section 7.7.1 (Flexibility));
- the payment mechanism should not be constructed as a technical document drafted only by technical, financial and legal advisers. It must be user-friendly. An over-complex mechanism risks being ignored in practice. Where it is necessary to have a complex structure, consideration should be given to what in practice might be the distinction between features applied on a day-to-day basis and those which are designed to ward off specific potential performance problems; and
- where the Contract will be managed for the Authority by an individual or group which is relatively remote from the actual Project (for example, where a local authority will manage a schools project), careful consideration should be given to initiatives to ensure that contract management arrangements are robust and that the Service is responsive to the requirements of users. Authorities and Contractors should put in place training sessions to assist third parties in understanding their monitoring role and should issue user guides so that the processes and the communications between the Authority/Contractor/third party are clearly set out.

10.2 MONITORING AGAINST THE PAYMENT MECHANISM

10.2.1 There must be a mechanism under the Contract which enables the Authority to monitor the Contractor's performance against the payment mechanism so that the payment mechanism can operate effectively. The Authority should also be able to identify other performance problems so that any other remedies for poor performance can be pursued if necessary.

10.2.2 The monitoring requirement should be set out in the main bid documents² and a full methodology included in the bid. The methodology will normally include a substantial element of

² Including an indication of who should bear the costs associated with performance monitoring (see Section 10.5 (Who pays for the Monitoring?)).

monitoring by the Contractor, subject to periodic Authority audits.³ Additional Authority monitoring will also take place on an exceptional basis, for example teachers, or medical staff identifying and reporting performance failures.

10.2.3 The reports relied upon for monitoring performance will be key to the management of the Contract and the payment mechanism, and should be specifically tailored to meet these requirements. Monitoring reports should be set out in detail in the Contract sufficient to minimise the scope for future disagreement.

10.2.4 Monitoring involves the collection and evaluation of data that should be objective, relevant, quantifiable and agreed with the Contractor. There should be a clear connection between the data collected, unavailability and the financial penalties for poor performance.

10.3 COMMENCEMENT OF MONITORING

10.3.1 Whilst availability should only be recognised from the time that the Service is actually available, further consideration may be appropriate as regards whether the Contract should specify the performance regime to apply in full from the Service Commencement Date.⁴ In some projects, such as prisons, it is recognised that issues are inevitable in the bedding-in period, and the Contractor can be afforded a degree of flexibility. In other projects, such as roads (where the safety element is crucial), it is essential that the Contractor ensures there are no settling in problems, and the Authority requires the full performance regime from day one,⁵ even if the road is opened in phases.

10.3.2 One approach which gives flexibility in the bedding-in period is to allow the Contractor to accrue a higher number of performance points during that period before financial penalties are triggered than is allowed during the remainder of the Contract. Some Contracts (e.g. where the Service involves a relocation from existing facilities into new facilities) have alternatively made successful use of a regime where the Contractors are allowed a 3 to 6 month bedding-in period. During this time, monitoring takes place, but any financial deductions imposed on the Contractor for poor performance are set at a lower level than is the case once operations are fully established (but, in such cases, this does not affect the Authority's rights to terminate for Contractor Default).⁶ A third approach is to award performance points at the normal Contractual rate so that the Authority only pays for the Services which it receives but to apply a more lenient mechanism in counting the points which trigger the right to terminate for Contractor Default.

10.4 WHO DOES THE MONITORING?

10.4.1 A key issue is who will do the monitoring – the Authority, the Contractor, a partnership between the two or a third party.

10.4.2 Monitoring should occur at three levels:

- a systematic monitoring by the Contractor through a quality management system measuring availability and performance (see Section 3.5 (Quality Management Systems));

³ See Section 10.4 (Who does the Monitoring?).

⁴ This will be more complicated where the Project has more than one Service Commencement Date (see Section 3.6 (Acceptance and Service Commencement)).

⁵ See also Section 3.6 (Acceptance and Service Commencement).

⁶ See Section 3.7.4 (Existing Services).

- a review of the quality management system of the Contractor by the Authority with certain planned and random spot checks (with an ability to increase monitoring on repeated failure or poor performance) (see Section 9.5 (Consequences of Poor Performance)); and
- the ability for users to report failures (e.g. doctors, teachers and service personnel).

A failure to agree such a system can cause difficulties, particularly if disputes arise on the issue of whether a payment is due.

10.4.3 Monitoring requires the use of information that can only be gathered with co-operation from the Contractor. Mechanisms must be in place to ensure the Contractor provides data accurately.⁷ The right approach depends on the particular Project but will always call for co-operation between the parties as benefits will accrue to the Contractor as well as the Authority. Where a Contractor is providing the information, the Authority should obtain a right of audit to verify the information.

10.4.4 The Authority must ensure that sufficient resources and people with the right level of experience are available to manage and monitor the Contract. Some projects arrange for joint training and development of Authority and Contractor staff to encourage partnership.

10.5 WHO PAYS FOR THE MONITORING?

10.5.1 Monitoring arrangements impose obligations on the Contractor and may cause the Contractor natural concern about any exposure to onerous obligations. It is therefore sensible for each party to bear its own costs of monitoring and this should reassure the Contractor that the Authority will not act with too heavy a hand and avoid any possible conflict of interest. The Authority's cost of additional monitoring or audit required due to the poor performance of the Contractor however should be paid for by the Contractor.

10.5.2 The Authority should ensure that the monitoring arrangements are proportional to the consequences of Service failure. This will ensure that where it is possible to have a less onerous system it will be in all parties' interests to do so. Equally, where the consequences of failure are severe, for example, hygiene in an operating theatre, then a rigorous monitoring system should be specified.

10.6 REPORTING THE RESULTS OF MONITORING

10.6.1 The Contract will need to specify the way in which information regarding shortfalls in availability or performance are reported. Wherever possible, monitoring should allow co-ordination of report production in a way that avoids duplication of effort and all parties (including the Senior Lenders) should consider carefully what is needed. The key issues which have to be considered are:

- what reports are required by whom? How frequently? Are different reports required by different people in the organisation, e.g. contract manager, chief executive?
- what is the content of the various reports (it is not enough for the Contract simply to state that a "report" be produced)?
- is there to be a standard monitoring form or an electronic format to present results?
- how soon after a monitoring period is the report to be received?
- how often are meetings required between the Authority and the Contractor?

⁷ Failure to provide data should give rise to deductions and/or the award of performance points under the performance regime.

- who is required to attend from the Contractor?

11 MAINTENANCE

11.1 INTRODUCTION

11.1.1 The Contractor will base its costings on a forecast capital replacement programme of plant, machinery, equipment, fixtures, fittings and furniture designed to maintain the building environment at the specified output standards. The Contractor will also consider the means of funding this expenditure throughout the life of the Project. The risk associated with assessing what will need replacing, when and how much this will cost, is one that the Contractor should take and therefore the Authority should not attempt to be prescriptive in this respect.

11.1.2 The Authority will find it easier to achieve this risk transfer if it starts by expressing its service requirements as an output specification. Bidders should be allowed to develop their own proposals which may, for example, incorporate alternative programmes of maintenance where assets with a longer life are used or used differently. An Authority should not attempt to impose its own system of asset replacement on bidders.

11.1.3 The parties should, however, establish a planned preventative maintenance programme so that both parties know when parts of the Service are permitted to be “unavailable” without any payment deductions being made (see Section 8.10 (Planned Maintenance)). The Contract should also contain a mechanism by which either party can propose reasonable alterations to the planned programme (i.e. alterations which will not adversely affect the delivery of the Service).

11.1.4 Required drafting for a maintenance Clause is as follows:

11.1 Maintenance¹

The Contractor shall ensure on a continuing basis that at all times its maintenance and operating procedures are sufficient to ensure that:

- (a) the Service is continuously available;²
- (b) it can maintain the design intention of the assets³ to achieve their full working life;⁴ and
- (c) [the Assets are handed back to the Authority on the Expiry Date in a condition complying with the requirements of this Clause.]⁵

11.2 SINKING FUND

11.2.1 The Unitary Charge will usually be made on a broadly level basis in accordance with the principles of value for money, whereas the need for capital replacement will only occur at

¹ It may also be appropriate to include a further provision within this Clause requiring the Contractor to keep the physical assets in good structural and decorative order (subject to fair wear and tear).

² This provision should cross refer to the relevant output specification.

³ These are the physical assets referred to in the definition of “Assets”. In certain Contracts this may not be required and in others, such as IT contracts, equivalent provision may be needed in relation to any maintenance of IPR.

⁴ This will often be for the life of the Contract. To the extent a significantly longer period is required then this should be made clear as soon as possible in the competitive process (and certainly not after the bid documentation has been issued). If relevant, reference could be made to the output specification.

⁵ Paragraph (c) will only apply to the extent that the Authority has at least an option to acquire the Assets and the Contractor does not bear the residual value risk (see Section 20 (Treatment of Assets on Expiry of Service Period)).

intervals. The Unitary Charge will accordingly include amounts to cover the Contractor's anticipated future expenditure on maintenance, such as servicing plant and other more major refit maintenance.

11.2.2 The Contractor will therefore usually build up a sinking fund over some years, in anticipation of significant capital expenditure in future periods. It will usually be required to do so by its financiers, particularly where the maintenance risk is left with the Contractor and not passed to Sub-Contractors. The sums involved could be considerable.

11.2.3 Maintenance should be left firmly at the Contractor's risk and the Authority should not attempt to prescribe the quantum, location or availability of a sinking fund.⁶ The Authority should not require rights over any sinking fund established by the Contractor and should instead ensure that the maintenance requirement is adequately protected through payment and termination provisions.⁷ The Authority will wish to ensure that the Contractor is as equally incentivised to maintain the Assets in the later years of the Contract as it is to the early years. The Authority should have the ability to conduct a final survey towards the end of the Contract and withhold payment of the Unitary Charge if the Assets are not restored to the required maintenance standard.⁸

11.2.4 To protect themselves in the event of Contractor Default, the Senior Lenders will have a charge over the sinking fund as security (see Section 24.5 (Financers' Security)). The Contractor should look to its own resources first to repay its Senior Lenders, and so any compensation payable to the Contractor by the Authority on a termination should be reduced by all cash held by the Contractor, including amounts in sinking funds (see Section 22 (Calculation and Payment of Early Termination Payments) and the definitions of "Base Senior Debt Termination Amount" and "Revised Senior Debt Termination Amount" in Clause 1.7.1 (Definitions)). The Authority should not need any additional rights over the sinking fund.

11.3 EXPIRY OF THE CONTRACT

11.3.1 As the Expiry Date approaches, the Authority's interest in the maintenance of any Asset will become most acute where ownership and use of the physical assets will (or may) rest with the Authority from expiry. The Contractor's proper management of the maintenance requirements of such physical assets will be facilitated by the Authority informing the Contractor of its handover requirements as early as possible prior to the Expiry Date. These issues are dealt with in Section 23 (Surveys on Expiry and Termination).

11.4 TRANSFER OF ASSETS AT END OF CONTRACT

11.4.1 In projects where the assets are unlikely to revert to the Authority on termination, and the Contractor is taking a risk on their residual value, then it is in the interests of the Contractor properly to maintain any assets. Accordingly, the Authority may be less concerned to put in place protections in respect of asset condition on expiry of the Contract (unless it retains an option to purchase).

⁶ The Contractor may, however, be required to provide the Authority with details of the balance of the sinking fund in accordance with Clause 26.2 (Contractor's Records and Provision of Information).

⁷ If, however, the size of the Project (including associated maintenance obligations) is comparatively large in relation to the financial resources of a Contractor which is not relying on third party Senior Debt financing, the Authority may want to consider requiring a sinking fund over which it has secured rights. Similarly, if the term of the Senior Debt is significantly shorter than the term of the Contract, the Authority may wish to have secured rights over a sinking fund once the Senior Debt has been repaid in full.

⁸ See Section 23 (Surveys on Expiry and Termination).

11.4.2 In contrast, if the assets are likely to revert to the Authority on termination at no cost or a fixed price, then the Authority will have to ensure that the price it is paying for the Service during the term of the Contract (and on which its value for money assessment has been made) includes coverage for appropriate maintenance obligations. Generally, the transfer or reversion to the Authority at the end of the Contract will be at zero cost. In these circumstances, the Contract should provide for sums to be retained in the final years (or alternatively bonding to be provided by the Contractor) if handback surveys reveal that significant maintenance is likely to be required to ensure that the relevant assets meet the handover requirements at the end of the term of the Contract (see Section 23 (Surveys on Expiry and Termination)).

11.5 SURVEYS

11.5.1 Particularly where the Authority will take back the Assets at the end of the Contract, maintenance obligations need to be monitored (other than through the performance monitoring system – see Section 10 (Payment Mechanism Management and Monitoring)) and a mechanism needs to be agreed whereby this can be done in as non-intrusive a manner as possible.

11.5.2 The following is the required drafting for a Clause dealing with surveys:

11.5 Surveys

- (a) If the Authority reasonably believes that the Contractor is in breach of its obligations under Clause 11.1 (Maintenance) then it may carry out (or procure) a survey of the Assets to assess whether the Assets have been and are being maintained by the Contractor in accordance with its obligations under Clause 11.1 (Maintenance).⁹ This right may not be exercised more often than once every [two¹⁰] years.
- (b) The Authority shall notify the Contractor in writing a minimum of [14] days in advance of the date on which it wishes to carry out the survey. The Authority shall consider in good faith any reasonable request by the Contractor for the survey to be carried out on a different date if such request is made at least [7] days prior to the notified date and the Contractor (acting reasonably) is able to demonstrate that carrying out the survey on the notified date would materially prejudice the Contractor's ability to provide the Service.¹¹
- (c) When carrying out any survey, the Authority shall use reasonable endeavours to minimise any disruption caused to the provision of the Service by the Contractor. The cost of the survey shall, except where paragraph (d) below applies, be borne by the Authority. The Contractor shall give the Authority (free of charge) any reasonable assistance required by the Authority during the carrying out of any survey.
- (d) If the survey shows that the Contractor has not complied or is not complying with its obligations under Clause 11.1 (Maintenance), the Authority shall:
 - (i) notify the Contractor of the standard that the condition of the Assets should be in to comply with its obligations under Clause 11.1 (Maintenance);
 - (ii) specify a reasonable period within which the Contractor must carry out any necessary rectification and/or maintenance work; and
 - (iii) be entitled to be reimbursed by the Contractor for the cost of the survey.¹²

⁹ Any such survey should be based upon the original output specifications. The Authority should ensure at all times that it does not delay in notifying the Contractor of any deficiencies in the maintenance of the Assets.

¹⁰ Other periods may be appropriate (e.g. for an asset that requires a high or low level of maintenance).

¹¹ There may be other relevant considerations which need to be specified e.g. in some sectors the survey might prejudice security if carried out on a certain date.

¹² This can be set-off under Clause 12 (Set-off). Please note that for projects where the scope and hence cost of such survey may be large (e.g. grouped school or large road projects), some threshold level of failure may be appropriate so that the Contractor is not penalised for

- (e) The Contractor shall carry out such rectification and/or maintenance work within the period specified and any costs it incurs in carrying out such rectification and/or maintenance work shall be at its own expense.

12 PAYMENTS AND SET-OFF

12.1 INTRODUCTION

12.1.1 The Authority should ensure that the Contract contains an express right for the Authority to deduct liquidated amounts owed to it by the Contractor under the Contract from any payments it is obliged to make to the Contractor (whether during the Service Period or on termination). This applies to liquidated damages and all other debts or liabilities owed to the Authority (including amounts owed in respect of failure by the Contractor to comply with its maintenance obligations at the end of the Contract (see Section 23 (Surveys on Expiry and Termination)). Senior Debt service should not be insulated from set-off or deductions.

12.1.2 Set-off on termination is dealt with specifically in Section 22.4 (Set-off on Termination).

12.1.3 The right to set-off being described here does not apply to deductions for non-availability or sub-standard performance of the Service (see Section 7 (Price and Payment Mechanism)) as these are contractual deductions which apply automatically if the relevant circumstances arise (e.g. if the availability or performance criteria are not met). Disputes relating to these are dealt with under Section 28 (Dispute Resolution).

12.2 SCOPE OF AUTHORITY'S RIGHT TO SET OFF

12.2.1 Standard practice in all fields of civil procurement has been for the Authority to have the right to set-off amounts owed to it by the Contractor against amounts due to the Contractor under any contract between the Contractor and the Crown. In practice, there are not likely to be any other contracts between the Contractor and the Crown, as the Contractor will usually be a SPV whose only business is the Project in question.

12.2.2 If the Contractor does have other contracts with the Crown, its third party financiers would be highly unlikely to allow it to agree to a wide set-off clause which enabled amounts relating to other contracts (whether PFI or non-PFI contracts) to be set off against amounts due under the Contract. Generally, the financiers will only agree to the Authority having the right to set-off any ascertained amount owed to it by the Contractor under the Contract and Project Documents (subject to any agreed restrictions) against amounts the Authority owes to the Contractor under such documents. The Authority should not usually seek to extend such right as many of the value for money benefits of PFI projects come from isolating the rights and obligations of the Project from more general rights and obligations.

12.2.3 Over-payments, liquidated damages and amounts claimed under indemnities are the only liquidated claims that are likely to give rise to a set-off. Provided that any relevant criteria are fulfilled, as specified in the Contract (e.g. the Planned Service Commencement Date is missed due to the Contractor's fault or the Authority suffers a loss due to a breach covered by an indemnity), then the applicable amounts should be calculated by the Authority and set-off against the next payment. The determination of any dispute as to whether such criteria were fulfilled or about the level of any indemnity amount set-off will also determine whether or not any amounts should be repaid. Interest should be paid on any amounts which it is determined should be repaid with effect from the due date.

12.2.4 To the extent an amount owed is disputed, the Authority should pay the undisputed amount, but be entitled to retain the disputed amount until the dispute is resolved (see Clause 28 (Dispute Resolution)).

12.3 TIMING OF SET-OFF

12.3.1 During the Service Period, any amount to be set-off should generally be applied against the next payment of the Unitary Charge (or other payments) due after the amount owed by the Contractor has fallen due and payable (unless the Contractor has already paid the Authority the relevant amount).

Suitable drafting is as follows:

12 Set-off

- (a) The Contractor shall not be entitled to retain or set off any amount due to the Authority by it, but the Authority may retain or set off any amount owed to it by the Contractor under this Contract which has fallen due and payable¹ against any amount due to the Contractor under this Contract.²
- (b) If the payment or deduction of any amount referred to in paragraph (a) above is disputed³ then any undisputed element of that amount shall be paid and the disputed element shall be dealt with in accordance with Clause 28 (Dispute Resolution).

12.4 VAT ON PAYMENTS

12.4.1 Standard required provisions for VAT on such payments are as follows.⁴

12.4 VAT

- (a) All amounts due under this Contract are exclusive of VAT.
- (b) If any supply made or referred to in this Contract is or becomes chargeable to VAT then the person receiving the supply (the "Recipient") shall in addition pay the person making the supply (the "Supplier") the amount of that VAT against receipt by the Recipient from the Supplier of a proper VAT invoice in respect of that supply.⁵

12.4.2 If amounts due under the Contract are calculated by reference to costs incurred by any person and VAT has been incurred on the costs, then VAT should not be included in the calculation of those costs if the person concerned can recover the VAT from HMRC. Required drafting for this is as follows:

Where under this Contract any amount is calculated by reference to any sum which has or may be incurred by any person, the amount shall include any VAT in respect of that amount only to the extent that such VAT is not recoverable as input tax by that person (or a member of the same VAT group), whether by set-off or repayment.

12.4.3 A provision as follows is also required for the above to work:

The Contractor shall provide the Authority with any information reasonably requested by the Authority in relation to the amount of VAT chargeable in accordance with the Contract and payable by the Authority to the Contractor.

¹ This must be by definition an ascertained amount.

² The right to set-off here is subject to the restriction in Clause 22.4 (Set-off on Termination).

³ This would apply, for example, to performance or availability deductions.

⁴ For changes in law relating to VAT that qualify for compensation see Section 14.10.2 (Changes in VAT Scope).

⁵ In relation to transactions that are "VATable" at the election of the Supplier (e.g. grants of land interests) then other considerations will be relevant. Typically, the Recipient should be entitled to agree the election before it is made.

13 CHANGE IN SERVICE

13.1 INTRODUCTION

13.1.1 The Service requirements set out in the Contract should take into account the Authority's long-term (and not just its current) requirements, anticipating any changes in Service that can reasonably be foreseen. Accordingly, an appropriate amount of flexibility should be designed into the initial bid solution to cope with *anticipated* changes, and a well-developed change mechanism put in place in the Contract to cope with the residual *unanticipated* changes to the Service over the length of the Contract period.

13.1.2 Changes in Service can take various forms in PFI projects (see below), but may broadly be categorised into at least three distinct types as follows:

- Changes in use or functionality, for example:
 - conversion of non-teaching to teaching areas;
 - greater community use of schools; and/or
 - conversion of general ward areas into an operating theatre.
- Changes in capacity or throughput, for example:
 - more classrooms;
 - additional operating theatres or ward spaces;
 - more prison places;
 - increase in waste processing capacity; and/or
 - partial terminations (in grouped schools projects).
- Changes in service specifications or performance standards, for example;
 - changes in construction standards;
 - higher recycling targets (in waste management);
 - new nutritional requirements for schools catering; and/or
 - introduction of new services (e.g. offender management in prisons).

13.1.3 Authorities should consider carefully whether anticipated changes in its Service requirements are capable of being specified, designed and priced as part of the initial bid solution, ideally at a stage where there is some competitive pressure in the procurement. This will ensure that the desired flexibility is priced efficiently, and will enable the change to be processed and implemented effectively at the appropriate time, imposing minimum disruption on the Project.

13.1.4 In some projects, changes to requirements may be quite foreseeable (e.g. in street lighting projects, demographic projections may suggest that the Authority is quite likely to require new units to be brought into the scope of the Contract as housing increases in the area). In such circumstances, the Authority should consider the feasibility of requiring the Contractor to commit to pricing pre-specified changes as part of the Contract (e.g. unit prices for new lamp posts). Similarly, it is feasible in some cases to include within the Contract a formulaic method of adjusting the Unitary Charge for increases or decreases in capacity. In the housing sector for instance, dwellings can exit from a housing PFI contract as a result of the exercise by tenants of their right-to-buy their property. To cope with this foreseeable change, housing PFI contracts

often contain formulaic adjustments to the Unitary Charge (based on changes in underlying fixed, variable and semi-variable costs) as the number of units managed by the Contractor changes. Similar techniques could be applied to other sectors where there is a reasonably well-defined relationship between the outputs of the Contract and the cost structure of the Contractor.

13.1.5 However, many changes, even if anticipated, may not be amenable to specification, design and pricing during the initial procurement – for instance, an Authority may anticipate a phased expansion of capacity to accommodate expected increases in demand, but may not be in a position during the procurement to specify the scale of expansion required. In such circumstances, Authorities should carefully assess if additional flexibility can be created within the Contract to deal appropriately with changes in Service that can be anticipated but not specified upfront with any degree of precision. The following elements of the Contract could be reviewed for greater long-term flexibility:

- well-developed change mechanisms;
- shorter Contract lengths;
- financial structures with lower levels of leverage, shorter term hedges and/or lower breakage costs;
- early termination rights (including the ability to terminate parts of a Contract and/or Authority Break Points); and
- phased project development through long-term partnering frameworks (e.g. in the LIFT and BSF programmes).

13.1.6 In general, greater flexibility in PFI Contracts will usually come at a higher price. Well-designed Contracts therefore need to strike a balance between price, long-term flexibility and certainty of whole-life costs, and so consideration of all these issues should form an important part of procurement design and evaluation.

13.1.7 PFI Contracts tend to be long-term contracts, commonly ranging from 20 to 30 years. Over such long periods, it is inevitable that changes will occur that cannot be anticipated at the start. Provided long-term requirements have been well thought through and adequate flexibility built into the design of the Contract (as discussed above), the frequency and impact of unanticipated changes should be limited and manageable.

13.1.8 All PFI Contracts can and should deal effectively with a limited volume of unanticipated change, and this is best achieved through well-developed change mechanisms written into the Contract. Good change mechanisms should seek to achieve at least the following four outcomes:

- **Clear** process, with clearly defined roles, responsibilities and timescales;
- **Quick** and **efficient** procedures (appropriate to the scale and complexity of the change required), with transaction time and cost kept to a minimum;
- **Transparent** pricing; and
- **Value for money.**

13.2 A TYPOLOGY OF CHANGES

13.2.1 Changes in PFI Contracts can be classified in different ways, and it is recommended that Authorities collect data on changes to projects to build up a pattern of changes that are occurring in their sector.

13.2.2 The typology below should help Authorities in drafting change mechanisms that are best suited for the pattern and types of changes occurring in their sector.

13.2.3 Changes in Service can be classified:

By Origin

- Authority change
- Contractor change
- Changes in law

By Timing

- Construction
- Early operations
- Steady state operations

By Value

- Small
- Medium
- Large

By Impact

- Financial only
- Works only
- Services only
- Works and Services

By Type

- Change in use or functionality
- Change in capacity or throughput
- Change in service specifications or performance standards.

13.2.4 Changes by origin: As discussed above, the Authority may wish to make anticipated or unanticipated changes to its Service requirements. In many cases, such changes tend to be driven either by underlying changes in the Authority's business strategy (e.g. changes in care delivery strategies in hospitals) or changes in legislation.¹ Similarly, the Contractor may wish to propose changes to either the Service requirement itself (e.g. to improve efficiency), or to the way in which it delivers the Service. Although the output specification should generally be flexible enough to allow the Contractor to make changes to its method of delivering the Service (e.g. by introducing new technology) without formally consulting the Authority, there may be circumstances where aspects of the method of delivery impact on the Service requirement and are therefore critically important to the Authority. In such circumstances, the Authority will wish to be formally consulted prior to the implementation of the changes. This can usually be done most efficiently by including in the Contract a suitable form of review procedure (providing a quicker, simpler way of dealing with these matters than a full-fledged change mechanism)². Such review procedures deal typically, for instance, with design development and changes to construction proposals, the construction programme, Service Delivery proposals, programmed maintenance and third party use arrangements.

¹ Changes in Law are discussed in Section 14.

² In most PFI contracts, there is a clear and deliberate distinction made between the change mechanism (which is used to make changes to the Authority's Service requirements) and a review procedure through which the Authority is given the right to comment on (and in some cases – if it wishes – to raise objections to) the manner in which the Contractor delivers the Authority's Service requirements. Apart from its limited rights under the review procedure, the Authority should not otherwise constrain the Contractor's ability to make changes to its Service delivery methodology so long as the Service requirements are met. See, for example, the BSF Standard Form PFI Project Agreement March 2006 at Schedule 6, on the Partnerships for Schools website www.partnershipsforschools.org.uk or the Department of Health Standard Form Project Agreement (Version 3) at schedule 10, available at www.dh.gov.uk.

13.2.5 The rights of the parties will vary depending on the origin of the change. For instance, the Authority should generally have an unfettered right to request changes in the operational period, but a more restricted ability to do so during the construction period. The Contractor should generally be given only limited rights to object to or refuse to undertake the changes, such as if the change would imperil the economics of the Project or otherwise make it impossible for the Contractor to meet its obligations under the Contract. In contrast, the Contractor should generally be given the right to propose changes to the Service requirements but the Authority should have an absolute right to approve or reject such proposals. However, if the change is required to comply with a Qualifying Change in Law, then both parties will be obliged to agree and implement it.

13.2.6 *Changes by timing:* Changes during the construction phase should, where possible, be kept to a minimum and unless a long period of time is scheduled to elapse before the Service Commencement Date (e.g. three years or more) the Authority should not ordinarily seek to change its construction requirements prior to Service Commencement. In exceptional circumstances the Contractor may be able to incorporate such a change during the construction period (if it is requested early enough in the construction programme) more cheaply than after the Service has commenced, and the Contract (in such exceptional circumstances) should then incorporate provisions to reflect this possibility. However, in general Authorities should seek to ensure that no significant changes of scope occur during the construction period, as this can seriously imperil the ability of the Contractor to deliver the project to time and budget.

13.2.7 *Changes by value:* The majority of unanticipated changes in PFI projects tend to be small in relation to the capital value of the transaction. Such changes (particularly in the accommodation sector) reflect the need to cater to different user preferences in the detailed design and operation of the facility (e.g. changing furniture layout based on teacher preferences). Small and medium value changes need to be specified, agreed and implemented relatively quickly and cost-effectively to avoid users perceiving the Contract as “inflexible”, causing in turn a negative impact on user satisfaction.

13.2.8 In contrast, large-value changes typically reflect major changes in strategy or policy that could not have been anticipated when the Contract was signed. As such, they tend to occur less frequently and generally warrant the time and cost of proper due diligence (from the Authority, the Contractor and the Senior Lenders). The Authority should consider what rights the Contractor should have to refuse to implement large-value changes (particularly if they impact on the risk profile of the Project), and how to secure transparent, value-for-money pricing from the Contractor. Large value changes could give rise to procurement issues if they were not properly covered under the terms of the original OJEU advertisement.³

13.2.9 The definition of small, medium or large-value changes should be relative to the size of the Project. For instance, a £100 million schools PFI scheme may define “small” as less than £5,000, “medium” as £5,000 to £100,000 and “large” as values higher than £100,000; a £1 billion hospital transaction may well have different thresholds.

13.2.10 *Changes by impact:* A proposed change may involve construction and/or changes to the facilities management “(FM)” services. It is generally easier to accommodate changes which are solely related to the FM service provision but do not involve additional construction works. For the latter, a variety of commercial issues surface in relation to how the change should be implemented – for instance, the choice of the construction company could be significant if there are interfaces between the new construction and the existing facility which will need to be managed by the Contractor. Similarly, large extensions to the built area (particularly in accommodation projects) will tend to have a significant impact on the calibration of the payment

³ Authorities should seek professional procurement advice when drafting their original advertisements to ensure that, as far as possible, procurement issues do not obstruct the processing of changes.

and performance mechanism, and on the risk profile of the Project. These will need to be negotiated with the Contractor and the Senior Lenders.

13.2.11 Changes by type: The commercial issues related to different types of change normally arise from their differential value or impact. For instance, changes in use or functionality typically tend not to be large-value, and may not even involve any change to Works or Services (e.g. where changes to classroom timetables mean that hours available for community or third party use of schools need to be modified). On the other hand, changes in capacity would almost certainly involve both new construction and more Services, and would tend to be large in value. Changes in Service specifications or performance standards probably fall somewhere in between and can be much more variable – they may have a purely financial effect (e.g. a change in the risk sharing on energy efficiency), or they may involve both Works and Services.

13.2.12 Other Changes: Occasionally other changes are needed to the arrangements between the parties, which are neither changes to the Services or to the Works or to the Contractor's proposals. These would not fit in to the review procedure or the change mechanisms, but would involve a change to the Contract, negotiated between the parties and effected through a Deed of Amendment. It is vital to the integrity of the arrangements between the parties that all such amendments, together with all other various change orders which might be implemented, are clearly recorded and that the Contract, as an ongoing document, remains complete, coherent and up to date.

13.3 CHANGE PROTOCOLS

13.3.1 Authorities must include in their Contract a well-developed Change Protocol that deals effectively and appropriately with the different kinds of changes discussed above. Such Change Protocols must be developed during the procurement process, and be agreed and incorporated into the Contract at Financial Close. At the same time, Authorities must ensure (as part of the evaluation process prior to the selection of the winning bidder) that the Contractor will be properly resourced to provide an appropriate change management service to the Authority that complies with the Change Protocol during the operational period, reflecting its responsibilities and obligations as a responsive partner.

13.3.2 Change Protocols should cover, at a minimum, the following elements of the change management process for all types of changes:⁴

- Notification and Specification;
- Contractor's Estimate;
- Authority Approval;
- Change Implementation;
- Funding and Payment;
- Due Diligence; and
- Documentation and Monitoring.

At each stage, the Change Protocol should clearly define the roles and responsibilities of each party and the timescales within which they are expected to perform, whilst recognising the different requirements (in terms of process and timing) of different types of changes.

13.3.3 Notification and Specification: It is important that Authorities inform the Contractor early on of their intention to request changes (and vice versa). The Change Protocol should set out a clear format and timing for early notification, following which the parties should collaborate in good faith to develop an appropriately detailed specification for the change request. The specification

⁴ See, for example, Part 18 of the MOD Standard Form Project Agreement for a systematic step-by-step approach to the change management process for all types of changes.

should wherever possible be a restatement of the original output specification, and where not, an alternative output specification. However, it may be that (particularly with small to medium-value changes) an input specification may be more appropriate where the Works or Services required are very specific. Authorities should agree with the Contractor at Financial Close a catalogue of pre-specified small Works and Services that can simply be ordered (at pre-priced rates – see below). The rates in this catalogue can then be reviewed and refreshed each year of the Contract by indexing them to an appropriate inflation index like the CPI or RPIX. The final specification should be signed off by the Authority and submitted to the Contractor as a formal Change Request (unless it relates to a Contractor change), together with any other information the Contractor may reasonably require in order to develop a design solution and estimate for the change.

13.3.4 Contractor's Estimate: Following the receipt of the Change Request from the Authority, the Contractor should generally be given a reasonable period of time (depending on the scale and complexity of the change requested) to notify the Authority if it wishes to refuse to implement the change.⁵ It would be reasonable for the Contractor to have the right to refuse on the following grounds.⁶

- if it requires the Service to be performed in a way that infringes any law or is inconsistent with good industry practice;
- if it would cause any consent to be revoked (or a new consent required to implement the relevant change in Service to be unobtainable);
- if it would materially and adversely affect the Contractor's ability to deliver the Service;
- if it would materially and adversely affect the health and safety of any person;
- if it would require the Contractor to implement the change in Service in an unreasonable period of time;
- if it would (if implemented) materially and adversely change the nature of the Project (including its risk profile); and/or
- the Authority does not have the legal power or capacity to require the implementation of such a Change.

If the Contractor agrees to proceed with the change (or, in the case of a Contractor change, once the final specification is agreed), the Change Protocol should set out the timescales by when the Contractor will respond with a design solution (if required) and an estimate of the costs of the change, together with any other information the Authority reasonably requires to approve the change ("the Contractor's Estimate"). The Contractor's Estimate should generally include the opinion of the Contractor on (as appropriate).^{7 8}

- a detailed timetable for implementation;
- whether relief from compliance with obligations is required, including the obligations of the Contractor to achieve the Planned Service Commencement Date and meet the performance regime during the implementation of the change in Service ;

⁵ Although the expectation must be that any issues the Contractor has with respect to the change are resolved in the collaborative process of developing the specification. Furthermore, small value changes should not generally have any material impact on the Project and so it should be the presumption that the Contractor will have no objection to carrying them out.

⁶ Other than where the change is required to comply with a Change in Law – this situation is dealt with in Section 14.

⁷ Other information may be needed on certain projects (for example, to allow a certain level of security clearances). Also, most of this list will not be applicable for small value changes – see e.g. Part 18 of the MOD PFI Project Agreement which differentiates information requirements in the Contractor's response based on the type of changes.

⁸ The timetable should identify the different phases of the development period, such as technical, pricing, planning, legal, etc. and indicate which of the deliverables will be issued in which phase, and the points at which the Contractor will require the Authority to issue any further confirmations to proceed.

- any impact on the provision of the Service;
- any amendment required to the Contract and/or any Project Document;
- any Estimated Change in Project Costs, taking into account any Capital Expenditure that is required or no longer required;
- any gain or loss of revenue;
- any regulatory approvals which are required; and
- the proposed method of certification of any construction or operational aspects of the Service required by the change in Service if not covered by the procedures specified in Section 3 (Service Commencement).

Timescales for the submission of the Contractor's Estimate should distinguish between the scale and complexity of different change requests. The Change Protocol should set out a definite (and short) timescale for responding to requests for small value changes to the service, whereas timescales for medium to large value changes can be agreed flexibly between both parties in each case depending on the type and complexity of the change.

13.3.5 Authority Approval: Upon receipt of the Contractor's Estimate, the Authority should similarly have a reasonable period of time in which to consider the response, and then indicate its approval or otherwise to the Contractor. The Authority's rights of approval should be related to the origin of the change as discussed above: it should have absolute rights to approve or reject the Contractor's Estimate if the change is an Authority or Contractor change. The Authority should not be able to reject a change in Service which is required in order to conform to a Qualifying Change in Law. The costs of introducing a change in Service resulting from a Qualifying Change in Law (including any resulting variation in the Unitary Charge) should be shared in accordance with Section 14 (Change in Law) and to the extent not dealt with should be borne by the Contractor.

It is recommended that for large-value changes, Authorities should follow a 2-stage approval process with the Contractor providing an initial budget price at Stage 1 (based on which the Authority can confirm it can afford to pay for the change), followed by detailed design work and a fixed price at Stage 2. This will prevent significant abortive costs from being incurred by the Contractor in the earlier (less certain) stages, and also give the Authority more confidence and certainty of affordability.

For small-value changes, Authorities should consider delegating approval authority to local representatives so that such changes can be agreed quickly and without too much process or bureaucracy (e.g. school head teachers could be given the responsibility to agree small value changes related to their school where the change was funded through their own delegated budgets).

13.3.6 Change Implementation: Once the Authority has signalled its approval of the Contractor's Estimate, the Contractor should proceed to implement the change in Service in accordance with the agreed timetable. A standard timescale can be set out in the Change Protocol for small-value changes (such as those listed in an agreed catalogue of small Works and Services), or agreed on a case by case basis for larger or more complex changes.

13.3.7 Funding and Payment: Authorities will generally be liable for the cost of changes associated with Authority changes, and should ensure they have budgeted accordingly. For Contractor changes, the Authority should be under no obligation to pay unless a payment from the Authority is specifically agreed as part of the discussions with the Contractor. Finally, the costs of introducing a change in Service resulting from a Qualifying Change in Law should be shared with in accordance with Section 14 (Change in Law) and to the extent not dealt with should be borne by the Contractor.

Where the Authority is responsible for bearing or sharing the cost of the change in Service, it should generally be assumed that:

- the payment for any capital works will be made on the achievement of milestones or on completion through lump sum capital payments; and
- the payment for any change to Services shall be made through an adjustment to the Unitary Charge.

It should only be in limited circumstances (for instance, large-value works) that the Authority should consider whether the disciplines of securing additional private finance to fund the capital cost of a change will be worth the extra cost and complexity of securing the funding.⁹ There should, however, be an obligation on the Contractor to use reasonable endeavour to seek any additional finance if required (even though in practice this may be limited to obtaining the finance from the existing Senior Lenders).

13.3.8 Due Diligence

13.3.8.1 Senior Lenders' Due Diligence: It is reasonable for the Senior Lenders to wish to conduct due diligence on changes which can alter the risk profile of the Contract, in order to protect their investment. However, due diligence costs can be significant and can render smaller value changes uneconomic if not managed properly. Accordingly, Change Protocols should set out a framework for due diligence which, whilst protecting the position of the Senior Lenders, allows routine small value changes to be processed at minimal transaction costs. Some ways in which this might be achieved are suggested below.

13.3.8.2 Legal and technical due diligence: Legal due diligence will generally be necessary whenever there is either a change to the terms of the Contract, or a separate Deed of Amendment (see Section 13.3.8.9) is required to give effect to the change. Similarly, where changes in Service pose any additional (and material) design or construction risks, or may have a material impact on the operating and life-cycle costs of providing the original Service, technical due diligence will be necessary and desirable.

The Change Protocol should list circumstances where a change in Service can be agreed between the Authority and the Contractor without the need for legal and/or technical due diligence. This could include for example:

- where the change in Service is called off from a pre-priced catalogue of small Works and Services; and/or
- where the change in Service can be implemented without any material impact on the ability of the Contractor to deliver the existing Service.

13.3.8.3 Financial due diligence: Financial due diligence will typically concentrate on adjustments to the financial model and calibration of the payment mechanism.

13.3.8.4 Adjustments may need to be made to the financial model to give effect to a change in Service, so that the Unitary Charge is adjusted to take into account the change in Project Costs and the Contractor is left in a no better no worse position.¹⁰ In particular, the Senior Lenders will

⁹ There is a balance to be struck between requiring Contractors to put in place facilities to cover changes (which may involve a commitment fee), or leaving the financing of change to be dealt with as it arises over the project life. Contractors sometimes include standby facilities or variation bonds as part of their finance package to cover foreseeable changes which can be a useful element of flexibility. Unforeseen changes on the other hand have tended in practice to be funded by the Authority itself through capital payments without prior facilities being put in place.

¹⁰ See e.g. Schedule 22 of the NHS Standard Form Project Agreement Version 3 as an example of how to update the financial model to account for the cost of implanting variations. See also section 13.4.3 for a discussion of including or excluding different types of costs in the costing of variations.

wish to conduct due diligence over the financial model to ensure that cover ratios remain acceptable.

13.3.8.5 To improve the efficiency and speed of the process, Authorities should agree with the Contractor that the financial model should generally only be adjusted and reviewed periodically (say once or twice a year), so that all the changes that have occurred during that year can be 'bundled' together into a single cumulative adjustment as necessary. This will avoid the expensive and cumbersome exercise of carrying out financial due diligence on the financial model every time a change occurs, and greatly reduce the transaction costs of undertaking changes. An exception to this rule can be on the occurrence of large-value changes, where it is quite likely that the financial model will need to be adjusted on a case by case basis.

13.3.8.6 Similarly, payment mechanisms are usually calibrated at Financial Close based on the economics of the Project at that time. As changes in Service accumulate, the payment mechanism may well need to be re-calibrated to ensure that it remains a fair and effective method of incentivising the Contractor whilst being acceptable to Senior Lenders. To keep due diligence costs at an efficient level however, it is strongly recommended that Authorities agree with the Contractor (who in turn should agree with the Senior Lenders) as part of the Change Protocol that reviews of the Payment Mechanism should only be triggered after changes up to a certain aggregate value have occurred in a year. Below this threshold, the parties should only need to agree a periodic review of the payment mechanism (such as every year or every two years) to ensure that the calibration stays in line with its desired objectives.

13.3.8.7 *Insurance due diligence:* Changes in Service, particularly where they involve a change to the insured assets, may also require authorisation from the insurers.¹¹ Underwriters rely on the concept of utmost good faith, and will normally expect to be notified immediately of any material change in the scope of the Project. Materiality will to a large extent depend on the size and nature of the scope change. The insurance arrangements can be structured to give the Contractor a degree of flexibility in processing changes without any additional insurance due diligence. For instance:

- A capital additions Clause in the material damage insurance will cover the Contractor for 'modest' changes in the scope of the Project leading to a change in the capital value of the insured assets. Typically the amount is capped at a relatively low level (e.g. c. £100,000). The insurer will still need to be advised of the material change, though this can be when the insurance is renewed, rather than at the time of the scope change.
- A contract works extension could be included in the insurance package which will cover the Contractor for works undertaken during the operational period.

The above provisions are fairly standard and are included in the Required Insurance template in Annex 1 referred to in Section 25 (Insurance).

13.3.9 *Documentation and Monitoring:* All changes in Service should be implemented in accordance with the Change Protocol, with the Contractor acting as the prime counter-party responsible for implementation. The alternative to this is for the Authority to contract directly with a builder or FM services company to implement the change, but this is not recommended as, over time, it can lead to serious interface risks and confusions as to responsibilities. It could also have significant value for money implications if it displaces the basic risk allocation embedded in the Contract.

¹¹ Whilst project specific insurance provides a greater level of protection than group insurance, and hence represents the preferred insurance solution, it is worth noting that a change in the scope of the Works is much less likely to have in impact on the insurance programme if a group policy is used. The same point applies, albeit to a lesser extent, to project specific insurances where the cover provided is also on a first loss basis, and so routine operational changes in scope are unlikely to impact on the assessment of the first loss limit.

There is a separate issue as to the *terms* under which the Authority should contract for changes in Service. Small value changes should generally be capable of being covered under the existing terms of the Contract and the Change Protocol where the implementation process is typically straightforward and construction or operation risks are not substantial. However, for those changes in Service where the implementation is complex or the risks are substantial, it is quite likely that the parties will need to agree a bespoke set of terms and conditions under which the Contractor will deliver the change particularly in relation to matters such as:

- payment terms;
- land/site issues;
- statutory permissions;
- warranties from construction or services sub-contractors;
- protections against failure to complete (liquidated damages, deductions, termination rights);
- Relief and Compensation Events (including the interface with the existing Project);
- limits of liability; and/or
- indemnities and insurance issues.

This makes it likely that for complex changes, a separate Deed of Amendment that accurately encapsulates the particular terms agreed in relation to such changes will usually be appropriate.

It is important for both parties to accurately document and monitor all changes, and ensure that they are captured in a change log which tracks any new assets or services agreed as part of the Change Protocol, and references the terms (e.g. Deed(s) of Amendment) under which the changes have been carried out.

13.4 TRANSPARENCY OF PRICING AND VALUE FOR MONEY

13.4.1 The Change Protocol should place a general requirement on the Contractor to process and implement changes using a transparent open-book approach to pricing, with an obligation to secure value for money for the Authority.

13.4.2 Two key questions arise in relation to the issue of transparency and value for money:

- which items should reasonably be included and which excluded when costing a variation, and
- for the pricing of items which *are* included, how might the Authority assess whether or not it is getting value for money?

13.4.3 Costing Issues

13.4.3.1 *Time and materials costs:* Clearly, the costing of a variation must include the basic resource costs of implementing the change (i.e. in terms of the labour and materials expended on design, construction, facilities management, raising finance (if applicable) and/or maintenance). This can also include professional fees (e.g. where design work or construction engineering is involved), and (particularly for significant construction works) an element of contingency to deal with any performance risk being accepted by the Sub-Contractor.

13.4.3.2 *Sub-Contractor margins:* In addition to the basic resource costs, many Sub-Contractors charge a “margin” that provides a contribution to overheads and profits at the Sub-Contractor level. While this is fairly standard practice in the industry, the levels can vary. In the context of

variations, Sub-Contractor margin levels could be set in two ways:

- the levels could be fixed in the Change Protocol with reference to the levels set in the original Sub-Contracts; and/or
- independent technical advice could provide a market benchmark for margin levels at the time of the change.

For small-value changes, the catalogue pricing should include both the time and materials cost, as well as any Sub-Contractor margins.

13.4.3.3 Contractor mark-ups: There are three potential areas in respect of which the Contractor may seek to charge a separate fee or margin over and above the elements discussed above:

- processing time and cost (e.g. paperwork, liaison, meetings, external advice etc);
- accepting performance risk on the implementation of the change (i.e. “wrapping” the performance of the Sub-Contractors carrying out the change in terms of the time, cost and quality of delivery); and
- accepting any interface risks between the implementation of the change and the provision of the existing Service.

13.4.3.4 In some cases (particularly during the construction period), the Contractor acts largely as a passive intermediary, whilst the work to process and implement changes occurs at the Sub-contractor level. In such cases, there is very little case for any additional processing charges being paid to the Contractor.

In most other cases (certainly during the operational period), the Contractor should be resourced to process changes themselves and add value in providing a change management function for the Authority. The proper resourcing of Contractors to provide an effective change management Service should be a part of the specification set at Financial Close. Since change management therefore forms a routine part of the Service provided by the Contractor, there should be no need for the Authority to pay any additional Contractor fee or margin for processing each variation. However, there may still be instances (e.g. complex changes) where the Contractor is required to put in significant additional resources of its own over and above what was envisaged as part of the standard Service. In such cases, the Change Protocol should:

- enable fair re-imburement of any third party costs (such as consultant fees) incurred by the Contractor to supplement its own resources; and/or
- set out a standard day rate by which any additional Contractor staff time incurred on processing the change (i.e. over and above what is required as part of the Service).

The Contractor should make the case for such additional processing costs on a case-by-case basis and a suitable budget should be established with the Authority before work is commenced.

13.4.3.5 The Authority should consider carefully how performance risk is priced by the Contractor. Where the Contractor is required to raise private finance to fund the change (see Section 13.3.7 above), the “charge” for bearing the Sub-Contractor performance risk will be reflected in the rates of return charged by the funders (both equity and debt) providing the additional finance, and will be reflected in the calculation of the revised Unitary Charge. No separate Contractor mark-up (over and above the appropriately benchmarked cost of capital) should therefore be included within the costing of the change for this reason.

However, where the change is funded by lump sum capital payments by the Authority, the risk of Sub-Contractor failure should be carefully considered.. It may be the case (in limited circumstances such as high-value or complex changes) that the risk of Sub-Contractor default is material. In such cases an additional mark-up in the costing of the change reflecting the risk and impact of Sub-Contractor default may be reasonable.

13.4.3.6 Finally, the Contractor will need to manage any interface risks between the implementation of the change in Service and the existing Service. How significant these interface risks are and what value should be assigned to them will vary from case to case, and it is impossible to generalise. Indeed, in some cases, it is entirely possible that a change in Service may reduce the overall risk for the Contractor. Authorities will need to seek specialist technical advice for the impact and valuation of such interface risks. In any case these risks, where justified, should be priced separately (as higher construction, operating or lifecycle costs, reserve levels and/or rates of return) rather than being included as a standard Contractor mark-up over the basic costs of the change.

13.4.3.7 In summary, there should not generally be any separate Contractor mark-up priced into the costing of changes. The exceptions to this rule would be:

- where the Contractor is likely to be required to put more significant additional resources into the processing of a change (e.g. in procurement or project management) than contemplated as part of the standard change management service (in which case an additional fee should be calculated based on a pre-set daily rate); and
- where the Contractor is not required to raise additional private finance, but is nevertheless asked to take performance risk on the Sub-Contractors implementing the change (in which case a mark-up reflecting the probability and impact of Sub-Contractor failure will usually be reasonable).

13.4.3.8 *Transaction Costs:* Finally, there are the costs of conducting financial, technical, legal and insurance due diligence on variations. All such costs, where reasonably incurred by the Contractor, ought to be re-imbursed or compensated by the Authority provided that budgets are agreed in advance. However, the Change Protocol should require the Contractor to minimise such costs as described in Section 13.3.8 above.

13.4.4 Pricing Issues

13.4.4.1 There are a number of different pricing techniques which could be systematically introduced into the Change Protocol to increase transparency and certainty in pricing changes (although different techniques will be relevant to different types of changes).

13.4.4.2 *Small-Value Changes:* The recommended approach for transparent pricing of small value changes is that Authorities agree a detailed catalogue of small works and Services (at pre-set prices that are linked to a suitable inflation index such as CPI or RPI-X), so that such small-value changes can simply be “called off” the catalogue. For small-value changes that cannot be pre-priced in the catalogue, there should be a schedule of rates for any specialist labour required for design, construction, installation or commissioning purposes, and any cost of materials incurred in implementing the change should be charged at cost to the Authority on an open-book basis or using industry benchmarks such as the BMI price book. Wherever possible, the small value change in service should be carried out by a suitably qualified on-site Contractor employee (e.g. a caretaker or handyman) so that specialist labour charges are avoided¹².

13.4.4.3 Where small-value changes have long-term lifecycle or FM implications, the Contractor should clearly indicate this to the Authority as part of the specification-setting process, and the pricing for such extensions to the FM and lifecycle Services should be done on an open-book and transparent basis. Wherever practicable, however, Contractors should seek to develop a flexible Service solution so that small-value changes (particularly those drawn from a catalogue of pre-priced works and services) can be accommodated relatively easily.

¹² See e.g. the standard PFI Project Agreement for the BSF programme (available at the Partnerships for Schools website www.partnershipsforschools.org.uk) for an example of this approach.

13.4.4.4 *Medium-Value Changes:* One of the difficult pricing issues in respect of medium-value changes is that they can encompass a very large variety of fairly bespoke works and services, and frequently have long-term lifecycle and FM service implications. As a result, they are neither standard enough to allow a pre-priced approach (as for small-value changes) nor large enough to warrant a full-fledged technical audit, benchmarking or competitive tendering approach (as would apply for large-value changes).

13.4.4.5 As a result, it is likely that the best method of introducing greater transparency into the pricing of medium-value changes is to adopt a framework approach with:

- standard allowances agreed between the Authority, the Contractor and the Construction and Services Sub-Contractors at Financial Close for professional fees, overheads, contingencies and profit margins (as described above in Section 13.4.3);
- a schedule of rates for specialist labour services and an agreement to charge the cost of materials based defined on market rates (e.g. the BMI price book); and
- the pricing for any bespoke risks (e.g. site conditions) agreed on an open-book basis.

13.4.4.6 This framework approach could reflect a form of “after-sales support” provided by the Construction Sub-Contractor, and a method of on-going support from the Services Sub-Contractor(s) during the operational period. Other than for projects with very long construction periods, it should be possible for the Construction Sub-Contractor to sign up to a support package for implementing medium-value changes that runs for at least 2 years post-Service Commencement. The framework can then be renewed (depending on use and anticipated activity) every few years from then on by the Contractor, or put out to competition.

13.4.4.7 *Large-Value Changes:* For Large Value changes, it will usually be cost-effective to go through an intensive due diligence process that ensures the Authority can be confident about the value for money of the price developed by the Contractor. Authorities can choose from any of the following approaches to ensuring value for money in pricing large value changes:¹³

- benchmarking;
- independent technical adviser approach; and/or
- competitive tendering/market testing.

13.4.4.8 *Benchmarking:* A benchmarking approach requires the Authority to develop its own independent estimate of the cost of the change in Service (perhaps with the assistance of its own technical advisers), so that it can intelligently query the Contractor’s Estimate, and judge whether or not it is getting value for money. This benchmarking approach can be quite useful and efficient where the types of Works and Services involved are relatively standard and there is sufficient data available in-house to conduct the benchmarking. In the absence of good data however, there is a risk that the approach can collapse into a dispute between the technical advisers on either side, and other alternatives (such as the ones discussed below) should be considered.

13.4.4.9 *Independent Technical Adviser approach:* Under this approach, both parties agree a joint appointment for a suitably qualified independent technical adviser (ITA) who will advise on the pricing for the change in question. This jointly appointed adviser would be independent in the sense that it is not contracted solely to either party and therefore would not face a conflict of interest.

The terms of reference of the ITA could include:

¹³ See e.g. Part 18 of the MOD Standard Form Project Agreement, which gives the Authority the option of two of these techniques in the form of a full technical and cost audit, and/or requiring the Contractor to seek competitive quotes from substitute Sub-Contractors.

- assisting the Authority and the Contractor in developing a high level Reference Price based on a clear specification for the change order as part of the Stage 1 approval, before detailed design or pricing work is done by the Contractor; and
- reviewing and sign off the Contractor's estimates for reasonableness as part of the Stage 2 approval.

The cost of the ITA's services would be borne by the Authority.

13.4.4.10 Competitive Tendering approach: Under this approach, the Authority can require the Contractor to obtain competitive quotes from at least three suppliers for the provision of the Works and Services associated with the change. The Contractor should generally be responsible for:

- deciding how best to package the Works and Service into work packages;
- running the competition for Sub-Contract work packages;
- evaluating and selecting the preferred suppliers;
- negotiating and finalising appointments of suppliers; and
- managing the implementation of the change order.

The Authority should have the following rights in respect of the tendering procedure:

- the right to approve the tendering procedure (including the evaluation criteria) for suppliers to ensure that it is fair and transparent;
- the right to prevent the selection of any person as a prospective tenderer if it reasonably believes that such person does not (or could not reasonably be considered to) comply with the evaluation criteria;
- the right to prevent the selection of any person as a tenderer on the grounds that the prospective tenderer has committed a Prohibited Act;¹⁴
- the right to review the list of prospective tenderers. The Contractor should provide the Authority with an explanation of the reasons behind the non-inclusion on the list of prospective tenderers of any person identified as suitable by the Authority, if so requested by the Authority; and
- the right to dispute the Contractor's decision on the selected tenderer.

Where any company associated with the Contractor, its shareholders or its Sub-Contractors intends to bid, the Authority may require that an independent tender process manager is appointed to manage the tendering process.

13.4.4.11 Authorities involved in the BSF, LIFT and similar partnering-based programmes should also explore the possibility of implementing large-value changes through the project development processes set out in these partnering contracts. One of the merits of the partnering approach is that it allows for projects that cannot be specified fully at the start to be developed over time using an open-book collaborative framework that is designed to test value for money.

13.4.5 Abortive Costs

In cases where the Authority decides to withdraw a request for a change in Service (particularly following Stage 1 approval for large-value changes) and the Contractor has incurred significant third party costs, the Authority should agree to reimburse the Contractor for any such third party

¹⁴ This may also include breach of security requirements in certain sectors. See Section 21.4 (Termination on Corrupt Gifts and Fraud) for the definition of Prohibited Act.

costs reasonably incurred and evidenced in developing proposals up to the time the change request was withdrawn provided that budgets for such costs have been agreed in advance.

13.5 INCENTIVISATION

13.5.1 An important consideration for Authorities in managing changes to their projects is how to ensure the Contractor is incentivised to perform in accordance with the Change Protocol. The procedures set out in the Change Protocol should generally encourage a collaborative working relationship between the Authority and the Contractor, but explicit incentivisation through the payment and performance mechanism is nevertheless recommended.

13.5.2 The Contract should contain some performance indicators for the “change management service” that the Contractor is asked to provide in accordance with the Change Protocol. This should set reasonable targets for the Contractor’s performance (particularly in respect of meeting the agreed timescales for processing and implementing changes). Failure to meet these timescales should attract deductions, which should increase with further delay. The Authority could also consider whether it would offer value for money to reward performance in excess of the targets (i.e. changes processed or implemented earlier than expected) through e.g. bonus payments or reward points that can be used to offset other deductions¹⁵.

13.5.3 Wherever possible, the Contractor and the Authority should both establish a framework of delegated authority to local representatives, so that changes can be agreed and processed quickly with minimum bureaucracy.

13.5.4 Experience from the management of earlier PFI contracts shows that tiers of sub-sub-contracting by the Contractor can slow-down and, potentially, impair the process of communication between the Authority and those providing the Services on the ground. Accordingly, the Change Protocol should include an obligation on the Contractor to ensure that regardless of whether it performs all the Services itself, or through Sub-Contracts or through sub-sub-contracts to any level, the speed and responsiveness of those providing the Service to requests and other communications from the Authority should be in accordance with performance standards set out in the payment and performance mechanism.

¹⁵ See Section 7.2.6

14 CHANGE IN LAW

14.1 INTRODUCTION

14.1.1 The Contractor must comply with all applicable legislation. A failure to comply could give rise to termination for Contractor Default (see Section 21.2 (Termination on Contractor Default)). The cost of complying with legislation which is current or foreseen at the time of the Contract should be built into the price the Contractor bids to provide the Service. Nevertheless, the Contractor may not, for example, be capable of including in the price specific costs arising from changes in law which are not foreseeable prior to contract signature. Accordingly, the issues concern who should be responsible for the costs arising from changes in law and how such costs should be funded.

14.1.2 The treatment of changes in law relates very closely to the issues of indexation, benchmarking and market testing (see Section 15 (Price Variations)), particularly in relation to the risk of increases in operating costs. These provisions must be developed in conjunction with each other when negotiating the overall level of change in law risk to be transferred by the Authority. For example, the more often a Contract provides for benchmarking and market testing to occur (allowing upward revisions of price), then the more likely an apparently tougher change in law provision can be achieved by the Authority. It is recognised, however, that benchmarking, market testing and indexation provisions are not likely to have a significant bearing on the risk transfer position in relation to increases in capital costs due to a change in law.

14.2 CONTRACTOR'S AND AUTHORITY'S CONCERNS

14.2.1 Contractors have in the past expressed concern that change of law is a risk which they cannot control and which they regard as being within the control of the Authority or wider Government. In practice, however, many Authorities (particularly local authorities) have negligible influence over legislation whereas the private sector has traditionally proved adept at managing the effects of changes of law and minimising their impact on their business. Hence it is appropriate for the Contractor to bear or share in the risk.

14.2.2 Under more traditional commercial contracts, the Contractor is usually able to pass on the costs of changes in law to its customers through an increase in price or, in Contracts of relatively short duration, is able to take a view on the prospects of changes in law arising during the term of the Contract. As the prices in PFI Contracts are agreed on a long-term basis and are not flexible in the same way, the Contractor will often not be in a position to price the full cost of prospective changes in law effectively.

14.2.3 A sharing approach is the best way to ensure that the costs of implementing changes in law are minimised. The approach set out in this Section in respect of the sharing of risks relating to changes in law is intended to play to the strengths of both the public and private sectors and ensure that the Contractor is incentivised to manage its costs, even where the Authority agrees to meet the Contractor's costs resulting from complying with a change in law.

14.3 DEFINITION OF CHANGE IN LAW

14.3.1 The Contract should specify that the Contractor is expected to comply with all relevant law and should contain a mechanism for handling the effects of a change in law.

Required drafting for change in law is as follows:

14.3 “Change in Law”

means the coming into effect after the date of this Contract of:

- (a) Legislation, other than any Legislation which on the date of this Contract has been published:
 - (i) in a draft Bill as part of a Government Departmental Consultation Paper;
 - (ii) in a Bill;
 - (iii) in a draft statutory instrument; or
 - (iv) as a proposal in the Official Journal of the European Communities,¹
- (b) any Guidance,² or
- (c) any applicable judgment of a relevant court of law which changes a binding precedent.³

“Legislation”

means any Act of Parliament or subordinate legislation within the meaning of Section 21(1) of the Interpretation Act 1978, any exercise of the Royal Prerogative, and any enforceable community right within the meaning of Section 2 of the European Communities Act 1972, in each case in the United Kingdom.⁴

14.4 ALLOCATION OF RISK OF CHANGE IN LAW

14.4.1 In some projects, it is possible to treat changes in law of any type as the Contractor’s risk. This has occurred in particular in projects in which such costs can be passed on to the users of the Project (e.g. toll bridges).

14.4.2 In other sectors, a risk sharing approach has developed where the main user of the Project is the Authority and it is not appropriate for the Contractor to bear all of the change in law risks as the risk cannot be quantified or passed on to third party users. There are a number of different possible approaches to risk sharing that build on the distinctions between discriminatory/specific legislation and general legislation. These all involve a sharing of the risk of changes in law.

14.5 MITIGATION

14.5.1 Whenever the Authority bears some of the risk of a change in law, the Contractor should be obliged to keep any cost increases to a minimum.

14.5.2 This duty to mitigate can be measured, in part, by reference to the extent to which price increases in comparable sectors are experienced. It will also require the Contractor to foresee and anticipate the effect of changes in law, particularly in relation to expenditure which it has planned to incur anyway in the ordinary course of the Contract. For example, a Contractor cannot on one day change a boiler under its normal maintenance programme and then argue that it immediately has to replace it due to a subsequent change in law which the Contractor should have anticipated

¹ This presumes that such legislation is foreseeable in all projects. A more general foreseeability requirement is also included in the definition of “Qualifying Change in Law”.

² Such as the health sector guidance. Whether this is required will depend upon the sector concerned.

³ This drafting is intended to deal with changes in interpretation of law, which should not be defined more widely.

⁴ See Clause 1.7.2(a)(v) (Interpretation) - Legislation includes any re-enactment, amendment, consolidation or replacement of legislation.

at the time of replacement (and for which the Authority bears the cost in whole or in part). For that reason, any compensation should reflect any anticipated future saved maintenance costs.

14.6 DISCRIMINATORY, SPECIFIC AND GENERAL CHANGES IN LAW

14.6.1 Required drafting for definitions of Discriminatory Change in Law and Specific Change in Law are as follows:

“Discriminatory Change in Law”

means a Change in Law, the terms of which apply expressly to:

- (a) the Project and not to similar projects procured under the PFI;
- (b) the Contractor and not to other persons; and/or
- (c) PFI Contractors and not to other persons.

“Specific Change in Law”

means any Change in Law which specifically refers to the provision of [services the same as or similar to the Service]⁵ or to the holding of shares in companies whose main business is providing [services the same as or similar to the Service].

14.6.2 Required drafting for a definition of General Change in Law is as follows:

“General Change in Law”

means a Change in Law which is not a Discriminatory Change in Law or a Specific Change in Law.⁶

14.6.3 Where a risk sharing approach is adopted in respect of Change in Law (as referred to in Section 14.4.2),⁷ any costs arising from Discriminatory Changes in Law and Specific Changes in Law should be at the Authority’s risk.

14.7 GENERAL CHANGE IN LAW AT CONTRACTOR’S RISK

14.7.1 Costs arising from changes in non-discriminatory/non-specific legislation (i.e. General Changes in Law) can either be for the account of the Contractor or shared between the Contractor and the Authority.

14.7.2 General Changes in Law are generally only at the Contractor’s sole risk in specific sectors where the length of the Contract is such that the Contractor is comfortable that the risk of General Changes in Law occurring is low, or where the relationship between the parties and the history of changes in the sector concerned is such that the Contractor is prepared to accept this risk. For example, in some MOD projects this risk is passed to the Contractor.

14.7.3 Although the Contractor may appear to bear all the risk of General Changes in Law, this approach will often involve some method of mitigating the effect on the Contractor. For example, market testing, benchmarking and/or indexation provisions will in fact lead to the sharing of some

⁵ In a Project involving construction, the “provision” of the Service will include the related construction of an asset to enable the Service to be provided. The Authority and its advisers will need to arrive at a definition of Specific Change in Law that gives protection in relation to Changes in Law which are targeted at companies delivering similar services to those being carried out by the Contractor (e.g. in NHS PFI Projects Specific Change in Law covers changes in law relating to the provision or operation of healthcare premises and changes in NHS requirements).

⁶ See Section 14.8.8 below.

⁷ The Authority should, accordingly, receive the full benefit of cost savings arising from Discriminatory Changes in Law and Specific Changes in Law. How such benefits are passed through to the Authority is a matter for discussion between the parties.

of this risk (see Section 15 (Price Variations)) in that additional operating costs may be reflected in increases to the Unitary Charge following a benchmarking or market testing and/or indexation, although the Contractor will bear such risk for the period up to benchmarking or market testing.

14.8 GENERAL CHANGE IN LAW AS A SHARED RISK

14.8.1 General Change in Law may affect the Project in a variety of ways. For example:

- the change may require alterations to the structure of a building or its fixtures (with an impact both on Capital Expenditure and, potentially, timetable); and
- the change may necessitate a change in the way a Service is delivered (e.g. the number of people required to deliver it or the rights of employees may change).

14.8.2 Costs arising from General Changes in Law should generally be for the account of the Contractor, as the Contractor is protected through the combined effects of benchmarking, market testing and indexation.⁸

14.8.3 This alternative approach recognises, however, that it may be more equitable for the Authority to share costs which are difficult for the Contractor to manage. An exception is therefore made of General Changes in Law which:

- require Capital Expenditure; and
- take effect during the Service Period (i.e. after construction is completed (but see Section 14.8.8)); and
- were not reasonably foreseeable at Contract signature.

Under this approach the costs of a General Change in Law falling within this exception are shared between the Contractor and the Authority. If the change was foreseeable during the construction period although not yet in effect, the Contractor's obligation to mitigate (see Section 14.5 (Mitigation)) would require it to have taken all reasonable action to minimise the eventual cost of implementing such change (e.g. by altering construction works prior to completion). This approach promotes a shared incentive to keep the costs of a change in law to a minimum without exposing the Contractor to excessive risk.

14.8.4 An appropriate approach to sharing the risk of the type of change in law described in Section 14.8.3 is to share such risk on a progressive scale so that, for example, the Contractor takes 100% of the first £x of Capital Expenditure, 75% of the next £y, 50% of the next £z and so on (see the table set out in Section 14.8.10). Once a certain amount is reached, the Authority takes 100% of any amounts above that amount.⁹ The threshold figures agreed and the number of graduated steps will take into account the size of the Project and the impact of other factors such as the likelihood of environmental and health and safety legislation. The levels of Cumulative Capital Expenditure (see Section 14.8.10) are not indexed (as the totals are cumulative, indexation can lead to unnecessary complication). The Contractor's total liability should generally be between 2% to 5% of the initial capital cost of the Project.¹⁰ A cap by reference to time is not recommended.

⁸ The Contractor should also receive the benefits of any cost savings resulting from General Changes in Law. Benchmarking, market testing and indexation should act to restrict the overall benefits received by the Contractor.

⁹ This will enable the Contractor and its financiers to quantify the Contractor's maximum exposure.

¹⁰ Bidders will price into their bid submissions any General Change in Law risk they are required to take. Both the Authority and bidders should seek to ensure that cost and adequate risk transfer are balanced as far as possible to achieve the best value for money.

14.8.5 The advantage of sharing the risk in the way described (as opposed to the Contractor simply being liable for the first £x of Capital Expenditure) is that it both incentivises the Contractor to minimise the cost of implementing the change (as opposed to the Contractor simply invoicing the Authority for whatever it costs) and reduces any concern the Contractor has that the Authority can take advantage of the situation.

14.8.6 Although it is the responsibility of the Contractor to manage the way in which it will fund any increases in capital costs which occur as a result of a General Change in Law occurring during the Service Period, if it is clear to the Authority from the winning bidder's Base Case that it has priced the risk at 100 percent,¹¹ the Authority may wish to retain the risk on value for money grounds. For example, if the Base Case shows amounts being drawn from Senior Debt to fund a so called "Change in Law Reserve Account", the Authority is paying for this account to be placed in-funds as if it were an expected cost of the Contractor.¹² Experience has shown however, that the competitive bidding process incentivises bidders to price the risk at less than 100 percent and Senior Lenders are typically comfortable that General Changes in Law can be managed either by: (i) standby finance (from Shareholders or Senior Lenders); (ii) undrawn revolving working capital facilities; or (iii) building up sums over time from free cashflow without the need for a pre-funded Change in Law Reserve Account because:

- changes in law are usually consulted well in advance;
- there is normally a grace period for implementation; and
- such changes rarely apply retrospectively.

14.8.7 The Authority should generally pay such Capital Expenditure in accordance with the principles set out in Section 13.3.7 (Funding and Payment). Any consequent operating cost increases are borne by the Contractor although these costs will be mitigated by the effects of market testing, benchmarking and/or indexation¹³ (see Section 15 (Price Variations)). The points made in Section 5.2.3 (Calculation of Compensation) are similarly relevant here.

14.8.8 All other General Changes in Law requiring Capital Expenditure (e.g. those which take effect during a typical construction period) should, with this approach, be at the risk of the Contractor in terms of time and money.

14.8.9 For projects which have unusually long construction periods, transferring the risk of General Changes in Law for the entire construction period (rather than adopting a sharing approach) may in fact be poor value for money and is likely to be difficult to achieve in practice (see in particular Department for Environment, Food and Rural Affairs' guidance for Waste PFI projects).¹⁴

14.8.10 Changes arising in operational costs as a result of a General Change in Law should also be borne by the Contractor (subject to Section 15 (Price Variations)). If a General Change of Law requires changes to the Service then either party should be entitled to require a variation to the project specifications to comply with a Change in Law and no breach of contract should arise while this is being done.¹⁵

Required drafting is as follows:¹⁶

¹¹ i.e. 100 pence in the pound.

¹² The cost of funding such an account is not likely to offer good value for money to the Authority.

¹³ Indexation is much less likely to have an effect here than market testing and benchmarking.

¹⁴ See Department for Environment, Food and Rural Affairs website at www.defra.gov.uk.

¹⁵ The required drafting that follows may be incorporated into a Change Protocol as described in Section 13 (Change in Service).

¹⁶ This will have to be adapted to the extent the approach in Section 14.7 (General Change in Law at Contractor's Risk) is taken. The

“Contractor’s Share”

means the percentage figure corresponding to that part of the Cumulative Capital Expenditure at the relevant time, shown in the first column of the table set out below.

Cumulative Capital Expenditure ¹⁷	Contractor’s Share ¹⁸
£0 – £ [a] million (inclusive)	100%
£[a] million to £ [b] million (inclusive)	80%
£[b] million to £ [c] million (inclusive)	60%
£[c] million to £ [d] million (inclusive)	40%
£[d] million to £ [e] million (inclusive)	20%
£[e] million to £ [f] million (inclusive)	10%
£[f] million and above	0%

“Cumulative Capital Expenditure”

means the aggregate of:

- (a) all Capital Expenditure that has been incurred as a result of each General Change in Law that has come into effect during the Service Period; and
- (b) the amount of Capital Expenditure that is agreed, or determined to be required, as a result of a General Change in Law under Clause 14.8 (Qualifying Change in Law).

“Qualifying Change in Law”¹⁹

means:

- (a) a Discriminatory Change in Law;
- (b) a Specific Change in Law; and/or
- (c) [a General Change in Law which comes into effect during the Service Period and which involves Capital Expenditure,²⁰

which was not foreseeable at the date of this Contract.²¹

14.8 Qualifying Change in Law

- (a) If a Qualifying Change in Law occurs or is shortly to occur, then either party may write to the other to express an opinion on its likely effects, giving details of its opinion of:
 - (i) any necessary change in Service,²²

“sharing” approach is set out as it includes both approaches.

¹⁷ These figures are to be bid as part of the bid submission. In each case they are not to be indexed.

¹⁸ These figures are illustrative only and it is open for the Authority or bidders to set the Contractor’s or Authority’s Share at zero or one hundred per cent with no incremental changes, or have only one or two stages in the graduation. This approach will help the Authority find the appropriate level.

¹⁹ It may of course be that there is a particular uncertainty attaching to a particular change in law (even if foreseeable), such as where, for example, its effects can vary by a significant factor. If this is so, then risk sharing can be agreed where the value for money impact is extremely difficult to assess. One example of such an issue is projects for energy from waste plants, given the Electricity Supply Industry Rateable Values Order, SI 1994/3282.

²⁰ This will depend on which option in Section 14.7 (General Change in Law at Contractor’s Risk) is adopted and the extent to which Capital Expenditure is at the risk of the Contractor (i.e. the extent to which such amounts have been included in the bid).

²¹ If any greater clarity can apply to this in a particular Project (such as concerns over particular envisaged changes in law) then this should be expanded upon.

²² For example, the contractual, financial, operational and/or construction implications of the change in Service. Any change in Service should be agreed and implemented in accordance with the Change Protocol described in Section 13 (Change in Service), with the costs of the change being shared as recommended in this Section 14.

- (ii) whether any changes are required to the terms of this Contract to deal with the Qualifying Change in Law;
- (iii) whether relief from compliance with obligations is required, including the obligation of the Contractor to achieve the Planned Service Commencement Date and/or meet the [performance regime] during the implementation of any relevant Qualifying Change in Law;
- (iv) any loss of revenue that will result from the relevant Qualifying Change in Law;
- (v) any Estimated Change in Project Costs that directly result from the Qualifying Change in Law; and
- (vi) any Capital Expenditure that is required or no longer required as a result of a Qualifying Change in Law taking effect during the Service Period,

in each case giving in full detail the procedure for implementing the change in Service. Responsibility for the costs of implementation (and any resulting variation to the Unitary Charge) shall be dealt with in accordance with paragraphs (b) to (f) below.

- (b) As soon as practicable after receipt of any notice from either party under paragraph (a) above, the parties shall discuss and agree the issues referred to in paragraph (a) above and any ways in which the Contractor can mitigate the effect of the Qualifying Change of Law, including:
 - (i) providing evidence that the Contractor has used reasonable endeavours (including (where practicable) the use of competitive quotes) to oblige its sub-contractors to minimise any increase in costs and maximise any reduction in costs;
 - (ii) demonstrating how any Capital Expenditure to be incurred or avoided is being measured in a cost effective manner, including showing that when such expenditure is incurred or would have been incurred, foreseeable Changes in Law at that time have been taken into account by the Contractor;
 - (iii) giving evidence as to how the Qualifying Change in Law has affected prices charged by any similar businesses to the Project, including similar businesses in which the Shareholders or their Affiliates carry on business; and
 - (iv) demonstrating that any expenditure that has been avoided, which was anticipated to be incurred to replace or maintain assets that have been affected by the Qualifying Change in Law concerned, has been taken into account in the amount which in its opinion has resulted or is required under paragraph (a) (v) and/or (vi) above.
- (c) If the parties agree or it is determined under Clause 28 (Dispute Resolution) that the Contractor is required to incur additional Capital Expenditure due to a Qualifying Change in Law (excluding the Contractor's Share of any Capital Expenditure agreed or determined to be required as a result of a General Change in Law under this paragraph), then the Contractor shall use its reasonable endeavours to obtain funding for such Capital Expenditure on terms reasonably satisfactory to it and the Senior Lenders.
- (d) The Contractor's Share shall be solely for the account of the Contractor.
- (e) If the Contractor has used reasonable endeavours to obtain funding for Capital Expenditure referred to in paragraph (c), but has been unable to do so within [60] days of the date that the agreement or determination in paragraph (c) occurred, then the Authority shall pay to the Contractor an amount equal to that Capital Expenditure on or before the date falling 30 days after the Capital Expenditure has been incurred.

- (f) Any compensation payable under this Clause by means of an adjustment to or reduction in the Unitary Charge²³ shall be [see Section 5.2.3 (Calculation of Compensation) above].²⁴

14.9 CHANGES IN TAX LAW

14.9.1 Discriminatory and specific changes in tax law should be dealt with in accordance with Section 14.6 (Discriminatory, Specific and General Changes in Law).

14.9.2 Whichever approach is adopted on General Changes in Law, all costs arising from changes in tax law that are general should be for the account of the Contractor, except as stated in Section 14.10 (Changes in VAT) in relation to changes in VAT legislation.

14.9.3 Save as otherwise expressly permitted by this guidance (e.g. gross up on certain termination payments or change in VAT regime), Authorities should not provide tax indemnities to the Contractor, and the Change of Law provisions should not be used as a device to transfer tax risk.²⁵

14.10 CHANGES IN VAT

14.10.1 Changes in the VAT Rate

14.10.1.1 The Contract should be explicit regarding the consequences of a change in the rate of VAT affecting the Service. Where the Service is within the scope of VAT, a change in the rate will affect the Unitary Charge paid by the Authority. This risk is borne by the Authority.

14.10.1.2 A change in the rate of VAT may also affect the gross costs borne by the Contractor if input VAT is not reclaimable (i.e. the Service supplied by the Contractor to the Authority is specifically disallowed or relates to “exempt supplies” as at the date of the Contract). If the rate changes in relation to supplies received by the Contractor, then the Contractor will benefit or not in the same way as if its general corporation tax bill changes. This risk should, therefore, be borne by the Contractor.

14.10.1.3 Changes in the rate of VAT can lead to a cashflow cost or advantage. There is always a difference in timing of VAT payments and their recovery. A Contractor should not increase its Unitary Charge to deal with any such disadvantage, but instead should take such timing differentials into account in structuring its financing.

14.10.2 Changes in VAT Scope

14.10.2.1 During the course of the Contract, changes in the scope of VAT may affect the Contractor’s ability to recover its input VAT. The Contract should make it clear that the Contractor bears this risk unless it results from a change in the VAT status of the Service e.g. the Service becomes exempt from VAT. In this exceptional case, the Contract should provide for an adjustment to the Unitary Charge.

²³ There will only be an adjustment to the Unitary Charge in respect of increased capital costs if the Contractor’s Share is less than 100% and the Authority does not make a lump sum payment to the Contractor (see Clause 14.8(e) above). Increased operational costs resulting from any General Change in Law are borne by the Contractor and will not result in an adjustment to or reduction to the Unitary Charge (see Section 14.8.7 above).

²⁴ See also Sections 14.6.3 and 14.8.2.

²⁵ If a change of tax law does however fall within the Discriminatory Change in Law or Specific Change in Law provisions, the normal protections available to the Contractor would apply. The loss of charitable status which a Contractor could suffer as a result of any General Change of Law would not fall within these categories.

Suitable drafting is as follows:

14.10 Payment of Irrecoverable VAT

The Authority shall pay to the Contractor from time to time as the same is incurred by the Contractor sums equal to any Irrecoverable VAT but only to the extent that it arises as a result of a Change in Law. Any such payment shall be made within 28 days of the delivery by the Contractor to the Authority of written details of the amount involved accompanied by details as to the grounds for and computation of the amount claimed. For the purposes of this Clause 14.10 "Irrecoverable VAT" means input VAT incurred by the Contractor on any supply which is made to it which is used or to be used exclusively in performing the Works or the Services or any of the obligations or provisions under the Contract (together with input VAT incurred as part of its overhead in relation to such activities) to the extent that the Contractor is not entitled to repayment or credit from HMRC in respect of such input VAT.

15 PRICE VARIATIONS

15.1 INTRODUCTION

15.1.1 The Contract will set out the Unitary Charge for the entire Contract term. However, due to the uncertainties of inflation rates and certain operating costs over a long-term contract, it is usually in the interests of both Authority and Contractor to set out provisions for varying the Unitary Charge in certain specified circumstances. The Contractor should always be encouraged to control its costs, but if there are mechanisms for addressing unforeseeable changes in costs, the Contractor can reduce the contingency in its bid price for such risk. Similarly, although the Authority should ensure it obtains a competitive price initially by holding a well-run competition, it will take additional comfort if there is some means of ensuring the price it has agreed to pay in future years will not be in excess of future market prices for such Services.

15.1.2 The Contract must achieve the right balance between the provisions for change in law (see Section 14 (Change in Law)), indexation and value testing; these are inherently interrelated, particularly in relation to the allocation of operating-cost risk. Contractors will be more willing to take risk in relation to certain changes in law, or in relation to cost increases above the relevant indexation rate, if they have some protection through the value testing provisions (i.e. they can bear certain risks for the period up to value testing as the extra costs are likely to be covered to an extent following value testing). The Authority should consider such inter-relationships when preparing its bid documents.

15.2 INFLATION INDEXATION

15.2.1 The Contractor will be concerned to protect itself against its costs inflating over the course of the Contract, rendering the Unitary Charge insufficient to meet its operating costs and financing obligations.¹ The payment mechanism should therefore usually include arrangements for indexing the Unitary Charge to this extent. If there is no indexation mechanism, the Contractor is likely to have to build a contingency into its price to cover operating-cost inflation risk and this is unlikely to give the Authority value for money (as the risk is outside the control of the Contractor and, historically, has been difficult to forecast accurately). It is highly unusual for prices to be fixed (i.e. without indexation) throughout the term of any Contract for periods for which PFI Contracts are typically let. Conversely, it is not usual for the whole Unitary Charge to be indexed, and such “over-indexation” should not be used as a method of artificially reducing the initial Unitary Charge.

15.2.2 The Authority should focus on the appropriate method of applying indexation to the payment stream at an early stage in Project development. By the time an ITPD is issued, the Contract should specify the index to be applied and how it applies (i.e. how the proportion of the Unitary Charge to be indexed is to be determined). Authorities should not leave the indexation proportion or choice of indices to the bidders, given the difficulties in comparing one bidder’s price and value for money with that of another bidder where different bidders use different proportions and methods of indexation.²

¹ See HMT’s Application Note—*Interest-Rate & Inflation Risks in PFI Contracts* (May 2006). The possible adjustment to Unitary Charges for movements in interest rates in the periods before or after contract signature are not considered here, but see Section 33.2.1 and HMT’s Application Note.

² It is open to the Authority, however, in the interests of value for money, to invite bidders to propose alternative indices, provided the choice of such alternates is supported in the bid with appropriate Models demonstrating their financial impact and the issues addressed in HMT’s Application Note referred in footnote 1 above are properly addressed.

15.2.3 Authorities should bear in mind that the use of benchmarking or market testing gives some protection to Contractors for the Services covered by these arrangements. In most cases value for money can be achieved through indexation of a proportion of the Unitary Charge which matches the proportion of total costs represented by any elements of the Contractor's underlying costs which are not fixed, using a general price index such as RPI or RPIX.

15.2.4 On certain projects, the use of a more focussed index such as a construction index for construction prices, a facilities management index, or a weighted basket of indices, may be preferable. In these cases, the Authority should take care with index selection. Choosing an index that may be short lived, or is not independently produced, is not a sensible approach.³ It is also not appropriate to have too narrow a focus on a particular industry or sector, as in specific sectors (such as the defence industry), Contractors or their Affiliates are themselves responsible to a significant extent for inflationary costs (that is, they can actually affect the index by increasing their price).⁴

15.2.5 Whilst choosing an index and weighting that reflect the underlying cost exposure of the Contractor has the effect of reducing its cost risk, amended forms of such indexation formulae can incentivise real cost savings over the life of the Contract.⁵

15.2.6 For more detailed guidance in this area, please see HMT *Application Note – Interest-Rate and Inflation Risks in PFI Contracts* (May 2006).

15.3 VALUE TESTING OF OPERATING COSTS

15.3.1 Introduction

15.3.1 As noted above, it may be beneficial to include within the Contract provisions for periodic value testing of certain Services provided by the Contractor. By "value testing", this guidance generally refers to either market testing or benchmarking, although other forms of value testing may sometimes be appropriate.

15.3.2 Market testing means the re-tendering by the Contractor of a relevant Service to ascertain the market price of that Service. This may lead to the replacement of the Sub-Contractor operating such Service by the winning bidder. Any increase or decrease in the cost of such Service following market testing should be reflected by an adjustment in the price charged to the Authority.

15.3.3 Benchmarking is a process by which the Contractor compares either its own costs or the cost of its Sub-Contractors for providing certain Services against the market price of such Services. This may lead to a price adjustment, but not to a change in the sub-contractor providing the Service.

15.3.4 The Services provided by the Contractor that are suitable for value testing are generally limited to soft services. By "soft services", this guidance means Services such as facilities management services for an accommodation project (e.g. catering, cleaning and security), to the extent they do not involve a significant capital outlay in their performance or affect the value of any capital asset under the Contract. These services are suitable as the prices charged by the

³ In any event, the Contract should include provisions dealing with circumstances where the specified index (or indices) is not published or the basis upon which it is calculated is changed – see Section 1, footnote 45.

⁴ Suggested drafting on indexation can be found in Clause 1.7.2(b) (Interpretation).

⁵ One such amended indexation formula of $x \times (1 + RPI \pm y)$ could be used by the Authority in its ITPD, with bidders required to bid values of x and y . Where future cost reductions are reasonably foreseeable and not reflected in the initial Unitary Charge these can be reflected in the value of y . The bidder can propose a value of x reflecting the percentage of any elements in its cost structure that are not fixed. The variable x will therefore be a number between 0 and 1.

incumbent sub-contractor and by various potential sub-contractors for such services from year to year should be comparable. Where an incumbent sub-contractor has incurred capital costs, its price cannot be expected to compete with the price of a bidder who was not required to incur those capital costs. Services such as building “re-fit” or lifecycle maintenance or “heavy maintenance” of equipment should not generally be market tested or benchmarked.⁶ These services are referred to as “hard services”.

15.3.5 Providing for periodic value testing of soft services in the Contract may benefit both the Authority and the Contractor. Testing against the market is an important mechanism for the Authority to ensure that the soft service costs remain value for money over the life of the Contract and that the Contractor does not become complacent in its pricing or delivery. In addition, if the Contractor was required to enter into a fixed price long-term contract for soft services (with a simple indexation mechanic and the assumption of operational change of law risk) without any form of periodic testing, significant risk reserves may need to be built into its price. This in turn would not offer value for money to the Authority. It is important that both the Authority and the Contractor understand the purpose of the value testing process and the results it may yield. In particular, if the Contractor has misjudged its original service delivery bid or is inefficient in its operation, value testing should not be viewed by it as a means of passing Service or delivery risk back to the Authority.

15.3.2 Choice of Value Test - Preference for Market Testing

15.3.2.1 It is now standard practice in most sectors of the PFI market to include some form of value testing. The recommended approach in Version 3 of this guidance was to adopt benchmarking as the preferred value testing mechanism and to use market testing only to the extent that the parties cannot agree on the outcome of benchmarking. This position has now changed.

15.3.2.2 Market testing allows a more flexible approach to the provision of Services than benchmarking because it ensures that the soft service provision for the Project can be re-assessed to match public sector requirements at the time the exercise takes place. Market testing also offers greater opportunity for transparency and competition. Accordingly, and because of a greater maturity in the soft services market, the recommended approach is to provide for market testing of soft services, as this is most likely to yield best value for money.

15.3.2.3 In certain limited circumstances however, it may not be appropriate to provide for market testing. For example:

- the Service may be specialised and only provided by one or two contractors, or it may require specific security clearance. In these cases neither market testing nor benchmarking may be appropriate but some alternative form of value testing such as profit-sharing may be considered,⁷ or
- there may be no competitive market for the relevant Service in the area, although Authorities should be expected to actively develop a market for the Service where possible. If no competitive market exists or can be developed and effective market testing would thus be impossible, benchmarking (perhaps against suppliers of a similar service operating in a different geographic region) or an alternative form of value testing may be used.

⁶ In some Contracts, it may nevertheless be possible for the Contractor to market test or benchmark “hard services” because they are of a standard nature (e.g. routine vehicle maintenance). The decision on the appropriateness and extent of market testing or benchmarking should be considered on a case by case basis in such Contracts.

⁷ See for instance Part 15 of the MOD PFI Standard Contract (August 2006) and related guidance, on the MOD website, www.mod.uk where, on these grounds, they provide for a value for money review instead of a benchmark or market test procedure.

Authorities should consult their relevant departmental Private Finance Units for guidance where benchmarking is proposed instead of market testing.

15.3.2.4 Whether the Authority determines market testing or benchmarking to be appropriate, it should consider whether it would be beneficial to include provisions in the Contract for an alternative method of value testing. Where market testing is selected as the primary value testing method, provisions could be included to allow the Authority to require a benchmarking process following the initial market test procedure if the market test fails, perhaps due to lack of any bidder other than the incumbent.

15.3.2.5 Similarly, where benchmarking is thought to be the most appropriate value test, it will usually be appropriate to include provisions in the Contract to allow the Authority to require a market test, at its discretion, with or without a prior benchmarking process. Benchmarking on its own is unlikely to produce best value for money results. Authorities should move to market testing following a benchmarking process where adequate benchmark data was not available, a robust benchmark process had not been achieved, or a price adjustment was not agreed. Further, it would be appropriate to move straight to a market test where benchmarking was selected due to a lack of competitive market, and a sufficiently competitive market has developed between Contract signature and the value testing date.

15.3.2.6 Different Services within the same Project may need different treatment (or possibly the same Service could have different treatment at different points in the Project). Authorities need therefore to consider their options carefully both at the outset and at any value testing point.

15.3.3 Planning and Management

15.3.3.1 At the outset of the Project, when developing its business case, the Authority should consider what Services it needs and whether it is appropriate to include soft services (see paragraph 4.25 and beyond of HMT's *"Value for Money Assessment Guidance"* November 2006). An Authority may decide that only those Services intimately connected with the design solution of the Project, such as hard services, should be included in the Project; a number of hospital projects have taken this route. If soft services are to be included in the Contract, the nature of the individual services and their degree of integration in the design solution and with each other needs to be considered.

15.3.3.2 The Authority should specify in the ITPD when the first value testing exercise will take place. Commonly the value testing exercise will occur at five to seven year intervals with a longer interval before the first exercise. The longer initial period (which should be well into the Service Period) should ensure that bidders do not set a deliberately low initial price that they then try to increase through the review. An excessively long initial period may, however, expose the Authority to an unreasonable price premium for transferring this risk. Where benchmarking is appropriate, the first benchmarking exercise could be limited such that it is capable of resulting in decrease in price only or a capped increase in price.

15.3.3.3 Some early projects have experienced practical difficulties in managing their benchmarking and market testing procedures and some early contracts lack detail on these processes. Contracts in any event are unlikely to provide a comprehensive blue print for such procedures. The Operational Taskforce has published guidance on this entitled "Operational Taskforce Note 1: *Benchmarking and market testing guidance*" (October 2006)⁸ which, in particular, sets out the relevant practical considerations to be taken into account. Any practitioners preparing for a market test or benchmark exercise should refer to this.

⁸ See HMT website at www.hm-treasury.gov.uk.

15.3.3.4 Benchmarking and market testing are the responsibility of the Contractor, from both a cost and management perspective. Depending on the Project, this may involve an independent tender manager being employed to manage the market testing and/or benchmarking processes. Having some independent management level (coupled with appropriate information barriers) would be essential where the current service provider, or any bidder, or any member of their respective groups, had a shareholding interest in the Contractor or relevant sub-contractor.

15.3.3.5 This guidance assumes that the person providing the soft services to be benchmarked or market tested is an operating Sub-Contractor who has a direct contractual relationship with the Contractor. If the relevant Services are instead being provided by a sub-contractor to such an operating Sub-Contractor, and thus there is no direct contract with the Contractor, the same principles apply. However, in these cases the calculation of pricing adjustments to the Unitary Charge following value testing may become more complicated, since the relationships between cost and price charged to the Contractor become more remote.⁹

15.4 MARKET TESTING

15.4.1 As outlined in Section 15.3.2, the recommended approach is to provide for market testing of soft services in the Contract, as this is most likely to yield best value for money. The procedure for market testing should be as follows:

- on certain fixed dates, the Contractor re-tenders the relevant Project Document and conducts a competition for potential replacement sub-contractors (and normally the existing sub-contractor would be allowed to bid).¹⁰ Care must be taken to avoid any conflict of interest issues, for instance where the Contractor may be part of the same corporate group as any bidder;¹¹
- if the competition shows that the Contractor can obtain better value for money with a new winning tenderer, then the Unitary Charge should be reduced (as described in Section 15.5.4) and the Contractor would obtain a reduction in cost by appointing the winning tenderer as a replacement sub-contractor; and
- if the competition shows that the Contractor's current sub-contractor is better value for money than any potential replacement, then the sub-contractor should continue, but with an appropriate change being made to the Unitary Charge to reflect the sub-contractor's bid price.

See further Operational Taskforce Note 1 referenced at footnote 8.

15.4.2 Information will need to be collected by the Contractor and made available to tenderers for the market testing to be effective. For example, information relating to the terms and conditions, job title, age, length of service and benefits of the employees of the service provider engaged wholly or mainly in the provision of the market tested services may be required.¹² The Contract should provide that this information is provided to the Authority (see Section 26, (Information and Confidentiality)).

15.4.3 The Contract should also make clear that the market testing of each Service is the responsibility of the Contractor who should ensure a smooth transition between sub-contractors.

⁹ See Chapter 5 of Operational Taskforce Note 1 "*Benchmarking and market testing guidance*", October 2006.

¹⁰ If, in unusual projects, the Authority is concerned that there may be a lack of bidders, the Authority could consider provisions whereby the incumbent was required to bid (if otherwise no bids might be made). If this is considered a possibility however, this may indicate that these are not actually suitable Services to be market tested. See Section 15.3.2.3.

¹¹ See Chapter 4 of Operational Taskforce Note 1 "*Benchmarking and market testing guidance*", October 2006. See also footnote 18 below.

¹² It may also be appropriate for the Contractor to make available to tenderers information relating to the relevant Service provider's shareholding in the Contractor (and/or Operating Sub-Contractor), including the terms of any associated shareholders' agreement.

The Authority may however wish to actively support the Contractor in encouraging bidders for the relevant Services, perhaps by the appointment of an independent tender manager, in order to ensure there are sufficient bidders willing to compete against an incumbent Service provider to provide an effective competition.

15.4.4 Suitable drafting for a market testing programme is as follows:

15.4.4 Market Testing

- (a) At least [40] weeks¹³ before each market testing date, the parties shall meet together as often as may be necessary in respect of all market tested services to be market tested on that date:
- (i) to consider any changes required to the relevant services;
 - (ii) to discuss and seek to agree the appropriate manner of advertising the services required and the means of identifying prospective tenderers;¹⁴
 - (iii) to discuss and seek to agree the tender requirements which must include:
 - (A) a statement of the tender validity period;
 - (B) details of the tender evaluation criteria;¹⁵
 - (C) the terms and conditions under which the services will be contracted;
 - (D) information relating to employees and their conditions of employment;¹⁶
 - (E) the information that tenderers are required to provide;
 - (F) how many tenders are required for the market testing to be valid; and
 - (G) whether or not an independent tender manager needs to be appointed by the Contractor to manage the tender process.

15.4.5 Where a number of Services are being market tested, the question may arise as to whether bidders must tender for all such Services or whether they can select certain Services and tender in respect of those only (for example, some bidders may only want to take over the catering function, whereas others may want a wider role). One way of dealing with this is as follows:

Grouping of Services

Unless the Contractor can demonstrate to the Authority that best value for money is likely to be achieved for the Contractor if market tested services are tendered separately or in particular groupings, or if any market tested service is divided into separate parts, the grouping of any market tested services shall be left to the discretion of tenderers on the basis that the tender requirements shall specify that:

- (a) tenderers may submit tenders for all or any of the market tested services; and
- (b) if a tenderer submits a tender for a group or groups of market tested services, then it may be required to provide all or any of the services in such group or groups.¹⁷

¹³ Precise timing will depend on whether any prior benchmarking exercise is conducted. See Section 15.3.2.5 above.

¹⁴ This may include an OJEU notice. See further guidance at footnote 8.

¹⁵ These must be objective criteria.

¹⁶ This will deal with any exclusion required (such as retirement benefits and occupational pensions). Applicable TUPE regulations must be complied with.

¹⁷ The Authority should be aware of the danger of any less attractive services not being bid for and so may require these to be included in bids.

15.4.6 The next step in the market testing provisions will be to specify how tenderers are selected.¹⁸ A suggested way of doing this is set out below:

Selection of Tenderers

- (a) The Contractor shall be responsible for compiling the list of prospective tenderers and selecting the tenderers from the list of prospective tenderers on the basis of their:
 - (i) financial standing; and
 - (ii) technical and managerial experience and ability (taking into account any relevant references).
- (b) The Authority shall have a right to prevent the selection of any person as a prospective tenderer if it reasonably believes that such person does not (or could not reasonably be considered to) comply with any of the criteria referred to in Clause 15.4.4 (a)(iii) above.
- (c) The Authority shall, in its absolute discretion, have the right to prevent the selection of any person as a tenderer on the grounds that the prospective tenderer has committed a Prohibited Act.¹⁹
- (d) The Authority shall have a right to review the list of prospective tenderers. The Contractor shall provide the Authority with an explanation of the reasons behind the non-inclusion on the list of prospective tenderers of any person identified as suitable by the Authority, if so requested by the Authority.
- (e) The Contractor shall provide any prospective tenderer which is unsuccessful in being selected with an explanation of the reasons behind its non-selection, if so requested by the person in question.

15.4.7 Once the period for submission of tenders has ended, the Contractor must determine the best tender. The following drafting deals with this issue:

- (a) The Contractor shall determine which compliant tender in respect of any market tested service represents the best value for money.²⁰
- (b) On making this determination, the Contractor shall supply to the Authority a copy of its tender evaluation, together with sufficient supporting information concerning the tender evaluation to enable the Authority to analyse and understand the basis for the Contractor's determination.
- (c) If the Authority does not agree with the Contractor's determination, the Authority may, within 15 Business Days of being provided with the tender evaluation, dispute such determination and, if the parties do not resolve such dispute within a further 15 Business Days, the dispute shall be dealt with in accordance with Clause 28 (Dispute Resolution).

¹⁸ The Contract will also have to deal with the extent to which any person is disqualified from selection as a tenderer merely by virtue of its connection with any other person in the Project. Typically, no such connection should disqualify a tenderer provided an independent tender manager is appointed and appropriate information barriers are put in place. See Section 15.3.3.4.

¹⁹ This may also include breach of security requirements in certain sectors. See Section 21.4 (Termination on Corrupt Gifts and Fraud) for the definition of "Prohibited Act".

²⁰ If only one compliant tender is submitted in respect of some or all of the market tested services, the Authority is at risk of being obliged to pay an uncompetitive price for that part or all of the Service. Accordingly, the Contract may provide a right for the Authority to prevent the Contractor appointing a single bidder and passing those costs onto the Authority through the Unitary Charge without its approval. The risks of only one such bid being received in practice should be remote and capable of assessment by the Contractor (unless there are project specific reasons to the contrary) which should enable the Contractor to accept the inclusion of a provision of this nature. If the parties wish to specify what would happen in those circumstances, the provision should be amended on a project specific basis.

15.4.8 On selection, the winning tenderer will take over the provision of the Service and the Unitary Charge should be adjusted on the basis agreed in the Contract. As the Contractor is responsible for the market testing, the Authority should be indemnified against any claims brought against it (for example, from a losing tenderer) as a result of any market testing (for example, for a breach of the agreed market testing procedures).

15.5 BENCHMARKING

15.5.1 The following provisions of this Section 15.5 are relevant if a benchmarking process is included in the Contract, either as the sole value test or included along with market test provisions (as outlined in Section 15.4).

15.5.2 To ensure any benchmarking exercise provides a good comparison with the costs of a Sub-Contractor, the Contractor will have to ensure the following issues are addressed:

- that the cost comparison encompasses only the services being benchmarked;
- that the cost comparison includes factors relating to risks inherent in a change of service provider (such as mobilisation costs);²¹
- that Contractors' own costs are not used as a benchmark;
- whether individual services are to be benchmarked separately, in clusters, or all together;
- whether it is possible to rely on the information being provided by those persons contacted for benchmarking information;
- whether it is possible to verify the appropriateness of the benchmarking information as a comparator for the service being benchmarked; and
- whether there is any other reason or factor that would make benchmarking unrealistic or impracticable.

See further Operational Taskforce guidance referenced at Section 15.3.3.3 above.

15.5.3 The procedure for carrying out a benchmarking exercise is as follows:

- on certain fixed dates, the Contractor compares certain of its costs (e.g. what it pays its Sub-Contractors providing soft services) with equivalent prevailing market costs (e.g. what it would have to pay other Sub-Contractors to provide the equivalent service) and, if appropriate, proposes a variation to the Unitary Charge;
- the Authority and the Contractor should generally begin planning 40 weeks ahead of the benchmark adjustment date in order to allow sufficient time to complete the benchmarking process (and allow a market testing to occur, should this be needed and provided for in the Contract), though this period could be longer or shorter depending on the scale and nature of the relevant services;
- if the market cost is higher than the Contractor's current costs and the current Sub-Contractor is still obliged to provide the Service at the lower price, there is no need to adjust the Unitary Charge (it may be that the Sub-Contractor concerned is simply more efficient than the rest of the market);

²¹ Another relevant consideration may be the credit standing of a replacement service provider. This will depend upon the particular service being benchmarked (or market tested) but will be of specific application where the particular service involves significant capital outlay over a long term.

- if the market cost is higher than the Contractor's current costs and the current Sub-Contractor is contractually entitled to review its price, the Unitary Charge may be adjusted (although this will not necessarily be the case - see Section 15.5.4);
- if the market cost is lower than the Contractor's current costs, there should be an adjustment to the Unitary Charge (see Section 15.5.4). It could be that the Sub-Contractor is not as efficient as its competitors. The price decrease should encourage the Contractor to take appropriate steps to reduce its costs (for example by replacing the sub-contractor, taking into account the costs of such replacement). The Authority should encourage efficiency, for example by comparing the Contractor's costs to those of the most efficient quartile of the market, rather than the median;
- the Authority must have the right to inspect the Contractor's and sub-contractor's cost information to confirm cost details. Full transparency of cost information is needed for benchmarking to function properly (see Clause 26.2 (Contractor's Records and Provision of Information) and
- if the Authority and the Contractor cannot agree on any price adjustment or the Authority is not satisfied that there has been a robust benchmark process, then if the Contract so provides the Service concerned should be market tested (see Section 15.4 (Market Testing)).

15.5.4 The outcome of the review should not necessarily be a direct pass-through to the Authority of the benefit or burden of all the cost change. There should instead be a formulaic adjustment that shares any cost increase or decrease in a way that incentivises the Contractor to control its costs. The sharing ratios need not be symmetrical on an upwards and downwards price variation, and the Authority should assess the likely value for money impact of a greater sharing in a price reduction than a price increase when deciding on such an approach.

16 SUB-CONTRACTING, EMPLOYEES AND DOCUMENTARY CHANGES

16.1 CONTROL OVER SUB-CONTRACTORS

16.1.1 The Authority often has the perception that it must retain a large degree of control of a subjective nature over Sub-Contractors. This perceived need for control applies both to the performance of the Sub-Contractors and to any procedure for appointing replacement Sub-Contractors. The Contractor's stated view is often that as it originally selected these Sub-Contractors and has taken risk on their performance, it should be entitled to change them at will (for example, if they are not performing) whilst recognising the legitimate interest of the Authority in the identity of key sub-contractors (as provided for in Section 16.1.5).¹

16.1.2 In general, attempts by the Authority to control Sub-Contractors are to be discouraged as it is in most cases unnecessary and may dilute the level of risk transfer achievable by the Authority (see also Section 9.4 (Monitoring of Sub-Contractors)). The Authority should in any event (if control is needed) generally only seek a degree of control in relation to Sub-Contractors and not in relation to sub-contractors of Sub-Contractors, though the ability to engage directly with the service provider on-site may also be needed (see further Section 13.5.3).

16.1.3 In certain limited cases, there may be overriding reasons why the Authority should have a degree of control over sub-contractors. For example, there may be national security issues (particularly in some defence projects), other public interest issues (e.g. regarding who should be allowed to be involved in schools), or the Authority may have a statutory duty that it needs to carry out.

16.1.4 In such cases, the criteria that a replacement sub-contractor must satisfy should be reasonable (for example, they should require that the potential sub-contractor is not a threat to national security or other relevant aspect of the public interest). Any judgment that the potential sub-contractor does not satisfy the criteria should be based on objective evidence. For example, a judgment that employment of a certain sub-contractor would represent a threat to national security or the public interest should be made on the basis of concrete information received from a relevant legal, financial or other authority demonstrating that the national interests would be detrimentally affected. In the majority of cases, criteria of this nature will not be needed.

16.1.5 In cases in which there is no specific reason to control sub-contractors, the Authority may still want some control on the basis that it placed reliance on the original sub-contractor's identity and ability to perform in awarding the Contract to the Contractor. In such cases, satisfaction of a limited set of objective criteria should prove an acceptable level of control to the Authority and the Contractor. Any such criteria should include:

- technical ability and competence; and
- financial strength (including any willingness to give guarantees to the Contractor).

16.1.6 If in the circumstances described the Authority retains some control over replacement Sub-Contractors or sub-contractors of Sub-Contractors, these controls will also apply to any substitute Sub-Contractors or sub-contractors whom the financiers wish to appoint in accordance

¹ Controls over the performance and identity of Sub-Contractors will be expected by Senior Lenders. These controls will be set out in the Senior Financing Agreements.

with their rights under the Direct Agreement (see Section 31 (Direct Agreement and Senior Lenders)).

16.2 CONTROL OVER EMPLOYEES²

16.2.1 The Authority should not generally seek to control whom the Contractor (or its sub-contractors) employs, except where there are valid reasons to do so (e.g. overriding public policy considerations, national security issues, security clearances or statutory duties).

16.2.2 The Authority's concerns are likely to be focussed on preventing or terminating the employment of persons with a criminal conviction relevant to their employment. This is unlikely to be an issue for the Contractor where the concern relates to a matter which is also of concern to the Contractor (e.g. dishonesty convictions). The Contractor will be equally keen to build in safeguards into its employment procedures to take action against dishonest employees.

16.2.3 Examples where a degree of Authority control is required include prison and defence projects, where the Authority retains a need to approve all staff because of statutory duties relating to sensitive security considerations. The Authority has the right to prevent the employment, or require the removal, of any staff. Similarly, public policy considerations may mean that an Authority involved in school projects, for example, does not want employees with convictions of a certain nature (but, again, the Authority and Contractor are likely to have a common interest on such issues).

16.2.4 In the cases in which the Authority is justified in retaining a degree of control over the Contractor's employees, the Authority should agree the relevant restrictions with the Contractor as part of the bidding process. The Contractor's personnel and employment policy will need to reflect the Authority's requirements and this may have a cost implication. The Contract provisions should be reasonable and allow the Authority to veto or require the removal of staff, with the Contractor bearing the risk of the consequences of such action. Any judgment that an employee does not satisfy certain relevant criteria should, to the extent within the Authority's control, be made on the basis of objective evidence. Contractors should note that certain security clearance procedures may be outside the control of the Authority.

16.2.5 Controls need to be exercised over employees at the end of the Service Period, where the considerations referred to in Section 20.4 (Handover Provisions for Assets which transfer to the Authority) apply. Other statutory restrictions will still apply after the end of the Service Period (for example, the Official Secrets Acts 1911, 1920, 1939 and 1989).

16.3 CONSEQUENCES OF CONTROL

16.3.1 If the Authority does retain some control over sub-contractors and/or employees then the Contract should contain a procedure to be followed to confirm whether the Authority has any objections to a particular party. Any failure by the Authority to respond within the specified time limit should be dealt with in accordance with Section 5.2 (Compensation Events). Authorities should consider carefully whether their "approval" can be deemed to be given if they fail to respond.

² For more general guidance on TUPE issues, please see the 4ps Guidance "*Code of Practice on Workforce Matters in Local Authority Service Contracts*" on the 4ps website and please see "*Standardisation of PFI Contracts for Local Authorities*", published on the HMT website and the TUPE provisions contained in the BSF standard form schools PFI contract.

16.4 CHANGES TO PROJECT DOCUMENTS AND FINANCING AGREEMENTS

16.4.1 The Contractor will want to retain flexibility in case its sub-contracting or financing arrangements need updating, but the Authority will want to ensure that this does not prejudice the Project, and that the Project Documents and Financing Agreements reviewed by it prior to Financial Close, as part of its due diligence, are not simply rewritten. Section 22.3.8 ensures that the Authority's own exposure to liability on termination of the Contract is not increased without the Authority's consent, despite any changes being made to the Project Documents or Financing Agreements. Section 34 (Refinancing) contains further provisions relating to the amendment of Financing Agreements. If, however, an Authority feels that this protection is insufficient and that any Project Document or Financing Agreement entered into by the Contractor is sufficiently important to require ongoing oversight, provision for this may be made in the Contract. Authorities should not use this as a device to micro-manage delivery of the Service. Suitable drafting is as follows:

16.4.1 Delivery of Initial and Changed Project Documents and Financing Agreements

- (a) The Contractor has provided to the Authority copies of the Project Documents³ [(as listed in Part 1 of Schedule [])] and of the Initial Financing Agreements [(as listed in Part 2 of Schedule [])].
- (b) Without prejudice to the provisions of Clauses 16.4.2 or 16.4.3, or to the definition of Senior Financing Agreements in Clause 1, if at any time an amendment is made to any Project Document or Financing Agreement, or the Contractor enters into a new Project Document or Financing Agreement (or any agreement which affects the interpretation or application of any Project Document or Financing Agreement), the Contractor shall deliver to the Authority a conformed copy of each such amendment or agreement within ten (10) Business Days of the date of its execution or creation (as the case may be), certified as a true copy by an officer of the Contractor.

16.4.2 Changes to Project Documents

The Contractor shall perform its obligations under, and observe all of the provisions of, the Project Documents and shall not:

- (a) terminate or agree to the termination of all or part of any Project Document;
- (b) make or agree to any material variation of any Project Document;
- (c) in any material respect depart from its obligations, (or waive or allow to lapse any rights it may have in a material respect), or procure that any counterparty to a Project Document in any material respect departs from its obligations (or waives or allows to lapse any rights they may have in a material respect), under any Project Document; or
- (d) enter into (or permit the entry into by any other person of) any agreement replacing all or part of (or otherwise materially and adversely affecting the interpretation of) any Project Document, unless the proposed course of action (and any relevant documentation) has been submitted to the Authority for review and there has been no objection made by the Authority within [] Business Days of receipt by the Authority of such submission, or such shorter period as may be agreed by the parties, [and provided, in the circumstances specified in Clause 16.4.2 (a), that the Contractor has complied with the provisions of [Section 16 (Sub-Contracting,

³ If there are any key second tier sub-contracts (beneath the main construction Sub-Contract or operating Sub-Contract) these could also be listed here and additionally referenced, as appropriate, in Clauses 16.4.1 (b) and 16.4.2.

Employees and Documentary Changes)].⁴ The Authority may only make objection on the following reasonable grounds [].⁵

16.4.3 Changes to Financing Agreements

Without prejudice to the provisions of Clauses 16.4.1 (Delivery of Initial and Changed Project Documents and Financing Agreements), 22.3 (Changes to Financing Agreements and Project Documents), and 34 (Refinancing), the Contractor shall not, without the prior written consent of the Authority, enter into new Financing Agreements or terminate, amend, waive its rights or otherwise deal with its Financing Agreements if the same may reasonably be expected to have a material adverse effect on the ability of the Contractor to perform its obligations under the Project Documents or this Agreement.

⁴ Reference to control over Sub-Contractors is only relevant if the Authority has decided to take approval rights as described in Section 16.1. If so, the relevant clause should be cross referenced.

⁵ The Authority should list out its possible grounds of objection, which may be based around any adverse consequences to the Contractor, the Authority or the Services. If the Contract makes provision for a formal Review Procedure, proposed changes pursuant to this Clause 16.4.2 could be put through this rather more detailed procedure and this provision amended accordingly (see for example the March 2006 BSF School Standard Form on the PfS web site at Clause 7 and Schedule 8 and in particular paragraph 3.1.2 "Grounds of Objection").

17 ASSIGNMENT

17.1 INTRODUCTION

17.1.1 Over the course of a long-term contract, the identity of the Authority, the Contractor or its financiers may change to some extent. This should be recognised at the time of negotiating the Contract and an appropriate balance struck which allows some flexibility for change where appropriate but gives the parties sufficient comfort about the identity and/or creditworthiness of their counterparties.

17.2 RESTRICTIONS ON THE CONTRACTOR

17.2.1 The Contract should not allow the Contractor to assign, novate or transfer its rights under the Contract, except as part of its Senior Lenders' security package. If a replacement Contractor is appointed by the Senior Lenders in accordance with their rights under the Direct Agreement (see Section 31 (Direct Agreement and Senior Lenders)), the Contract should allow for the original Contractor's rights and obligations to be transferred. Senior Lenders may also, in accordance with security rights which they may take over the shares in the Contractor, transfer these shares as allowed by Section 18.4 (Transfer of Interest: Flexibility and Restrictions).

17.3 RESTRICTIONS ON THE AUTHORITY

17.3.1 The Contract should generally not allow the Authority to assign or transfer its rights or obligations under the Contract without the consent of the Contractor.

17.3.2 The main exceptions to the above are where transfer either takes place under statute or is required to facilitate a public sector reorganisation. Specific exceptions may also have to be provided for in a particular project if a transfer is anticipated (e.g. the London Underground project which was, under statute, transferred to Transport for London) or particular sectors (e.g. the local authority sector where transfers may be required due to boundary changes). Authorities should recognise that financiers will be concerned to ensure that any transferee's covenant is as strong as that of the original Authority and that the transfer could not prejudice their security.¹ If this is not the case, appropriate credit enhancement (e.g. in the form of a guarantee) may be required so that the Contractor's position is not prejudiced. Where such a right is required by the Authority, appropriate drafting for both central and non-central government projects is set out below.

Required drafting is as follows:

17.3(A) Restrictions on Transfer of the Contract by the Authority in Central Government Projects

The rights and obligations of the Authority under this Contract shall not be assigned, novated or otherwise transferred (whether by virtue of any Legislation or any scheme pursuant to any Legislation or otherwise) to any person other than to any public body (being a single entity) [acquiring the whole of the Contract and] having the legal capacity, power and authority to become a party to and to perform the obligations of the Authority under this Contract being:

¹ Pursuant to the Enterprise Act 2003 (the "Act"), lenders to PFI transactions can benefit from exemption from the effect of the changes to the Insolvency Act made by the Act. This exemption may only be available to the extent that the PFI Contract is between the Contractor and a public body; accordingly, financiers will be concerned to ensure that the Contract cannot be transferred to a non-public body (whether or not any proposed non-public body transferee's obligations are guaranteed by a public body).

- (a) a Minister of the Crown pursuant to an Order under the Ministers of the Crown Act 1975; or
- (b) any other public body whose obligations under this Contract are unconditionally and irrevocably guaranteed (in a form reasonably acceptable to the Contractor) by the Authority or a Minister of the Crown having the legal capacity, power and authority to perform the obligations under the guarantee and the obligations of the Authority under this Contract.

17.3(B) Restrictions on Transfer of the Contract by the Authority in Non-Central Government Projects

The rights and obligations of the Authority under this Contract shall not be assigned, novated or otherwise transferred (whether by virtue of any Legislation or any scheme pursuant to any Legislation or otherwise) to any person other than to any public body (being a single entity) [acquiring the whole of the Contract and] having the legal capacity, power and authority to become a party to and to perform the obligations of the Authority under this Contract being:

- (a) a Minister of the Crown pursuant to an Order under the Ministers of the Crown Act 1975;
- (b) any [local authority] which has sufficient financial standing or financial resources to perform the obligations of the Authority under this [Contract²];³ or
- (c) any other public body whose obligations under this Contract are unconditionally and irrevocably guaranteed (in a form reasonably acceptable to the Contractor) by the Authority or a Minister of the Crown having the legal capacity, power and authority to perform the obligations under the guarantee and the obligations of the Authority under this Contract.

17.4 RESTRICTIONS ON THE SENIOR LENDERS

17.4.1 The Authority may be tempted to seek to limit the ability of Senior Lenders to transfer their rights. This is due in part to a perceived need to have the original Senior Lenders involved who understand the deal negotiated, but is primarily a confidentiality and national security/public policy issue. The Authority may be concerned, for example, about whose hands project information may be in and to whom the Authority may end up owing money. The Authority does not want to become embroiled in national security issues.

17.4.2 The Authority should not attempt to put restrictions on the identity of the Senior Lenders unless exceptional circumstances apply. The appropriate way to deal with confidentiality issues, for example, is to impose confidentiality obligations in either the Contract (as against the Contractor) and the Direct Agreement (as against the Senior Lenders) (see Section 26 (Information and Confidentiality) and Section 31 (Direct Agreement and Senior Lenders)).

17.4.3 To the extent that transfer restrictions against financiers can be justified, however, they should focus on objective categories (e.g. credit ratings or EU/OECD banks) or should prescribe a list of acceptable transferees rather than adopting the clumsy, all encompassing approach of a general right of veto (which, in any event, is unlikely to work). Such a list should be updated as and when appropriate. Restrictions of this type can be dealt with in the Direct Agreement, or in a

² This should also include any other Project Documents that the Authority is a party to (e.g. any direct agreements or leases).

³ This Sub-Clause will only be applicable in non-central government projects. A transfer pursuant to this Sub-Clause should only be to an authority with the same status as the procuring authority. For example, on a local authority Project, the transfer must be to a local authority.

separate confidential letter if there are particular sensitivities (see Section 31 (Direct Agreement and Senior Lenders)).

17.4.4 Restrictions are often more cosmetic than real, as they can usually be circumvented through assignment or sub-participation and so reliance should not be placed on such arrangements being effective or meeting the Authority's concerns. However, structures in which the interests of the Senior Lenders are assigned or transferred to entities in which or with which the shareholders (or Junior Lenders) have an economic interest are likely to be linked to a Refinancing and, if so, may require Authority consent on those grounds (see Section 34 (Refinancing)).

17.4.5 Where projects are financed by bond issues, it is likely to be particularly difficult to identify the bondholders at any one time. The Authority should not seek to impose or rely on any restrictions on such Senior Lenders either (this is particularly impractical where bondholders are not registered e.g. holders of bearer bonds or where bonds are cleared through a clearing system, as is commonly the case). Where bonds are privately placed and the Authority can justify imposing restrictions on financiers, a similar approach as under Section 17.4.3 may be adopted. The Authority should note that Stock Exchange or listing authority rules on bond issues may require details of the Contract and underlying documents to be publicly displayed (although there are some exceptions to such rules (e.g. if display would prejudice national security)).⁴

⁴ See Clause 26(b)(iv) (Confidentiality) below.

18 CHANGE OF OWNERSHIP

18.1 INTRODUCTION

18.1.1 Having formed a relationship with bidders in the procurement phase, an Authority may be concerned about changes in the Contractor's shareholders thereafter. If this is the case then it may seek to impose restrictions on the ability of shareholders to transfer their shareholdings in the Contractor. Shareholders will usually object to such restrictions other than restrictions on transfers of equity prior to the end of the defects liability period (at the end of the construction phase). As a general rule, it should not be necessary for the Contract to contain other restrictions on the transferability of equity, other than a need to inform the Authority, except perhaps where the Authority would object to particular classes of shareholder being involved in the Project for particular reasons.¹

18.1.2 Suitable drafting is set out below:

18.1 Ownership Information

- (a) The Contractor represents and warrants to the Authority that at the date of the Contract the legal and beneficial ownership of the Contractor [and Holdco] is as set out in Schedule [] and that [, other than any Shareholder pre-emption rights,] no arrangements are in place that have or may have or result in any sale, transfer or disposal of any legal, beneficial, equitable or other interest in any or all of the shares in the Contractor [or Holdco].
- (b) The Contractor shall inform the Authority as soon as reasonably practicable (and in any event, within [30] days) of any Change of Ownership occurring.
- (c) The Authority may, not more than [twice] in any Contract Year, or at any time when a Contractor Default is outstanding, require the Contractor to inform it, as soon as reasonably practicable and in any event within 30 days of receipt of the Authority's request for details, of any Change of Ownership.
- (d) The Contractor's obligations under (b) and (c) above shall, except where a legal transfer of shares has occurred, be limited to the extent of the Contractor's awareness having made all reasonable enquiry.

18.1.3 Authorities will wish to adopt a suitable definition of change of ownership to use with the above provisions and to apply where restrictions on changes of ownership are required in the Contract. Any such definition should cover any transfers (whether by sale or otherwise) of any interest (legal, beneficial or equitable) in shares, and transfers of economic interest in shares (such as dividend or voting rights) should also be covered. Furthermore, Authorities should consider whether subordinated debt has characteristics that would usually be associated solely with shares (e.g. voting rights) or whether the subordinated debt may be converted to equity in certain circumstances. Where this is the case then the transfer of subordinated debt should also be restricted.² Suitable drafting is set out below:

“Change of Ownership”

means

¹ See section 18.4.5.

² The transfer of shares and subordinated debt are usually “stapled” i.e. the transfer of one would compel the transfer of the other. Where shares and subordinated debt are not stapled it may be appropriate to restrict the transfer of subordinated debt where, for example, shareholder contributions to project costs are to be made at a time other than Contract signature.

- (a) any sale, transfer or disposal of any legal, beneficial or equitable interest in any or all of the shares³ in the Contractor and/or [Holdco] [and/or []] (including the control over exercise of voting rights conferred on those shares, control over the right to appoint or remove directors or the rights to dividends); and/or
- (b) any other arrangements that have or may have or which result in the same effect as paragraph (a) above.

18.1.4 Authorities will need to consider the above definition carefully in the light of each Project's particular ownership structure; issues that should be considered include how far up the ownership chain the Authority would require the change of ownership provisions to extend and whether limited partnerships or other non-corporate entities are used in the Contractor's ownership structure.

18.1.5 Where unincorporated entities form part of the ownership structure, additional considerations will apply. Authorities will want to ensure, for example, that any lock-in requirement covers transfers of relevant interests in any relevant unincorporated entity (e.g. limited partnerships) and Authorities may wish to consider requiring that the unincorporated entity is at all times during the lock-in period managed and advised by a member of the relevant investor's or Sub-Contractor's group (if the identity of the group is important to the Authority).

18.1.6 The Contractor may request that the Authority consent to a change of ownership during the period when restrictions to changes of ownership apply (see Section 18.4). The Authority should consider whether to agree to such a request at its sole discretion. Where the Authority agrees to any such request it should consider whether any amendments to the change of ownership restrictions will need to be made so that they continue to apply to any transferee (for example, amendments should be considered where a non-corporate entity, such as a limited partnership, joins the Contractor's ownership structure).

18.2 AUTHORITY'S CONCERNS

18.2.1 Imposing a restriction on shareholders' ability to transfer their interests in the Contractor is partly to prevent any party the Authority views as unsuitable from being involved in the Project (or in control of the Contractor) and partly because the Authority may take comfort from the original shareholders continuing to retain their economic stake in the Project.

18.2.2 The Authority should generally look to other provisions under the Contract to address its concerns about the effect which a change in shareholders may have on the Contractor. For example, any concerns relating to the ability of the Contractor to perform the Contract without the support of the original shareholders should be addressed by the payment mechanism and termination rights.

18.2.3 The Authority may seek to restrict equity transfers if it is concerned that the original shareholders may leave the Project before all their equity commitments have been fulfilled. There should be no reason to prevent transfers of equity (at least following the end of the defects liability period, post Service Commencement), provided that any such deferred equity commitments are fully supported (e.g. by suitable letters of credit) and a substantially similar overall package is available from the proposed new shareholder (e.g. if technical support was provided by a shareholder in its capacity as a shareholder then, if still required, equivalent support should be put in place before a transfer can occur). It is not unreasonable for the Authority to restrict equity

³ Where limited partnerships are used then a reference to the general partner and/or manger should be made here. See Section 1 footnote 2.

transfers in the Contractor by the Construction Sub-Contractor (or any of its Affiliates) until Service Commencement or by the Operating Sub-Contractor (or any of its Affiliates) until Service delivery is established.

18.3 SHAREHOLDERS' CONCERNS

18.3.1 Holders of shares in Contractors will not want their ability to transfer their investment to be unnecessarily restricted. Allowing them to transfer their investments in Contractors extends the availability of capital for projects, makes the market more liquid and, as a consequence, can help improve value for money.

18.4 TRANSFER OF INTERESTS: FLEXIBILITY AND RESTRICTIONS

18.4.1 Practice concerning change of ownership provisions across PFI sectors has developed so that a lock-in period (usually up to the Service Commencement Date plus the defects liability period) is provided for, during which no Change of Ownership is permitted. In limited circumstances, however, transfers will be permitted during such lock-in period.

18.4.2 Circumstances where transfers are permitted during a lock-in period are usually restricted to (i) transfers that arise as a consequence of the enforcement by Senior Lenders of security over or in connection with shares to which the Change of Ownership provisions apply, (ii) any shares that are dealt in a recognised investment exchange, and (iii) intra-Affiliate transfers (although in such cases the Authority should be careful to ensure that where an Affiliate that has had shares transferred to it subsequently leaves the group, the shares are transferred back to a member of that group).

18.4.3 Suitable drafting is set out below:

18.4 Change of Ownership

- (a) No Change of Ownership may occur during the [lock-in period⁴].
- (b) Any Change of Ownership arising as a consequence of:
 - (i) the grant or enforcement of security in favour of the Senior Lenders over or in relation to any of the shares of the Contractor [or Holdco], provided that any document conferring security over any shares has been approved by the Authority (such approval not to be unreasonably withheld or delayed); or
 - (ii) any change in legal or beneficial ownership of any shares that are listed on a recognised investment exchange (as defined in [Section 285 of the Financial Services and Markets Act 2000]); [or]
 - [(iii) any transfer by a Shareholder [or []]⁵ to an Affiliate of such transferor,]

shall be disregarded for the purpose of paragraph (a) above.

[Where sub-paragraph (iii) applies and subsequent to any such transfer (the "Original Transfer") the transferee ceases to be an Affiliate of the original transferor, it shall be a breach of this Clause 18.4 if the shares or interests which were the subject of the Original

⁴ This is usually defined by reference to the Service commencement date plus the defects liability period.

⁵ Reference should be made to the owner of each entity to which the lock-in provisions apply. See definition of Change of Ownership at paragraph (a). See also Section 18.1.4 and footnote 3.

Transfer are not within [20 days] of the transferee ceasing to be an Affiliate of the original transferor transferred to that original transferor or any Affiliate of such transferor.]⁶

18.4.4 It is important to ensure that the flexibility afforded above should not operate so as to disapply the notification provisions set out in Section 18.1.2 or to circumvent any provisions preventing transfers to any particular category of shareholder (as envisaged in Section 18.4.5).

18.4.5 As well as restrictions on transfers during the lock-in period an Authority may wish to impose some wider restriction on the transfer of ownership or investment in a Contractor (and the precise restrictions will depend on the financing structure of the Project). Restrictions should address specific concerns and not be blanket restrictions, and legal advice should be sought. For example, in certain defence projects, the Authority may be concerned that national security may be threatened by unsuitable shareholders and for that reason restrictions will exist. Similar public interest concerns will exist in prison projects. Other considerations may also apply – for example, an Authority may not wish to have tobacco companies holding shares in schools. The Authority should ensure bidders are made aware of such concerns and restrictions as early as possible.

18.4.6 In such cases the Contract should either seek to set out in an objective manner the grounds on which a transfer is not permitted or, if necessary and practical, set out a list of unacceptable holders of equity. A less attractive option for all concerned is to include a provision requiring the investor to seek the prior written consent of the Authority before transferring its shareholding (or other investment). If this latter course of action is taken, it should be made clear in the Contract that any such consent should not be unreasonably withheld (nor a response delayed). The Authority should be obliged, unless there are public policy reasons to withhold reasons, to specify the reason for any refusal.

18.4.7 Suitable drafting is set out below

Restricted Share Transfer

The Contractor shall obtain the Authority's prior written consent (which may be given subject to conditions) to any [Restricted Share Transfer].⁷

18.5 RELATED ISSUES

It is not always possible to ascertain who holds an interest or beneficial interest in shares and it may not be possible in any event to police more remote changes in ownership. The use of nominees means the Authority may not even be aware of changes. The protection offered by change of ownership provisions should therefore be seen by the Authority as an important but imperfect tool for controlling the substantive ownership of its counterpart.

18.6 OWNERSHIP DEFAULT

Paragraph (i) of the definition of Contractor Default at Section 21.2.2.1 applies where a restriction on the transfer of shares is included in the Contract, and any transfer of a shares or a beneficial or economic interest in a share in breach of any transfer restrictions is a Contractor Default. The Authority and the Contractor should agree whether or not to extend this Contractor Default event to breach of the notification provisions as set out in Section 18.1.2 above.

⁶ Not required where sub-paragraph (iii) is not used.

⁷ This term will need to be defined in the Contract but should generally relate to any proposed share transfer to any party on a restricted (or not on a permitted) list (see Section 18.4.5 above).

19 LAND, EQUIPMENT AND OTHER PROPERTY INTERESTS

19.1 INTRODUCTION

19.1.1 In the majority of PFI projects involving buildings, the Authority will own the land and grant a licence or lease to the Contractor. Occasionally, however, the Contractor will procure land itself. On PFI projects involving equipment, the Contractor will commonly procure the equipment itself. During the life of the Project the Contractor will manage the operation and maintenance of the relevant assets.

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

19.1.3 On equipment projects, where the Contractor will commonly own or procure the equipment¹ and the equipment is important to the ability of the Authority to fulfil its statutory duties, it is vital that the arrangements are structured so that the Authority can always obtain use and, if necessary, ownership of the equipment, and that no insolvency or receivership of the Contractor will disturb this. The Authority should seek appropriate legal advice and ensure that the Direct Agreement, and the Authority's broader relationship with the Senior Lenders (who may have security rights in the equipment), is structured accordingly. Similar considerations apply on PFI projects involving land where the Contractor procures the land².

19.1.4 On property projects, commonly the Authority will own the land (and buildings built on it). The Authority must, in these circumstances, ensure that it conducts due diligence over its property rights early in the procurement process³ to ensure that the Project will not be jeopardised during the procurement due to a late discovery of a problem relating to the nature of the Authority's interest in the property.

19.2 PROPERTY TRANSFER

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

- the extent to which it will be required to transfer assets, or grant a licence or lease, to the Contractor (so as to allow the Contractor to carry out and perform the Service);
- its ability to transfer such assets⁴ or grant such a licence or lease to the Contractor; and
- the extent to which the Authority requires control over, and/or access to the assets during the life of the Project.

¹ This has been the case in certain MOD equipment projects.

² In this connection, where it is important for the Authority to be able to take back control of the property, it is more secure for the Authority to take a freehold interest in the property (and grant a lease or licence) rather than taking a mere option.

³ The Authority should ensure legal due diligence is conducted to verify the legal interest and also that the condition of the asset is verified.

⁴ The nature of the Authority's interest in the relevant asset will dictate the extent to which, and manner in which, the Authority can transfer the benefit of the relevant asset to the Contractor. Legal due diligence over the Authority's interest in the asset will highlight any restrictive covenants, conditions of transfer and /or claims over the relevant asset. See also footnote 1 above.

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

19.2.3 The Authority may already own the freehold to the land and property. In this case, it can transfer an interest in the land and property (freehold or long leasehold/headlease) to the Contractor, whilst at the same time securing for itself a sub-lease or licence, which allows it to access and use the land and property for the term of the Contract. More commonly, however, Authorities now merely grant a licence in respect of such property (see Section 19.3 below).

19.2.4 If the Authority only has a leasehold interest in the land and property, and a lease structure is used, it is likely that the consent of the freeholder will be required before the Authority can grant any interest in the land and property to the Contractor.

19.3 PROPERTY PURCHASE AND DISPOSAL AND RESIDUAL VALUE

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

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

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

19.3.3 Where land and property owned by the Authority becomes surplus as a result of the Project and this surplus land is dealt with as part of the procurement, the Authority must ensure that it receives market value⁵ for such land from the Contractor. When surplus land and property features as an integral part of a bid, it can be difficult for the Authority to reach clear judgements about market value. However, this does not relieve an Authority from its obligation to demonstrate that it has achieved market value. The risks involved in surplus property development are different to those within a PFI Contract and Authorities should consider in advance of procurement:

⁵ See section 24.2 (General Principles, Disposal of Surplus Property) of Government Accounting 2000.

- how best value can be extracted from surplus land assets to the benefit of the public sector (including whether it should form part of the Contract or be sold separately), taking account of the town planning status and market risks;
- if land is to be included in the Contract, how mandatory and variant bids will be evaluated to take account of differing approaches by bidders to the treatment of land receipts within the PFI; and
- whether it is appropriate to introduce competitive market testing of the surplus land proceeds and/or gain sharing mechanisms within the Contract.

19.3.4 Where the Authority cannot satisfy itself that market value has been achieved it should consider seeking bids that remove the financial benefit of the surplus land and property. Where the Authority intends to release property to the Contractor, it must consider carefully how best this is done, over time, in order to achieve best value for money. For example, transfer of surplus property at Financial Close prior to it receiving detailed planning permission, is unlikely to prove good value for money. Care should be taken in evaluating proposals that combine the realisations from sale and/or development of surplus land with the construction of operational property and provision of services.

19.3.5 The Authority needs to take care that the inter-relationship between the realisation of proceeds from the sale of surplus land, and the property and the facilities from which services will be delivered during the term of the Contract, supports the overall objectives of the Project and also does not prejudice the Authority's position should an event of early termination arise.⁶

19.3.6 Residual value interests may form an important part of some projects.⁷ Such projects require very careful structuring. In addition to financial and legal advice, Authorities should seek early guidance from their Private Finance Unit on such schemes. In addition to value for money, balance sheet, termination payment and other derogation issues, the relevant property and security interests would need attention. Commonly in such Projects, the Contractor would assume a certain residual value for the relevant asset at the end of the Project term (which would be bid as part of the tendering process and appear in the bidder's financial model) and, in the light of this, the amount of Unitary Charge bid by the bidder would be reduced. Authorities must however be clear as to:

- who is taking the residual value risk in the Project (i.e. the risk of the actual value of the asset being greater or less than the assumed value either at expiry of the Term or on early termination in any of the early termination scenarios);
- how this may impact the balance of risk and incentive in the project;
- how this is best and most securely structured (in terms of property interests and options and possible value sharing arrangements);⁸ and
- the precise basis on which the residual value is valued at expiry or termination.⁹

On a facilities Project (where the assumption is that the underlying value of land will go up) Authorities will want to ensure that they have a proper interest in increased land values. On an equipment Project (where the assumption is that the value of equipment will go down) Authorities

⁶ Where the Contractor takes the market movement risk, it may be exposed in the event of a termination at a down-cycle in the property market.

⁷ This has been the case in certain housing projects and certain MOD equipment projects.

⁸ See section 19.1.3 above.

⁹ Any definition of Market Value used should be as precise as possible to avoid future disputes. See footnote 5 above. See generally Section 20.5 (Transfer of Residual Value Risk).

may want to ensure access to the equipment at a value for money price should they continue to need it at expiry or early termination of the Contract.

19.3.7 On the Department of Health LIFT programme,¹⁰ the LIFT companies bought the properties at the start of the Contract and took the residual value risk on them. Public sector gain sharing provisions applied on disposal of surplus property, and the public sector had to pay open market rates if it wanted continued use of the properties at the end of the term.

19.4 CAPITAL ALLOWANCES ACT, 2001

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

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

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

19.4.4 Whether the Contractor claims capital allowances or pursues alternative taxation treatments, such as composite trader status, could have material impact on the Project’s economics and the level of Unitary Charge bid by bidders. Distinctions between licences and leases may well therefore be significant commercial issues affecting the financial model for the Project, as well as being technical legal points. Accordingly, the Authority and its advisers should satisfy themselves that the taxation assumptions within the bidders’ financial models are realistic, consistent with the proposed contractual structures and fully anticipated within the Unitary Charge bid (see further Section 34.4.5 (Taxation and Accounting Policies)).

19.5 COMPOSITE TRADER

19.5.1 Early PFI projects were often structured by way of lease and lease back with the Contractor, such that construction expenditure in the Contractor would be capital, qualifying, where appropriate, for capital allowances tax relief. Under this treatment, part of the Unitary Charge is treated as rental income in the Contractor. Typically, as much of the expenditure by the Contractor is on buildings not qualifying for capital allowances, tax relief is limited.

19.5.2 PFI projects are now commonly structured by way of licence, rather than lease and lease back, with a view to allowing the Contractor to become eligible for composite trade tax treatment.

¹⁰ See standard LIFT documents on the Partnerships for Health website: www.partnershipsforhealth.co.uk.

Under composite trade tax treatment all Contractor expenditure on the Project may be treated as being trading expenditure and thereby, in principle, wholly eligible for tax relief. This may give tax relief to design and construction expenditure that would not otherwise qualify.

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

20 TREATMENT OF ASSETS ON EXPIRY OF SERVICE PERIOD

20.1 INTRODUCTION

20.1.1 A distinction can be drawn between:

- Contracts where it represents best value for money for the Authority to take control of the Assets on Expiry. This includes Assets where the long-term public sector demand is clear or for which there is no practical alternative use (for example, schools, hospitals, prisons, specialist information technology systems and office accommodation that, due to its location or nature, is only of value to the public sector client). These are dealt with in Section 20.2 (Assets where the Authority Retains Residual Value on Expiry); and
- Contracts where residual value of the Assets is best transferred to the Contractor. These are generally generic Assets which have alternative use outside the public sector and for which there is no clear long-term public sector need (for example, office or housing accommodation in areas where there is demand from other users, generic information technology systems and alternative land use). These are discussed in Section 20.5 (Transfer of Residual Value Risk).

20.1.2 By “residual value” this guidance means, in the context of a Contract, the market value of the Assets associated with the Contract at the time it expires. When the Contract is signed, the residual value of the Assets is not known. “Residual Value Risk” refers to the uncertainty as to what the residual value will prove to be. There will usually be some estimate of the approximate residual value to be expected, which may be factored into the overall financing structure of the Contract.

20.1.3 The Contract should deal comprehensively with the treatment of Assets on all types of terminations. Which party retains the Assets on termination, and whether those Assets have any alternative use, will affect the level of termination payment (if any) payable by the Authority.

20.2 ASSETS WHERE THE AUTHORITY RETAINS RESIDUAL VALUE ON EXPIRY

20.2.1 In most PFI projects, the Authority’s long-term objectives will be best served by requiring either automatic transfer or reversion of the Assets to itself on expiry of the Contract or at a minimum an option to purchase the assets at nominal cost. This may be because:

- legal constraints prevent any practical alternative option, for example, the private sector cannot be a highway authority so roads must revert to the public sector Authority;
- contracts which involve Assets, such as hospitals and schools are specifically designed to cater for a particular service. In these sectors, the Assets have a useful economic life if retained by the Authority but there is no realistic alternative use for the Assets. There may be only limited scope for alternative use on expiry of the Contract and conversion is likely to be costly;

- the Authority requires long-term use of the Asset for the continued provision of its services;
- bidders are likely to discount the residual value of the Assets; or
- the expiry of the useful economic life of the Asset means it has no value but there is a separate reason for the Asset, such as any freehold of the land, to revert to the Authority.¹

20.2.2 The Contract must, however, protect the Authority's interest by not restricting the options exercisable at or immediately before the end of the Contract. These may include:

- taking possession of any Assets² at no cost;
- retendering the provision of the Service, with the outgoing Contractor making any Assets available to the new Contractor at no cost;³ and
- removing any Assets.

20.2.3 In most cases in which the Authority retains Assets at no cost, the Authority should consider the extent to which it should have recourse to the Contractor if the condition of the Assets reveals that the Contractor has not carried out all its contractual (for example, maintenance) obligations (this issue is dealt with in Section 23 (Surveys on Expiry and Termination)). This would not be necessary if such Assets had reached the end of their useful economic life (as may be the case, for example, in equipment based projects). The Authority should be driven by its operational requirements and value for money rather than by an attempt to create some residual value interest.

20.2.4 Suitable drafting (where no residual value risk has been transferred) is as follows:

20.2 Treatment of Assets at Expiry Date

- (a) On or before a date falling no later than [12]⁴ months prior to the Expiry Date, the Authority shall notify the Contractor in writing whether it wishes to retender the provision of the Service.
- (b) If the Authority wishes to retender the provision of the Service then:
 - (i) the Contractor shall do all necessary acts (including entering into any contracts) to ensure that the successor contractor obtains all of its rights, title and interest in and to the Assets with effect on and from the Expiry Date; and
 - (ii) the Authority will bear all costs of any retendering of the Contract on expiry.⁵
- (c) If the Authority does not wish to retender the Service then the Assets shall transfer to the Authority on the Expiry Date and the Contractor shall do any necessary acts (including entering into any contracts) to ensure that the Authority obtains all of its rights, title and interest in the Assets with effect on and from the Expiry Date.

¹ In some cases, the land will have significant residual value in its own right, notwithstanding that the other Assets may not (see Sections 20.1.1 and 20.5 (Transfer of Residual Value Risk)).

² See Section 20.6.1.

³ Any retendering of the Service should usually allow the incumbent Contractor to rebid for the Contract.

⁴ This date should be consistent with Clause 23 (Surveys on Expiry and Termination) to enable a decision to be made in sufficient time to facilitate the build-up of an adequate retention fund where the Authority requires the transfer of the Assets to itself in accordance with paragraph (a)(ii). See Section 23.3.1.

⁵ Costs of retendering of the Contract by the Authority following termination for Contractor Default should not be borne by the Authority. See Section 21.2 (Termination on Contractor Default).

20.2.5 The parties may also wish the Contract to deal with a mandatory second term option with the existing Contractor (see Section 20.6.3) in conjunction with an open competition.⁶ If this is the case, then the retendering would have to be on substantially the same terms as the original Contract,⁷ so that this can be evaluated against other bids. The Authority must also consider what the effect will be on the Authority's option if it wants to retender on different terms. The effect of this may then be to transfer some residual value risk.

The provisions of Clause 23 (Surveys on Termination) are relevant in relation to assets with no alternative use.

20.3 PRESERVING THE CONDITION OF THE ASSETS ON EXPIRY

20.3.1 Some early Contracts used Terminal Payments at the end of the Contract (even where the Authority retained control of the Assets on Expiry) as a means of incentivising the Contractor to maintain high standards of Service throughout the Service Period. The argument here is that if there is a Terminal Payment related to the value of the Assets at the end of the Contract then the Contractor will ensure high Service standards are maintained to the end. This argument confuses the purpose of payments for Services and payments for Asset transfer, as service standards can still be low, even if the Assets are very well maintained. Terminal Payments are not therefore recommended (except for any residual value transfer arrangement – see Section 20.6 and see generally Section 19 (Land, Equipment and other Property Interests)).

20.3.2 The payment mechanism should be the main method by which the Contract incentivises the Contractor to maintain service standards at all stages of the Contract. If there will be a re-competition of the Service, this provides further incentive on the Contractor to continue to meet the Authority's requirements until the Expiry Date.

20.3.3 One means of incentivising the Contractor to maintain Service standards where there is no alternative use for the Assets would be to structure the Contract to give the Authority an option to enter a secondary Contract period with the initial Contractor.⁸ This will increase the incentive for the Contractor to maintain standards through to the Expiry Date, in addition to the payment mechanism incentives, without the need for a Terminal Payment. The Contractor is obliged to enter into a second term if the Authority decides to exercise its option, but such decision will be taken in the context of an open competition with other bidders. One drawback of this is that the prices for such a second term (if it is added to the typical term for a PFI contract) are very difficult to bid in advance. The likelihood is that at best only a mechanism for calculating the price for the second period can be set out and such a mechanism is of questionable value. The Authority may, of course, instead opt to contract with another contractor if this offers better value for money. If this happens, the new contractor will have to bid to take over the use of the Assets.

20.4 HANDOVER PROVISIONS FOR ASSETS WHICH TRANSFER TO THE AUTHORITY

20.4.1 Provisions dealing with the transfer of the Assets will need to be set out in the Contract. These will have to deal with:

- the condition of the Assets, any rectification works, their cost and how they are paid for (see Sections 11 (Maintenance) and 23 (Surveys on Expiry and Termination));
- any design life requirement after the Expiry Date;

⁶ Such a competition may be subject to any procurement regulations applicable at the time.

⁷ That is, the Unitary Charge may be substantially different, particularly if the incumbent or incoming Contractor is not, as part of the competition, purchasing any Assets, but is taking over existing Assets.

⁸ See also Section 2.2.1.

- inspection prior to handover;
- checking any rectification works have been done;
- provision for any assignment of warranties, contracts and other rights relating to the Project; and
- any disputes in connection with the above.

20.4.2 Other relevant issues include how employees should be dealt with, as they will often transfer to any successor contractor or the Authority.

20.4.3 To the extent that employees are being transferred, then the Contract should contain restrictions on the ability of the Contractor to alter either the number of employees or their terms and conditions as the end of the Contract approaches (such as in the last 2 to 3 years of the Contract).

20.4.4 A general further assurance provision is usually included in relation to termination, such as the following:

The Contractor shall take all reasonable steps and co-operate fully with the Authority and any successor contractor so that any continuation in the Service is achieved with the minimum of disruption and so as to prevent or mitigate any inconvenience or risk to health or safety of the employees of the Authority and members of public.

20.5 TRANSFER OF RESIDUAL VALUE RISK

20.5.1 Where there is the potential for alternative use, and hence alternative users, of the Service or any Assets, there may be scope for the Contract to include provisions that transfer some residual value risk to the Contractor.⁹ It is crucial that this issue is dealt with as part of the competitive bidding process if it is to deliver real value.

20.5.2 There are a number of issues for an Authority to consider. First, is it likely to require long-term use of the Assets? If so, it is unlikely to derive best value from transferring residual value risk. Second, if the Authority has no clear long-term requirement for the Assets, is it possible for the Authority to pass on any residual value risk to the Contractor? Third, will transfer of residual value risk provide value for money? Finally, how will transfer of residual value impact on any payment on termination on expiry of the Contract.

20.5.3 It will not be possible in all cases to leave the residual value risk of the Assets with the Contractor, even if there is some potential for alternative use. The difficulty of estimating value and the required length of the initial Contract may make it uneconomic for the Contractor to estimate the residual value of the Asset at anything other than an insignificant amount. In such circumstances, financiers¹⁰ are unlikely to accept being exposed to significant residual value risk. It will in such circumstances generally not represent value for money for the Authority to transfer this risk as the Contractor will expect to obtain its return over the life of the Contract.

20.5.4 If transfer of residual value risk will enhance value for money, the Authority can pay a Unitary Charge which does not enable the Contractor to cover the complete cost of financing its investment through the service payments it receives during the Contract. The Contractor instead has to rely on value being left in the Assets remaining on the Expiry Date to recover all such cost. This leaves some real risk with the Contractor in relation to the residual value at the end of the

⁹ See for instance the social housing sector and see Section 19.3.

¹⁰ Senior Debt is usually profiled to be repaid in advance of the Expiry Date. This may not however be the case on a corporately financed housing project.

Contract. Where this is the case it will be possible to have a shorter Contract length (see Section 2 (Duration of Contract)). When residual value is to be transferred, an appropriate leasehold (or freehold) structure should be used and the definition of Assets amended accordingly. Authorities should also consider Residual Value Risk when setting any capital expenditure contribution limits or liabilities (for example on a Qualifying Change of Law – see Sections 14.6 to 14.8).

20.5.5 The options exercisable by the Authority on the Expiry Date in relation to Assets with an alternative use where the Contractor is taking the residual value risk are:

- to take over the Asset, in which case a payment should be made to the Contractor (see Section 20.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been Transferred));
- to re-tender the Service, in which case the successful Contractor in the re-tendering exercise should make a payment to the previous Contractor reflecting the value of the Assets (see Section 20.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been Transferred)); or
- if the Authority has no further use for the Assets, to walk away at no further cost, leaving the Contractor to realise their value.

20.5.6 Each of these options affords the Contractor the ability to realise the value of the Assets upon expiry of the Contract, and accordingly the NPV of the total Unitary Charges payable under the Contract should be lower than if the Residual Value Risk had been retained (subject, of course, to there having been a well run competition).

20.5.7 Suitable drafting (where residual value risk has been transferred) is as follows:

20.5 Assets with an Alternative Use

- (a) On or before the date falling [six] months¹¹ before the Expiry Date, the Authority shall notify the Contractor in writing whether it wishes to:¹²
- (i) purchase the Assets by paying to the Contractor an amount equal to the Terminal Payment;
 - (ii) retender the provision of the Service;¹³ or
 - (iii) do neither (i) nor (ii) above.
- (b) If no notice is given under paragraph (a) above, then the Authority shall be deemed to have exercised its option under paragraph (a)(iii) and the Assets shall remain with the Contractor.
- (c) If the Authority wishes to exercise its option under paragraph (a)(i) above, then:
- (i) the Contractor and the Authority shall do all necessary acts (including entering into any contracts) to ensure that on the Expiry Date, the Assets are transferred to the Authority;
 - (ii) Within [30] days of effective transfer of ownership of the Assets to the Authority, the Authority shall pay to the Contractor the Terminal Payment.¹⁴

¹¹ The precise wording will depend on the specific circumstances. This wording assumes that effective ownership of the Assets is already with the Contractor and that, if the Authority wishes to continue to use the Assets, the Authority will need to make a payment or hold a new tender competition. If the Authority already owns part or all of the Asset (or will do so at the end of the Contract) these provisions would need amending accordingly.

¹² Any relevant procurement implications should be taken into account. To the extent option (a)(ii) is likely, the process may have to start earlier.

¹³ The Authority will also need an option to purchase the Assets to allow any new Contractor to provide the Service.

- (d) If the Authority wishes to exercise its option under paragraph (a)(ii) above, then:¹⁵
- (i) it shall carry out the retendering with the aim of entering into a new contract with a successor contractor to provide the Service on and from the Expiry Date;¹⁶
 - (ii) a condition of any retendering shall be that the successor contractor must pay the Contractor the Terminal Payment on transfer of ownership of the Assets to the successor contractor; and
 - (iii) the Contractor and the Authority shall do all necessary acts (including entering into any Contracts) to ensure that ownership of the Assets is transferred to the successor contractor with effect on and from the Expiry Date.

20.5.8 The Contract will also need to take account of Assets retained by the Contractor in the various scenarios where the Contract may be terminated prior to its expiry date. See Section 22.6 (Retention of Assets by Contractor on Termination).

20.6 VALUATION OF TERMINAL PAYMENTS ON EXPIRY WHERE RESIDUAL VALUE RISK HAS BEEN TRANSFERRED

20.6.1 The two main options for determining amounts payable by the Authority at the expiry of the Contract in respect of Assets with an alternative use (and which are owned by the Contractor) are:

- the market value of the Assets in their existing use; and
- an amount bid by the Contractor when negotiating the original Contract, indexed through the duration of the Contract.

These amounts are referred to as “Terminal Payments”.

20.6.2 The market value of the Assets is the more valid basis for a payment to be made at the end of the Contract. If, however, there is a possibility of an extraordinary increase in market value during the duration of the Project and the Assets are critical to the Authority’s needs (i.e. the Service cannot be obtained without them) then a cap on the amount payable may be prudent (for example, to guard against excessively inflated property prices).

20.6.3 The mechanism for arriving at the market value must be specified in the Contract to avoid a dispute over the valuation. The final amount will reflect the condition of the Assets.

20.6.4 The alternative method (bid amount) referred to in Section 20.6.1 is unlikely to be appropriate. The value paid should reflect the actual value of the Assets (for example, their condition) and a fixed sum transfers no risk in this regard.

¹⁴ This Clause should not be used and no payment should be made by the Authority if the Contractor did not accept any residual value risk during the term of the Contract so that the Authority paid a Unitary Charge which was capable of providing the Contractor with sufficient funds to fully amortise its capital debt and equity in accordance with its base case financial model. The meaning of “Terminal Payment” is explained in Section 20.6.1.

¹⁵ If the incumbent Contractor wins a retender then it should still be entitled to receive a Terminal Payment, reflecting the market value of the Assets unless such value has been included within the incumbent Contractor’s tender price.

¹⁶ Any retendering would have to follow any applicable procurement rules.

21 EARLY TERMINATION

The intention of the parties to the Contract should be that it will run its full course and terminate on the Expiry Date (see Section 20 (Treatment of Assets on Expiry of Service Period)), but the Contract must deal comprehensively with the consequences of early termination. The Contract should specify precisely what compensation is payable if it is terminated early. The amount of compensation payable will depend on the reason for termination. Early termination can be caused by Authority Default (see Section 21.1 (Termination on Authority Default)), Contractor Default (see Section 21.2 (Termination on Contractor Default)), Force Majeure (see Section 21.3 (Termination on Force Majeure)) and Corrupt Gifts (see Section 21.4 (Corrupt Gifts and Fraud)), Uninsurability (see Section 25.9 (Risks that become Uninsurable)), and breach of Refinancing provisions (see Section 21.6 (Termination for breach of the Refinancing Provisions)). It can also be caused by the Authority exercising a right to terminate the Contract voluntarily (see Section 21.5 (Voluntary Termination by Authority and Section 21.5.4 (Authority Break Points))).

21.1 TERMINATION ON AUTHORITY DEFAULT

21.1.1 Introduction

21.1.1.1 The Contract should define the events that give the Contractor the right to terminate and determine the rights of the relevant parties under this scenario.

21.1.2 Contractor's Right to Terminate for Authority Default

21.1.2.1 The Contractor should be allowed the right to terminate the Contract where the Authority or Government acts in a way which renders their contractual relationship untenable or completely frustrates the Contractor's ability to deliver the Service. A minor breach will not fall into this category and even a material breach of itself is likely to be insufficient if the Authority's actions do not have the effect described above.

Required drafting for Authority Default is as follows:

"Authority Default"

means one of the following events:¹

- (a) an expropriation, sequestration or requisition of a material part of the Assets and/or shares of the Contractor² by the Authority or other Relevant Authority;
- (b) a failure by the Authority to make payment of any amount of money exceeding £[] (indexed) that is due and payable by the Authority under this Contract within 30 days of service of a formal written demand by the Contractor, where that amount fell due and payable [two] (or more) months prior to the date of service of the written demand;³

¹ In certain cases, it may be appropriate to include additional events. See Section 21.1.2.2.

² This may need to be extended to cover shares in the holding company of the Contractor if the main shareholdings in the Contractor are held through such a medium and/or the assets and shares of the Construction Sub-Contractor and the Operating Sub-Contractor if such an expropriation, sequestration or requisition would prevent the Contractor from performing its obligations under the Contract.

³ This provision assumes that interest on late payment is provided for in the Contract (see Clause 30.6 (Interest on Late Payments)).

- (c) a breach by the Authority of its obligations under this Contract which substantially frustrates or renders it impossible for the Contractor to perform its obligations under this Contract for a continuous period of [two] months,⁴ or
- (d) a breach by the Authority of Clause 17 (Restrictions on Transfer of the Contract by the Authority) occurs.

21.1.2.2 Beyond this, the circumstances in which the Contractor is permitted to terminate for Authority Default must be considered on a project by project basis. The Authority needs to examine the nature of its obligations during the Contract and should only extend the list of Authority Default events to include breaches of other obligations which will render the contractual relationship untenable or completely frustrate the Contractor's ability to deliver the Service.

21.1.2.3 Termination by the Contractor should be a last resort and it is important to ensure that there are no "hair triggers" which could put the Authority at risk of termination before it has had an opportunity to remedy its default. There can be no question of reciprocity with the defaults that trigger a Contractor Default as the obligations of the Authority are principally payment obligations and approval rights, rather than detailed performance or other credit related obligations.

21.1.2.4 The Contractor should bear in mind that a failure by the Authority to comply with the provisions of the Contract before Service Commencement (for example issuing approvals) and sometimes after that date, can in most cases be adequately dealt with by way of a Compensation Event (see Section 5 (Supervening Events)). In addition, any failure by the Authority to pay sums when due should give rise to interest on late payment (see Section 7.2.3 and Clause 30.6 (Interest on Late Payments)) and so a reasonable grace period for non-payment should be built into the Contract and so neither of these should trigger termination. Required drafting is as follows:

21.1.2 Termination on Authority Default

- (a) If an Authority Default has occurred and the Contractor wishes to terminate the Contract, it must serve a termination notice⁵ on the Authority⁶ within [45] days of becoming aware of the Authority Default.
- (b) The termination notice must specify the type of Authority Default which has occurred entitling the Contractor to terminate.
- (c) The Contract will terminate on the day falling [45] days after the date the Authority receives the termination notice, unless the Authority rectifies the Authority Default within [30] days of receipt of the termination notice.

21.1.3 Compensation on Termination for Authority Default

21.1.3.1 The objective should be to ensure that the Contractor and its financiers are fully compensated⁷ (i.e. no worse off because of Authority Default than if the Contract had proceeded as expected).

21.1.3.2 The Contractor should be required to specify its preferred method of calculation of equity return at the time of its bid. It should choose between the level set out in the original base case,

⁴ The periods triggering Authority Default in paragraphs (b) and (c) are subject to the further rectification periods set out in Clause 21.1.2 (Termination on Authority Default).

⁵ This will contain detailed requirements and information on the Authority Default. See Section 5 (Supervening Events).

⁶ In certain cases a third party (e.g. the relevant Secretary of State) should also receive notice.

⁷ The compensation payable should reflect a realistic calculation of an anticipated claim for damages and therefore should be an exclusive remedy of the Contractor leaving no residual claim for damages (see Section 22.7 (Exclusivity of Remedy)).

the market value at the time of termination and the original base case return from the Termination Date (see Section 21.1.3.6).

21.1.3.3 In most PFI projects, equity is invested as a blend of share capital and Junior Debt. In calculating Authority Default compensation, many projects have distinguished between Junior Debt and equity.

21.1.3.4 Since in most PFI projects, the substantial majority of “equity” is invested as Junior Debt, the approach taken in the early PFI projects was to give the Contractor the opportunity of equity upside (through the market value compensation) but insulate it from downside (since Junior Debt is repaid in full). This is not appropriate. It is important that the same method of calculation (whether “market value” or “base case return”) is used for both equity and Junior Debt. If the project concerned has an element of mezzanine debt then the Authority will have to consider the extent to which it is more akin to Senior Debt or Junior Debt⁸ and apply the termination compensation provisions accordingly. Guidance should be sought from departmental Private Finance units and/or HMT. Once mezzanine debt has been appropriately classified as Senior Debt or Junior Debt, it should be treated as such for all purposes under the Contract.

21.1.3.5 For similar reasons, calculations based on “the higher of base case return and market value” (giving the Contractor all upside but no downside) or “the lower of base case return and market value” (giving the Contractor all downside but no upside) are inappropriate.

21.1.3.6 Bidders must be invited to bid which of the following levels of equity/Junior Debt compensation they prefer:

- Compensation to reflect the base case IRR for equity and Junior Debt for the entire duration of the Contract. The purpose is to provide equity investors with the returns they expected from the Project at the outset, regardless of actual Project performance (whether better or worse than expected).

The compensation payment is the amount which, when taken together with all amounts already paid to equity (in dividends/redemption payments etc) and Junior Debt (in interest and principal repayments) taking account of the actual timing of all such payments, provides equity and Junior Debt with their base case project-life IRR as agreed on signature of the Contract up to the Termination Date. Where equity or Junior Debt have already hit their project-life base case IRR, no payment should be made.

- Compensation to reflect the market value of both equity and Junior Debt for the entire duration of the Contract. The purpose is to allow the equity investors to take the full benefit of good Contractor performance but bear the risks associated with poor performance.

The Authority pays an amount for both equity and Junior Debt based on their market value on a going concern basis immediately prior to the termination i.e. the amount for which the equity and Junior Debt could have been sold to a willing buyer at the relevant date (the calculation being based on the assumption that there had been no Authority Default and that both equity and Junior Debt were freely transferable).

The market valuation will reflect the value of anticipated future cashflows (both revenue and costs); risk allocation under the Contract; and market appetite for Contracts of a similar nature. It will also take into account the value of the Assets (including any cash balances) held by the Contractor at the Termination Date.

⁸ Mezzanine debt will typically seek a much higher return than Senior Debt.

- Compensation to reflect the base case return for equity and Junior Debt for the remainder of the duration of the Contract. This is an amalgamation of the first two approaches. The compensation payment is the amount of future return that the equity and Junior Debt providers originally provided for in the base case bid.

Care should be taken that if a refinancing has occurred (see Section 34 (Refinancing)) and the original equity and/or Junior Debt reduced, there is no double counting.

21.1.3.7 The Contractor is likely to incur redundancy costs as a result of the termination of the Contract and, to the extent that these will occur, these should be included in the compensation payable by the Authority. Similarly, the Sub-Contractors may incur losses as a direct result of the early termination of the Contract (e.g. in respect of cancellation of orders for materials and goods). The Contract should specify those heads of loss which the Authority will pay to the Contractor, on account of the Sub-Contractors' losses. If the Authority proposes to offer compensation to cover the Sub-Contractors' future loss of profits, it should limit the period of time for which it will pay for such future loss (e.g. for a one year period from termination) and satisfy itself (through conducting due diligence over Sub-Contracts or otherwise) that the quantum of the loss of profit and other consequential losses and breakage costs are reasonable and appropriate.

21.1.3.8 The Authority should also decide what happens to the Assets following a compensation payment. As the Authority has fully compensated the Contractor, they should usually revert to the Authority. Where the assets may have a significant residual value and the Contractor retains the assets then different considerations will apply (see, for example, Section 22.6 (Retention of Assets by Contractor on Termination)).

21.1.3.9 In certain termination scenarios, the amount payable will be adjusted for any Additional Permitted Borrowing advanced by Senior Lenders (on a rescue refinancing) – see Section 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreement) and definitions in Section 1.7.1.

Required drafting is as follows:

21.1.3 Compensation on Termination for Authority Default

(a) On termination of the Contract under Clause 21.1.2 (Termination on Authority Default) the Authority shall pay⁹ the Contractor the “Authority Default Termination Sum” in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)] on the Termination Date. Subject to paragraphs (c) to (e) below the Authority Default Termination Sum shall be an amount equal to the aggregate of:

- (i) the Base Senior Debt Termination Amount,¹⁰
- (ii) redundancy payments for employees of the Contractor that have been or will be reasonably incurred by the Contractor as a direct result of termination of this Contract and any Sub-Contractor Breakage Costs; and

either:

- (iii) [an amount which when taken together with
 - (1) dividends (or other distributions) paid by the Contractor on its share capital on or before the Termination Date; and

⁹ See Section 22 (Calculation and Payment of Early Termination Payments) for the rights of set-off against such payments.

¹⁰ See Section 1.7.1 (Definitions).

- (2) interest paid and principal repaid by the Contractor under the Subordinated Financing Agreements on or before the Termination Date,¹¹

taking account of the actual timing of all such payments, gives a real internal rate of return on the share capital subscribed and amounts advanced under the Subordinated Financing Agreements equal to the Base Case Equity IRR.]

or

- [(iii) the aggregate amount for which the share capital of the Contractor and the amounts outstanding under the Subordinated Financing Agreements could have been sold on an open market basis based on the Relevant Assumptions.¹²]

or

- [(iii)¹³ all amounts shown in the Base Case as payable by the Contractor from the Termination Date, either in dividends or other distributions on the share capital of the Contractor or as payments of interest or repayments of principal made by the Contractor under the Subordinated Financing Agreements, each amount discounted back at the Base Case Equity IRR from the date on which it is shown to be payable in the Base Case to the Termination Date.]

- (b) On payment of the amount referred to in paragraph (a) above, the Authority shall have the option to require the Contractor to transfer its right, title and interest in and to the Assets to the Authority or as directed by the Authority.
- (c) If the aggregate of the amounts referred to in paragraphs (a)(i) and (a)(iii) is less than the Revised Senior Debt Termination Amount, then the Authority Default Termination Sum shall be increased so that it is equal to the aggregate of the Revised Senior Debt Termination Amount and the amount referred to in paragraph (a)(ii) provided always that:
- (i) the amount referred to in paragraph (a)(ii) shall only be paid to the extent that the Contractor has demonstrated to the reasonable satisfaction of the Authority that the amount will not be paid in payment (in whole or in part) of any Distribution; and
- (ii) if, at the time of termination, there are any Additional Permitted Borrowings outstanding, no Sub-Contractor Breakage Costs shall be paid in respect of any Sub-Contract in circumstances where there is an event of default under such Sub-Contract which would entitle the Contractor to terminate such Sub-Contract.
- (d) If a Distribution is made whilst any Additional Permitted Borrowing is outstanding and the Contractor has wilfully, or through gross negligence, failed to comply with its obligations under Clause 10(d)(iv)(a) of the Direct Agreement then in addition to the deduction of the Distribution referred to in paragraph (v) of the definition of Revised Senior Debt Termination Amount, the Authority shall be entitled to set off the value of

¹¹ These amounts will take into account the initial investments of the shareholders.

¹² The assumptions behind the sale include that there is no default by the Authority, that the sale is on a going concern basis and that no restrictions exist on transfer of share capital. The effect of any Additional Permitted Borrowing should be disregarded from the open market value calculation, but the actual state of the Project (e.g. any increased costs of operation or maintenance) should be taken into account in the open market value calculation. Required drafting for the relevant assumptions is set out in the definitions at Section 21.1.3.

¹³ If a refinancing occurs then adding this figure to Senior Debt could give rise to an element of double counting. To the extent a refinancing is possible or likely this point will have to be addressed.

that Distribution a second time against the Authority Default Termination Sum, provided that the amount of the Authority Default Termination Sum will never be less than the Revised Senior Debt Termination Amount.

- (e) If the Contractor has wilfully or through gross negligence failed to comply with its obligations under Clause 10(d)(iv)(b) of the Direct Agreement and there has been an overstatement of the cash balances by the Contractor as at that date which has caused the Authority to reasonably believe that it would be required to pay a lesser sum at the Termination Date than it actually is required to pay under the terms of this Clause 21.1.3, then the Authority Default Termination Sum, shall be reduced by the amount of such overstatement (to the extent such overstatement is still applicable at the Termination Date), provided that the amount of the Authority Default Termination Sum will never be less than the Revised Senior Debt Termination Amount.

“Base Case Equity IRR”

means [●]%,¹⁴

"Losses"

means all damages, losses, liabilities, costs, expenses (including legal and other professional charges and expenses), and charges whether arising under statute, contract or at common law or in connection with judgments, proceedings, internal costs or demands;

“Relevant Assumptions”

means the assumptions that the sale of the Contractor is on the basis that there is no default by the Authority, that the sale is on a going concern basis, that no restrictions exist on the transfer of share capital, that no Additional Permitted Borrowing has taken place and therefore that the effect of the Additional Permitted Borrowing on the calculation of such amount is disregarded but that otherwise the actual state of affairs of the Contractor and the Project is taken into account;

"Sub-Contractor Breakage Costs"

means Losses that have been or will be reasonably and properly incurred by the Contractor as a direct result of the termination of this Contract, but only to the extent that:

- (a) the Losses are incurred in connection with the Project and in respect of the provision of Services or the completion of Works, including:
- (i) any materials or goods ordered or Sub-Contracts placed that cannot be cancelled without such Losses being incurred;
 - (ii) any expenditure incurred in anticipation of the provision of services or the completion of works in the future;
 - (iii) the cost of demobilisation including the cost of any relocation of equipment used in connection with the Project; and
 - (iv) redundancy payments; and
- (b) the Losses are incurred under arrangements and/or agreements that are consistent with terms that have been entered into in the ordinary course of business and on reasonable commercial terms [and []];¹⁵ and
- (c) the Contractor and the relevant Sub-Contractor has each used its reasonable endeavours to mitigate the Losses;

¹⁴ This is the real pre-tax (i.e. pre-tax with respect to Shareholders in the Contractor, post-tax with respect to the Contractor) blended rates of return for equity or amounts advanced under the Subordinated Financing Agreements (as appropriate) shown in the Base Case.

¹⁵ Authorities should consider inserting a relevant Sub-Contractor loss of profit cap as recommended by Section 21.1.3.7.

21.1.3.10 This is the same level of compensation as is appropriate on a voluntary termination by the Authority (see Section 21.5.3 (Compensation for Voluntary Termination)). Choosing different approaches for these two types of termination could lead to the Authority to be incentivised to default in certain circumstances, which is why this document recommends that the methods used should be the same for both Voluntary Termination and Termination for Authority Default.

21.2 TERMINATION ON CONTRACTOR DEFAULT

21.2.1 Introduction

21.2.1.1 The Contract must deal comprehensively with the possibility of early termination due to Contractor default. It must achieve a fair balance between the Authority's desire to be able to terminate for inadequate service provision, even if caused by relatively minor defaults (a right which Authorities are used to having in conventional service contracts) and the Contractor's and its financiers' interest in restricting termination to the severest of defaults, when all other reasonable alternative options have been exhausted, including a reasonable rectification period procedure and a Direct Agreement (see Sections 21.2.4 (Rectification) and 31 (Direct Agreement and Senior Lenders)). It should be the Authority's last resort to exercise rights of termination.

21.2.2 Events Leading to Termination

21.2.2.1 The Contract should specify the events of Contractor Default which may lead to termination. As far as practicable, these should be objective, clear and provide for reasonable tolerances,¹⁶ bearing in mind the undesirable consequences of a termination.

Required drafting is as follows:

“Contractor Default”

means one of the following events:

- (a) a breach by the Contractor of any of its obligations under this Contract which materially and adversely affects the performance of the Service;
- (b) a Persistent Breach occurs;¹⁷
- (c) a court makes an order that the Contractor [or Holdco] be wound up or a resolution for a voluntary winding-up of the Contractor [or Holdco] is passed;
- (d) any receiver or manager in respect of the Contractor [or Holdco] is appointed or possession is taken by or on behalf of any creditor of any property that is the subject of a charge;
- (e) any voluntary arrangement is made for a composition of debts or a scheme of arrangement is approved under the Insolvency Act 1986 or the Companies Act 1985 in respect of the Contractor [or Holdco];
- (f) an administration order is made, or an administrator is appointed in respect of the Contractor [or Holdco];
- (g) [a breach of Clause 16 (Sub-Contracting, Employees and Documentary Changes)¹⁸ occurs;]

¹⁶ For example with performance points triggering termination.

¹⁷ See Section 21.2.3 (Termination for Persistent Breach by the Contractor) as to whether this is appropriate.

¹⁸ This catches non-permitted replacement of Sub-Contractors. See Section 16 (Sub-Contracting, Employees and Documentary Changes) as to whether (and if so what) restrictions should be imposed.

- (h) [a breach by the Contractor of its obligations in Clause [17] (Assignment) occurs;¹⁹]
- (i) [a breach of Clause [18] (Change of Ownership) occurs;²⁰]
- (j) the abandonment of the Contract by the Contractor;²¹
- (k) a failure to achieve the Service Commencement Date by [date];²²
- (l) a failure to provide [] Available [places/areas] [availability for use] for [x] period;
- (m) the accumulation of [] or more [performance points] in any [Quarter/Year];²³
- (n) failure to provide [] Available [places/areas] for [] period [and accumulation of [] [performance points] in respect of the same period]; or
- (o) a breach by the Contractor of its obligation to take out and maintain Required Insurances.²⁴

21.2.2.2 Other events of default may be included on a project-specific basis.²⁵ If the Authority places restrictions on assignment, change in ownership or replacement of Sub-Contractors, then it may be appropriate to include a corresponding event of default for breach of such restrictions (see Sections 16 (Sub-Contractors, Employees and Documentary Changes), 17 (Assignment) and 18 (Change of Ownership)). Similarly, if the Project is in a security-sensitive sector, breach of specific security requirements might be included. Generally, it is not necessary to include non-payment of sums by the Contractor as a Contractor Default as the Contractor's payment obligations are limited and the Authority should have the ability to set off certain amounts (see Section 12 (Payments and Set-off)), although particular projects may require this (e.g. where the Project has significant third party income).

21.2.2.3 Generally, insolvency events of default should not be extended to include Sub-Contractor's or the Contractor's shareholders. This is because the Contractor will in any event be incentivised to replace the Sub-Contractor concerned to ensure performance of the Contract. An exception to this would be where the contractual structures concerned make it necessary that such parties owe unusually significant financial or contractual obligations to the Contractor (or the Authority) and no replacement can be found who would match such obligations.

21.2.2.4 Termination should be subject to any rectification procedures (see Section 21.2.4 (Rectification)) and the rights of the Senior Lenders under the Direct Agreement (see Section 31

¹⁹ This catches non-permitted assignment by the Contractor of its rights and obligations under this Contract. See Section 17 (Assignment) as to whether (and if so what) restrictions should be imposed.

²⁰ This catches non-permitted transfers of shares in the Contractor. See Section 18 (Change of Ownership) and in particular Section 18.6 (Ownership Default) to whether such restrictions are appropriate.

²¹ This is likely to be the only circumstance in which Contractor Default during the construction phase can occur. The existence of early termination milestones are unlikely in most projects to be of any practical benefit (see Section 3.2.5). Authorities may provide a more specific definition of "abandonment".

²² A sufficiently distant date will normally be necessary to render such a provision bankable. See Sections 2 (Duration of Contract) and 4.5 (Long-Stop Date) which allow the long stop date to be based on the Planned Service Commencement Date (and therefore be self-adjusting). If this is done however, no allowance should be made for the possible occurrence of Relief Events, Compensation Events or force majeure when setting the base line long stop period (prior to any adjustment).

²³ Financial advisers may advise on suitable calibration. See further Section 9 (Performance Requirements).

²⁴ Not all failures to insure should lead to a termination event occurring. Only the Required Insurances should be caught. This approach goes hand in hand with the treatment of the issues relating to non-availability of certain insurances (see Section 25 (Insurance) and, in particular, Section 25.8 (Risks that Become Uninsurable).

²⁵ For example, the NHS requires a right to terminate if the Contractor prevents the Authority from carrying out its retained activities.

(Direct Agreement)). Accrued performance points should not generally be altered on appointment of a replacement Sub-Contractor (see Section 9.3 (Replacement of Sub-Contractors)).

21.2.2.5 These events are not mutually exclusive, since breaches covered under certain events (e.g. performance point limit) can still be caught under other default events.

21.2.3 Termination for Persistent Breach by the Contractor

21.2.3.1 The Contract should incentivise the Contractor in some way in respect of any breach by the Contractor, however minor. There are various means to deal with the persistent occurrence of minor defaults. The recommended approach is to impose performance points in respect of all types of minor defaults. This is a particularly effective means of incentivising the Contractor when coupled with a right to terminate the Contract if the total number of performance points accrued exceeds a certain level (see above).

21.2.3.2 It may not be feasible in every case to negotiate an all-encompassing performance points regime. This could leave the Authority exposed to a situation in which minor breaches are occurring persistently or being left unremedied, but as they have no effect on the Unitary Charge, the Authority will have little ability to influence the Contractor to perform. If such circumstances are likely to exist, the Authority should retain a right to terminate the Contract for Persistent Breach.²⁶ The Contractor and its financiers will be anxious to avoid a “hair trigger” default and will wish to ensure the mechanics relating to this default are as objective as possible.

21.2.3.3 The Contract should therefore include a warning procedure which provides that the Contractor is served a formal preliminary notice that a certain type of breach has been persistently occurring. The Contractor should in any case be aware of such breaches already. If such breach continues to occur persistently in, say, the 12 months following such notice (allowing a short rectification period), a final notice is served warning the Contractor that any further single occurrence of such breach in, say, the following 6 months will entitle the Authority to terminate the contract. This then gives the Contractor the opportunity to remedy. The Authority should consider whether it requires a persistent breach remedy during the construction period as well as the operational period. The concerns of the Authority in the construction period are likely to be greater when the Authority shares the site during that period.

To the extent such provisions are needed, the following shall be used as required drafting:

“Persistent Breach”

means a breach for which a final warning notice (referred to in paragraph (b) of Clause 21.2.3 (Persistent Breach)) has been issued, which has continued for more than [] days or recurred in [] or more months within the [six] month period after the date on which such final warning notice is served on the Contractor;²⁷

²⁶ A Persistent Breach default should complement, and not be a substitute for, a fully effective payment mechanism.

²⁷ This event of default addresses “Persistent Breaches” of the same type where each single breach may in itself not constitute a material breach but the persistent nature renders the contractual relationship untenable. This type of default should be used where the performance regime is not able to cover all types of breaches and the Authority would otherwise be left with no sanction for persistent failure by the Contractor to perform. This does not address the Persistent Breaches of different types (since persistent service failures covered by the performance regime are excluded by the definition). This does not mean that the Persistent Breach Clause should itself include wording to the effect that the relationship between the Authority and the Contractor has become untenable, which is in itself highly subjective. The mechanism in Clause 21.2.3 relating to warning notices, and final warning notices, leading to termination, in itself demonstrates that the relationship between the parties has become untenable. Neither should the Clause be amended to the effect that the Authority, in terminating the Contract for Persistent Breach, is acting in a “reasonable and proportionate manner”. Again, the detailed mechanism in Clause 21.2.3 is itself sufficient in ensuring that the right to terminate is only exercised for repeated failures following service of a series of warnings, and final warning notices, to the Contractor.

21.2.3 Persistent Breach

- (a) If a particular breach, other than any breach for which performance point deductions could have been awarded and/or availability deductions could have been made, has continued for more than [] days or occurred more than [] times in any [] month period then the Authority may serve a notice on the Contractor:
- (i) specifying that it is a formal warning notice;
 - (ii) giving reasonable details of the breach; and
 - (iii) stating that such breach is a breach which, if it recurs frequently or continues, may result in a termination of this Contract.
- (b) If, following service of such a warning notice, the breach specified has continued beyond 30 days or recurred in [] or more months²⁸ within the [] month period after the date of service, then the Authority may serve another notice on the Contractor:
- (i) specifying that it is a final warning notice;
 - (ii) stating that the breach specified has been the subject of a warning notice served within the [twelve] month²⁹ period prior to the date of service of the final warning notice; and
 - (iii) stating that if such breach continues for more than [] days or recurs in [] or more months within the [six] month³⁰ period after the date of service of the final warning notice, the Contract may be terminated.
- (c) A warning notice may not be served in respect of any breach which has previously been counted in the making of a separate warning notice.

21.2.3.4 Once a termination notice is served for a Persistent Breach, the Contractor should not be entitled to any further rectification period, although the provisions of the Direct Agreement will still apply (see Section 31 (Direct Agreement and Senior Lenders)).

21.2.4 Rectification

21.2.4.1 The Authority should afford the Contractor the opportunity of remedying any breach capable of remedy and/or financially compensating the Authority for the effects of the breach. As stated in Section 21.2.1 (Introduction), termination should only be used as a last resort. Accordingly, the Contract should set out a mechanism allowing the Contractor the opportunity to remedy breaches which are capable of remedy to avoid termination. Rectification will not be appropriate in respect of all types of breach. Some breaches may not be capable of remedy (for example, failure to complete construction by the long-stop date) and some events may only qualify as termination events after some kind of grace has already been given (e.g. after the accrual of a specified level of performance points or because of the tolerances contained in the Persistent Breach concept).

Required drafting is as follows:

21.2.4 Rectification

- (a) If a Contractor Default has occurred and the Authority wishes to terminate the Contract, it must serve a termination notice³¹ on the Contractor.

²⁸ This will depend on the particular breach concerned, but a certain number of recurrences should be specified. In paragraph (b) (but not in (a)) it is provided that the persistent breach should occur across a number of months in order for it to accrue towards possible termination.

²⁹ The time periods should be fixed by reference to the nature of the Project.

³⁰ See footnote 29 above.

³¹ This notice will specify at least the information in paragraph (b). For the Direct Agreement to work effectively, a similar notice should be

- (b) The termination notice must specify:
- (i) the type and nature of Contractor Default that has occurred, giving reasonable details; and
 - (ii) that in the case of any Contractor Default falling within the limbs (a), (g), (h), (i) and (o) of the definition of Contractor Default this Agreement will terminate on the day falling [sixty]³² days after the date of the date the Contractor received the termination notice, unless:
 - (A) in the case of a breach under limb (a) of the definition of Contractor Default the Contractor puts forward an acceptable rectification programme within [thirty] days after the date the Contractor receives the Termination Notice (and implements such programme in accordance with its terms and rectifies the Contractor Default in accordance with the programme); or
 - (B) in the case of any Contractor Default falling with the limbs (a), (g), (h), (i) and (o) of the definition of Contractor Default the Contractor rectifies the Contractor Default within [sixty] days after the date the Contractor receives the Termination Notice; or
 - (iii) that in the case of any other Contractor Default (not being limbs (a), (g), (h), (i) or (o)), this Agreement will terminate on the date falling [thirty] days after the date the Contractor receives the termination notice.
- (c) If the Contractor either rectifies the Contractor Default within the time period specified in the termination notice, or implements the rectification programme, if applicable, in accordance with its terms, the termination notice will be deemed to be revoked and the Contract will continue.
- (d) If:
- (i) in the case of a Contractor Default within limb (a) of the definition of that term no acceptable rectification programme has been put forward pursuant to Clause 21.2.4(b) (ii) (A) and the Contractor fails to rectify the Contractor Default within the time period specified in the termination notice; or
 - (ii) in the case of a Contractor Default falling within limbs (g), (h), (i), or (o) of the definition of Contractor Default, the Contractor fails to rectify the Contractor Default within the time period specified in the termination notice,
- the Authority may give notice stating that the Contract will, subject to the terms of the Direct Agreement, terminate on the date falling [seven] days after the date of receipt of such notice.³³
- (e) If the Contractor fails to implement any rectification programme in accordance with its terms, the Contract will, subject to the terms of the Direct Agreement, terminate on the date falling [seven] days after the date of notification by the Authority to the Contractor of such failure to implement the rectification programme in accordance with its terms.

delivered to the Agent containing the information required by the Senior Lenders (see Section 31 (Direct Agreement and Senior Lenders)).

³² This will depend on the Project concerned and (as stated in Section 21.2.4.1) the breach concerned.

³³ See footnote 36 below.

21.2.4.2 The rectification procedure should allow the Contractor to propose a rectification programme which the Authority may comment on and approve. There will usually be a fixed period within which such programme must be carried out, although it may be appropriate to agree a different, reasonable, period in circumstances where the period set out in the Contract is agreed to be inappropriate, taking into account the nature of the specific breach.

21.2.4.3 During the rectification period it will be to the Contractor's benefit to claim that a Relief Event has occurred. It is for this reason that wilful acts and defaults of the Contractor are excepted from the definition of Relief Events (see Section 5.3.2 (Scope of Relief Events)).^{34 35} Failure to rectify the default within the agreed period will lead to termination, subject to any step-in rights of the Senior Lenders under the Direct Agreement.

21.2.5 Compensation on Termination for Contractor Default

21.2.5.1 One question that may be asked is why compensation should be paid to the Contractor when it has failed to perform in accordance with the Contract. Under a typical service contract, not only would no compensation be paid but the non-performing party could expect the innocent party to bring claims for damages. The reason that compensation is paid is that a failure to compensate could unfairly benefit the Authority. This would be the case, for example, where a particular asset is developed to deliver a particular service and the Authority is entitled to have the asset transferred to it on a termination without compensating the Contractor for its value. The question that is then relevant is how best to assess what an appropriate level of compensation is for Contractor Default.

21.2.5.2 The amount of compensation payable on Contractor Default termination is one of the key commercial issues for all parties concerned. The market value approach described below is the required approach for all PFI projects.

21.2.5.3 In order to understand why the market value principle has been adopted, and accepted by the PFI market, it is helpful to understand the variety of alternatives which preceded it. These ranged from early roads projects, which provided for no compensation for Contractor Default, prisons projects, which offered no compensation for termination during the construction period, early accommodation, schools and hospital projects, which were based on a wide range of calculations usually linked during the construction period to capital costs less rectification costs and during the Service Period to the NPV of future cashflows, and some contracts which virtually guaranteed (implicitly or explicitly) full payout of Senior Debt.

21.2.5.4 The market value approach represents a balance between protecting the Authority's interests and not imposing unreasonable deductions on the Contractor for its default. It also encourages the Senior Lenders to step-in and rescue the Project instead of simply relying on the termination payment to pay their outstanding debt (see Section 31 (Direct Agreement and Senior Lenders)).

21.2.5.5 The "no compensation" models have been driven by a proper concern that, on Contractor Default, Senior Lenders should be encouraged to step-in and work the Project out. They do expose, however, the public sector to the charge that it is seeking a possible windfall gain in the event that termination occurs (e.g. if it takes over a valuable asset), although this may be refuted by the Authority agreeing to pay the market value for any assets to be transferred to it. They may also serve to increase the cost of projects to the public sector by forcing bidders to take

³⁴ See Section 31 (Direct Agreement and Senior Lenders). This gives the Senior Lenders an opportunity to rectify or "sell" the unexpired terms of the Contract themselves.

³⁵ It may be appropriate in the light of these concerns to extend the exceptions to the definition of "Relief" to cover the wilful acts and defaults of other concerned parties.

a conservative approach to risk pricing, liquidated damages and the limits on liability they require from their Sub-Contractors.

21.2.5.6 On the other hand, calculations based on the NPV of future cashflows proved extremely complex and difficult to negotiate. In practice, they are unlikely to take full account either of the performance history of the defaulting Project (and so expectations of future performance), the extra costs accruing to the Authority over the period of the Contract or of the risk transfer to the Contractor (particularly in relation to whole life costing). Equally, if payments based on NPV calculations were sufficient to pay Senior Debt in full, the Senior Lenders would have less incentive to rescue the ailing Project. This might well result in terminations which would otherwise have been avoidable and would be to the detriment of Authorities and Contractors.

21.2.6 Market Value

21.2.6.1 The required approach follows the principle set out in Section 21.2.5.4. It facilitates the Senior Lenders' rights to step-in, manage and rescue or sell the Project if the Contractor defaults, but, if they fail to do so, offers compensation on termination based on the market value of the unexpired term of the Contract.

21.2.6.2 The approach:

- does not require the Senior Lenders to make attempts to take responsibility and seek to transfer the Project if there is no liquid market for similar PFI projects;
- does not penalise Senior Lenders for stepping in if, subsequently, they choose to step-out (see Section 31 (Direct Agreement and Senior Lenders));
- increases the incentives for Senior Lenders to work with the Authority and the Contractor to achieve a long term solution rather than terminate a Project that encounters difficulties;
- ensures that the Authority is no worse off as a result of the termination where Senior Lenders elect not to step-in;
- does not give the Authority a windfall gain on termination; and
- does not discriminate against different classes of finance or against bidders who are prepared to finance the Project through their own balance sheets.

21.2.6.3 If the Authority issues a Termination Notice to the Contractor, the Senior Lenders will require an opportunity to put together a remedial plan and accordingly, the right to attempt to rectify breaches or transfer the Contract. The Senior Lenders are given this opportunity under the terms of the Direct Agreement.³⁶ In such circumstances, the Senior Lenders are incentivised to take control of the Project because any failure to do so will lead to termination of the Contract and allow the Authority to elect to retender the Contract (see Section 21.2.7 (Retendering Election and Liquid Market) below). Senior Lenders accept that they should take the risk of the Contractor's performance and take responsibility for the Project if the Authority elects to terminate the Contract for poor performance. The Senior Lenders will not, however, agree to any requirement to take reasonable steps to transfer the Contract to a third party at the time of the issuance of the Termination Notice if there is no liquid market for similar types of PFI projects. The required approach is therefore that if at the time the Authority issues the Termination Notice the parties agree that there is no liquid market (or it is determined in accordance with the Dispute Resolution Procedure), the procedure set out in Clause 21.2.9 (No Retendering) should be used to determine the compensation payable to the Contractor.³⁷

³⁶ See Section 31 (Direct Agreement and Senior Lenders).

³⁷ See Clause 4 (No Liquid Market) of the Direct Agreement set out at Section 31 (Direct Agreement and Senior Lenders).

21.2.7 Retendering Election and Liquid Market

21.2.7.1 Clause 21.2.7 gives the Authority a choice in certain circumstances whether to retender the Contract or not following termination. It would not be appropriate for the Authority to choose between these two methods of compensation if:

- there is no liquid market for similar PFI projects; or
- the Senior Lenders have stepped-in and are using their reasonable efforts to find a buyer for the Contract.

The Authority should, however, in other circumstances have the right to elect whether to require retendering of the unexpired term of the Contract or to have the Contract valued on the basis of there being no retendering (i.e. which of Clause 21.2.8 (Retendering Procedure) and Clause 21.2.9 (No Retendering Procedure) applies) (e.g. if Senior Lenders decide not to step-in).

21.2.7.2 If there is no liquid market for the Contract or similar contracts, and the Contract terminates, then the procedure set out in Clause 21.2.9 (No Retendering Procedure) should be used.

21.2.7.3 There will be a liquid market for the Contract if there are a sufficient number of contractors in the prevailing PFI market (or markets for similar contracts to PFI Contracts)³⁸ to ensure that the price that a Contractor will offer for the Contract is reasonably likely to represent a fair value.

21.2.7.4 The question is whether the market for contracts of this type in general is liquid (it is possible for there to be no bidders for a retendered Contract and there still to be a liquid market). If the Authority only receives one compliant tender then the amount that the compliant tenderer bids for the new contract should not automatically be rejected as not representing the fair value of the new Contract. The relevant test is not what happens at the end of the Retendering Procedure, but the state of the PFI market for similar contracts at the time the liquid market test is run. If there is a liquid market for PFI and the Authority elects to retender the Contract, the market will determine the Fair Value of the Contract (i.e. if there are no bidders for the retendering of the Contract, the market has, by definition, determined that the market value of the Contract is less than or equal to zero). The Senior Lenders are therefore incentivised to exercise their rights under their Direct Agreement with the Authority³⁹ to ensure greater control by means of retendering of the Contract.

21.2.7.5 If the Contract is transferred to a new contractor via the Retendering Procedure, the price for which the Contract is to be sold will be determined through a competitive bidding process, controlled by the Authority. The Senior Lenders will generally prefer to control any transfer of the Contract, and the price achieved for the transfer, themselves. This they are permitted to do by stepping in under the Direct Agreement (see Section 31 (Direct Agreement and Senior Lenders)). Accordingly, the Senior Lenders are incentivised to exercise their rights of step-in and take control of the sale of the Contract to a new contractor.

21.2.7.6 Any dispute as to the existence of a liquid market for the Contract should be dealt with through the dispute resolution procedure (see Section 28 (Dispute Resolution)).

Required drafting (including definitions) is as follows:

“Fair Value”

³⁸ By definition, a liquid market must consist of more than one bidder. In the context of any new PFI project, the Authority will wish to ensure that there is at least one bidder in the market for similar contracts. This principle should also apply in this context and accordingly, a liquid market should only exist if there are at least two suitably qualified entities capable of bidding in the market.

³⁹ See Section 31 (Direct Agreement and Senior Lenders).

means the amount at which an asset or liability could be exchanged in an arms length transaction between informed and willing parties, other than in a forced or liquidation sale.

“Liquid Market”

means that there are sufficient willing parties (being at least two parties, each of whom is capable of being a Suitable Substitute Contractor) in the market for PFI contracts or similar contracts for the provision of services (in each case the same as or similar to the Contract) for the price that is likely to be achieved through a tender to be a reliable indicator of Fair Value provided always that any vehicle controlled and established by the Senior Lenders specifically for the purposes of this Project and to which this Contract may be novated shall be discounted in assessing whether there are sufficient willing parties in the market for such purposes.

21.2.7 Retendering Election

- (a) Subject to paragraph (b), the Authority shall be entitled⁴⁰ either to:
 - (i) retender the provision of the Project in accordance with Clause 21.2.8 (Retendering Procedure); or
 - (ii) require an expert determination in accordance with Clause 21.2.9 (No Retendering Procedure).
- (b) The Authority shall be entitled to retender the provision of the Project in accordance with Clause 21.2.8 (Retendering Procedure) if:
 - (i) the Authority notifies the Contractor on or before the date falling 20 Business Days after the Termination Date that it intends to retender; and
 - (ii) there is a Liquid Market, and either:
 - (A) the Senior Lenders have not exercised their rights to step-in under Clause 5 of the Direct Agreement;⁴¹ or
 - (B) the Contractor or Senior Lenders have not procured the transfer of the Contractor’s rights and liabilities under this Contract to a Suitable Substitute Contractor⁴² and have failed to use all reasonable efforts to do so.⁴³

but otherwise the Authority shall not be entitled to re-tender the provision of the Project and Clause 21.2.9 shall apply.

21.2.8 Retendering Procedure

21.2.8.1 The Authority will in the circumstances referred to in Clause 21.2.7 (Retendering Election) be entitled to elect to sell (i.e. retender) the unexpired term of the Contract on its original terms and pay the proceeds of the sale (net of the Authority’s costs) to the former Contractor.

21.2.8.2 Bidders would be invited to tender to the Authority for the provision of the Service set out in the Contract at the same Unitary Charge as that set out in the Contract. Since both the Service and price remain unchanged, the Authority will be no better and no worse off than it would have been had the Contract not been terminated, save for the disruption caused. If the Authority wishes to retender the Contract on the basis of a different Service, then the Authority will need to

⁴⁰ The presumption should be in favour of a retender.

⁴¹ See Section 31 (Direct Agreement and Senior Lenders).

⁴² As defined in Section 31 (Direct Agreement and Senior Lenders).

⁴³ The Retendering Procedure should apply during both the construction and operational period.

agree with the Contractor (and its lenders) any changes which would adversely affect the Contractor, or alternatively pay the Adjusted Estimated Fair Value of the Contract.

21.2.8.3 The Unitary Charge should be sufficient, in most circumstances, to represent a positive valuation from prospective bidders (and so generate a cash sum) since, particularly if termination takes place during the Service Period, bidders will not typically incur capital costs on the scale envisaged when the price was originally agreed. The private sector is, of course, familiar with the cashflow valuation techniques which would be used to assess the value of the Contract. These involve their valuing a number of factors, including the revenue stream of the Project, the capital and service costs they expect to incur (taking into account the conditions of the Assets), the perceived risks associated with the Project, financing costs and market appetite.

21.2.8.4 One of the concerns that the outgoing Contractor will have is that, in the period between the Termination Date and the date of the New Contract, there will be no income, finance costs will increase, the condition of the Assets may deteriorate (thereby detrimentally affecting their value) and the Authority will potentially be obtaining some value even though there is no Service (in that, even with the Authority itself performing the Service, a significant benefit exists). For that reason, the Authority should periodically pay a Post Termination Service Amount to the outgoing Contractor which should approximate to the value received in this interim period. The required approach is to take the Unitary Charge that was paid at the Termination Date and deduct from that both the costs of alternative provision of the Service and any rectification costs (allowing the Contractor the benefit of any rectified availability as a result of rectification costs being incurred).

21.2.8.5 To the extent that the term of the New Contract is the same as the unexpired term for the terminated Contract (i.e. the expiry date in the New Contract is later than that in the Contract by the amount of time the Retendering Procedure has taken) then any Post Termination Service Amounts should be deducted from the ultimate payment made. That is, once the estimated value of the post termination period to the Authority has been accurately assessed, this deduction is appropriate.

21.2.8.6 It may be, however, for operational reasons that a service requirement can, in fact, only be delivered for a period that expires on the original Expiry Date. In such circumstances, it would not be possible for the term of the retendered contract to be for a period equal to the unexpired term of the Contract. If it is not possible to relet for a period equal to the unexpired term (e.g. the Expiry Date of the original Contract is the date on which the Service ceases to be required) then the Post Termination Service Amounts should not be deducted from the Market Value of the Contract.⁴⁴

21.2.8.7 As in the original procurement, the Authority will select the bid which represents best value (which should not simply be the highest price). Given the need for the outgoing Contractor to be protected and to give the Authority flexibility, the highest priced compliant tender is the amount paid by the Authority to the outgoing Contractor in compensation, even if the Authority decides to contract with a separate compliant tenderer offering better value for money and which has agreed to pay a lower price. In such a situation the Authority will have to have satisfied itself as to the value for money benefits of choosing such a tenderer. All things being equal, and provided bidders are able to show that they are capable of meeting the service requirements, the best priced compliant bid should win. The bid price, net of the Authority's own costs of retendering and any costs incurred in relation to running the Service prior to replacement of the Contractor (having taken into account non-payment of the Unitary Charge), will be paid to the former Contractor as compensation (this is defined as the Adjusted Highest Complaint Tender price in the drafting).

⁴⁴ If this is the case then the parties will have to fix a date for the new Contract to come into effect, so that tenderers can bid for a fixed term.

21.2.8.8 It is important that neither party is incentivised to delay the process by which market value is determined. These provisions help prevent such a delay occurring.

21.2.8.9 If the Authority elects to retender the Contract, the Authority will be responsible for and will control the retendering process. Consequently, if the Senior Lenders decide not to step-in, or have subsequently stepped-out without satisfying the requirements of Clause 21.2.7(b), they will cease to have any control over the transfer of the Contract to the new contractor. However, the Senior Lenders will be concerned to ensure that the Authority correctly follows the Tender Process so as to help ensure that a fair market value for the Contract is received. The Senior Lenders (through the Contractor) should therefore have the right to appoint a third party (the "Tender Process Monitor") to monitor the retendering process and report on its progress to the Contractor and Senior Lenders. Although the Tender Process Monitor should have the right to attend meetings, review tender process documentation and bids, the Authority should not be required to have regard to any representations made by the Tender Process Monitor in respect of the Tender Process.

Required drafting (including definitions) is as follows:

"Adjusted Highest Compliant Tender Price"⁴⁵

means the Highest Compliant Tender Price less the aggregate of:

- (a) any Post Termination Service Amounts paid to the Contractor to date;
- (b) the Tender Costs; and
- (c) amounts that the Authority is entitled to set off or deduct under Clause 12 (Set-off),

plus an amount equal to the aggregate of:

- (i) all credit balances on any bank accounts held by or on behalf of the Contractor on the date that the highest priced Compliant Tender is received;
- (ii) any insurance proceeds and other amounts owing to the Contractor, to the extent not included in (i); and
- (iii) the Post Termination Service Amounts (if a negative number),

to the extent that:

- (a) (i), (ii) and (iii) have not been directly taken into account in that Compliant Tender; and
- (b) the Authority has received such amounts in accordance with the Contract.

"Compensation Date"

means either:

- (a) if Clause 21.2.8 (Retendering Procedure) applies, the earlier of:
 - (i) the date that the New Contract is entered into; and
 - (ii) the date on which the Authority pays the Adjusted Highest Compliant Tender Price to the Contractor, or
- (b) if Clause 21.2.9 (No Retendering Procedure) applies, the date that the Adjusted Estimated Fair Value of the Contract has been agreed or determined.

"Compliant Tender"

means any tender submitted by a Compliant Tenderer that meets the qualification criteria notified under Clause 21.2.8(c).

⁴⁵ This definition sets out the adjustments which should be made to the Highest Compliant Tender Price before it is paid by the Authority.

“Compliant Tenderer”

means a tenderer who is a Suitable Substitute Contractor.⁴⁶

“Highest Compliant Tender Price”

means the price offered by the Compliant Tenderer (if any) with the highest tender price⁴⁷ and, if no Compliant Tenders are received, zero.

“Market Value Availability Deduction Amount”⁴⁸

means for any month or part of a month, an amount equal to the availability deduction that was made to the Unitary Charge under [see Section 7 (Price and Payment Mechanism)] in the month immediately preceding the Termination Date, less an amount equal to any availability deduction that was made for an [available place] which was unavailable at the Termination Date but which has subsequently become available whether as a result of the Authority incurring Rectification Costs or otherwise.⁴⁹

“Maximum⁵⁰ Unitary Charge”

means, in respect of a month, the unitary charge payable during that month before any deductions under [see Section 7 (Price and Payment Mechanism)] but allowing for indexation under the [indexation provisions (see Clause 1.7.2(c) (Interpretation) and Section 15.2 (Indexation))].

“New Contract”

means an agreement on the same terms and conditions⁵¹ as this Contract⁵² at the Termination Date, but with the following amendments:

- (a) if this Contract is terminated prior to the Service Commencement Date, then the Service Commencement Date shall be extended by a period to allow a New Contractor⁵³ to achieve Service Commencement;
- (b) any accrued [performance points] and/or warning notices shall, for the purposes of termination only, and without prejudice to the rights of the Authority to make financial deductions, be cancelled;
- (c) the term of such agreement shall be equal to the term from the [Termination Date]⁵⁴ until the Expiry Date; and
- (d) any other amendments which do not adversely affect the Contractor.

“New Contractor”

⁴⁶ As defined in Section 31 (Direct Agreement and Senior Lenders).

⁴⁷ The tender price must be bid as a lump sum. If this were not the case then the Authority would have to fund the delay in payment of the compensation amount, which is unlikely to represent value for money.

⁴⁸ See Section 21.2.8.4 above.

⁴⁹ This is effectively adding back to the Unitary Charge any such deduction. The Rectification Costs themselves are then deducted from the Post Termination Service Amounts.

⁵⁰ This will require careful consideration if significant third party income or usage payments exist.

⁵¹ The New Contractor will take over from the Contractor as counterparty under the Contract and therefore take on all existing and antecedent liabilities (except in respect of Performance Points and Warning Notices). Any bidder will therefore conduct extensive due diligence over the Project for the purposes of correctly pricing its bid.

⁵² This should also include other documents entered into between the parties, where appropriate.

⁵³ That is, time to complete is given if termination occurs prior to Service Commencement. If termination occurs during the construction period or rectification work is required following termination, but while the new Contract is in effect, then the remaining service period under the New contract may be shorter than the unexpired Service Period under the existing Contract.

⁵⁴ In projects in which the Service ceases to be required on or shortly after the original Expiry Date, then the term of the New Contract will be reduced and so Post Termination Service Amounts will not be deducted (or added back).

means the person who has entered or who will enter into the New Contract with the Authority.

“Post Termination Service Amount”⁵⁵

means for the purposes of Clause 21.2.8 (Retendering Procedure), for the whole or any part of a month for the period from the Termination Date to the Compensation Date, an amount equal to the Maximum Unitary Charge which would have been payable in that month under the Contract had the Contract not been terminated, less an amount equal to the aggregate of:

- (a) the Market Value Availability Deduction Amount for that month;
- (b) the Rectification Costs incurred by the Authority in that month; and
- (c) (where relevant), the amount by which the Post Termination Service Amount for the previous month was less than zero.⁵⁶

“Rectification Costs”

means, for the purposes of any Termination Date that occurs during the Service Period, an amount equal to the reasonable and proper costs incurred by the Authority in a particular month or part of a month in ensuring that the Service⁵⁷ is available.

“Tender Costs”

means the reasonable and proper costs of the Authority incurred in carrying out the Tender Process and/or in connection with any calculation of the Estimated Fair Value of the Contract.

“Tender Process”

means the process by which the Authority requests tenders from any parties interested in entering into a New Contract, evaluates the responses from those interested parties and enters into a New Contract with a new service provider, in accordance with Clause 21.2.8 (Retendering Procedure).

“Tender Process Monitor”

means a third party appointed by the Contractor under Clause 21.2.8(e).

21.2.8 Retendering Procedure

If the Authority elects to retender the provision of the Project under Clause 21.2.7 (Retendering Election), then the following provisions shall apply:

- (a) The objective of the retendering procedure shall be to establish and pay to the Contractor the Highest Compliant Tender Price, as a result of the Tender Process.
- (b) The Authority shall (subject to any legal requirements preventing it from doing so) use its reasonable endeavours to complete the Tender Process as soon as practicable.
- (c) The Authority shall notify the Contractor of the qualification criteria⁵⁸ and the other requirements and terms of the Tender Process, including the timing of the Tender Process but shall act reasonably in setting such requirements and terms.

⁵⁵ This payment is made both to ensure that the Authority is incentivised to expedite the retender and that any value received by the Authority is reflected post termination. Usage based payments will need to be addressed specifically.

⁵⁶ A positive Post Termination Service Amount will occur where the cost incurred by the Authority in procuring the Service itself (including rectification costs) is less than the Unitary Charge. A negative Post Termination Service Amount will arise if the costs incurred in procuring the Service (including rectification costs) are greater than the Unitary Charge.

⁵⁷ That is, in accordance with the output specification under the Contract.

⁵⁸ The Authority may wish to define qualification criteria. See the Department of Health standard form PFI Agreement.

- (d) The Contractor authorises the release of any information by the Authority under the Tender Process which would otherwise be prevented under Clause 26 (Information and Confidentiality) that is reasonably required as part of the Tender Process.
- (e) The Contractor may, at its own cost, appoint a person (the "Tender Process Monitor") to monitor the Tender Process for the purpose of monitoring and reporting to the Contractor and the Senior Lenders on the Authority's compliance with the Tender Process and making representations to the Authority. The Tender Process Monitor will not disclose any confidential information⁵⁹ to the Contractor or any other person (and shall provide an undertaking to the Authority to such effect as a condition of its appointment) but shall be entitled to advise the Contractor as to whether it considers that the Authority has acted in accordance with the Tender Process, and correctly determined the Adjusted Highest Compliant Tender Price.
- (f) The Tender Process Monitor shall enter into a confidentiality agreement with the Authority in a form acceptable to the Authority and shall be entitled to attend all meetings relating to the Tender Process, inspect copies of the tender documentation and bids and shall be required to make written representations to the Authority regarding compliance with the Tender Process. All representations shall be made by the Tender Process Monitor in a timely manner as the Tender Process proceeds. The Authority shall not be bound to consider or act upon such representations but acknowledges that such representations may be referred to by the Contractor in the event that the Contractor refers a dispute relating to the Adjusted Highest Compliant Tender Price to dispute resolution in accordance with Clause 28 (Dispute Resolution).
- (g) For all or any part of a month, falling within the period from the Termination Date to the Compensation Date, the Authority shall pay to the Contractor:
 - (i) the Post Termination Service Amount for that month, on or before the date falling 10 Business Days after the end of that month; and
 - (ii) the Post Termination Service Amount for the period ending on the Compensation Date, on or before the date falling [20] Business Days after the Compensation Date.
- (h) If any Post Termination Service Amount is less than zero then it shall be carried forward and shall be set off against any future positive Post Termination Service Amounts. If any such Post Termination Service Amount has not been set off on or before the Compensation Date then it shall be taken into account in the calculation of the Adjusted Highest Compliant Tender Price.
- (i) The Authority shall require bidders to bid on the basis that they will receive the benefit of any outstanding claims under material damage insurance policies and amounts (if any) standing to the credit of the Joint Insurance Account on the date that the New Contract is entered into.
- (j) As soon as practicable after tenders have been received, the Authority shall (acting reasonably) determine the Compliant Tenders and shall notify the Contractor of the Adjusted Highest Compliant Tender Price.
- (k) If the Contractor refers a dispute relating to the Adjusted Highest Compliant Tender Price to dispute resolution in accordance with Clause 28 (Dispute Resolution), the Authority shall be entitled to enter into a New Contract. The Authority shall pay to the Contractor the Adjusted Highest Compliant Tender Price on or before the date falling [20] Business Days after it has been determined in accordance with Clause 28 (Dispute Resolution) and the Authority shall pay interest to the Contractor at the

⁵⁹ The parties will agree what constitutes "confidential information" when the Tender Process Monitor is appointed.

Senior Debt Rate on any amount of Adjusted Highest Compliant Tender Price which had been withheld, from the date specified in paragraph (l) below until the date specified in this paragraph (k).⁶⁰ For the avoidance of doubt, where there is an agreed amount and a disputed amount in respect of the Adjusted Highest Compliant Tender Price the Authority shall (where it is agreed that the Adjusted Highest Compliant Tender Price is a positive number) pay to the Contractor the agreed amount no later than the date specified in paragraph (l) below, with the disputed amount being dealt with in accordance with this paragraph (k).

- (l) Subject to paragraphs (k) and (o), the Authority shall pay to the Contractor an amount equal to the Adjusted Highest Compliant Tender Price no later than the date falling [20] Business Days after the date of the New Contract.⁶¹
- (m) The discharge by the Authority of its payment obligation in paragraphs (i) and/or (j) above shall be in full and final settlement of all the Contractor's claims and rights against the Authority for breaches and/or termination of this Contract and the Project Documents⁶² whether under contract, tort, restitution or otherwise, save for any liability of the Authority which arose prior to the Termination Date that has not already been taken into account in the Adjusted Highest Compliant Tender Price.
- (n) Subject to paragraphs (o) and (r) below, if the Authority has not paid an amount equal to the Adjusted Highest Compliant Tender Price to the Contractor on or before the date falling two years after the Termination Date then the following provisions of this Clause shall not apply to that termination and the provisions of Clause 21.2.9 (No Retendering Process) shall apply instead.
- (o) If the Adjusted Highest Compliant Tender Price is zero or a negative number then the Authority shall have no obligation to make any payment to the Contractor and with effect from the time that the Authority gives notice of that event to the Contractor, the Authority shall be released from all liability to the Contractor for breaches and/or termination of this Contract and any other Project Document⁶³ whether under contract, tort, restitution or otherwise save for any antecedent liability of the Authority which arose prior to the Termination Date (but not from the termination itself) that has not already been taken into account in determining the Adjusted Highest Compliant Tender Price.
- (p) If the Adjusted Highest Compliant Tender Price is less than zero then an amount equal to the Adjusted Highest Compliant Tender Price shall be due and payable by the Contractor to the Authority on the date of the New Contract.⁶⁴
- (q) The Authority may elect at any time prior to the receipt of a Compliant Tender to follow the no retendering procedure under Clause 21.2.9 (No Retendering Procedure) by notifying the Contractor that this election has been made.
- (r) If the Authority has received all bids from bidders under the Tender Process and has received a Compliant Tender but decides not to complete the Tender Process, it shall notify the Contractor of this decision and pay to the Contractor an amount equal to the Adjusted Highest Compliant Tender Price within [20] Business Days of such notification.

⁶⁰ If there is an agreed amount and a disputed amount then the Authority should only be entitled to retain the disputed amount.

⁶¹ It may be that the Authority decides for value for money reasons to receive the capital sum over time. Even if this is the case the old Contractor should receive the capital sum bid (i.e. the Authority would have to demonstrate the value for money of the financing of such amounts).

⁶² Any other relevant contract should also be included here.

⁶³ See footnote 62 above.

⁶⁴ This right is granted to give the Authority a claim as an unsecured creditor of the Contractor and is not intended, or likely, to result in any significant recovery for the Authority.

21.2.9 No Retendering

21.2.9.1 Alternatively, either the Authority may elect (for example, for operational reasons⁶⁵) not to retender the Project or it may be that there is no Liquid Market, in which case the Authority will instead pay to the Contractor (from its own resources) an assessed value of the amount it would have received through an appropriate retender process (again net of costs) (see Clause 21.2.8 (Retendering Procedure)) that is, if a Liquid Market had existed (the “Estimated Fair Value of the Contract”).

21.2.9.2 Estimated Fair Value computations are conducted by forecasting the full Unitary Charge from the date of termination to the expiry of the Contract (ignoring any deductions for performance or availability), from which the estimated costs of delivering the service to the required standard in the output specification (this includes the running costs, lifecycle costs and any rectification costs) are deducted to arrive at the estimated operating cash-flow stream which, had a liquid market existed and the project been re-tendered, a hypothetical bidder would have valued to determine the amount to bid for the project.

21.2.9.3 The first point to consider in making this computation is whether this computation should be conducted in nominal terms (i.e. using current prices) or in real terms (i.e. using constant prices). For contracts with 100% indexation to RPI, it should not normally matter since both methods would return the identical result. However, it is easier and safer to conduct the analysis in nominal terms because:

- (a) many elements of a Project (including tax and cost of funds) are always quoted in nominal terms, and it is easy to make errors by ignoring this when conducting ‘real’ computations, and
- (b) the majority of PFI Contracts let in the PFI market are partially indexed. For such contracts, the “real” value of the Unitary Charge effectively declines with time. The effect of indexation must therefore be recognised by explicitly including the indexation effects and conducting the analysis in nominal terms.

21.2.9.4 The calculation must also take care to ensure that if the forecast cash flows are expressed in nominal terms (i.e. taking indexation into account), the discount rate used must also be expressed in nominal terms. The discount rate is usually made up of a ‘real’ rate of return, on top of which an allowance for inflation is added. A methodology for making this adjustment is set out in the drafting below.

21.2.9.5 The Authority and the Contractor will need to agree a forecast rate of inflation to be applied to the indexation formula to make the nominal computations. It is recommended that the agreed assumed rate of inflation should be an easily observable and transparent figure.

21.2.9.6 The next question is whether the Estimated Fair Value analysis should be conducted in pre- or post-tax terms. It is considerably easier and more transparent to conduct the analysis in pre-tax terms because this avoids protracted scrutiny of the assumptions underlying the tax forecasts. Since neither the public sector nor the private sector is actually going to be paying taxes going forwards, it is not necessary to assess taxation in the calculation. Moreover, the risk of changing tax regimes between financial close and termination date lies squarely with the private sector, and this should not be made an occasion to revisit that risk transfer. The analysis should therefore be conducted in pre-tax terms.

⁶⁵ There will, in any event (even if a Liquid Market exists), clearly be circumstances in which an Authority will not wish to retender the Project on the original terms – for instance, where its service requirements have radically changed or where the time to retender will give rise to safety or other policy concerns that cannot be addressed adequately in the context of a retender.

21.2.9.7 The forecast cash-flows should be discounted at a discount rate which reflects the risk of the underlying cash-flow. The most transparent measure of the risk of the cashflows is the real pre-tax project IRR reflected in the Base Case. However, since underlying rates in the market such as the real yields on Government Gilts or the London Interbank Offered Rate (LIBOR) can and do vary over time, the Authority must consider carefully whether, in setting a discount rate for the Estimated Fair Value calculation, it should acknowledge the effect of changes to these underlying variables.

21.2.9.8 The main argument in favour of giving effect in the discount rate to changes in underlying risk-free rates is that if a liquid market existed and the Contract were successfully re-tendered, a hypothetical bidder would take into account current market yields on risk-free investments in choosing what discount rate to apply to the Project. If these benchmark rates had moved upwards, for instance, in the time between Financial Close and Date of Termination, an incoming bidder would bid a lower sum for the Project and vice versa. Not recognising this difference could create a discrepancy between the compensation sums arising out of the Retendering procedure and the No Retendering procedure. Therefore an adjustment should be made as set out in the drafting below to reflect the impact on the Estimated Fair Value discount rate of changes to underlying market rates.

21.2.9.9 The adjustment set out below provides the Contractor with a natural hedge against movements in underlying market rates that may cause losses or profits on broken interest rate hedges on Termination. If interest rates move down between Financial Close and Termination Date, the Contractor would find itself having to pay positive breakage costs on the interest rate swap (if one was put in place at Financial Close). Adjusting the Estimate Fair Value discount rate downwards in line with market rate movement would have the effect of generating a larger compensation sum, thereby partially or fully protecting the Contractor against the adverse position on its interest rate swap. Upwards movements in interest rates would likewise have the opposite effect, generating profits on the broken hedge but a smaller compensation sum from the Authority.

21.2.9.10 From the point of view of Authorities, it is also beneficial to have adjustments as set out below to the discount rate because, just as the adjustment provides the Contractor with a natural hedge against breakage costs, it provides Authorities with a natural hedge against the cost of funding compensation payments. To illustrate, an upward movement in interest rates would make it more expensive for Authorities to finance a given compensation payment, but the proposed mechanism would adjust the discount rate upward in line with market movement and reduce the amount of compensation to be paid, thereby partly protecting the Authority's position. A downward movement in market rates would have the opposite effect.

21.2.9.11 Any dispute as to the assessed value of the terminated Contract should be dealt with through the dispute resolution procedure (see Section 28 (Dispute Resolution)).

Required drafting (including definitions) is as follows:

“Adjusted Estimated Fair Value of the Contract”

means the Estimated Fair Value of the Contract, less an amount equal to the aggregate of:

- (a) [where relevant any Post Termination Service Amounts⁶⁶ paid to the Contractor (if a positive number)⁶⁷;
- (b) the Tender Costs; and
- (c) amounts that the Authority is entitled to set off or deduct under Clause 12 (Set-Off),

⁶⁶ There will only be any Post Termination Service Amounts here to the extent that the Authority starts the retendering process, but then decides to follow the no retendering approach.

⁶⁷ These amounts are not deducted to the extent paragraph (c) of the definition of “New contract” is a period from the date of the New Contract to the original Expiry Date (rather than the Termination Date to the original Expiry Date).

plus an amount equal to the aggregate of:

- (i) all credit balances on any bank accounts held by or on behalf of the Contractor on the date that the Estimated Fair Value of the Contract is calculated;
- (ii) any insurance proceeds and other amounts owing to the Contractor (and which the Contractor is entitled to retain), to the extent not included in (i); and
- (iii) the Post Termination Service Amounts (if a negative number),⁶⁸

to the extent that:

- (1) (i), (ii) and (iii) have not been directly taken into account in calculating the Estimated Fair Value of the Contract; and
- (2) the Authority has received such amounts in accordance with the Contract or such amounts are standing to the credit of the Joint Insurance Account.

“Deemed New Contract”

means an agreement on the same terms and conditions as this Contract, as at the Termination Date, but with the following amendments:

- (a) if this Contract is terminated prior to the Service Commencement Date, then the Service Commencement Date shall be extended by a period to allow a New Contractor⁶⁹ to achieve Service Commencement;
- (b) any accrued [performance points] and/or warning notices shall, for the purposes of termination only, and without prejudice to the rights of the Authority to make financial deductions, be cancelled; and
- (c) the term of such agreement shall be for a period equal to the term from the Termination Date⁷⁰ to the Expiry Date.

“Estimated Fair Value of the Contract”

means the amount determined in accordance with Clause 21.2.9 (No Retendering Procedure) that a third party would pay to the Authority as the market value of the Deemed New Contract.

“Termination Date Discount Rate”

means a discount rate expressed as $[(1 + \text{real base case project IRR} + \text{Gilt B} - \text{Gilt A}) * (1 + i) - 1]$

where:

“real base case project IRR” is the real pre-tax Project IRR as set out in the Base Case;⁷¹

“i” is the agreed assumed forecast rate of increase in the [indexation formula] set out in the Contract for the remaining term of the Contract;

“Gilt A” is the real yield to maturity on a benchmark government Gilt instrument of the same maturity as the average life of the outstanding Senior Debt as shown in the Base Case at Financial Close; and

⁶⁸ See footnote 56 above.

⁶⁹ That is, time to complete is given if termination occurs prior to Service Commencement. Other timing related issues may require a similar treatment depending on the Contract.

⁷⁰ The Termination Date here is the relevant date as no New Contract is actually being entered into.

⁷¹ Parties should not agree a discount rate other than this (this is the discount rate contained in the Base Case (see Clause 34 (Refinancing) for definition).

“Gilt B” is the real yield to maturity on a benchmark government Gilt instrument of the same maturity as the average life of the outstanding Senior Debt as shown in the Base Case as on the date of Termination.

21.2.9 No Retendering Procedure

If either the Authority is not entitled to retender the provision of the Project under Clause 21.2.7 (Retendering election) or the Authority elects to require an expert determination in accordance with this Clause 21.2.9 (No Retendering Procedure) then the following procedure shall apply.

- (a) Subject to paragraph (b) below, the Contractor shall not be entitled to receive any Post Termination Service Amount.
- (b) If the Authority elects to require an expert determination in accordance with this Clause 21.2.9 (No Retendering Procedure) after it has elected to follow the procedure under Clause 21.2.8 (Retendering Procedure), then the Authority shall continue to pay to the Contractor each Post Termination Service Amount until the Compensation Date, in accordance with Clause 21.2.8 (Retendering Procedure).
- (c) In agreeing or determining the Estimated Fair Value of the Contract the parties shall be obliged to follow the principles set out below:
 - (i) all forecast amounts should be calculated in nominal terms at current prices, recognising the adjustment for indexation in respect of forecast inflation between the date of calculation and the forecast payment date(s) as set out in the Contract;
 - (ii) the total of all future payments of the full Unitary Charge (without deductions) forecast to be made shall be calculated and discounted to the Termination Date at the Termination Date Discount Rate;
 - (iii) the total of all costs forecast to be incurred by the Authority as a result of termination shall be calculated and discounted at the Termination Date Discount Rate and deducted from the payment calculated pursuant to subparagraph (ii) above, such costs to include (without double counting):
 - (A) a reasonable risk assessment of any cost overruns that will arise,⁷² whether or not forecast in the relevant base case;
 - (B) the costs of the Service forecast to be incurred by the Authority in providing the Project to the standard required,⁷³ and
 - (C) any rectification costs required to deliver the Project to the standard required (including any costs forecast to be incurred by the Authority to complete construction or development work and additional operating costs required to restore operating services standards),in each case such costs to be forecast at a level that will deliver the full Unitary Charge referred to in paragraph (ii) above.
- (d) If the parties cannot agree on the Adjusted Estimated Fair Value of the Contract on or before the date falling [30] days after the date on which the Authority elected to require an expert determination in accordance with this Clause 21.2.9 (No Retendering Procedure), then the Adjusted Estimated Fair Value of the Contract shall be determined in accordance with Clause 28 (Dispute Resolution).

⁷² A methodology can be agreed in advance for agreeing what constitutes a reasonable risk assessment.

⁷³ This includes both the every day running costs and the costs of the service and life cycle maintenance costs. Forecasts by agreement or, in the event of dispute, by an expert.

- (e) The Authority shall pay to the Contractor an amount equal to the Adjusted Estimated Fair Value of the Contract on the date falling 60 days after the date on which the Adjusted Estimated Fair Value of the Contract has been agreed or determined in accordance with this Clause 21.2.9 (No Retendering Procedure).
- (f) The discharge by the Authority of its obligation in paragraph (e) is in full and final settlement of all the Contractor's claims and rights against the Authority for breaches and/or termination of this Contract or other Project Document⁷⁴ whether in contract, tort, restitution or otherwise save for any liability that arose prior to the Termination Date (but not from the termination itself) that has not been taken into account in determining the Adjusted Estimated Fair Value of the Contract.
- (g) To the extent that the Adjusted Estimated Fair Value of the Contract is less than zero, then an amount equal to the Adjusted Estimated Fair Value of the Contract shall be due and payable by the Contractor to the Authority on the Compensation Date.⁷⁵

21.2.10 Transfer of Assets on Contractor Default

On termination under Clause 21.2 (Contractor Default), the Authority shall have the option to require the Contractor to transfer to the Authority all of its rights, title and interest in and to the Assets.

21.3 TERMINATION ON FORCE MAJEURE

21.3.1 Failure to agree

21.3.1.1 As set out in Section 5.4 (Force Majeure Events), the Contract should define the Force Majeure Events that can lead to termination and determine the rights of the relevant parties if this occurs. If a Force Majeure Event occurs and the parties cannot agree a solution within a specified period (6 months is typical), either party is entitled to terminate the Contract with compensation payable to the Contractor as set out in Section 21.3.2 (Compensation on Termination for Force Majeure). The Contract should, however, give the Authority the right to prevent termination by paying the Contractor as if the Service were being fully provided after such period. In such circumstances the Authority should specify a fixed period for which it will make such payment, before reconsidering the situation, so that the Contractor can plan accordingly.

Required drafting is as follows:

21.3 Termination on Force Majeure

- (a) No party shall be entitled to bring a claim for a breach of obligations under the Contract by the other party or incur any liability to the other party for any losses or damages incurred by that other party to the extent that a Force Majeure Event occurs and it is prevented from carrying out obligations by that Force Majeure Event. For the avoidance of doubt (but without prejudice to Clauses 21.3(e) or 21.3(g)), the Authority shall not be entitled to terminate this Agreement for a Contractor Default if such Contractor Default arises from a Force Majeure Event.
- (b) Nothing in paragraph (a) above shall affect any entitlement to make deductions or any deductions made as a result of [Section (Price and Payment Mechanism)] in the period during which the Force Majeure Event is subsisting.⁷⁶

⁷⁴ See footnote 67 above.

⁷⁵ See footnote 64 above.

⁷⁶ During the period for which a Force Majeure Event is subsisting, the payment mechanism should operate to ensure that the Contractor is paid only for such of the Services that it performs.

- (c) On the occurrence of a Force Majeure Event, the Affected Party shall notify the other party as soon as practicable. The notification shall include details of the Force Majeure Event, including evidence of its effect on the obligations of the Affected Party and any action proposed to mitigate its effect.
- (d) As soon as practicable following such notification, the parties shall consult with each other in good faith and use all reasonable endeavours to agree appropriate terms to mitigate the effects of the Force Majeure Event and facilitate the continued performance of the Contract.⁷⁷
- (e) If no such terms are agreed on or before the date falling [120]⁷⁸ days after the date of the commencement of the Force Majeure Event and such Force Majeure Event is continuing or its consequence remains such that the Affected Party is unable to comply with its obligations under this Contract for a period of more than [180] days, then, subject to paragraph (f) below, either party may terminate the Contract by giving [30] days' written notice to the other party.
- (f) If the Contract is terminated under paragraph (e) above or (g) below:
 - (i) compensation shall be payable by the Authority in accordance with Clause 21.3.2 (Compensation on Termination for Force Majeure); and
 - (ii) the Authority may require the Contractor to transfer its title, interest and rights in and to any Assets to the Authority.
- (g) If the Contractor gives notice to the Authority under paragraph (e) above that it wishes to terminate the Contract, then the Authority has the option either to accept such notice or to respond in writing on or before the date falling [10] days after the date of its receipt stating that it requires the Contract to continue. If the Authority gives the Contractor such notice, then:
 - (i) the Authority shall pay to the Contractor the Unitary Charge⁷⁹ from the day after the date on which the Contract would have terminated under paragraph (e) as if the Service was being fully provided;⁸⁰ and
 - (ii) the Contract will not terminate until expiry of written notice (of at least [30] days) from the Authority to the Contractor that it wishes the Contract to terminate.
- (h) The parties shall at all times following the occurrence of a Force Majeure Event use all reasonable endeavours to prevent and mitigate the effects of any delay and the Contractor shall at all times during which a Force Majeure Event is subsisting take all steps in accordance with industry good practice to overcome or minimise the consequences of the Force Majeure Event.
- (i) The Affected Party shall notify the other party as soon as practicable after the Force Majeure Event ceases or no longer causes the Affected Party to be unable to comply with its obligations under this Contract. Following such notification the Contract shall continue to be performed on the terms⁸¹ existing immediately prior to the occurrence of the Force Majeure Event.

⁷⁷ These terms may include deciding to suspend the Contract for a period if it is anticipated that the effects of the Force Majeure will be surmountable in time; possibly agreeing to extend the Service Period (and the Planned Service Commencement Date) by the amount of the delay, and/or agreeing that only part of the Service should continue to be provided.

⁷⁸ These timings are indicative only.

⁷⁹ That is, without any availability or performance deductions. If only a part of the Service is affected by the Force Majeure Event then this provision only applies to that part of the Unitary Charge.

⁸⁰ This will be subject to general mitigation obligations.

⁸¹ Taking into account the time that has elapsed, when an extension has been agreed.

21.3.2 Compensation on Termination for Force Majeure

21.3.2.1 If the Contract terminates for Force Majeure, the Authority should pay compensation to the Contractor reflecting the principle that Force Majeure is neither party's fault and the financial consequences should to some extent be shared. There is, however, no equitable reason for "full" compensation (i.e. repayment of debt plus equity service and equity with profits) as this would involve the Authority in bearing all the pain.

21.3.2.2 The Contract should in addition provide the Authority with the option to retain or walk away from the Assets. Whatever the Authority decides, only the payment outlined in Clause 21.3.2 (Compensation on Termination for Force Majeure) should be made (see also Section 21.1.3.9 above for explanation where there has been Additional Permitted Borrowing).

Required drafting is as follows:

21.3.2 Compensation on Termination for Force Majeure

- (a) On termination of the Contract under Clause 21.3 (Termination on Force Majeure), the Authority shall pay⁸² to the Contractor the "Force Majeure Termination Sum" in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].

Subject to paragraphs (c) to (e) below the Force Majeure Termination Sum shall be the amount equal to the aggregate of:

- (i) the Base Senior Debt Termination Amount;
 - (ii) the Junior Debt less an amount equal to the aggregate of payments of interest made by the Contractor under the Subordinated Financing Agreements;⁸³
 - (iii) all amounts paid to the Contractor by way of subscription for shares in the capital of the Contractor less dividends and other distributions paid to the shareholders of the Contractor (save to the extent deducted under (ii) above); and⁸⁴
 - (iv) redundancy payments for employees of the Contractor that have been or will be reasonably incurred by the Contractor as a direct result of termination of the Contract and any Sub-Contractor Breakage Costs.
- (b) If the amounts referred to in paragraphs (a)(ii) and/or (iii) are less than zero, then, for the purposes of the calculation in paragraph (a) they shall be deemed to be zero.
- (c) If the aggregate of the amounts referred to in paragraphs (a)(i), (a)(ii) and (a)(iii) is less than the Revised Senior Debt Termination Amount, then the Force Majeure Termination Sum shall be increased so that it is equal to the aggregate of the Revised Senior Debt Termination Amount and the amount referred to in paragraph (a)(iv) provided always that:
- (i) the amount referred to in paragraph (a)(iv) shall only be paid to the extent that the Contractor has demonstrated to the reasonable satisfaction of the Authority that the amount will not be paid in payment (in whole or in part) of any Distribution and
 - (ii) if, at the time of termination, there are any Additional Permitted Borrowings outstanding, no Sub-Contractor Breakage Costs shall be paid in respect of any

⁸² See Section 22 (Calculation and Payment of Early Termination Payment) for the rights of set-off against such payments.

⁸³ The Junior Debt documentation should be checked to ensure that interest accrued, but not paid, will not come within the definition of Junior Debt. If it does, paragraph (ii) should be amended, to provide for its deduction.

⁸⁴ The effect of this paragraph is to ensure that there are no circumstances in which a refund to the Authority is required.

Sub-Contract in circumstances where there is an event of default under such Sub-Contract which would entitle the Contractor to terminate such Sub-Contract.

- (d) If a Distribution is made whilst any Additional Permitted Borrowing is outstanding and the Contractor has wilfully, or through gross negligence, failed to comply with its obligations under Clause 10(d)(iv)(a) of the Direct Agreement then in addition to the deduction of the Distribution referred to in paragraph (v) of the definition of Revised Senior Debt Termination Amount, the Authority shall be entitled to set off the value of that Distribution a second time against the Force Majeure Termination Sum, provided that the amount of the Force Majeure Termination Sum will never be less than the Revised Senior Debt Termination Amount.
- (e) If the Contractor has wilfully or through gross negligence failed to comply with its obligations under Clause 10(d)(iv)(b) of the Direct Agreement and there has been an overstatement of the cash balances by the Contractor as at that date which has caused the Authority to reasonably believe that it would be required to pay a lesser sum at the Termination Date than it actually is required to pay under the terms of this Clause 21.3.2, then the Force Majeure Termination Sum, shall be reduced by the amount of such overstatement (to the extent such overstatement is still applicable at the Termination Date), provided that the amount of the Force Majeure Termination Sum will never be less than the Revised Senior Debt Termination Amount.
- (f) Such amount shall be determined and paid in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].
- (g) On termination, the Authority shall have the option to require the Contractor to transfer to the Authority all of its right, title and interest in and to the Assets.

21.4 TERMINATION ON CORRUPT GIFTS AND FRAUD

21.4.1 Introduction

21.4.1.1 The Contract must deal comprehensively with termination as a result of corrupt acts or fraud involving the Contractor, any sub-contractor and any servant of the Crown.

21.4.1.2 A balance must be struck between the Authority's proper desire for the right to free itself from a corrupt or fraudulent partner and the financiers' fear of losing their funding for reasons beyond their control due to the corrupt actions of the Contractor or third parties or an individual within either of them.

21.4.1.3 The required drafting for the corruption and fraud that should be dealt with in such a Clause is as follows:

“Prohibited Act”

means⁸⁵

- (a) offering giving or agreeing to give to [any servant of the Crown⁸⁶] any gift or consideration of any kind as an inducement or reward:

⁸⁵ The MOD deals with “National Security” in a similar way.

⁸⁶ This will need to be amended where the Authority is not a central government department. For example, the NHS Guidance refers to the “[Authority] or any other public body or any person employed by or on behalf of [the Authority] or any other public body”.

- (i) for doing or not doing (or for having done or not having done) any act in relation to the obtaining or performance of this Contract or any other contract with the Crown; or
- (ii) for showing or not showing favour or disfavour to any person in relation to this Contract or any other contract with the Crown;
- (b) entering into this Contract or any other contract with the Crown in connection with which commission has been paid or has been agreed to be paid by the Contractor or on its behalf, or to its knowledge, unless before the relevant contract is entered into particulars of any such commission and of the terms and conditions of any such contract for the payment thereof have been disclosed in writing to the Authority;
- (c) committing any offence:
 - (i) under the Prevention of Corruption Acts 1889–1916;
 - (ii) under Legislation creating offences in respect of fraudulent acts, or
 - (iii) at common law in respect of fraudulent acts in relation to this Contract or any other contract with the Crown; or
- (d) defrauding or attempting to defraud or conspiring to defraud the Crown.

21.4.2 Scope of Corrupt Gifts and Fraud

21.4.2.1 The corrupt gifts and fraud provision is aimed at all types of bribery, corruption and fraudulent acts perpetrated against the Authority, in connection with the procurement of the Contract and the ongoing contractual relationship.

21.4.2.2 As the Authority's ultimate sanction to terminate for such acts is severe, the recommended approach allows the Contractor the opportunity to avoid termination where the act has been carried out by a sub-contractor or employee acting on his own. Within a specified reasonable time period, the Contractor has to ensure that any relationship with the relevant party is terminated and, if applicable, a replacement procured for such party.

21.4.2.3 The following approach is the most appropriate way of dealing with the issue:

- if the relevant breach is committed by the Contractor or one of its employees and this is not the action of an employee acting independently (i.e. it is in some way "corporate corruption"), the Authority may terminate the Contract on payment of the Revised Senior Debt Termination Amount and can recover from the Contractor either any losses it suffers as a result of the breach or the amount of the value of the corrupt gift in question. If the breach is the result of the action of an employee acting independently, then the Contractor should terminate the person's employment and procure a replacement within [30] days of notice of the breach. If this is not done, then the Contract can be terminated on payment of the Revised Senior Debt Termination Amount and recovery of the Authority's losses;
- if the breach is committed by one of the Contractor's main Sub-Contractors (e.g. the Operating Sub-Contractor or Construction Sub-Contractor) or their employee and this is not the action of an employee acting independently (it is in some way "corporate corruption"), the Authority may terminate the Contract as above, unless the Contractor terminates the relevant main Sub-Contract and procures the performance of such service by another person within [30] days of notice of the breach. If the breach is the result of the action of an employee acting independently, then the Sub-Contractor should terminate that person's employment and procure a replacement within [30] days of notice of the breach. If this is not done, then the Contract can be

terminated on payment of the Revised Senior Debt Termination Amount and recovery of the Authority's losses;

- if the breach is committed by any other party, the Authority may terminate as above unless within 30 days of notice of the breach the Contractor procures the termination of the employment of such person and of their employer (if not employed by the Contractor or its main Sub-Contractors) and the performance of such service by another person.

Required drafting is as follows:

21.4.2 Corrupt Gifts and Fraud

The Contractor warrants that in entering the Contract it has not committed any Prohibited Act.

21.4.3 Termination for Corrupt Gifts and Fraud

- (a) If the Contractor or any Sub-Contractor (or anyone employed by or acting on behalf of any of them) or any of its or their agents or shareholders⁸⁷ commits any Prohibited Act, then the Authority shall be entitled to act in accordance with paragraphs (b) to (g) below.
- (b) If a Prohibited Act is committed by the Contractor or by an employee not acting independently of the Contractor,⁸⁸ then the Authority may terminate the Contract by giving notice to the Contractor.
- (c) If the Prohibited Act is committed by an employee of the Contractor acting independently of the Contractor, then the Authority may give notice to the Contractor of termination and the Contract will terminate, unless within [30] days of receipt of such notice the Contractor terminates the employee's employment and (if necessary) procures the performance of such part of the Works and/or Service by another person.⁸⁹
- (d) If the Prohibited Act is committed by a Sub-Contractor or by an employee of that Sub-Contractor not acting independently of that Sub-Contractor,⁹⁰ then the Authority may give notice to the Contractor of termination and the Contract will terminate, unless within [30] days of receipt of such notice the Contractor terminates the relevant Project Document and procures the performance of such part of the Works and/ or Service by another person.⁹¹
- (e) If the Prohibited Act is committed by an employee of a Sub-Contractor acting independently of that Sub-Contractor, then the Authority may give notice to the Contractor of termination and the Contract will terminate, unless within [30] days of receipt of such notice the Sub-Contractor terminates the employee's employment and (if necessary) procures the performance of such part of the Works and/or Service by another person.

⁸⁷ The extension of this concept to shareholders of the Contractor or any Sub-Contractor should be reviewed if the shares of any such companies are listed on a stock exchange, albeit in the light of the restricted nature of a "Prohibited Act".

⁸⁸ This means the employee acts under the authority of or with the knowledge of a director of the Contractor (rather than a majority board decision).

⁸⁹ Depending on the Project, there may be provisions regarding the approval of replacement Sub-Contractors, employees and other sub-contractors which will need to be satisfied.

⁹⁰ This means the employee acts under the authority of or with the knowledge of a director of the Sub-Contractor (rather than a majority board decision).

⁹¹ This must comply with the provisions of replacement Sub-Contractors - see Section 16 (Sub-Contracting, Employees and Documentary Changes).

- (f) If the Prohibited Act is committed by any other person not specified in paragraphs (b) to (e) above, then the Authority may give notice to the Contractor of termination and the Contract will terminate unless within [30 days] of receipt of such notice, the Contractor procures the termination of such person's employment and of the appointment of their employer (where not employed by the Contractor or the Sub-Contractors) and (if necessary) procures the performance of such part of the Works and/or Service by another person.
- (g) any notice of termination under this Clause shall specify:
 - (i) the nature of the Prohibited Act;
 - (ii) the identity of the party whom the Authority believes has committed the Prohibited Act;
 - (iii) the date on which the Contract will terminate, in accordance with the applicable provision of this Clause;⁹² and
 - (iv) the Authority's chosen option under Clause 21.4.3 (Compensation on Termination for Corrupt Gifts and Fraud).

21.4.3 Compensation on Termination for Corrupt Gifts and Fraud

21.4.3.1 Regardless of whether or not the Assets have any alternative use, only the Revised Senior Debt Termination Amount should be paid out on a termination for Corrupt Gifts or Fraud. If the Authority wishes to have the right to terminate, it should accept such level of compensation.

21.4.3.2 Equity holders should acknowledge that their relationship to the Contractor renders them responsible for the Contractor's acts – the level of return they expect reflects the greater risks equity holders must accept. Where the Contractor itself is not the perpetrator of the relevant act, the recommended approach gives them ample opportunity to ensure termination does not occur.

21.4.3.3 Where the Project is fully financed by equity providers with no Senior Debt, it will be necessary to examine their relationship to the person who commits the breach in order to ascertain whether any payment is appropriate. Authorities are unlikely to agree in effect to paying out the breaching party (by paying out to its shareholder or parent).

21.4.3.4 The Contract should also provide the Authority with the option to retain or walk away from the asset. Whatever the Authority decides, only the payment outlined above should be made.

Required drafting is as follows:

21.4.4 Compensation on Termination for Corrupt Gifts and Fraud

- (a) On termination of the Contract in accordance with Clause 21.4.3 (Termination for Corrupt Gifts and Fraud), then the Authority shall pay⁹³ the Contractor an amount equal to the Revised Senior Debt Termination Amount.
- (b) Such amount shall be determined and paid in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].
- (c) If termination occurs then the Authority may require the Contractor to transfer its rights, title and interest in and to the Assets to the Authority.⁹⁴

⁹² Either immediately or following the 30 day period specified.

⁹³ See Section 22 (Calculation and Payment of Early Termination Payments) for the right of set-off against such payments.

⁹⁴ The Contract must provide that any charges are released by the financiers in this circumstance. See Section 31.3.8.

21.5 VOLUNTARY TERMINATION BY AUTHORITY

21.5.1 Introduction

The intention of all parties to a Contract should be that it will run its full course. There may be circumstances, however, in which the Authority is no longer able to continue the relationship it has with the Contractor under a Contract. For example, there may be a policy change which makes further provision of the Service redundant. In order to cater for such circumstances, the Authority may wish to retain the right to terminate the contract voluntarily.

21.5.2 Consequences of Voluntary Termination

21.5.2.1 The Contractor should not object to the Authority having such a right provided that it is compensated in full if such right is exercised.

21.5.3 Compensation for Voluntary Termination

21.5.3.1 The Contractor should receive a termination payment which leaves it in the position it would have been in had the Contract run its full course.

21.5.3.2 Regardless of whether or not the asset has any alternative use, the level of compensation on a voluntary termination should be the same as the level proposed on a termination for Authority default (see Section 21.1.3 (Compensation on Termination for Authority Default) and 21.1.3.9).

21.5.3.3 Again, the Contract should clarify what happens to the asset following such full payout. It would usually be expected to revert to the Authority.

Required drafting is as follows:

21.5.1 Voluntary Termination by the Authority

- (a) The Authority may terminate the Contract at any time on or before its Expiry Date by complying with its obligations under paragraphs (b) to (d) below.⁹⁵
- (b) If the Authority wishes to terminate the Contract under this Clause, it must give notice to the Contractor stating:
 - (i) that the Authority is terminating the Contract under this Clause 21.5.1 (Voluntary Termination by Authority);
 - (ii) that the Contract will terminate on the date specified in the notice, which must be a minimum of [30] days after the date of receipt of the notice; and
 - (iii) whether the Authority has chosen to exercise its option under paragraph (c) below.
- (c) On termination, the Authority shall have the option to require the Contractor to transfer its right, title and interest in and to the Assets to the Authority or as directed by the Authority.
- (d) The Contract will terminate on the date specified in the notice referred to in paragraph (b) above;

⁹⁵ This could arise, for example, if the Authority did not wish the Project to continue for reasons unconnected with the Contractor.

21.5.2 Compensation on Voluntary Termination

On termination under Clause 21.5.1(d) above, the Authority shall pay the Contractor an amount equal to the amount payable under Clause 21.1 (Authority Default) in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].

21.5.4 Authority Break Points

21.5.4.1 In addition to a general right to terminate at any time, an Authority may consider whether it would be beneficial to have the option to terminate the Contract on specified dates (“Authority Break Point Dates”) for a specified compensation amount for equity and Junior Debt.

21.5.4.2 The method of calculation used to determine compensation for equity and Junior Debt in the case of Authority Voluntary Termination (see Section 21.1.3) may make it difficult to accurately calculate the compensation required in advance. Having a specified compensation amount will assist the Authority in planning, increase transparency in the cost of early termination and provide a tangible basis for assessment of the Contract’s flexibility as part of the value for money analysis.

21.5.4.3 The degree of increased Contract flexibility for the Authority introduced through Authority Break Point Dates will clearly depend upon the extent to which the specified compensation amounts are less than the alternative amounts payable under Clause 21.5.2 (Compensation on Voluntary Termination) on these dates. Accordingly, in evaluating bids, Authorities and their advisers should prepare projections of what is expected to be payable on such voluntary termination based upon the bidders’ chosen compensation basis (see Section 21.1.3), and evaluate the prospective discount being offered through the specified compensation amounts.

21.5.4.4 Authorities should consider when and how frequently they require Authority Break Point Dates at an early stage in the procurement. If known, these dates should correspond with times when there is likely to be a reassessment of the Services provided under the Contract, to increase Contract flexibility. Authorities should consider their general right to terminate at any time when determining the frequency of these dates. In any event, Authority Break Point Dates should not occur during the construction period.

21.5.4.5 The Contractor should be required, as part of the competitive bidding process, to provide specified compensation sums for equity and Junior Debt for each Authority Break Point Date. The expectation should be that amounts will reduce for later dates.

21.5.4.6 The Contractor may set the compensation sums at any level and by any method, but the final amount must be a set figure and not calculated by reference to any formula. The Contractor should provide this as a no-cost option to the Authority (i.e. without any related change in Unitary Charge).

Suitable drafting is as follows:

21.5.4 Termination on an Authority Break Point Date

- (a) Without prejudice to its rights under Clause 21.5.1 (Voluntary Termination by the Authority), the Authority may terminate the Contract on any of the Authority Break Point Dates by complying with its obligations under paragraphs (b) to (d) below.
- (b) If the Authority wishes to terminate the Contract under this Clause, it must give notice to the Contractor stating:

- (i) that the Authority is terminating the Contract under this Clause 21.5.4 (Termination on an Authority Break Point Date);
 - (ii) that the Contract will terminate on the specified Authority Break Point Date; which must be a minimum of [30] days after the date of receipt of the notice; and
 - (iii) whether the Authority has chosen to exercise its option under paragraph (c) below.
- (c) On termination, the Authority shall have the option to require the Contractor to transfer its right, title and interest in and to the Assets to the Authority or as directed by the Authority.
- (d) Provided the notice has been provided in accordance with paragraph (b) above, the Contract will terminate on the specified Authority Break Point Date.

21.5.5 Compensation on Termination on an Authority Break Point Date

- (a) On termination under Clause 21.5.4(d) above, the Authority shall pay the Contractor, in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)],⁹⁶ an amount equal to the amount payable under Clause 21.1 (Authority Default), save that in calculating such amount, the amount specified in Clause 21.1.3 (a) (iii) shall be substituted by:

[(A) in the case of termination on the first Authority Break Point Date,] £[]; [or]

(B) [in the case of termination on the second Authority Break Point Date, £[];]⁹⁷

“**Authority Break Point Date**” means [];⁹⁸

21.6 TERMINATION FOR BREACH OF THE REFINANCING PROVISIONS

21.6.1 Introduction

21.6.1.1 The Contract must deal comprehensively with termination as a result of a breach of the refinancing provisions⁹⁹ by the Contractor.

21.6.1.2 A balance must be struck between the Authority’s proper desire to incentivise the Contractor to be open and transparent in relation to refinancing, and the Senior Lenders’ fear of losing their funding for reasons beyond their control due to the actions of the Contractor.

21.6.2 Compensation on Termination for Breach of the Refinancing Provisions

21.6.2.1 Equity investors should acknowledge that their relationship with the Contractor renders them responsible for the Contractor’s acts – the level of return they expect reflects the greater risks that equity holders accept.

⁹⁶ Where Authority Break Points are included in the Contract, Authorities should also include the provisions set out in Section 22.5 (Method of Payment) to allow the Authority to elect to pay the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount in instalments. The application of the provisions may be limited to termination on Authority Break Point Dates. Authorities should, at the time of termination, consider whether this would provide value for money.

⁹⁷ Provisions to be included for each relevant Authority Break Point Date.

⁹⁸ This term should be defined on a project-specific basis.

⁹⁹ See Section 34 (Refinancing).

21.6.2.2 Regardless of whether or not the Assets have any alternative use, the level of compensation payable on termination for breach of the refinancing provisions should be the same as the level proposed on a termination for corrupt gifts or fraud (see Clause 21.4.4 (Compensation on Termination for Corrupt Gifts and Fraud)).

Required drafting is as follows:

21.6.1 Termination by the Authority for Breach of the Refinancing Provisions

- (a) If the Contractor wilfully breaches Clause 34.1 (Refinancing) then the Authority may terminate the Contract at any time on or before its Expiry Date by complying with its obligations under paragraphs (b) to (d) below.
- (b) If the Authority wishes to terminate the Contract under this Clause, it must give notice to the Contractor stating:
 - (i) that the Authority is terminating the Contract under this Clause 21.6.1 (Termination by the Authority for breach of the Refinancing provisions);
 - (ii) that the Contract will terminate on the date falling [30] days after the date of receipt of the notice; and
 - (iii) whether the Authority has chosen to exercise its option under paragraph (c) below.
- (c) On termination, the Authority shall have the option to require the Contractor to transfer to the Authority all of its right, title and interest in and to the Assets.
- (d) The Contract will terminate on the date falling [30] days after the date of receipt of the notice referred to in paragraph (b) above;

21.6.2 Compensation on Termination for Breach of the Refinancing Provisions

On termination under Clause 21.6.1(d) above, the Authority shall pay the Contractor an amount equal to the amount payable under Clause 21.4 (Termination on Corrupt Gifts and Fraud) in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].

22 CALCULATION AND PAYMENT OF EARLY TERMINATION PAYMENTS

22.1 INTRODUCTION

22.1.1 This Section sets out the principles which should apply to termination payments.

22.2 GROSS UP OF TERMINATION PAYMENTS

22.2.1 Compensation on early termination should be calculated on the basis that there is grossing-up of payments (for tax deductions), save in the case of Contractor Default where a market value payment makes grossing-up inappropriate as the Contractor is basically receiving the sale value of the outstanding Contract rather than receiving amounts designed to compensate specific elements of its financing.

A grossing-up provision would typically be as follows:

If any amount of compensation payable by the Authority under Clauses 21.1.3 (Compensation on Authority Default), 21.3.2 (Compensation on Termination for Force Majeure), 21.4.4 (Compensation for Termination for Corrupt Gifts and Fraud), 21.5.2 (Compensation on Voluntary Termination), [21.5.4 (Compensation on Termination on an Authority Break Point Date)] and 21.6.2 (Compensation on Termination for Breach of the Refinancing Provisions) is subject to Tax payable to a Relevant Authority in the United Kingdom¹, then the Authority shall pay to the Contractor such additional amount as will put the Contractor in the same after Tax position as it would have been had the payment not been subject to Tax, taking account of any relief, allowances deduction, setting off or credit in respect of Tax (whether available by choice or not) which may be available to the Contractor to reduce the Tax to which the payment is subject.

22.2.2 With the approaches taken in Section 21 (Early Termination) to termination compensation, there is no need to deal in the drafting with the extent to which payments to replace the Unitary Charge should reflect tax deductions that would otherwise have occurred.

22.3 CERTAINTY OF COMPENSATION PAYMENT AMOUNTS AND CHANGES TO FINANCING AGREEMENTS

22.3.1 Compensation payments where there has been a voluntary termination (see Section 21.5.2 (Consequences of Voluntary Termination) and Section 21.5.4 (Compensation on Termination on an Authority Break Point Date)), a termination for Authority Default (see Section 21.1.3 (Compensation on Termination for Authority Default)), force majeure (see Section 21.3.2 (Compensation on Termination for Force Majeure)), corrupt gifts and fraud (see Section 21.4.3 (Compensation on Termination for Corrupt Gifts and Fraud)) or wilful breach of the refinancing provisions (see Section 21.6.2 (Compensation on Termination for Breach of the Refinancing Provisions)) are all calculated in whole or in part by reference to the level of the Contractor's Senior Debt outstanding at the time of the termination payment.

¹ The Authority should ensure that UK tax only is relevant, so that no liability to foreign tax authorities is caught, as can occur if, for example, the Contractor's Affiliates are registered or located abroad. The Authority should also ensure that it retains the right to pay the amount of gross-up directly to HMRC or other Relevant Authority and to contest the Contractor's tax liability.

22.3.2 Authorities should be concerned to ensure that the level of Senior Debt outstanding at any time is not inflated in a way that will significantly and unexpectedly increase the Authority's liability on termination². The Contract should always ensure that the amount of Senior Debt and Junior Debt cannot be artificially inflated.

22.3.3 The Contractor may, during the course of the Contract, refinance or reschedule its debt obligations. This may be either to increase or accelerate its return (see Section 34 (Refinancing)) or to attempt to save the Project if it is in difficulties due to construction delays, cost overruns or temporary poor performance. In the latter case, it is in the interests of all parties to ensure that a rescheduling of debt can take place as quickly as possible, without the need for the Contractor and/or Senior Lenders to obtain consents from the Authority. To reflect this principle, Section 34 (Refinancing) states that any Refinancing that does not increase the Equity IRR above that projected in the Base Case shall not require the prior consent of the Authority (though the provisions of Clause 16.4.3 (Changes to Financing Agreements) may still apply)³. If the Project is in difficulty and in need of rescue, the Senior Lenders will also be reluctant to rescue the Project unless they know that any rescheduled or new Senior Debt required to rescue the Project will be compensated if the Authority chooses to terminate voluntarily or at an Authority Break Point Date, or termination occurs as a result of Authority Default, Force Majeure or Corrupt Gifts.

22.3.4 The Senior Lenders will only agree to reschedule or commit new Senior Debt to the Project as a last resort. In recognition of this and to protect the Authority from Senior Debt levels being artificially inflated, the amount of compensation payable by the Authority in respect of Senior Debt on early termination should only include additional Senior Debt if it was incurred either under a "standby" facility committed at financial close or alternatively if this constitutes Additional Permitted Borrowing. This provision does not preclude Senior Lenders otherwise relying upon compensation payable to equity investors upon early termination for recovery of rescheduled or increased levels of Senior Debt.

22.3.5 In certain termination scenarios, the amount payable will be adjusted for any Additional Permitted Borrowing advanced by Senior Lenders (on a rescue refinancing) – see Section 21.1.3 and definitions in Section 1.7.1.

22.3.6 Following the making of any Additional Permitted Borrowing if the Project terminates early on the grounds of Authority Voluntary Termination or at an Authority Break Point Date or on Authority Default or Force Majeure, the Authority will pay to the Contractor:

- the Senior Debt, plus the Additional Permitted Borrowings less any Distribution made while the Additional Permitted Borrowing is outstanding (the "New Senior Debt Amount"). The Senior Lenders are protected even if the New Senior Debt Amount exceeds the aggregate amount which would have been payable (to both debt and equity) had no Additional Permitted Borrowing been made (the "Original Aggregate Compensation Amount");
- if the New Senior Debt Amount is greater than the Original Aggregate Compensation Amount, the Shareholders and Subordinated Lenders will receive no termination payment;

² Consequently the Authority should also be concerned to capture increases in the Senior Debt profile caused by rescheduling of the Senior Debt (which may not include the provision of additional Senior Debt).

³ If the Project is in difficulties and in need of rescue by the Senior Lenders, the Equity IRR should not increase above that projected in the Base Case.

- if the Original Aggregate Compensation Amount is greater than the New Senior Debt Amount, the Shareholders and Subordinated Lenders will, broadly, be paid the excess.⁴

22.3.7 Distributions made while such Additional Permitted Borrowing is outstanding will reduce the amount payable to the Senior Lenders in various circumstances (and it may be that the Senior Lenders would therefore cash collateralise any such amount which would otherwise have been distributed until the Additional Permitted Borrowing is fully covered).⁵ The amount of the Additional Permitted Borrowing which may be lent in this way is 10% of the initial principal commitment, reducing to 5% at such time as the initial principal senior debt is 50% paid down. There is also a requirement in the Direct Agreement for the Authority to be notified of any such Additional Permitted Borrowing, and the reasons for it, and to be notified, on an ongoing basis, of Distributions then made.

22.3.8 Senior Lenders, of course, remain able to advance new monies to the Contractor with the express consent of the Authority, but this Additional Permitted Borrowing provision will offer the Senior Lenders flexibility to rescue projects in difficulty without (subject to Clause 16.4.3) having to obtain the prior consent of the Authority and without having to step-in to the project. Authorities should not give their consent to other increases to their liabilities on termination until such time as the Contractor/Senior Lenders have exhausted their rights to put more money into the project by way of Permitted Borrowing. The Authority should also consider the relationship between these provisions and Section 34 (Refinancing) if a request is received to increase the Authority's termination liabilities beyond the extent permitted for Permitted Borrowings.

Required drafting is set out below:

22.3 Changes to Financing Agreements and Project Documents

No amendment, waiver or exercise of a right under any Financing Agreement or Ancillary Document shall have the effect of increasing the Authority's liabilities on early termination of this Contract unless:

- (a) the Contractor has obtained the prior written consent of the Authority to such increased liability for the purposes of this Clause 22.3; or
- (b) it is an Additional Permitted Borrowing.

22.4 SET-OFF ON TERMINATION

22.4.1 The Authority should be fully entitled to set off any outstanding liabilities of the Contractor against the amounts it pays in compensation on a Contractor Default, but for the reasons set out in Section 22.4.2 this will in all likelihood not affect the termination payment concerned. There should be no ring-fencing of Senior Debt under these circumstances. In circumstances other than Contractor Default, however, it is acceptable for a limit on set-off to be introduced. To minimise the possible effects of not having the right to set off in other circumstances, the Authority should ensure that minimum amounts are outstanding from the Contractor.

Required drafting is as follows:

⁴ However out of the total termination payment, the amount attributable to the Senior Lenders will be increased and the amount attributable to the equity will be decreased, in order to reflect the increased debt levels. This follows the logic that applies to ordinary monthly payments of Unitary Charge. These do not increase following any Permitted Borrowing (although, as between the Senior Lenders and the equity, the Equity's share of them may decrease).

⁵ If no distributions are made during this period but monies are kept in reserved accounts, the Permitted Borrowings will not be reduced, however the amount of the Senior Debt payable by the Authority on an early termination of the Project is reduced, under sub-paragraph (b) (i) of the definition of Base Senior Debt Termination Amount and Revised Senior Debt Termination Amount. It will be a matter for the Senior Lenders and the equity to decide whether surplus funds are used to repay Senior Debt, or are distributed or reserved.

22.4 Set-off on Termination⁶

Except where expressly stated otherwise, the Authority is not entitled to set off any amount against any payment of termination compensation (whether payable as a lump sum or in instalments) under Clauses 21.1.3 (Compensation on Authority Default), 21.3.2 (Compensation on Termination for Force Majeure), 21.4.3 (Compensation on Termination for Corrupt Gifts and Fraud), 21.5.2 (Compensation on Voluntary Termination) [, 21.5.4 (Compensation on Termination on an Authority Break Point Date)] and 21.6.2 (Compensation on Termination for Breach of the Refinancing Provisions), save to the extent that after such an amount has been set off, the termination payment made would be in an amount greater than or equal to the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount, as the case may be, at that time.

22.4.2 Claims against the Contractor by the Authority should be fully reflected in the “market value” based termination payment to the Contractor since bidders will discount the value of any claims (depending on the likelihood of their success) from the amount they are prepared to pay for a Project retendered on the same terms (that is, subject to any outstanding claims which the Authority would set off against the future Unitary Charge if the outgoing Contractor did not meet them). This is the case, therefore, with the second valuation options for Authority Default and Voluntary Termination and also for termination for Contractor Default. There should be no double counting in these circumstances, so the Authority must make it clear to potential replacement contractors what claims they should take into account in their bids.

22.4.3 Where termination has occurred for reasons other than Contractor Default, the Authority should be entitled to set off outstanding liabilities of the Contractor against all amounts it pays in compensation, except amounts paid to compensate Senior Debt (see above).

22.5 METHOD OF PAYMENT

22.5.1 Where an incoming Contractor pays market value on Contractor Default termination, or the Contract is terminated for Authority Default, the Authority should pay the Contractor by way of a lump sum.

22.5.2 On other types of termination, the Contract should deal with how compensation is paid. Value for money issues should be taken into consideration which in most cases will mean that compensation payments by lump sum will be the appropriate position. Value for money is unlikely to be achieved if the Authority repays such amounts over time (i.e. in instalments), as interest will continue to accrue on the compensation amount to reflect the equity/Junior Debt providers’ and Senior Lenders’ loss of opportunity. Moreover, the Authority’s choice between lump sum and instalments should not be influenced by arbitrage possibilities (i.e. it would be bad practice to choose the long term option just because it can earn higher interest on amounts on short term deposit than it pays the Contractor).

22.5.3 While the above is the general position, local authorities may wish to reserve the option to pay over time due to affordability constraints, particularly as their ability to raise debt is regulated (see footnote 10). Therefore, where a local authority (or any other public body which has a valid VfM reason in accordance with Section 22.5.2) seeks the right to pay compensation by instalments it should follow the guidance set out below.

22.5.3.1 The Contractor will require the Authority to pay interest on any outstanding balance at the Senior Debt rate.⁷ If equity/Junior Debt compensation is payable on termination, the

⁶ Clause 12 (Set-Off) contains the right to set off amounts.

⁷ This is the non-default of interest payable under the Senior Financing Agreement.

recommended approach for all Authorities is to restrict the Authority's right to pay by instalments to the Senior Debt related compensation.

22.5.3.2 If the Contract is terminated for Contractor Default and the Adjusted Estimated Fair Value of the Contract is payable to the Contractor as compensation, the appropriate interest rate payable on the outstanding balance is again the Senior Debt rate.⁸

22.5.3.3 If the Authority elects to pay compensation in instalments, the protections in the Contract in respect of payment default and unauthorised transfer of the Contract by the Authority should continue to operate⁹ but the Contractor should only have the ability to declare all outstanding instalments immediately due and payable on the occurrence of these events. If the Authority elects to pay compensation in instalments the Senior Lenders should not require the Authority to enter into new funding arrangements with them as they will have fixed security over the instalments to be paid by the Authority which will be paid in accordance with the Senior Lenders' instructions.

Required drafting for Contracts in which the Authority has the right to pay by instalments is set out below.¹⁰

22.5 Method of Payment

- (a) The Authority shall pay to the Contractor the Termination Sum, together with interest on any Base Senior Debt Termination Amount or Revised Senior Debt Termination Amount element of the Termination Sum at the Senior Debt Rate, on or before the date falling 60 days after the Notice Date provided that it may elect to pay the Adjusted Estimated Fair Value of the Contract or the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant) element of the Termination Sum in accordance with paragraph (b) below.
- (b) The Authority may, other than on an Authority Default, elect to pay the Adjusted Estimated Fair Value of the Contract or the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant) element of the Termination Sum:
 - (i) in instalments as follows:
 - (A) where the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount or the Adjusted Estimated Fair Value of the Contract (as relevant) is greater than or equal to the Outstanding Principal:
 - (i) in respect of that element of the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount or the Adjusted Estimated Fair Value of the Contract (as relevant) representing the Outstanding Principal, on the dates (the "Instalment Dates") and in the amounts that the Contractor would have been required to pay principal to the Senior Lenders under the terms of the Senior Credit Agreement had the Termination Date not occurred; and
 - (ii) in respect of the sum (if any) remaining after deducting the Outstanding Principal from the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount or the Adjusted Estimated

⁸ Although the Adjusted Estimated Fair Value of the Contract may be greater than amounts owing to the Senior Lenders, the Contract will have terminated for reasons that the Contractor can control. In such circumstances, it is equitable for the equity/Junior Debt providers to accept that to the extent that the Adjusted Estimated Fair Value of the Contract is greater than the outstanding Senior Debt, interest will accrue on all outstanding amounts at the Senior Debt rate.

⁹ Clause 30.7 (Continuing Obligations) should provide that Clause 17.3 (Restrictions on Transfer of Contract by the Authority) survives termination of the Contract.

¹⁰ These provisions should now be viewed against the rights of local authorities to use the prudential borrowing regime for local government.

Fair Value of the Contract (as relevant), in equal instalments on the Instalment Dates;

- (B) where the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount or the Adjusted Estimated Fair Value of the Contract (as relevant) is less than the Outstanding Principal, on the Instalment Dates pro rata to the amounts that the Contractor would have been required to pay as principal to the Senior Lenders on each Instalment Date under the terms of the Senior Credit Agreement had the Termination Date not occurred; or
 - (ii) as the parties may otherwise agree.
- (c) From the Notice Date until the date of payment, interest shall accrue on any unpaid element of the Termination Sum at the Senior Debt Rate and be payable on the next occurring Instalment Date.
- (d) If the Authority has elected to pay in accordance with paragraph (b) above, it may (on 28 days prior written notice to the Contractor) elect to pay the outstanding part of the Adjusted Estimated Fair Value of the Contract or the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant) element of the Termination Sum in full on any Instalment Date.
- (e) If the Authority:
 - (i) fails to make a payment to the Contractor in accordance with paragraphs (a) and/or (b) and/or (c) above; or
 - (ii) breaches Clause 17.3 (Restrictions on Transfer of Contract by the Authority),

the Contractor may issue a notice to the Authority declaring any unpaid and outstanding element of (as applicable) the Adjusted Estimated Fair Value of the Contract, the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant) element of the Termination Sum and any accrued but unpaid interest to be immediately due and payable.¹¹

“Notice Date”

means the later of the Termination Date and (if applicable) the date that the Adjusted Estimated Fair Value of the Contract is agreed between the parties pursuant to Clause 21.2.9 (No Retendering Procedure).

“Outstanding Principal”

means the principal amount outstanding at the Termination Date of each borrowing (other than any borrowing under any equity bridge facility) under the Senior Credit Agreement.

“Senior Credit Agreement”

means []¹²as at the date of this Contract or as amended with the prior written approval of the Authority pursuant to Clause 22.3 (Changes to Financing Agreements and Project Documents).

¹¹ Break costs arising should also be payable in respect of the Base Senior Debt Termination Amount or Revised Senior Debt Amount elements of the payment.

¹² Reference should be made here to the document under which the senior loan facility is made available.

“Termination Sum”

means any compensation payable by the Authority to the Contractor on an early termination of the Contract under [Section 21] (excluding the Adjusted Highest Compliant Tender Price).^{13 14}

"Senior Debt Rate"

means [incorporate the non-default interest rate definition in the Senior Credit Agreement] or such other lower rate as the parties may agree.

22.5.4 To the extent that any compensation amounts are paid to Senior Lenders, a provision such as the following should be included as required drafting:

The Authority shall be entitled to rely on the certificate of the Agent as conclusive as to the amount of the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount outstanding at any relevant time. The receipt by the Agent of the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount or elements thereof as relevant shall discharge the Authority's obligations to pay such sums to the Contractor.

22.6 RETENTION OF ASSETS BY CONTRACTOR ON TERMINATION

22.6.1 To the extent the Contractor retains Assets on a termination, then their value should be deducted from any compensation payments made. The value of the Assets will be close to zero in the case of Assets with no alternative use and so there may be no need to deal with this issue in the Contract. Where residual value exists the Authority should, however, carefully consider likely residual value out-turns, as the commercial incentives can be different if the residual value were to be significant. In certain scenarios (e.g. if residual value could exceed the original return) residual value could distort the effect of any compensation payment (e.g. for Contractor Default) and reduce the incentives to perform that would otherwise exist.¹⁵

22.7 EXCLUSIVITY OF REMEDY

22.7.1 The Contractor should typically agree that termination compensation payments are its sole remedy, subject to certain exceptions. The Authority's agreement to a similar provision in this regard should depend on the issues set out in Section 24.6 (Damages Claims).

22.7.2 Required drafting which deals with the Contractor's position is as follows:

Any payment of compensation shall be in full satisfaction of any claim which can be made against the Authority by the Contractor in relation to termination of this Contract or any Project Document. The compensation payable under Clauses 21.1.3 (Compensation on Authority Default), 21.3.4 (Compensation on Termination for Force Majeure), [21.4.3 (Compensation for Termination for Corrupt Gifts and Fraud),] 21.5.2 (Compensation for Voluntary Termination by the Authority) [, 21.5.4 (Compensation on Termination on an Authority Break Point Date)] and 21.6 (Termination for Breach of Refinancing provisions) shall be the sole remedy of the Contractor against the Authority in respect of termination of the Contract.

¹³ See Clause 21.2.8 (Retendering Procedure) for the timing and manner of payment of the Adjusted Highest Compliant tender Price.

¹⁴ See Section 21.1.2.1 and the definition of "Authority Default". If the Authority is in breach of its obligations and the Contract is terminated, the compensation payable by the Authority to the Contractor should not be payable by instalments. The Authority should be entitled to pay by instalments if there is a voluntary termination of the Contract.

¹⁵ See generally Section 20.5

Specific exclusions will exist in most transactions and these should be on a project specific basis, based on the principle that any compensation payment does not reflect other claims. Examples would include claims under Clause 26 (Information and Confidentiality), certain types of claims for infringement of intellectual property rights and other claims not reflected, such as claims by third parties against the Authority or claims arising from damage to other property of the Authority. See Clause 30.7 (Continuing Obligations) which may refer to these.

23 SURVEYS ON EXPIRY AND TERMINATION

23.1 INTRODUCTION

23.1.1 If the Assets may be transferred to the Authority at no cost on the Expiry Date (i.e. no residual value risk has been transferred to the Contractor) (see Sections 20.2 (Assets where the Authority retains Residual Value Risk) and 20.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been Transferred)), the Contract should specify what condition the Assets should be in at such time. It should also specify the arrangements for a survey of the condition of Assets before the end of the Contract to assess whether such standards have been met. The costs of the final survey are normally borne by the Authority subject to recovery from the Contractor where the survey finds that rectification work is needed.

23.1.2 Where there is a residual value payment to be made by the Authority to the Contractor reflecting the market value of the Assets at that time (see Section 20.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been Transferred)), then a survey will only be needed as part of a valuation, so that the condition of the assets¹ is reflected in any price paid on expiry.

23.2 TIMING OF SURVEY ON EXPIRY

23.2.1 The survey should usually be carried out one to two years prior to the end of the Contract, ideally by an independent party.²

23.2.2 If no payment is to be made on expiry and the survey reveals that the Contractor has not complied with its obligations so that the assets will not be handed over to the Authority in the required condition, the Contract should contain a mechanism to ensure that the cost of carrying out the necessary works is recoverable from the Contractor. This may be as a debt or by way of Set-off or withholding of the relevant amount from the Unitary Charge during the course of the Contract.

23.3 RETENTION FUND

23.3.1 Where the Authority elects to take possession of the Assets in accordance with Section 20.2.3 (i.e. where the Assets have no alternative use), the Contract may provide that the Authority pays a certain proportion of each Unitary Charge during the last few years of the Contract into a secured retention fund³ to ensure that it can call on sufficient funds to carry out any maintenance identified as necessary by the survey. The period for and the size of payments into the retention fund should be set on a project specific basis, by reference to the amount likely to be needed to rectify defects in the assets.⁴

23.3.2 If the Contractor carries out any maintenance identified as necessary by the survey, it can be reimbursed from the retention fund. Otherwise, the Authority can use such funds itself to carry out necessary maintenance. If the amount retained is insufficient to cover all required maintenance, the Authority will have to recover the balance from the Contractor as a debt. Any

¹ That is, the physical assets referred to in the definition of "Assets".

² The use of an independent party will not always be appropriate in defence projects particularly if the MOD is the only suitable surveyor.

³ This may be achieved by establishing the account in the sole name of the Authority or charging the account to the Authority.

⁴ See footnote 1 above.

balance remaining in the fund belongs to the Contractor and should be paid to the Contractor together with accrued interest.

23.4 GUARANTEES OR BONDS

23.4.1 A further alternative to the above is for the Contractor to procure a performance bond or alternative security in respect of the hand-back condition of the Assets. This would, for example, allow the release of any retention funds.

23.5 SURVEYS ON EARLY TERMINATION

23.5.1 Surveys will not generally be necessary on early termination of the Contract, except to the extent the condition of the Assets needs to be taken into account in calculating market value compensation payable on termination for Contractor Default (see Section 21.2 (Termination on Contractor Default)). This would only apply when the procedure referred to in Section 21.2.9 (No Retendering) is used. If a termination payment comes from a third party then it will be necessary for that third party to satisfy itself as to the condition of the Assets. If residual value risk has been transferred then any Assets may, of course, need to be valued.

Required drafting for this Section (where such a provision is needed)⁵ is as follows:

23 Surveys on Termination

- (a) [18] months prior to the Expiry Date, [the Authority⁶] shall be entitled to carry out a final survey of the assets⁷ to assess whether they have been and are being maintained by the Contractor in accordance with its obligations under Clause 11.1 (Maintenance).
- (b) [The Authority] shall notify the Contractor in writing a minimum of [7] days in advance of the date it wishes to carry out the final survey. [The Authority] shall consider in good faith any reasonable request by the Contractor for the final survey to be carried out on a different date if such request is made at least [2] days prior to the notified date and the Contractor (acting reasonably) is able to demonstrate that carrying out the final survey on notified date would materially prejudice the Contractor's ability to provide the Service.
- (c) When carrying out the final survey, [the Authority] shall use reasonable endeavours to minimise any disruption caused to the provision of the Service by the Contractor. The Contractor shall afford [the Authority] (free of charge) any reasonable assistance required by [the Authority] during the carrying out of the final survey. The cost of the final survey shall be borne by the Authority.
- (d) If the final survey shows that the Contractor has not complied with or is not complying with its obligations under Clause 11.1 (Maintenance), the Authority shall:
 - (i) notify the Contractor of the rectification and/or maintenance work which is required to bring the condition of the assets to the standard they would have been in if the Contractor had complied or was complying with its obligations under Clause 11.1 (Maintenance);
 - (ii) specify a reasonable period within which the Contractor must carry out such work; and

⁵ The need for a survey will depend upon the option exercised by the Authority for Assets with no alternative use. See Section 20.2.4.

⁶ The drafting of this Clause may need to be amended if it is likely that an independent third party will carry out the final survey.

⁷ See footnote 1 above.

- (iii) recover the cost of the survey from the Contractor by means of [a withdrawal from the Retention Fund Account] [a deduction from the next Unitary Charge] [other means of reimbursement].
- (e) If the Contractor has been notified under Clause 23(d)(i) that rectification and/or maintenance work is required, [twelve] months prior to the Expiry Date the Authority shall deduct the costs of that work as quantified by that survey from the next following instalment (or, if the amount of such instalment is insufficient, the next instalments as necessary) of Unitary Charge and pay such amount into an interest bearing account (the "Retention Fund Account").⁸
- (f) The Contractor shall carry out such rectification and/or maintenance work to the Authority's reasonable satisfaction within the period specified and any costs it incurs in carrying out such rectification and/or maintenance work shall be at its own expense.
- (g) If and to the extent that the Contractor carries out the necessary rectification and/or maintenance work to the Authority's reasonable satisfaction within the specified period, the Authority shall reimburse the Contractor's costs of so doing by withdrawing amounts from the Retention Fund Account.⁹ If the amount in the Retention Fund Account is insufficient to cover the Contractor's costs, the Contractor shall bear the balance of its costs itself.
- (h) If and to the extent that the Contractor fails to carry out the necessary rectification and/or maintenance work to the Authority's reasonable satisfaction within the specified period, the Authority shall be entitled to carry out itself, or procure, such rectification and/or maintenance work at the Contractor's expense and shall make withdrawals from the Retention Fund Account to pay for such work or, where there are insufficient funds in the Retention Fund Account, make deductions from the Unitary Charge to pay for such work.¹⁰
- (i) If:
 - (i) all the rectification and/or maintenance work identified by [the Authority] has been carried out to the Authority's reasonable satisfaction; and
 - (ii) all such work has been paid for by the Contractor; and
 - (iii) no termination notice given in accordance with this Contract is outstanding,
 then the Authority shall pay any credit balance on the Retention Fund Account to the Contractor as soon as practicable.

⁸ Such an account may be needed for early termination payments where residual value risk has been transferred (as the maintenance levels will be reflected in the market value of a termination payment).

⁹ The parties will need to agree whether reimbursement will be made by staged payments during the course of the works or by a lump sum payment on completion of the works. One of the relevant considerations may be the size and nature of the rectification/maintenance works.

¹⁰ If the balance standing to the credit of Retention Fund Account is not sufficient to cover the whole cost of the rectification and/or maintenance work carried out or procured by the Authority, the Authority can recover the balance from the Contractor either as a debt or through set off under Clause 12 (Set-off).

24 INDEMNITIES, GUARANTEES AND CONTRACTUAL CLAIMS

24.1 INTRODUCTION

24.1.1 The Authority will often be contracting with a Contractor which is a SPV with no track record of service delivery and whose main asset is the Contract. The Authority will therefore require comfort that the Contractor and its Sub-Contractors will be able to meet their contractual obligations to provide the Service and any corresponding financial liabilities.

24.1.2 In a traditional procurement, such comfort would normally take the form of guarantees, indemnities and collateral warranties to the Authority provided by the principal Contractor, its parent company and Sub-Contractors. Under PFI, where the majority of projects are financed on a limited recourse basis and the Contractor is not paid if the Service is not delivered, such extensive direct comfort will not normally be necessary or appropriate.

24.1.3 The Authority will, however, require certain types of comfort from the Contractor. This Section advises on the type of comfort the Authority should normally expect.

24.2 GUARANTEES

24.2.1 Authorities will have to be sure that continuity of service supply is maintained even if their counterparty is insolvent. In many service contracts this can be done by way of a guarantee by a parent company (whether this company is the ultimate parent company in a group or a sufficiently claim worthy person will be a matter for negotiation). In a Contract for the period of time that PFI contracts are typically provided for, such guarantees can be of much less value.

24.2.2 A limited recourse structure is typically used in PFI projects as it isolates and limits the liabilities of the Project from those of the shareholders. Consequently, the obtaining of direct guarantees by the Authority is not normally appropriate. The Authority should generally not insist on receiving guarantees from the parent companies of a Sub-Contractor or the Contractor's shareholders in respect of the obligations of the Contractor.

24.2.3 A well-advised Authority can usually obtain sufficient comfort from a well structured limited recourse project, provided Sub-Contractors have a suitable track record and financial standing, that the levels of equity are sufficient to demonstrate a commitment of shareholders to the Project and the rest of the financing structure is sufficiently robust. Appropriate levels of equity may well differ in the operating period from the development or construction period and will vary from project to project. This involves an analysis of the entirety of the structure (including the Contract, all Project Documents and any limits on liability of the Sub-Contractors under their Sub-Contracts), any liability interfaces (such as which Sub-Contractor is liable in the period between completion of construction and commencement of operation) and an understanding of the step-in rights of the Senior Lenders and other rights of the financiers (see Section 31 (Direct Agreement and Senior Lenders)).

24.2.4 One of the advantages in structuring projects on a limited recourse basis is that it requires bidders to thoroughly investigate all risks relating to the Project and clearly allocate the risks in a manner that delivers a robust project.¹

¹ See Section 6.2 (Due Diligence).

24.2.5 If the Contractor is funding the Project from its own internal resources and there is no third party Senior Debt being provided to the Contractor, the Authority should:

- assess the credit strength of the Contractor and consider whether or not it should require the Contractor to provide it with a guarantee from its parent or strongest credit within its group; and
- consider whether or not it should require the Contractor to maintain financial covenants throughout the term of the Contract.

24.3 INDEMNITIES

24.3.1 The Authority will want to ensure the Contract requires the Contractor to indemnify the Authority against certain costs and the Contractor will make provision for such contingent liability in its bid price.

24.3.2 The general principle in civil procurement is that there should be no limit on indemnities provided to the Authority. This principle can be overridden, however, if commercial necessities demand.

24.3.3 An analysis of the limits on liabilities under the Contract will be part of the assessment by the Authority of the strength of its counterparty. The existence and extent of any indemnity should be considered in conjunction with other obligations imposed on the Contractor and Sub-Contractor (e.g. under collateral warranties). In this context Section 24.6 (Damages Claims) is relevant. The levels of insurance in respect of any likely claim are also relevant and the Contractor should always set these at a level sufficient to compensate it for foreseeable loss.

24.3.4 Broadly, there are four heads of liability that the Authority will be concerned to be indemnified against if the liability arises as a result of the Contractor's operations. These are:

- death and personal injury;
- property damage;
- breach of statutory duty; and
- third party claims.

Liability for death and personal injury cannot, at law, be capped, and an Authority should only allow caps or restrictions² on other heads of claim if they believe this offers clear value for money benefits.³ Authorities should not offer such caps as a matter of course. As regards personal claims a Contractor enjoys no cap on the actions, claims, etc., made directly against it by third parties, and should set its insurance at whatever level it feels necessary to protect itself. It may not therefore provide any additional value for money to allow a Contractor to cap the identical liability which it may suffer indirectly through the Authority, in circumstances where the claimant makes its claim against the Authority and the Authority seeks to recoup its loss from the Contractor. In any event, if any cap is allowed (on a value for money basis), any such cap must not be used as a device to undermine the agreed insurance risk allocation position (e.g. by transferring responsibility for any deductible which would otherwise lie with the Contractor) or to backstop the credit of insurers. The indemnities should not be used to subvert core risk allocation principles.

² The Authority should consider whether or not it is appropriate to exclude consequential loss from the scope of the indemnity provisions. This approach has been adopted in the NHS sector, although in other sectors (e.g. transport) the potential for claims from third parties in relation to consequential loss may be greater.

³ For example, liabilities relating to environmental risk or breach of statutory duty are sometimes capped for value for money reasons.

24.3.5 The Authority should not generally use the indemnity provisions in the Contract as an additional layer of protection for specific remedies set out in the Contract. For example, if the deductions being made to the Unitary Charge under the performance mechanism are a genuine reflection of the losses that the Authority will incur as a result of the Contractor's non-performance, the Authority should not generally seek to rely on the indemnity as an additional or alternative means of claiming against the Contractor in respect of that loss.

24.3.6 Given the project specific nature of many of the employment issues that arise on projects no guidance can be given on either employment indemnities or issues arising out of the Transfer of Undertakings (Protection of Employment) Regulations 1981 SI No. 1794, save that they are appropriate in some cases.

24.3.7 The Authority may be faced with a request for a reciprocal indemnity from the Contractor. A general indemnity from the Authority should not be offered in response to such a request. If the request relates to possible breach of the Authority's obligations under the Contract, this should be dealt with under Compensation Events (see Section 5.2.1.4); and if the request relates to acts of the Authority during a step-in this is dealt with separately as part of any step-in arrangements where there is no default (see Section 29.5.1). Exceptionally an Authority may be faced with project specific issues which require it to offer a reciprocal indemnity, in which case the Authority should ensure that the indemnity is limited to the specific issue.

24.3.8 Appropriate drafting for a general form of indemnity from the Contractor is as follows:

24.3 Indemnity

- (a) The Contractor shall, subject to paragraph (b), be responsible for, and shall release and indemnify the Authority, its employees, agents and contractors on demand from and against, all liability⁴ for:
- (i) death or personal injury;
 - (ii) loss of or damage to property (including property belonging to the Authority or for which it is responsible "Authority Property");
 - (iii) breach of statutory duty; and
 - (iv) actions, claims, demands, costs, charges and expenses (including legal expenses on an indemnity basis),⁵

which may arise out of, or in consequence of, the design, construction, operation or maintenance of the assets or the performance⁶ or non-performance by the Contractor of its obligations under this Contract or the presence on the Authority's property of the Contractor, a sub-contractor of the Contractor, their employees or agents.

- (b) The Contractor shall not be responsible or be obliged to indemnify the Authority for:
- (i) any of the matters referred to in paragraphs (a)(i) to (iv) above which arises as a direct result of the Contractor acting on the instruction of the Authority;

⁴ See footnote 2 above.

⁵ See Section 24.6.3.

⁶ The Contractor will perform its obligations under the Contract in accordance with the solution it offers as part of its bid and in putting together such solution should have regard to the indemnity provisions. Accordingly, the Contractor should take account of the potential liability under the indemnity provisions in developing its methodology and pricing its bid. Some Contractors may try to argue that the indemnity provisions should only be triggered if the relevant liability arises as a result of (a) the Contractor being in breach of or not performing its obligations under the Contract; or (b) the Contractor being negligent. Such requests are unacceptable as they bring the risk of the Contractor's delivery plan (to meet the output specification) back on to the Authority. The only exception to this will be if the Authority has specified input requirements or is providing a degree of design sign-off (see Section 3.4) in which case the indemnity may need to acknowledge this.

- (ii) any injury, loss, damage, cost and expense caused by the negligence or wilful misconduct of the Authority, its employees, agents or contractors or by the breach by the Authority of its obligations under this Contract; [or
 - (iii) any claims made under Clause 24.3(a)[(iii)] in excess of [.]⁷
- (c) An indemnity by either party under any provision of this Contract shall be without limitation to any indemnity by that party under any other provision of this Contract.⁸

24.3.9 This Clause will also need to deal with:

- giving notice of claims (stating in reasonable detail the nature of the matter and the amount claimed). This will enable the proceedings to be contested before any judgment in respect of such proceedings is given;
- taking any action insurers may request to dispute the matter or enforce rights against any person;
- the exclusive conduct of the proceedings by the party giving the indemnity although it may be that certain politically sensitive issues would require the Authority to control proceedings which will require specific agreement; and
- there being no admission of liability or settlement of the matter without the consent of the indemnifying party.

24.4 COLLATERAL WARRANTIES

24.4.1 An Authority should seek a collateral warranty (i.e. a direct contractual undertaking) from each of the Sub-Contractors and, usually, key members of the professional team (such as architects) or other key sub-contractors, giving direct claims and the ability to step-in to the relevant sub-contracts in some circumstances. This does not undermine the limited recourse nature of the Project, provided that the content of any undertakings requested dovetail with the overall approach to the Project structure. That is:

- they should not be used to increase levels of liability or impose obligations where none would otherwise exist (see Sections 24.3 (Indemnities) and 24.6 (Damages Claims)); and
- they should take into account the rights of Senior Lenders (see Sections 24.5 (Financiers' Security) and 31.6 (Direct Agreement)).

24.4.2 The Authority should consider the strength of the covenant of the counterparty in the light of the obligation in the warranty. It may be that the Sub-Contract warranties are required to be guaranteed by the parent companies (or other companies of substance within the group) of the relevant Sub-Contractors. Except in the case of rights that exist to protect the position of the Authority,⁹ the rights of the Authority to bring an action under these collateral warranties should, however, be exercisable only on an early termination.

24.5 FINANCIERS' SECURITY

24.5.1 Although the interests of the Authority are not necessarily the same as those of the Senior Lenders, the Authority can take some comfort from the fact that Senior Lenders will usually insist on a security package from the Contractor and its consortium in return for providing the necessary debt finance. In the event of a default by the Contractor under the Senior Financing

⁷ Please see Section 24.3.4 and footnote 3 as to whether to include this cap and as to what it could cover.

⁸ See Section 24.6 (Damages Claims).

⁹ For example, liquidated damages under Section 4.2 (Liquidated Damages).

Agreements, Senior Lenders will be able to enforce their security and put the proceeds towards repaying Senior Debt. Such security may consist of an assignment of the Contractor's rights under the Project Documents, collateral warranties and performance bonds from the Construction Sub-Contractor, guarantees from the shareholders in the Contractor and shareholders of the Sub-Contractors. The Contractor and its consortium will, therefore, be under a great incentive to perform their obligations under the Contract to ensure that the security is never called.

24.5.2 Any such comfort that is taken should be qualified by the fact that the Senior Lenders will in many cases be repaid prior to the Expiry Date and so the Authority should be careful in placing undue reliance on such comfort.

24.6 DAMAGES CLAIMS

24.6.1 It is common practice to limit the ability of the Authority and the Contractor to make claims against each other for breach of obligation under the Contract. The rationale for limiting this ability is that the Contract payment mechanism is structured to ensure that there is an incentive to perform and that any deduction as a result of the payment mechanism reflects the loss to the Authority and so should usually be the exclusive remedy of the Authority. See Clause 7.8 (Payment Mechanism: No double remedy).

24.6.2 The issues here are similar to those in Section 4.2 (Liquidated Damages). This is because the issue of when liquidated damages and general damages claims are appropriate are closely connected. The Authority should strive to ensure that the performance payment mechanism works in such a way as to ensure that during the term of the Contract the absence of the Service reflects the costs the Authority incurs in not receiving the Service.

24.6.3 There will, as described in Section 4.2 (Liquidated Damages), be circumstances in which relying on the non-payment of the Unitary Charge is insufficient to compensate the Authority for its loss. For the reasons given in that Section, liquidated damages may be appropriate. A general damages claim for service failures is not something that the Authority should seek to obtain or preserve.¹⁰ A combination of the payment mechanism and market value assessment should deal with issues that are required to be covered. To the extent particular categories of claim need special treatment, they should explicitly be dealt with in Clause 24.3 (Indemnity).

24.6.4 On a termination for Contractor Default, the Contractor will have an ability to pursue claims against Sub-Contractors (this right will be taken as security by the Senior Lenders). This can lead to the Authority reasoning that it should have a right to claim in such a situation too. This may be the case in some situations (as described above), but in many cases (and probably most cases) the deductions from termination compensation payments will reflect any amount which, in traditional procurement, the Authority would normally expect to claim from the Contractor (see further Section 31.7 (Subordination and Related Provisions)).

24.6.5 On termination for Contractor Default, not all amounts which the Authority could claim on a termination are reflected in a reduced market value compensation payment. Examples would include claims under Clauses 24.3 (Indemnity), 26 (Information and Confidentiality) and Sections 27 (Intellectual Property Rights) and claims against the Authority by third parties. To the extent these claims are not deducted from the market value payment (for example for reasons set out in Section 12 (Payments and Set-off)), they should continue to be exercisable after termination. Such rights should therefore if relevant be included in any collateral warranties.

¹⁰ The Authority should recognise the importance of the relationship between its right to claim damages for breach of Contract, its ability to make deductions from the Unitary Charge and the scope of the indemnity provisions. For example, if the majority of the Contractor's income is generated through third party use or through charging the public for use of the Services, the Unitary Charge may be insufficient to allow the Authority to make deductions that are a realistic reflection of its loss. In such circumstances the Authority should not limit its right of recourse to deductions in the Unitary Charge.

24.6.6 The limits on liability within collateral warranties should be within the overall required limits on indemnities within the Contract (and, by implication, the Sub-Contracts) (see Sections 24.3 (Indemnities) and 24.4.1 (Collateral Warranties)). Accordingly, claims against indemnities which reduce the capped liability within the Contract should have the same effect on the maximum liabilities under the collateral warranties and vice-versa. The Authority should assess the optimum level of such a limit, taking into account all circumstances, such as value for money, consideration of specific rules and the issues referred to above.

24.6.7 Care should be taken to ensure that amounts dealt with under the payment mechanism or market value compensation on termination payment are not capable of being claimed, as this could result in double counting.

25 INSURANCE

25.1 INTRODUCTION

25.1.1 Traditionally, central government has chosen not to take out commercial insurance against insurable risks retained under conventional procurement techniques, as the premiums payable have not been seen to represent good value for money compared to self-insurance.

25.1.2 Local Authorities and other public bodies sometimes elect to insure some of their assets in the commercial insurance market, though typically this is with very high deductibles and a significant level of self-insurance.

25.1.3 The position is different under PFI, because insurable risks are transferred to the Contractor which may have limited free financial resources, particularly if it is a SPV. Moreover, the need to ensure continuity of service means that self-insurance by such a Contractor for the full range of insurable risks is, generally, not appropriate. The Senior Lenders will usually take the same view and not expect nor wish the Contractor to self-insure. To achieve an acceptable credit quality for their loans, Senior Lenders will, in fact, frequently require more extensive insurance cover for the Contractor than that required by the Authority. Nonetheless, the Authority should not rely on the Senior Lenders to look after the Authority's own insurance interests, and it is essential for the Authority to seek professional insurance advice on what insurance requirements should be imposed on the Contractor at an early stage in the procurement process (before issuing the tender documents) and during subsequent negotiations.

25.1.4 The main issues which the Authority will need to consider with its insurance advisers are:

- whether and the extent to which the Authority should require the Contractor to take out and maintain certain insurances as a means of managing particular risks (see Clause 25.2 and Section 25.11), and how these may change over time (see Section 25.2.5 and Section 25.5). A detailed Standard Required Insurance Schedule is set out in Annex 1;
- ensuring that the proceeds of any claim under any required insurance are used correctly by the Contractor (see Section 25.6);
- Authority control of litigation where the Contractor is the principal party insured (see Section 25.7);
- whether the Authority should share significant increases and decreases in the market-wide cost of maintaining the Contractor's operating period insurances (see Section 25.8);
- what should happen if a risk for which insurance is to be effected and maintained in accordance with the required insurance schedule in the Contract becomes uninsurable (see Section 25.9); and
- what should happen if any required insurance term becomes unavailable (see Section 25.10).

Insurance lies at the heart of the Contractor's risk management strategy and, in turn, efficient risk management lies at the heart of the value for money benefits of PFI that derive from long-term Asset ownership and stewardship by investors. The Contractor's approach to insurance is inseparable from its approach to Asset design, construction, choice of materials and maintenance

regimes etc. Accordingly, Authorities and their advisers should take care not to disturb the transfer of this integral package of risks, nor to disturb incentives that ensure these risks are efficiently priced and managed. Moreover it is essential that the Authority's insurance requirements and associated contractual provisions are clearly stated in the tender documents and that bidders are required to price these matters within their responses to the tender documents.

25.1.5 The Authority's insurance requirements in Clause 25.2 and Annex 1 will represent a minimum degree of cover which the Authority expects to see maintained by the Contractor. It is, of course, for the Contractor to determine the overall insurance programme to be implemented, consistent with the Authority's and Senior Lenders' respective requirements. To ensure delivery of value for money, the Contract should incentivise (or, as appropriate, require) the Contractor at all times to:

- ensure full integration between the insurance programme and their overall risk management strategy,¹
- make cost-effective trade-offs between lower deductibles and increased insurance premiums (within the constraints specified by the Authority and Senior Lenders);
- procure insurance from good quality and cost-effective suppliers; and
- look only to the Authority for cover in relation to unavailability of insurances as a last resort.

Under exceptional circumstances it may not be value for money for the private sector to bear all the risks associated with placing an insurance programme itself (e.g. in the event of (i) non availability of insurance or (ii) excessive market wide increases in insurance costs) and it is likely to be better value for money if an Authority provides a limited level of protection under specific circumstances (see Section 25.9 (Risks that Become Uninsurable) and Section 25.8 (Insurance Premium Risk Sharing Schedule)). Factors which should incentivise the Contractor to manage risks effectively and discourage the Contractor from seeking protection from the Authority, unless in exceptional circumstances and as a last resort, include the following:-

- the Contractor remains liable for deductible related losses;
- in the event of uninsurability and an uninsured risk materialising, the Authority may have the ability to terminate the Contract; and furthermore, the amount payable by the Authority to the Contractor upon such termination will be the same as that payable upon termination in the event of Force Majeure (i.e. equity payment limited to par value less Distributions paid to date (see Section 21.3)); and
- in respect of the operating period insurance premium risk sharing arrangement, protection is limited to general market wide changes in insurance costs. Furthermore the Contractor takes the first 30% of any relevant change in insurance cost, as well as 15% of any relevant change in insurance cost in excess of 30%.

25.2 AUTHORITY'S REQUIREMENTS

25.2.1 In general terms, the Contractor will be expected to insure in accordance with good industry practice.² However, in addition to the statutory insurances, there will be a number of

¹ For example, for a schools project, a Contractor should consider whether sprinklers should be installed, taking into account the lower cost of insurance which is likely to arise as a result.

² What constitutes good industry practice should be part of the advice sought by the Authority from its professional insurance adviser (see Section 25.1.3 above).

required insurances which the Authority will want to know are being taken out and maintained by the Contractor, to ensure that insurance proceeds are available to cover certain types of claims. Such required insurances should include third-party liability insurance, Contractors' "all risks" insurance and property damage insurance during operation.

25.2.2 Only those risks which are to be covered by the Required Insurances and insurances required by law (see Clause 25.2(a) and (b)) will attract uninsurability protection (see Section 25.9). It is therefore important that apart from delay in start up and business interruption insurance (see Section 25.2.3 below), only those insurances from which the Authority derives a benefit as a co-insured party should be designated Required Insurances. Furthermore, in respect of those risks that the Contractor is required to insure against, the Authority should ensure that the uninsurability protection³ does not extend to cover risks if it would have the effect of undermining the essence of the commercial principle that the risk being covered is a risk that the Contractor is required to manage. For example, if professional indemnity insurance or non-vitiation⁴ protection become unavailable, the Authority should not provide such cover since it would insure the Contractor against claims relating to the Contractor's (or its Sub-Contractors') negligence. Authorities should therefore ensure that any professional indemnity insurance does not feature as a Required Insurance and non-vitiation protection is carved out of the uninsurability protection provided under Clause 25.9.

25.2.3 The Senior Lenders will require the Contractor to take out delay in start-up and business interruption insurance. The effect of these insurances is to ensure that during any period of reinstatement of physical damage to the Project, the Contractor will be able to meet its unavoidable running costs and fund debt service obligations on its Senior Debt. If such insurances become unavailable in the market and material damage to the Project subsequently arises, the Contractor may (depending on the period of reinstatement) default under the terms of the Senior Financing Agreements. Without the benefit of uninsurability protection for delay in start-up and business interruption insurances,⁵ Senior Lenders are likely to require contingencies to be put in place by the Contractor to cover such eventualities. It is thus preferable that the Authority should, on value for money grounds, extend uninsurability protection in the Contract to cover business interruption insurance and delay in start-up insurance⁶, but this should exclude protection for Distributions. The Authority may be named as an additional insured under these two policies to the extent that it too has a demonstrable insurable interest. This is likely to be limited to any additional increase in the cost of working further to a loss which may form part of the cover, and will not extend to loss of revenue. It is important to remember that delay in start-up and business interruption insurances only respond in circumstances where an underlying policy covering material damage to the Project also responds, or would have responded in the case that this cover is also unavailable.

25.2.4 Insurance requirements should reflect the degree of risk transfer, the ability of the Contractor to make the premium payments (relative to the size of the risks), value for money considerations and the specifics of the Project. There are, of course, standard insurances that are required during the construction and operating phases of all projects, although the full scope of cover (e.g. the insured risks, the exclusions, the endorsements, the amounts of cover and the deductibles) will vary from project to project and from sector to sector.⁷ Whilst the construction phase insurances typically cover the whole of the construction phase, the operational insurance

³ See Section 25.9 (Risks that become Uninsurable) below.

⁴ See Section 25.2.9 below.

⁵ See footnote 61 below.

⁶ This is sometimes referred to as advanced loss of profits insurance (ALOP) although as noted protection for Distributions should be excluded.

⁷ Salient information as to the scope of the required insurances specified in Section 25.2.1 should be included within the Standard Required Insurance Schedule to the Contract (see Section 25.11 below).

are renewed periodically (mostly annually). It is important that the renewal process starts well in advance of the renewal date.

25.2.5 Insurers should inform the Authority of changes in the policy.

25.2.6 If the Authority wishes to increase the limits or scope of the insurances during the life of the Contract, then this should be treated as an Authority change in Service (see Section 13.2 (A Typology of Changes)).

25.2.7 As central Government generally self-insures, there should be no requirement for insurances to cover those risks retained under the Project by a central Government Authority. It is, however, reasonable to seek third-party public liability insurance where appropriate (this should be checked with the relevant policy unit within the Authority).

25.2.8 The Authority should protect its position by being a co-insured for its own interests (where it has an insurable interest) and requiring its interests to be noted as appropriate on the insurances taken out by the Contractor. This should be acceptable to the Contractor.⁸

25.2.9 The Authority should consider the value for money benefits of requiring the Contractor to take out “non-vitiation” protection in respect of certain required insurances. Non-vitiation protection allows the Authority to claim as a co-insured under a policy even if the insurer would be able to avoid a claim made by the Contractor on the basis that the Contractor, for example, withheld material information from the insurer (e.g. the Contractor does not make the insurer aware that it is intending to use highly flammable substances during the construction period). The Senior Lenders may also require non-vitiation cover. However, absence of such cover shall not be covered by the uninsurability protection given to the Contractor in respect of unavailability of insurance cover.⁹

Suitable drafting is as follows:

25.2 Insurance

- (a) The Contractor shall, prior to the Service Commencement Date, take out and maintain or procure the maintenance of the insurances described in [Part 1 of Annex 1 (Required Insurances)] and any other insurances as may be required by law. These insurances must be effective in each case not later than the date on which the relevant risk commences.¹⁰
- (b) The Contractor shall during the Service Period take out and maintain or procure the maintenance of the insurances described in Part 2 of Annex 1 (Required Insurances) and any other insurances as may be required by law.¹¹
- (c) No party to this Contract shall take any action or fail to take any reasonable action, or (insofar as it is reasonably within its power) permit anything to occur in relation to it, which would entitle any insurer to refuse to pay any claim under any insurance policy in which that party is an insured, a co-insured or additional insured person.
- (d) With the exception of any insurances required by law, the insurances referred to in paragraphs (a) and (b) shall:

⁸ Where possible, the Authority should be a co-insured on the Contractor’s insurance policies. This is a much stronger position for the Authority than being named as “loss payee” under the policy, as a co-insured can make the claim itself and is not (as in the case of a “loss payee”) reliant on the insured party making the claim.

⁹ See Section 25.9 (Risks that become Uninsurable).

¹⁰ These are the construction or development phase insurances and must be Required Insurances. The insurance schedule should specify the dates by which these insurances should be effective.

¹¹ These are the operational insurances and must be necessary insurances only. In some projects the operational phase may overlap with the construction phase (e.g. a grouped schools project) and insurance requirements will need to be tailored accordingly.

- (i) subject to paragraph (e) below, name the Contractor as co-insured with any other party maintaining the insurance;
 - (ii) [provide for non-vitiating protection in respect of any claim made by the Authority as co-insured in accordance with Endorsement [2] in Part 3 of [Annex 1],]¹²
 - (iii) contain a clause waiving the insurers' subrogation rights against the Authority, its employees and agents in accordance with Endorsement [2] in Part 3 of [Annex 1];
 - (iv) provide for 30 days prior written notice of their cancellation, non-renewal or amendment to be given to the Authority¹³ in accordance with Endorsement [1] in Part 3 of [Annex 1]; and
 - (v) in respect of the Physical Damage Policies provide for payment of any proceeds received by the Contractor to be applied in accordance with Clause 25.5 (Reinstatement).
- (e) Wherever possible, the insurances referred to in paragraphs (a) and (b) shall name the Authority as a co-insured for its separate interest.¹⁴
- (f) The Contractor shall provide to the Authority:
- (i) copies on request of all insurance policies referred to in paragraphs (a) and (b) (together with any other information reasonably requested by the Authority relating to such insurance policies) and the Authority shall be entitled to inspect them during ordinary business hours; and
 - (ii) evidence that the premiums payable under all insurance policies have been paid and that the insurances are in full force and effect in accordance with the requirements of this Clause 25.2 (Insurance) and Annex 1 (Required Insurances).
- (g) Renewal certificates in relation to the insurances referred to in paragraphs (a) and (b) shall be obtained as and when necessary and copies (certified in a manner acceptable to the Authority) shall be forwarded to the Authority as soon as possible but in any event on or before the renewal date.
- (h) If the Contractor is in breach of paragraphs (a) or (b) above, the Authority may pay any premiums required to keep such insurance in force or itself procure such insurance and may in either case recover such amounts from the Contractor on written demand.¹⁵
- (i) The Contractor shall give the Authority notification within 30 days after any claim in excess of £[] on any of the insurance policies referred to in this Clause accompanied by full details of the incident giving rise to the claim.¹⁶
- (j) Neither failure to comply nor full compliance with the insurance provisions of this Contract shall limit or relieve the Contractor of its liabilities and obligations under this Contract.

¹² For certain projects where there is significant Authority interface it may be appropriate for the Employer's Liability Insurance Policy to contain a similar waiver of subrogation.

¹³ To the extent that the Authority has an insurable interest.

¹⁴ This will only be possible for policies in which the Authority has an insurable interest (not, for example, professional indemnity insurance) or where the policy has an "indemnity to principals" provision (for example, in an employers liability insurance).

¹⁵ These amounts can be set off under Clause 12 (Payment and Set-off).

¹⁶ On projects on which many claims are expected, the Authority can agree a minimum amount below which it is not notified. If this is done, it may be necessary for the Authority to be notified of important claims (e.g. accident and injury based claims).

- (k) The insurance premiums in respect of the insurances referred to in paragraphs (a) and (b) shall be the responsibility of the Contractor.

25.3 MECHANISM TO INCREASE INSURED AMOUNTS

25.3.1 It is generally not possible to place insurance to cover the full life of a Contract, although a single policy to cover a construction phase (extending over several years) can usually be arranged. By contrast, policies covering the operational phases of projects are generally renewable annually. In this case, where policies are renewable annually, there needs to be a mechanism to ensure that the insured amounts and deductibles specified in the schedule of required insurances increase over the duration of the Contract in order to keep pace with inflation.¹⁷ This is commonly done through an index-linking mechanism. Alternatively, it may be by agreement on expiry and renewal of policies.

25.3.2 Index-linking can cause a problem for liability insurance if it cannot be bought in odd amounts (e.g. £50, £51.15, £52.53 etc) although this is normally dealt with by rounding up annually to the nearest whole insurable amount.

25.3.3 The risk of increases and decreases in insurance costs should be borne primarily by the Contractor.¹⁸ Whilst there may ultimately be indirect protection (e.g. via indexation (see Section 15.2 (Inflation Indexation))), the Contract should not include any provisions which expose the Authority to direct pass-through of such extra costs, save as described in Sections 25.8 (Insurance Premium Risk Sharing Schedule) and 25.9 (Risks that become Uninsurable). Increases or decreases in insurance premiums which result from Authority changes (see Section 13 (Change in Service)) should be taken into account in any price variations resulting from the change in Service. The Contractor should bear any premium increases resulting from any change in Service it proposes (see Section 13 (Change in Service)).

25.3.4 In no circumstances should the Authority introduce benchmarking of insurance provisions into the Contract, or any other arrangements which have the same commercial effect. The appropriate price protection mechanism is set out in Section 25.8 below. This will operate in addition to the uninsurability protection set out in Section 25.9.

25.4 ENSURING THE QUALITY OF THE INSURANCES

25.4.1 The Contract should require that all insurances are placed through a reputable insurer of good standing. In practice, financiers will ensure that insurances will be arranged by, and placed with brokers and insurers approved by them (or that fall within a particular category) and on terms acceptable to them.

25.4.2 There is usually no need to limit the market within which the Contractor must insure the relevant risks (e.g. the worldwide market is not unusual).

Suitable drafting is as follows:

The insurances referred to in this Clause shall be effected with insurers approved by the Authority, such approval not to be unreasonably withheld or delayed.

¹⁷ This will not be necessary where the insured amount is an unspecified amount (e.g. the reinstatement cost of a property) rather than a specific sum (as is usually the case for third party liability cover).

¹⁸ This risk relates not only to increased premiums but also to increased levels of deductibles. See Section 25.9.1.

25.5 REINSTATEMENT AND CHANGE OF REQUIREMENT AFTER INSURED EVENT

25.5.1 If an insured event occurs and certain Assets require replacement or reinstatement, the Authority may decide to change the service requirement. If it does so, the cost of reinstatement may be more or less than the cost of exact replacement. Clearly there is no problem where the cost is less. Where insurance proceeds do not cover the full reinstatement, and the additional cost is due to an Authority change in Service (and not under-insurance by the Contractor of the original asset), then the extra cost must be funded by the Authority in accordance with the change in Service mechanism (see Section 13 (Change in Service)).

25.5.2 Although insurance should be available for full reinstatement, the Contractor should nonetheless arrange cover on terms which reflect the fact that the Authority's requirements may change after an insured event occurs and that it is possible that there will be a requirement for something other than full or exact reinstatement.¹⁹

25.5.3 In practice, the parties are likely to discuss and negotiate whether (and how) to reinstate the Project after the occurrence of an insured event. Accordingly, the Contract should set out provisions regarding how the parties will agree a plan for the reinstatement of the Project ("Reinstatement Plan"). The Contract must be clear as to the remedy in the event of disputes over reinstatement. The Authority should be aware that following any physical damage to the Project, the Contractor will only be permitted to claim under the delay in start-up and business interruption insurances if the insurer is satisfied that the Contractor is using its reasonable endeavours to reinstate. Accordingly, the Authority's response to the proposed Reinstatement Plan should be reviewed by the Authority as a matter of priority and the Authority should respond to the Contractor within a reasonable period of time.

25.5.4 The Authority has a clear interest in the application of any insurance proceeds received by the Contractor under the physical damage policies that are to be applied in reinstatement of the Project. Although the Authority agrees a Reinstatement Plan with the Contractor, the Authority should also be concerned to ensure that any insurance proceeds are utilised in accordance with the agreed Reinstatement Plan. Additionally, the Authority must ensure that upon termination of the Contract (either through natural expiry or early termination) the Authority receives the benefit of any insurance proceeds so that it can continue with the reinstatement of the Project.²⁰ This is achieved by having the insurance proceeds in excess of a minimum level paid into a joint insurance account which is in the names of the Authority and the Contractor.²¹ Proceeds below the minimum level are paid directly to the claimant (with the exception of third party liability claims payments which are typically paid directly to the aggrieved party). A minimum level is set in order to avoid unnecessary administrative costs arising.

Required drafting is as follows:

25.5 Reinstatement

- (a) [Subject to Clause 25.6 (Economic Test)], all insurance proceeds received under any policy referred to in paragraph 1 of Parts I and 2 of Annex 1 (the "Physical Damage Policies")²² shall be applied to repair, reinstate and

¹⁹ If the Authority decides to reinstate with a lower level of Service requirement following an insured event, the Unitary Charge should remain the same unless compensation is paid to the Contractor. The Authority should also be aware of the fact that a decision not to reinstate fully may impact upon the amount of insurance proceeds recoverable.

²⁰ This is particularly important if the Contract is terminated for Contractor Default and the Authority elects (and is able) to retender the Contract.

²¹ To note that insurers generally settle as the costs of reinstatement are incurred and so large balances seldom build up in the joint insurance account.

²² This will not include, for example, third party liability, employers' liability, business interruption or advance loss of profits insurance.

replace each part or parts of the Assets in respect of which the proceeds were received.

- (b) All insurance proceeds paid under any Physical Damage Policy in respect of a single event (or a series of related events) in an amount in excess of £ [minimum level] (indexed) shall be paid into the Joint Insurance Account.²³
- (c) [Subject to Clause 25.6 (Economic Test)], where a claim is made or proceeds of insurance are received or are receivable under any Physical Damage Policy in respect of a single event (or a series of related events) (the (“Relevant Incident”) in an amount in excess of £[] (Indexed):
 - (i) the Contractor shall deliver as soon as practicable and in any event within [28] days after the making of the claim a plan prepared by the Contractor for the carrying out of the works necessary (the “**Reinstatement Works**”) to repair, reinstate or replace (the “**Reinstatement Plan**”) the assets which are the subject of the relevant claim or claims in accordance with paragraph (d) below. The Reinstatement Plan shall set out:
 - (A) if not the Construction Sub-Contractor, the identity of the person proposed to effect the Reinstatement Works, which shall be subject to the prior written approval of the Authority; and
 - (B) the proposed terms and timetable upon which the Reinstatement Works are to be effected (including the date that the Project will become fully operational), the final terms of which shall be subject to the prior written approval of the Authority, which approval shall not be unreasonably delayed;
 - (ii) provided that the Authority is satisfied that the Reinstatement Plan will enable the Contractor to comply with paragraph (d) below within a reasonable timescale:
 - (A) the Reinstatement Plan will be adopted;
 - (B) the Contractor shall enter into contractual arrangements to effect the Reinstatement Works with the person identified in the Reinstatement Plan approved by the Authority;
 - (C) prior to the earlier to occur of the Termination Date or the Expiry Date, any amounts standing to the credit of the Joint Insurance Account (the “**Relevant Proceeds**”) (together with any interest accrued) may be withdrawn by the Contractor from the Joint Insurance Account as required to enable it to make payments in accordance with the terms of the contractual arrangements referred to in paragraph (ii)(B) above, and to meet any other reasonable costs and expenses of the Contractor for the sole purposes of funding the Reinstatement Works and the parties shall operate the signatory requirements of the Joint Insurance Account in order to give effect to such payments. Following the earlier to occur of the Termination Date and the Expiry Date, the Authority may withdraw amounts standing to the credit of the Joint Insurance Account for the purposes of funding any Reinstatement Works;
 - (D) the Authority agrees and undertakes that, subject to compliance by the Contractor with its obligations under this Clause, and

²³ See Section 1.7 (Interpretation) for definition.

provided that the Contractor procures that the Reinstatement Works are carried out and completed in accordance with the contractual arrangements referred to in paragraph (ii) (B), it shall not exercise any right which it might otherwise have to terminate this Contract by virtue of the event which gave rise to the claim for the Relevant Proceeds;²⁴

- (E) the Authority undertakes to use reasonable endeavours to assist the Contractor in the carrying out of the Reinstatement Plan;
 - (F) after the Reinstatement Plan has been implemented to the reasonable satisfaction of the Authority and in accordance with paragraph (d) below the Authority shall permit withdrawal by the Contractor of any Relevant Proceeds then held in the Joint Insurance Account that have not been paid under paragraph (ii) (C) above, in respect of the Relevant Incident, together with any interest accrued; and
 - (G) subject to the provisions of Clause 24.3.8 (Indemnity) the Contractor shall be solely responsible for the payment of any deficiency.
- (d) Where insurance proceeds are to be used, in accordance with this Contract, to repair, reinstate or replace any Asset, the Contractor shall carry out the work in accordance with the [Construction Specification] so that on completion of the work, the provisions of the Contract are complied with.

25.6 APPLICATION OF INSURANCE PROCEEDS

25.6.1 The Contractor should always be obliged to reinstate the Asset and the Service if an insured event occurs. If the Authority does not require reinstatement, then any insurance proceeds should go to the Contractor but the Authority should be aware that this effectively results in a voluntary termination and the Authority will be obliged to make a full payout to the Contractor (see Section 21.5 (Voluntary Termination by Authority)), but deducting such amounts from the payment.

25.6.2 In some projects, Senior Lenders may want to impose a project economic test to determine whether reinstatement will enable them to recover their outstanding debt in full. If the economic test shows that this is not possible, Senior Lenders prefer to appropriate the insurance proceeds instead of allowing reinstatement. This should not be a first resort for the Senior Lenders and there should be good reasons for the Authority to agree to the inclusion of an economic reinstatement test in the Contract. Senior Lenders should focus instead on ensuring that the amounts insured under the delay in start up and business interruption insurances are sufficiently high, or that there is sufficient contingency in the Contractor's finances to deal with their concerns.

25.6.3 A project economic test should not be necessary where there is a low risk of total destruction of the asset (such as with a road or rail project, or a project that has a number of geographically diverse sites). Where the risk exists (e.g. a single-site project), the Authority may accept a project economic test but this should be based on the default senior loan life cover ratio so that Senior Lenders cannot abandon the Project if the test shows that debt service is achievable (even if there is a minimal amount of headroom). Including annual debt service cover

²⁴ This would apply if the definition of Relief Events (see Section 5.3.2 (Scope of Relief Events)) did not cover the insured event giving rise to the issue of reinstatement. If so, the Contract may confirm that the concepts of Compensation Events and Relief Events (see Section 5 (Supervening Events)) will apply during the period of carrying out the Reinstatement Works so that, for example, any Authority breach will be treated as a Compensation Event (see Section 5.2.1.2) during this period.

ratios in an economic test is not recommended (as these ratios give only an annual “snapshot” of performance, which is not relevant here). There should be no need to specify a threshold amount of insurance proceeds below which the economic test should not be applied because the test should in any event only be applied in cases of total or near total destruction.

25.6.4 If the result of the project economic test allows the Senior Lenders to appropriate the insurance proceeds or an amount equal to the outstanding Senior Debt (whichever is the lesser), the Contractor remains under an obligation to reinstate the asset. If, as is likely, it is not financially able to do so, it will be in breach of contract and the Authority will terminate for Contractor Default in the usual way (see Section 21.2 (Termination on Contractor Default)). The Authority can then rebuild the asset through a new competition.

Where an economic reinstatement test is used the following is the required drafting:

25.6 Economic Test

- (a) If all of the Assets are destroyed or substantially destroyed in a single event and the insurance proceeds (when taken together with any other funds available to the Contractor)²⁵ are equal to or greater than the amount required to repair or reinstate the Assets, then the Contractor²⁶ shall calculate²⁷ the senior debt loan life cover ratio²⁸ as used in the Base Case (on the assumption that the Assets are repaired or reinstated in accordance with Clause 25.5(c)).
- (b) If the calculation referred to in paragraph (a) above shows that the senior debt loan life cover ratio is greater than or equal to [event of default level] then the Contractor shall be subject to the procedure set out in Clause 25.5 (Reinstatement).
- (c) If the calculation referred to in paragraph (a) above shows that the senior debt loan life cover ratio is less than [event of default level] then an amount equal to the lesser of:
 - (i) the insurance proceeds; and
 - (ii) the Base Senior Debt Termination Amount, or, if any Additional Permitted Borrowing has been advanced, the Revised Senior Debt Termination Amount,²⁹shall be released from the Joint Insurance Account to the Contractor.³⁰
- (d) If, pursuant to paragraph (c) above, insurance proceeds are released from the Joint Insurance Account the Contractor shall be in breach of its obligations under this Contract and shall not, pursuant to Clause 5.3 (Relief Events), be relieved of its obligations unless it can demonstrate, to the satisfaction of the Authority, that it can carry out the works necessary to repair, reinstate or replace the assets which are subject to the relevant

²⁵ Such funds could, for example, include sums made available to the Contractor by the Authority to ensure that the test in paragraph (b) is passed and that, as a result, reinstatement occurs in accordance with Clause 25.5 (Reinstatement).

²⁶ The calculation will be controlled by the Senior Lenders in the Financing Agreements, and checks will need to be made by the Authority that this calculation allows reinstatement.

²⁷ There will be a debate as to how this should be done. Since the Senior Lenders are those whose interests are being protected, the formulae set out in the banking financial model should be used, having agreed exactly how the formula will work and memorialised this in the Contract (see footnote 25 above).

²⁸ For the meaning of this ratio see Section 5.2.3 (Calculation of Compensation).

²⁹ As set out in the relevant definition, excluded from this will be amounts standing to the credit of the Joint Insurance Account.

³⁰ This will mean the amounts are released to the accounts secured to Senior Lenders and the Senior Lenders will apply such amounts as a prepayment against Senior Debt.

claims in accordance with Clause 25.5(d) (Reinstatement) and within a reasonable timescale.

25.7 CONTROL OF THE DEFENCE ON LITIGATION OF AN INSURED EVENT

25.7.1 The Authority may wish to control the defence of any litigation against the Contractor which is likely to have implications for the Authority itself or wider Government. If the Authority is likely to become a co-defendant in the relevant litigation or a defendant in a number of similar litigations which will be based on the precedent in law set by the relevant litigation, it is likely to want to control the litigation from an early stage. This may involve prolonging litigation in order to establish a clear precedent instead of settling out of court. Alternatively, the Authority may wish to settle the litigation as soon as possible for public policy reasons and, in such cases, these will override commercial considerations (this may be the case, for example, in prison and hospital projects).

25.7.2 The Contractor's insurer will usually expect to be in control of any litigation which may lead to a claim under one of its policies. It will be reluctant to pay out for claims over which it has had no control of the defence. This might include claims which the Authority has settled out of court where the courts may have awarded a lesser amount had the action been fully pursued or claims which the insurer believes it could have settled out of court for a lesser amount than is awarded by the courts. The degree of control by the Authority which the insurer will accept should be examined on a project-specific basis.

25.7.3 Generally, the Authority should expect to take back some liability for litigation costs if it wishes to insist on controlling such litigation. In practice, it is extremely difficult to determine what such liability should be. In principle, the Authority should be liable for any difference between what the insurer would have paid and the final amount settled or decided. It would be very hard to establish, however, what amount would have been an acceptable settlement to all parties (including the plaintiff) in either case outlined in Section 25.7.2. In practice, the Authority may find it is obliged to take on the majority, or even all, of the relevant litigation costs in return for the right to control the defence.

25.8 INSURANCE PREMIUM RISK SHARING SCHEDULE

25.8.1 An Authority may elect to provide some protection to the Contractor for changes in the market wide costs of maintaining operational phase insurances. The Authority will need to form a view as to the extent to which this will improve value for money. In projects where the Contractor retains end user risk, the Authority should consider whether it should give the Contractor any price protection in relation to increases in insurance premiums, as the Contractor may be able to manage such increases by increasing the price that the end user pays for the Services. If the Authority decides to provide such protection, the Insurance Premium Risk Sharing Schedule ("IPRSS") (see Schedule A below) is the *only* mechanic which should be used and is required drafting.

If an Authority elects to provide relief for changes in insurance costs the IPRSS should be included in the tender documents, and agreed by the relevant party prior to award of winning bidder status. The appointment of the winning bidder will typically occur a few months prior to Financial Close. The Base Cost against which changes are measured must be agreed between the Authority (in conjunction with its insurance adviser) and the bidder, prior to the selected bidder status being awarded (See Section 32 (Competitive Dialogue and Commitment Letters)). There should normally be no variation to the modelled insurance premium assumptions after the appointment of a winning bidder. Only in the event of a delay in Financial Close beyond the expected Financial Close date resulting in an increase in the construction price and giving rise to a legitimate change in the relevant sum(s) insured should the bid Base Cost be allowed to vary

after the Contractor has been awarded winning bidder status. The Base Cost should be set at a *long run* median level, such that the probabilities of the outturn costs being higher or lower in the future (after adjusting for inflation) are the same. This will invariably differ from the prevailing cost of insurance at the Bid Date. Authorities and their advisers must take care to avoid accepting artificially depressed Base Cost figures which will underestimate the outturn unitary charge payment profile and simply lead to the Authority paying compensation above the upper 30% threshold during the Contract term. Conversely, they should not rely on the sharing of future cost reductions, below the lower 30% threshold, as justification for an overestimated Base Cost still representing value for money.

25.8.2 As stated in Section 25.3.3, the risk of increases in insurance costs should lie primarily with the Contractor. However it may not be value for money for the Authority to require the Contractor to take on the full risk of exceptional market wide movements in operational phase insurance costs: the issue here is similar to that on uninsurability (see Section 25.9). Senior Lenders may require the Contractor to establish large reserves against such risks (or increase the Unitary Charge to cover them), whereas if these exceptional risks are taken by the Authority, this may offer better value for money. However, if the Authority takes on the risk of exceptional upward movements in market wide insurance costs, it should also receive a corresponding benefit from reductions.

25.8.3 Authorities may, therefore, agree that if there is a movement of more than 30% in the projected operational insurance costs on account of market wide factors, any excess will be shared 85% to the Authority and 15% to the Contractor. Leaving this 15% risk with the Contractor will ensure that, in the event of such an exceptional increase, the Contractor will remain incentivised and focused on seeking to reduce premiums at each renewal. (It should be noted that the Contractor's liability will nonetheless be limited given the uninsurability protection available should insurance no longer be available on a commercially viable basis (see Section 25.9 and Clause 25.9.3(b)).

25.8.4 Authorities should benefit correspondingly from 85% of any falls in general market insurance costs in excess of a 30% reduction in the projected operational phase insurance costs.

25.8.5 This insurance cost sharing arrangement is limited to market wide movements and so should not take into account the following:-

- Any change in the cost of insurance which, with the exception of portfolio cost savings, is not attributable to a general movement in insurance costs across the PFI market as a whole, (i.e. changes in insurance costs due to circumstances generally prevailing in the insurance market in which insurance for the majority of all PFI projects (across all of the sectors) is placed). Accordingly changes in insurance costs which are project or sector-specific should not be taken into account;³¹
- changes in insurance premium tax;³² or
- changes in insurance intermediaries' fees and commissions.

25.8.6 As the PFI market matures and becomes less fragmented, Contractors who may have set the modelled cost of insurance on the basis of a single project placement may, during the course of the operational phase of the Project, elect to effect insurance on a portfolio basis (i.e. under a policy also covering risks on other projects or other matters which are outside the scope of the Project). This may give rise to significant cost savings (Portfolio Cost Savings). Given the

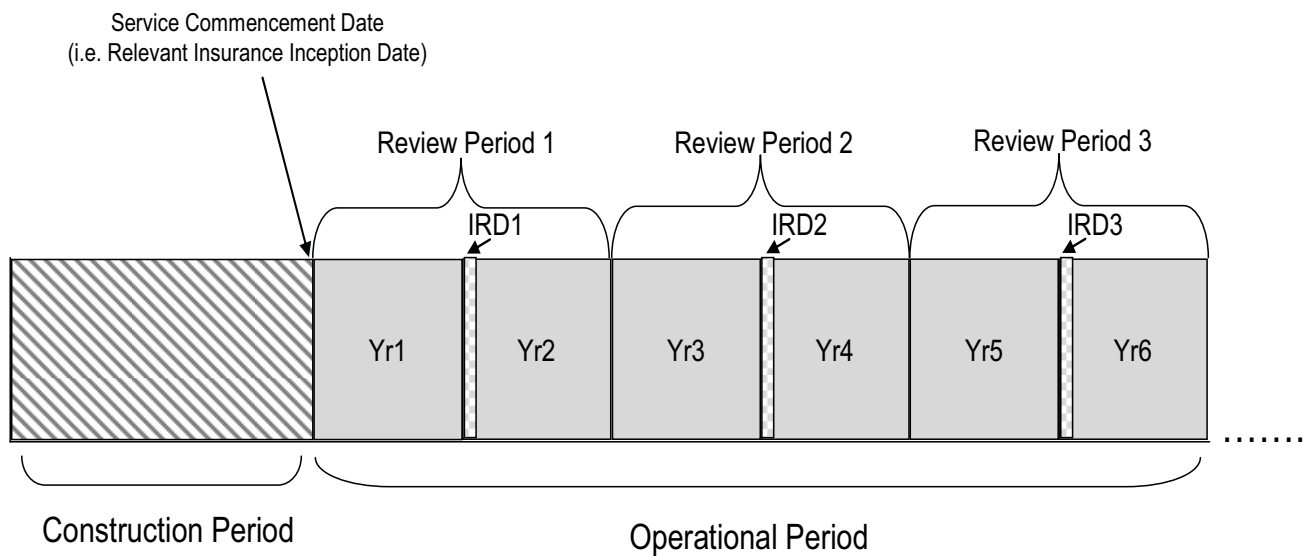
³¹ This therefore includes changes in insurance costs attributable to the actions of the Contractor, which should not be taken into account given the correlation between Contractor performance and insurance premiums.

³² Insurance premium tax is considered a commercial risk for the Contractor in the same way as Corporation Tax.

level of risk which the Authority is assuming, it is considered reasonable for the Authority to potentially benefit from this approach. Accordingly, in the event that there are any insurance cost savings from portfolio placements, for the purpose of determining the Project Insurance Change and Insurance Cost Differential (see Schedule [A] (Insurance Premium Risk Sharing Schedule)), such savings should be considered in the same way as other factors causing a general market movement in insurance costs. Therefore, the actual cost of insurance is not adjusted to reflect what the cost of insurance would have been in the absence of such savings.

25.8.7 Whilst effecting insurance on a portfolio basis may lead to significant cost savings on an aggregated basis, it is possible that the position on an individual project within the proposed portfolio arrangement is undermined. Accordingly, an individual Authority should not be obliged to join a portfolio solution if the effect is to make it worse off.

25.8.8 The cost-sharing calculations are to determine if any payments are to be made either by or to the Authority. This is based on a comparison of the relevant actual insurance cost with the relevant projected cost of insurance. With the exception of the first review, which should take place immediately after the first operational phase policy renewal, reviews of the actual insurance costs against the base projections, should take place biennially.³³ The cost of insurance for the previous year and the cost of insurance for the current year are assessed at each review. A diagrammatic representation of this is given below.



IRD = Insurance Review Date
 IRD1 = First Insurance Review Date

25.8.9 The renewal process will be transparent, enforceable and supported by evidence. At each review date, an insurance cost report should be provided by the Contractor's insurance broker on behalf of both the Contractor and the Authority (as joint assured). This will be at the Contractor's cost. This should, inter alia, provide an assessment of the reasons for the changes in

³³ The insurance market is cyclical and, arguably, if a period for aggregating insurance costs of, say, five years were used then there would be little need for the IPRSS. However, aggregating insurance costs over a period of several years can create working capital issues for Contractors and so a compromise period of two years has been chosen.

insurance costs for each of the main insurance covers and state the level of variation between the Base Cost and the actual insurance costs. (The bidder's financial model should contain a detailed breakdown of all insurance related costs in order to ensure transparency, including, but not limited to, the projected cost of each Relevant Insurance, insurance premium tax and brokers' fees and commissions).

25.8.10 For the cost sharing mechanic to operate effectively, there must be transparency, and the insurance costs assessment must be supported by appropriate evidence. When preparing the insurance cost report the broker should not only rely on the feedback from the insurance underwriter but should also refer to other suitable data sources, including the CBS Capital non marine index³⁴. In addition PFI insurance cost data will be collated centrally by HMT or its nominee and this will serve as an additional source of information. (When the report is submitted by the Contractor to the Authority, project insurance cost and deductible data for the relevant Insurance Review Period for each principal insurance cover is to be submitted to HMT or its nominee. This is intended to facilitate the creation and maintenance of a PFI insurance cost database.)

25.8.11 Given that the Authority is a joint insured and will be providing relief to the Contractor above a 30% threshold, a duty of care should be owed by the insurance broker to the Authority. Furthermore, given that the Authority will, to an extent, be relying on the findings in the insurance cost report when determining monies due, it is important that the insurance broker understands and commits to providing this duty of care to the Authority when preparing the Insurance Cost Report. Accordingly, the Brokers Letter of Undertaking should contain a duty of care undertaking in connection with the preparation of this report (see Clause 4.5 of Part 4 of Annex 1 (Brokers Letter of Undertaking)).

25.8.12 In addition an Authority may wish to consider employing the services of an 'independent' insurance advisor to confirm the accuracy of the information in the insurance cost report and help generally in the renewal process. It is important that the insurance advisor is not affiliated with the insurance broker placing the insurances and producing the insurance cost report.

25.8.13 If an insurance risk becomes uninsurable (see Section 25.9) or a term or condition is no longer available (see Section 25.10) the Base Cost (See "Definitions" in Schedule [A] below) should be adjusted to reflect the reduced level of cover being procured. Where possible the level of adjustment should be determined by the amount included in the Base Cost attributable to the uninsurable risk. Likewise, in circumstances of the Authority providing uninsurability protection (see Section 25.9), the Unitary Charge payable will be reduced by the cost most recently incurred for the insurance cover that is no longer being purchased by the Contractor. In practice, it may be difficult to discern from the financial model the cost projected to be incurred for the uninsurable risk, in which case it should be determined predominantly by the amount payable in the previous period for the particular risk.

25.8.14 It is not mandatory for an Authority to offer insurance premium risk sharing in the Contract. The decision on whether or not to do so must be taken in the light of the specific nature of the Project and a suitable value for money assessment. However, if the Authority does decide to offer insurance premium risk sharing, the only basis on which this may be included in the Contract is as set out in this Section 25.8.

The Contractor may in its pursuit of the best value for money for itself and the Authority wish to effect insurance for a period of in excess of one year, with insurance renewal taking place at intervals of in excess of 12 months. In this case, the Contractor should consult with the Authority

³⁴ The CBSPC non marine index may be accessed via the following web site www.cbs-lloyds.co.uk/cgi-bin/mri/FileReader.pl

before proceeding with the cover to ensure that both parties agree that it represents improved value for money.

If an Authority elects to share insurance cost risk, the required drafting is as follows (to be included as a schedule to the Contract):

Insurance Premium Risk Sharing Schedule (Schedule [A])

1 Definitions

1.1 For the purposes of this Schedule, the following words and expressions shall bear the following meanings:

“Actual Relevant Insurance Cost” means the aggregate of the annual³⁵ insurance premiums reasonably incurred by the Contractor to maintain the Relevant Insurance during the Insurance Review Period but excluding insurance premium tax and all broker’s fees and commissions;

“Base Cost” means £ [] being the amount as agreed at the Bid Date³⁶ and set out in the financial model which represents the insurance costs (which excludes amounts in respect of insurance premium tax and all brokers’ fees and commissions) which are proposed to be incurred to maintain the Relevant Insurance in each year following the Services Commencement Date, expressed in real terms as at the Bid Date;

“Base Relevant Insurance Cost” means, the aggregate of the Base Costs which were (at Bid Date) projected to be incurred to maintain the Relevant Insurance during the Insurance Review Period indexed by actual RPI from the Bid Date up to the dates on which the Relevant Insurance was placed or renewed either immediately before or during the Insurance Review Period (as applicable in respect of the year in question) less any Base Relevant Insurance Reduction;

“Base Relevant Insurance Reduction” the reduction to be made to the Base Relevant Insurance Cost in respect of a risk which has become Uninsurable or a term or condition which is no longer available and shall be an amount that is either:

- (a) the amount by which the Base Relevant Insurance Cost would have been a lesser amount had such a risk been Uninsurable or such a term or condition been unavailable at the Bid Date (which amount, for the avoidance of doubt, can be £0); or
- (b) if it is impossible to determine an amount pursuant to paragraph (a) above, an amount that is reasonable to be deducted from the Base Relevant Insurance Cost having due regard to:
 - (i) the amount by which the Actual Relevant Insurance Cost is less than it would have been as a result of the risk becoming Uninsurable, or the term or condition becoming unavailable (the “Actual Reduction”);

³⁵ Typically insurance premiums are payable annually.

³⁶ The Bid Date is the date on which the Contractor has fixed its price prior to appointment as the winning bidder. The Base Cost in bidders’ models should be set at a long run median level such that the probabilities of the outturn costs being higher or lower in the future (after adjusting for RPI inflation) are the same. This is to ensure that the approach is consistent with the symmetrical sharing of Insurance Cost Differentials (i.e. +/- 30% thresholds etc.). Furthermore, the median level should be held constant in real terms (year on year) and not profiled, as this will help to ensure that the symmetrical cost sharing band works as intended. Authorities and their advisers must take care to avoid accepting artificially depressed Base Cost figures which will underestimate the outturn unitary charge payment profile and simply lead to the Authority paying compensation above the upper 30% threshold during the Contract term. Conversely, they should not rely on the sharing of future cost reductions, below the lower 30% threshold, as justification for an overestimated Base Cost still representing value for money.

- (ii) the size of the Actual Reduction as a percentage of the Actual Relevant Insurance Cost immediately prior to the risk becoming Uninsurable, or the term or condition becoming unavailable; and
- (iii) the effects of RPI since the Bid Date;

“Business Interruption Cover” shall bear the meaning ascribed to it in Schedule [] (Required Insurance Schedule);³⁷

“Construction Period Insurance” means the Required Insurance in respect of the period from the date of this Contract to the Service Commencement Date;

“Contract Period” means the period from and including the date of this Contract to the Expiry Date, or if earlier, the Termination Date;

“Contractor Related Party” means the Contractor’s agents and contractors (including without limitation the Construction Sub-Contractor and the Operating Sub-Contractor) and its or their sub-contractors of any tier and its or their directors, officers, employees and workmen in relation to the Project and any person on or at any of the [sites] at the express or implied invitation of the Contractor (other than the Authority or any [Authority related party]);³⁸

“Exceptional Cost” means, for an Insurance Review Period, the extent to which there is an Insurance Cost Increase which exceeds in amount 30% of the Base Relevant Insurance Cost for that Insurance Review Period;

“Exceptional Saving” means, for an Insurance Review Period, the extent to which there is an Insurance Cost Decrease which exceeds in amount 30% of the Base Relevant Insurance Cost for that Insurance Review Period;

“First Insurance Review Date” means the first Business Day following the first anniversary of the Relevant Insurance Inception Date;³⁹

“Insurance Cost Decrease” means the Insurance Cost Differential if the value thereof is less than zero, multiplied by minus one;⁴⁰

“Insurance Cost Differential” shall, subject to the Insurance Review Procedure, be determined as follows:-

$$\text{Insurance Cost Differential} = (\text{ARIC} - \text{BRIC}) - (\pm\text{PIC})^{41}$$

³⁷ See Annex 1.

³⁸ This definition may need to be tailored on a project specific basis, depending on the sector in which the project is let, e.g. schools projects should use the definition in the most recent version of the Schools standard form.

³⁹ The first insurance review takes place 12 months and 1 day following the Relevant Insurance Inception Date. The costs considered at the time of the first review will be:-

- the insurance premium payable to cover the first year of operation; and
- the insurance premium payable to cover the second year of operation.

With the exception of the last review, which, depending on Contract Period, may also occur after a shorter period, all other reviews will take place biennially.

⁴⁰ The Insurance Cost Decrease is always a positive sum (if not zero).

⁴¹ In accordance with the definition of Project Insurance Change, the PIC may have either a positive or a negative value. In the event that the PIC is positive then the PIC is subtracted from the difference of the ARIC and the BRIC. If the PIC is negative, then the double negative means that the value of the PIC (ignoring the negative sign) is added to the difference of the ARIC and the BRIC.

where:

ARIC is the Actual Relevant Insurance Cost

BRIC is the Base Relevant Insurance Cost

PIC is any Project Insurance Change

“Insurance Cost Increase” means the Insurance Cost Differential if the value thereof is greater than zero;⁴²

“Insurance Cost Index” means any index introduced by the United Kingdom Government or the Office of National Statistics after the date of this Contract and which is anticipated to be published annually to provide an independent and objective measure of changes in prevailing market insurance costs;

“Insurance Review Date” means the First Insurance Review Date and, thereafter, each date falling on the second anniversary of the previous Insurance Review Date, except where such date lies beyond the end of the Contract Period, in which case the Insurance Review Date shall be the last renewal date of the Relevant Insurance prior to the end of the Contract Period;

“Insurance Review Procedure” means the procedure set out in paragraph 2 of this Schedule [A];

“Insurance Review Period” means a two year period from the Relevant Insurance Inception Date and each subsequent two year period commencing on the second anniversary of the Relevant Insurance Inception Date except where the end of such period lies beyond the end of the Contract Period, in which case the Insurance Review Period shall be the period from the end of the penultimate Insurance Review Period to the last day of the Contract Period;

“Joint Insurance Cost Report” shall bear the meaning ascribed to it in paragraph 2.2 of this Schedule [A];

“PFI” means the United Kingdom’s Private Finance Initiative;

“Portfolio Cost Saving” means any insurance cost saving which arises from the Contractor changing the placement of the Required Insurances from being on a stand-alone project-specific basis assumed at Financial Close and reflected in the Base Cost, to being on the basis of a policy (or policies) also covering risks on other projects or other matters which are outside the scope of the Project so as to benefit from portfolio savings. A Portfolio Cost Saving is defined to be a positive sum and cannot be less than zero;⁴³

“Project Insurance Change” means any net increase or net decrease in the Actual Relevant Insurance Cost relative to the Base Relevant Insurance Cost, arising from:

- (a) the claims history or re-rating of the Contractor or any Contractor Related Party;
- (b) the effect of any change in deductible unless the following applies:-

⁴² The Insurance Cost Increase is always a positive sum (if not zero).

⁴³ An Authority may not be compelled to join a portfolio solution which places it in a worse position than if insurance is placed on a separate stand-alone basis.

- i. such change is attributable to circumstances generally prevailing in the Relevant Insurance Market; and
 - ii. the deductible, further to such change, is either greater than or equal to the maximum⁴⁴ in Schedule [] (Required Insurance Schedule),⁴⁵
- (c) any other issue or factor other than circumstances generally prevailing in the Relevant Insurance Market, except for any Portfolio Cost Saving,⁴⁶

For the purpose of determining the Insurance Cost Differential, in the event that there is a net increase, the Project Insurance Change shall have a positive value. In the event that there is a net decrease the Project Insurance Change shall have a negative value;

“Relevant Insurance” means the Required Insurance and any other insurances as may be required by law other than:

- (a) Construction Period Insurance;⁴⁷
- (b) Business Interruption Cover except to the extent that it relates to Unavoidable Fixed Costs;⁴⁸ and
- (c) [any ancillary insurances];⁴⁹

“Relevant Insurance Inception Date” means the date on which the Relevant Insurance is first providing active insurance cover to the Contractor, being a date no earlier than the Service Commencement Date;

“Relevant Insurance Market” means the insurance market which insures the majority of all PFI projects across all of the PFI sectors (as determined by the number of PFI projects). At the date of this Contract, the Relevant Insurance Market is in the [United Kingdom];

“Required Insurance” shall bear the meaning ascribed to it in the Contract;⁵⁰ and

“RPI” [shall bear the meaning ascribed to it in the Contract];

⁴⁴ The Authority, in conjunction with its advisors, should set the maximum deductibles in the Required Insurance Schedule (see Annex 1) at the highest acceptable level.

⁴⁵ The effect of this clause is to incentivise the Contractor to manage and optimise the trade-off between insurance premium and deductible levels for deductible levels below the maximum stipulated within the Authority Required Insurances, whilst providing protection in two specific circumstances: the first is where, due to circumstances generally prevailing in the Relevant Insurance Market, the cost of maintaining deductibles at the maximum stipulated in the Required Insurance Schedule has increased; and the second is where, due to circumstances generally prevailing in the Relevant Insurance Market, the Required Insurances can only be purchased with deductible levels above the maximum stipulated in the Schedule, wherein two principles apply: (a) the Contractor is given relief from breach by virtue of the provisions which deal with terms and conditions that become unavailable (see Section 25.10); and (b) the additional cost of purchasing insurances even at these increased deductible levels is eligible as an Insurance Cost Differential.

⁴⁶ This means that in addition to portfolio cost savings, changes which are attributable to a general movement in insurance costs across the *entire* PFI market will be taken into account.

⁴⁷ This is assumed to be covered under fixed-price arrangements and so not subject to variation.

⁴⁸ In addition to senior debt service costs, the Contractor may incur other unavoidable costs if the start of the operational period is delayed or in the event of an interruption to the operation of the project, e.g. any fixed cost for the provision of utilities. These unavoidable costs will vary from project to project. Unavoidable Fixed Costs is defined in Part 5 of Annex 1 and excludes Distributions.

⁴⁹ If the Required Insurance contains any supplementary (i.e. non-standard) insurances, for which Insurance Premium Risk Sharing is not being provided, these must also be referred to here.

⁵⁰ This will comprise the insurances in the required insurance schedule contained in the Contract, which should be based on the Standard Required Insurance Schedule (see Section 25.11 and Annex 1).

2 “Insurance Review Procedure”⁵¹

- 2.1 This procedure shall be used to determine whether the Authority shall bear any increase or benefit from any decrease in Relevant Insurance costs.
- 2.2 The Contractor’s insurance broker shall prepare a report on behalf of both the Contractor and the Authority (the “**Joint Insurance Cost Report**”). The Report is to be prepared at the Contractor’s expense, and should, as a minimum, contain the following information for the relevant Insurance Review Period:
- 2.2.1 A full breakdown of the Actual Relevant Insurance Cost;
 - 2.2.2 A full breakdown of the Base Relevant Insurance Cost;
 - 2.2.3 A spreadsheet (the “**Insurance Summary Sheet**”) detailing separately:-
 - 2.2.3.1 the sum(s) insured/limit of indemnity (i.e. rateable factor) for each of the Relevant Insurances;
 - 2.2.3.2 the premium rate for each of the Relevant Insurances;
 - 2.2.3.3 the net premium paid (or to be paid) for each of the Relevant Insurances (i.e. excluding both insurance premium tax and brokers fees and commissions);
 - 2.2.3.4 the deductible(s) for each Relevant Insurance; and
 - 2.2.3.5 details of any claims (paid or reserved) (including incident date, type and quantum) in excess of £[],⁵² being the amount stated in Clause [25.2(i)];
 - 2.2.4 An assessment and quantification of each Project Insurance Change together with the reasons therefore;
 - 2.2.5 Full details of any Portfolio Cost Saving;
 - 2.2.6 Any other reasons that the Contractor believes may have caused a change (by way of increase or decrease relative to the Base Relevant Insurance Costs) in the Actual Relevant Insurance Cost;
 - 2.2.7 The opinion of the Contractor’s insurance broker as to the reasons why the Actual Relevant Insurance Cost has varied from the Base Relevant Insurance Cost, specifying the impact of each of the factors and quantifying the amount attributable to each factor specified above;
 - 2.2.8 The calculation of the Insurance Cost Differential and any Exceptional Cost or Exceptional Saving arising from this calculation;
 - 2.2.9 Evidence satisfactory to the Authority (acting reasonably) of any changes to circumstances generally prevailing in the Relevant Insurance Market that are claimed to account for the Insurance Cost Differential; and

⁵¹ The insurance review procedure takes place around each Insurance Review Date. The cost of insurance for the previous year and the cost of insurance for the current year are assessed at each review. With the exception of the first review, which takes place one day after the first insurance renewal, and possibly, depending on the Contract Period, the last review, all other reviews will take place biennially.

⁵² This amount should correspond to the amount agreed under Clause 25.2 (i) .

2.2.10 Details of movements in the CBS Private Capital non marine index⁵³ plus, if available from other appropriate sources, details of changes in insurance cost across the PFI market as a whole.⁵⁴

2.3 The Contractor shall procure that the Broker, no later than the date which is ten (10) Business Days after the Insurance Review Date, delivers to the Authority, at the same time as it delivers to the Contractor, at least two copies of the Joint Insurance Cost Report. At the same time the Contractor should send a copy of the Insurance Summary Sheet to HMT private finance unit or its nominee. Following receipt of the Joint Insurance Cost Report, the Authority shall notify the Contractor in writing within fifteen (15) Business Days whether or not it accepts the Joint Insurance Cost Report including full details of any disagreement.⁵⁵ If the Authority does not provide such notification and/or details of any disagreement to the Contractor within fifteen (15) Business Days, the Authority shall be deemed to have accepted the Joint Insurance Cost Report. If the Authority disagrees with any item in the Joint Insurance Cost Report, the Parties shall use their respective reasonable endeavours acting in good faith to agree the contents of the Joint Insurance Cost Report.⁵⁶ If the Parties fail to agree the contents of the Joint Insurance Cost Report within thirty five (35) Business Days from the date it was delivered to the Authority, the matter shall be resolved pursuant to Clause 28 (Dispute Resolution), provided always that references in Clause 28(d) to an expert shall be construed as references to an independent insurance expert agreed by the Parties or, in the absence of agreement, appointed by the President for the time being of the Chartered Institute of Arbitrators.

2.4 The Authority may make the Joint Insurance Cost Report available to any of its or HMT's agents or advisers or other body or bodies nominated by HMT for insurance cost verification, benchmarking or similar purpose.

3 Sharing of Exceptional Cost and Exceptional Saving

3.1 If, following the completion of the Insurance Review Procedure, it is agreed or determined that there is an Exceptional Cost, the Authority shall within thirty (30) days of completion of the Insurance Review Procedure make a one-off lump-sum payment to the Contractor equal to 85% of the Exceptional Cost.

3.2 If, following the completion of the Insurance Review Procedure, it is agreed or determined that there is an Exceptional Saving, the Contractor shall within thirty (30) days of completion of the Insurance Review Procedure make a one-off lump-sum payment to the Authority equal to 85% of the Exceptional Saving.

3.3 Following the completion of the Insurance Review Procedure, if it is agreed or

⁵³ CBS Private Capital (CBSPC) is a Lloyd's members' agent, specialising in the provision of advisory and administrative services to private and corporate capital providers underwriting in the Lloyd's insurance market. CBSPC uses syndicate analysts to undertake market research and, as part of its activities, maintains an index of insurance cost changes across the main asset classes. The CBSPC Market Rate Index was the first index of its kind, specifically focusing on the Lloyd's insurance market. It was started in 1994 and tracks the rate movements in the four main Lloyd's markets. The index was re-launched in 2005 when it was rebased to 1997, enabling investors to gauge where they are in the insurance cycle. The CBSPC non marine index may be accessed via the following web address:- <http://www.cbs-loyds.co.uk/cgi-bin/mri/FileReader.pl>

⁵⁴ A source for such data could be nominated by HMT to act as custodian of the Insurance Summary Sheets.

⁵⁵ The Authority should consider employing the services of a fully 'independent' insurance advisor to confirm the accuracy of the information in the Joint Insurance Cost Report.

⁵⁶ This may involve observing how insurance costs have changed during the same period across a representative sample of PFI projects from *all* of the PFI sectors. Such information is likely to be available from a number of sources. The collation of Insurance summary Sheets centrally should facilitate this exercise.

determined that there is neither an Exceptional Cost nor an Exceptional Saving, any Insurance Cost Differential shall be borne by or benefit the Contractor.

4 Insurance Cost Index

If at any time an Insurance Cost Index is published and intended for use in PFI contracts of a similar nature to this Contract, the Parties shall meet with a view to agreeing (a) its application to the Project, taking into account any relevant guidance issued by HMT and (b) how a Portfolio Cost Saving may be accounted for when the index is in use.

25.9 RISKS THAT BECOME UNINSURABLE

25.9.1 The Contract must address the situation where a risk required to be insured against (i.e. a risk covered by a Required Insurance or statutory insurance) and which was previously insurable becomes uninsurable. In this context unavailability includes both unavailability of insurance for a particular risk, or premiums being charged at a level which is not commercially viable. The approach adopted concentrates upon the availability of insurance cover for a particular risk rather than the availability of cover upon particular terms (with particular levels of deductibles) or conditions. Whilst unavailability protection may be available if insurance for a particular risk to be covered by a Required Insurance is not available, there should be no unavailability protection provided by the Authority to the Contractor for a term or condition (including deductibles at a specific level) becoming unavailable. In particular, unavailability protection should not be offered in the event that non-vitiating protection is no longer available (see Section 25.2.2). The provisions for non availability of a Required Insurance term or condition are set out in Section 25.10.

25.9.2 Whilst there is no unavailability protection per se for changes in deductibles Contractors may, given the inverse correlation between premiums and deductibles, nonetheless benefit indirectly under the insurance premium risk sharing arrangement (see Section 25.8). If underwriters are inclined to increase deductibles to levels above the contractually agreed maxima (specified in the Required Insurance Schedule), then the premium payable will need to increase in order that underwriters provide insurance with deductibles at levels which do not exceed the agreed maxima. Under such circumstances (and if no off-setting reductions in the cost of other insurance cover and terms are available) the increased cost may become an Exceptional Cost (as determined under the Insurance Premium Risk Sharing Schedule (Schedule [A]) in Section 25.8) and so be subject to sharing with the Authority.

25.9.3 The consequences of unavailability (ranging from Contractor Default to the Authority accepting liability for occurrence of the event) will depend on the type of risk involved and whether either party was responsible for the unavailability.

The required definition of “Uninsurable” for these purposes is as follows:

“Uninsurable”

means, in relation to a risk, either that:

- (a) insurance is not available to the Contractor in respect of the Project in the worldwide insurance market with reputable insurers of good standing in respect of that risk; or
- (b) the insurance premium payable for insuring that risk is at such a level that the risk⁵⁷ is not generally being insured against in the worldwide insurance⁵⁸ market⁵⁹ with reputable insurers of good standing by contractors in the United Kingdom.⁶⁰

⁵⁷ The effect of this provision should not be to give the Contractor protection against changes in terms of insurance or levels of deductibles, but to only give protection if the cost of insurance (on any terms) is at such a level that the market is not generally insuring against that risk.

25.9.4 A “risk” for these purposes is generally an insured peril which could be the proximate cause for a loss. The proximate cause is the initial act which sets off a natural and continuous sequence of events that produces physical loss or damage under a Material Damage policy, loss of revenue under a Delay in Start Up and Business Interruption policy, or injury and/or physical loss or damage to third parties and/or third party property under a Third Party Liability policy. For example, lightning causes a fire in school premises and this results in material damage to the school. In this example, the lightning is the proximate cause. Fire is not the proximate cause in the circumstances of this example (but could be a proximate cause for other claims).

25.9.5 The Contractor should not be required to insure risks which become Uninsurable.

The following Clause should be included to reflect this principle.

Nothing in this Clause shall oblige the Contractor to take out insurance in respect of a risk which is Uninsurable save where the predominant cause of the risk being Uninsurable is any act(s) or omission(s) of the Contractor or a Contractor Related Party.

If, however, a risk which is to be insured against under the Required Insurances or statutory insurances, becomes Uninsurable, the Contractor will be in breach of Contract where it has caused the relevant risk to be Uninsurable, which will give rise to a termination right for Contractor Default (see Section 21.2.2 (Events Leading to Termination)).

25.9.6 Unavailability of insurance should not be at the sole risk of the Authority. If a particular risk usually covered by the insurances referred to in Clauses 25.2(a) and 25.2(b)^{61 62} becomes uninsurable to the extent that the Contractor and other contractors operating in similar sectors shut down their operations as the means of managing the particular risk, then neither party should be entitled to terminate the Contract. If (in respect of the risk concerned) insurance becomes unavailable for reasons outside the control of the Contractor, then the parties should consider alternative approaches to the risk to consider if they can agree a means by which it can be managed or shared. If, however, no agreement is reached and the risk reverts to the Authority then (subject to Section 25.9.7 below) the amount of the premium previously paid is deducted from the Unitary Charge. If the risk then occurs, the Authority can choose either to pay an amount equal to the insurance proceeds that would have been payable had the Required Insurances or statutory insurances been available (in which case termination will not occur) or terminate the Contract and pay compensation equivalent to the amount payable on a Force Majeure termination to the Contractor (see Section 21.3).

25.9.7 In the event that a risk is uninsurable and the Contract continues, the Contractor shall be obliged to approach the insurance market at regular intervals to determine whether the risk has become insurable again.

25.9.8 The Contractor should not be obliged to continue to provide services under the Contract where third-party liability cover has ceased to become insurable and the Authority and the Contractor are unable to agree how to manage that risk. If third-party liability insurance becomes unavailable for reasons that are outside of the control of the Contractor and the parties

⁵⁸ To the extent relevant, the wider risk transfer market (rather than just the insurance market) should be referred to. Insurance advice should be taken on this. Reference to any geographically narrower market, such as the European market, will not be acceptable.

⁵⁹ This approach is preferable to one dealing with the extent to which prices of premiums have increased.

⁶⁰ In projects where the Contractor retains end-user risk, the Authority should consider whether it should give the Contractor any price protection in relation to increases in insurance premiums (i.e. paragraph (b) of the definition of Uninsurable can be deleted) as the Contractor can manage such increases by increasing the price that the end user pays for the Services to reflect any increase in insurance premiums for the Project.

⁶¹ See Sections 25.2.1 and 25.2.2 for discussion.

⁶² These are the Required Insurances (e.g. contractors’ “all risks” insurance, property damage insurance, delay in start up and business interruption insurance (but not loss of profits - see Section 25.2.3), third party liability insurance) and statutory insurances (e.g. employer’s liability insurance).

are unable to agree the means by which the risk should be managed by the Contractor, the Authority should be able to elect to either self-insure the risk or terminate the Contract and pay compensation to the Contractor equivalent to the amount payable on a Force Majeure termination (see Section 21.3). If it is agreed that the Contract should continue then the amount of the premium previously paid should be deducted from the Unitary Charge.

25.9.9 It is unacceptable for indemnity provisions in the Contract to be used to subvert the apportioned risk transfer position on uninsurability of risk and unavailability of deductibles in this Section 25.9.

The following is the required drafting:

25.9 Uninsurable Risks

(a) If a risk usually covered by [contractors' "all risks" insurance, property damage insurance, third party liability insurance, delay in start up and business interruption insurance (but not loss of profits)⁶³ or statutory insurances]⁶⁴ in each case required under this Contract becomes Uninsurable then:

(i) the Contractor shall notify the Authority within [5] days of the risk becoming Uninsurable;⁶⁵ and

(ii) if both parties agree, or it is determined in accordance with Clause 28 (Dispute Resolution) that the risk is Uninsurable and that:

(A) the risk being Uninsurable is not caused by the actions of the Contractor or any sub-contractor of the Contractor; and

(B) the Contractor has demonstrated to the Authority that the Contractor and a prudent board of directors of a company operating the same or substantially similar PFI businesses in the United Kingdom to that operated by the Contractor would in similar circumstances (in the absence of the type of relief envisaged by this Clause) be acting reasonably and in the best interests of the company if they resolved to cease to operate such businesses as a result of that risk becoming Uninsurable, taking into account inter alia (and without limitation) the likelihood of the Uninsurable risk occurring (if it has not already occurred), the financial consequences for such company if such Uninsurable risk did occur (or has occurred) and other mitigants against such consequences which may be available to such company

the parties shall meet to discuss the means by which the risk should be managed or shared (including considering the issue of self-insurance by either party).⁶⁶

(b) If the requirements of paragraph (a) are satisfied, but the parties cannot agree as to how to manage or share the risk, then:

⁶³ See Section 25.2.3.

⁶⁴ That is, the insurances referred to in Clause 25.2(a) and Clause 25.2(b). See Sections 25.2.1 and 25.2.2 for discussion.

⁶⁵ At the Authority's discretion it may elect to use the following alternative wording: "the Contractor shall notify the Authority of any risk becoming Uninsurable within 5 Business Days of becoming aware of the same and in any event at least 5 Business Days before expiry or cancellation of any existing insurance in respect of that risk".

⁶⁶ In the event that a risk becomes Uninsurable and the parties are required to meet to discuss how to manage the risk, the Authority should take into consideration the extent to which it may be deemed to be carrying out insurance business in the event that the parties are unable to agree and the provisions of Clause 25.9(b) apply. In the event that the Authority believes that it would be conducting insurance business, it should consider whether it has the necessary powers and authorisations to do so.

- (i) in respect of such third party liability insurance only the Authority shall (at the Authority's option) either pay to the Contractor an amount equal to the amount calculated in accordance with Clause 21.3.2 (Compensation on Termination for Force Majeure) and the Contract will terminate, or elect to allow the Contract to continue and paragraph (ii) below shall thereafter apply in respect of such risk; and
 - (ii) in respect of such [contractors' "all risks" insurance, property damage insurance, third party liability insurance (if the Authority elects to allow the Contract to continue in accordance with Clause 25.9(b)(i)), delay in start up and business interruption insurance (but not loss of profits) or statutory insurances] the Contract shall continue and on the occurrence of the risk (but only for as long as such risk remains Uninsurable) the Authority shall (at the Authority's option) either pay to the Contractor an amount equal to insurance proceeds that would have been payable had the relevant insurance continued to be available and the Contract will continue, or an amount equal to the amount calculated in accordance with Clause 21.3.2 (Compensation on Termination for Force Majeure) plus (in relation to third party liability insurance only) the amount of insurance proceeds that would have been payable whereupon the Contract will terminate; and
 - (iii) where pursuant to paragraphs (b)(i) and/or (ii) this Contract continues then the Unitary Charge shall be reduced in each year for which the relevant insurance is not maintained by an amount equal to the premium paid (or which would have been paid) by the Contractor in respect of the relevant risk in the year prior to it becoming Uninsurable (Indexed from the date that the risk becomes Uninsurable). Where the risk is Uninsurable for part of a year only the reduction in the Unitary Charge shall be pro rated to the number of months for which the risk is Uninsurable; and
 - (iv) where pursuant to paragraphs (b)(i) and/or (ii) this Contract continues the Contractor shall approach the insurance market at least every four months to establish whether the risk remains Uninsurable. As soon as the Contractor is aware that the risk is no longer Uninsurable, the Contractor shall take out and maintain or procure the taking out and maintenance of insurance (to be incepted as soon as is reasonably practicable) for such risk in accordance with this Contract.⁶⁷
- (c) If, pursuant to Clause 25.9(b)(ii), the Authority elects to make payment to the Contractor (such that the Contract will terminate)(the "Relevant Payment"), the Contractor shall have the option (exercisable in writing within (20) Business Days of the date of such election by the Authority (the "Option Period")) to pay to the Authority on or before the end of the Option Period, an amount equal to the insurance proceeds that would have been payable had the relevant risk not become Uninsurable, in which case the Contract will continue (and the Relevant Payment will not be made by the

⁶⁷ Additional sub-clauses (v) and (vi) may be added at the Authority's discretion as follows :

(v) In respect of any period between the Authority receiving notification in accordance with Clause 25.9(a)(i) that a TPL Risk has become Uninsurable and the Authority's notification to the Contractor in accordance with Clause 24.9(b)(i) in respect of such risk then, provided it is ultimately agreed or determined that the requirements of Clause 25.9(a)(ii) are satisfied in respect of the Uninsurable TPL Risk and subject to Clause 25.9(b)(vi) below, Clause 25.9(b)(ii) shall apply in respect of occurrences of the Uninsurable TPL Risk during such period unless the parties otherwise agree how to manage the risk during this period; and

(vi) Clause 25.9(b)(v) shall only apply provided the Contractor does not unreasonably materially delay (a) agreement and/or determination in accordance with the Dispute Resolution Procedure as to whether the requirements of Clause 25.9(a)(ii) are satisfied in respect of the Uninsurable TPL Risk and/or (b) meeting with the Authority to discuss the means by which the risk should be managed.

TPL Risk should be defined as 'a risk which is required to be insured under the third party liability insurance policy'.

Authority), and the Contractor's payment shall be applied for the same purpose and in the same manner as insurance proceeds would have been applied had the relevant risk not become Uninsurable.

25.10 TERMS AND CONDITIONS THAT BECOME UNAVAILABLE

25.10.1 If insurance for a term or condition (as opposed to a risk (see Section 25.9)) is no longer available, subject to the unavailability of such term or condition not being attributable to the actions of the Contractor or a sub-contractor, the Contractor should not be obliged to take out insurance in respect of that particular term or condition. Accordingly the Authority should not terminate for a Contractor Default (see Section 21.2) in this situation. Such unavailability will instead be treated like a Relief Event. Uninsurability protection under Clause 25.9 should not be offered by the Authority where any particular term or condition in the Required Insurance Schedule (including deductibles at levels above the maximum level stated in the required insurance schedule) is unavailable.

25.10.2 If insurance is no longer available for a term or condition included in the Contract as a Required Insurance, the parties may agree that the Unitary Charge should be reduced to reflect the extent to which the insurance premium payable by the Contractor is lower than it would have been had insurance been effected for the particular term or condition. Whilst the increased risk further to unavailability of a term or condition may reside first and foremost with the Contractor, the Authority's exposure is likely to be increased, as there may be certain circumstances where the Authority bears the risk e.g. where an aggrieved party brings a claim against the Authority for an act committed by the Contractor, but insurance proceeds to cover the claim are no longer available on account of the unavailability of a term or condition. The extent to which the Authority may be exposed will depend in part on the indemnity provisions. In addition where there is such a loss, then if the Contractor elects not to reinstate the loss, then depending on the size of the loss, it is possible that the Authority would not be able to terminate for Contractor Default, and be forced to accept instead a reduced service. Given that an Authority's potential exposure will depend on contractual provisions, some of which may be project specific, an adjustment to the Unitary Charge further to unavailability of a term or condition is not mandatory. It is for the Authority to determine, in conjunction with the insurance and legal advisors whether the Contract should contain a unitary charge adjustment provision. If it is determined that this provision is appropriate then suggested language is included in 25.10(d) and (e) below.

25.10.3 If a term or condition is not available, the Contractor should determine whether an alternative term or condition could, either wholly or partially, replace the term or condition which is unavailable. If appropriate and available on a commercially viable basis, the alternative term or condition should be procured.

Required drafting is as follows:

"Insurance Term" means any terms and/or conditions required to be included in a policy of insurance by Clause 25.2 and/or Schedule [] (Required Insurance Schedule) but excluding any risk.

25.10 Uninsurable Risks

- (a) If, upon the renewal of any insurance which the Contractor is required to maintain or to procure the maintenance of pursuant to this Contract:
 - (i) any Insurance Term is not available to the Contractor in the worldwide insurance market with reputable insurers of good standing; and/or

- (ii) the insurance premium payable for insurance incorporating such Insurance Term is such that the Insurance Term is not generally being incorporated in insurance procured in the worldwide insurance market with reputable insurers of good standing by contractors in the United Kingdom,

(other than, in each case, by reason of one or more actions of the Contractor and/or any sub-contractor of the Contractor) then paragraph (b) shall apply.

- (b) If it is agreed or determined that paragraph (a) applies then the Authority shall waive the Contractor's obligations in Clause 25.2 and/or Schedule [] (Required Insurance Schedule) in respect of that particular Insurance Term and the Contractor shall not be considered in breach of its obligations regarding the maintenance of insurance pursuant to this Contract as a result of the failure to maintain insurance incorporating such Insurance Term for so long as the relevant circumstances described in paragraph (a) continue to apply to such Insurance Term.
- (c) To the extent that the Parties agree (acting reasonably), or it is determined pursuant to the Dispute Resolution Procedure, that an alternative or replacement term and /or condition of insurance is available to the Contractor in the worldwide insurance market with reputable insurers of good standing which if included in the relevant insurance policy would fully or partially address the Contractor's inability to maintain or procure the maintenance of insurance with the relevant Insurance Term, at a cost which contractors in the UK are (at such time) generally prepared to pay, the Contractor shall maintain or procure the maintenance of insurance including such alternative or replacement term and/or condition. Notwithstanding any other provision of this Contract, the costs of such insurance shall be subject to the premium costs sharing mechanism set out at Schedule [A] [Insurance Premium Risk Sharing Schedule].
- (d) [Where the Authority has exercised the waiver pursuant to paragraph (b), it shall be entitled to deduct from the annual Unitary Charge the "Adjusted Amount", such amount being an amount equal to the amount paid for the particular Insurance Term in the preceding year (using a reasonable estimate of such amount where a precise figure is not available) less any annual amount paid or payable by the Contractor to maintain and/or procure the maintenance of any (whether full or partial) alternative or replacement insurance in respect of such Insurance Term pursuant to paragraph (c).]⁶⁸
- (e) [While paragraph (a) applies, the annual Unitary Charge shall be reduced each Contract Year by the Adjusted Amount, Indexed from the date that the particular Insurance Term is no longer available.]⁶⁹
- (f) The Contractor shall notify the Authority as soon as reasonably practicable and in any event within five days of becoming aware that paragraph (a)(i) and/or paragraph (a)(ii) are likely to apply or (on expiry of the relevant insurance then in place) do apply in respect of an Insurance Term (irrespective of the reason for the same). The Contractor shall provide the Authority with such information as the Authority reasonably requests regarding the unavailability of the Insurance Term and the parties shall meet to discuss the means by which such unavailability should be managed as soon as is reasonably practicable.

⁶⁸ See Section 25.10.2.

⁶⁹ See Section 25.10.2.

- (g) In the event that paragraph (a)(i) and/or paragraph (a)(ii) apply in respect of an Insurance Term, (irrespective of the reasons for the same) the Contractor shall approach the insurance market at least every four months to establish whether paragraph (a)(i) and/or paragraph (a)(ii) remain applicable to the Insurance Term. As soon as the Contractor is aware that paragraph (a)(i) and/or paragraph (a)(ii) has ceased to apply to the Insurance Term, the Contractor shall take out and maintain or procure the taking out and maintenance of insurance (to be incepted as soon as is reasonably practicable) incorporating such Insurance Term in accordance with this Contract.

25.11 STANDARD REQUIRED INSURANCE SCHEDULE

25.11.1 This Contract schedule sets out the Authority's Required Insurances requirements. The Standard Required Insurance Schedule ("SRIS") as set out below broadly reflects the insurance provisions included in the insurance schedule for the majority of PFI projects.

25.11.2 Variations from the SRIS should be kept to a minimum and Authorities should be aware that the broader the scope of the insurances, the greater the possibility that uninsurability protection will apply. However since this is a generic document, a limited level of adjustment may be appropriate during negotiations. This should be determined by the Authority in conjunction with its insurance adviser, to ensure that the provisions in the insurance schedule are tailored to the requirements of each Project. Project-specific modifications could, for example, include:-

- insertion of an appropriate limit of indemnity for the third party liability policies;
- a change to the period of insurance in the event that service commencement is phased, or construction extends beyond service availability date, e.g. a multi-site facility;
- addition or deletion of project specific extensions and relevant footnotes;
- inclusion of additional insurance cover where appropriate;
- insertion of a figure for each maximum deductible; and
- change to the jurisdiction and/or territorial limits under the third party liability policy.

25.11.3 In addition to the project-specific amendments, the drafting may to some extent need to be amended to reflect the availability of insurance generally, including the main terms and conditions in the prevailing insurance market. In particular, the detailed endorsement wordings in Part 3 may need to be amended should market circumstances change.

25.11.4 For the reason given in Section 25.2.2, professional indemnity insurance should not be included as a Required Insurance. Additional reasons for excluding this insurance from the Required Insurances include the following:

- it will not be possible for the Authority to be named as an additional insured and thus benefit directly from the insurance policy; and
- when placed on a project specific basis this tends to be very expensive and provide only limited additional comfort to the insured party.

25.11.5 Maximum deductibles should primarily be set at a level which reflects the maximum level of exposure which an Authority is reasonably able to bear for any of its own losses and which the Contractor could bear for its own losses. The main determinant should not be the lowest deductible limit available in the prevailing market. For many projects it is anticipated that the maximum deductible could be higher than that which is available in the prevailing market.

25.11.6 Section 25.9.1 states that uninsurability protection is intended to apply to risks only (rather than the availability of cover upon particular terms or conditions). The risks which benefit from uninsurability protection are those which are covered by the Required Insurances and any other risks covered by statutory insurance. If a risk is Uninsurable and the uninsurability test in Clause 25.9 is satisfied, the Authority may, on the occurrence of a loss (or, in respect of third party liability at the time that the risk becomes Uninsurable) terminate the Contract and pay compensation to the Contractor equivalent to an amount payable on a Force Majeure termination in accordance with Clause 25.9(b)(i) and (ii). This payment will therefore not represent “full” compensation as equity repayment will be limited to par value less Distributions paid to date. This provision serves to control the extent to which uninsurability protection is relied upon.

Suitable drafting is set out in Annex 1.

26 INFORMATION AND CONFIDENTIALITY

26.1 INTRODUCTION

26.1.1 The Contract should include provisions dealing with records, provision of information, personal data, publicity and confidentiality.

26.2 CONTRACTOR'S RECORDS AND PROVISION OF INFORMATION

26.2.1 Required drafting is set out below:

26.2 Contractor's Records and Provision of Information

- (a) The Contractor shall:
 - (i) at all times maintain a full record of particulars of the costs of performing the Service, including those relating to the design, construction, maintenance, operation and finance;¹
 - (ii) when requested by the Authority, provide a summary of any of the costs referred to in paragraph (i), including details of any funds held by the Contractor specifically to cover such costs, in such form and detail as the Authority may reasonably require to enable the Authority to monitor the performance by the Contractor of its obligations under this Contract; and
 - (iii) provide such facilities as the Authority may reasonably require for its representatives to visit any place where the records are held and examine the records maintained under this Clause.²
- (b) Compliance with the above shall require the Contractor to keep (and where appropriate to procure that the sub-contractors shall keep) books of account in accordance with best accountancy practice with respect to the Contract showing in detail:
 - (i) administrative overheads;
 - (ii) payments made to Sub-Contractors and to sub-contractors;
 - (iii) capital and revenue expenditure;
 - (iv) such other items as the Authority may reasonably require to conduct cost audits for verification of cost expenditure or estimated expenditure, for the purpose of Clause 5.2 (Delays in Service Commencement due to a Compensation Event), [Section] 13 (Change in Service), Clause 14.8 (Qualifying Change in Law), Clause 15.4 (Market Testing) and [Section 15.5] (Benchmarking),

and the Contractor shall have (and procure that the sub-contractors shall have) the books of account evidencing the items listed in paragraphs (i) to (iv) available for inspection by the Authority (and any expert) upon reasonable notice, and shall present a report of these to the Authority as and when requested.

¹ The records should include details of any commitments made by the Contractor for future expenditure and details of any funds held by the Contractor.

² See Section 29.6 (Rights of Access).

- (c) The Contractor shall maintain or procure that the following are maintained.³
- (i) a full record of all incidents relating to health, safety and security which occur during the term of the Contract; and
 - (ii) full records of all maintenance procedures carried out during the term of the Contract,
- and the Contractor shall have the items referred to in paragraphs (i) and (ii) available for inspection by the Authority upon reasonable notice, and shall present a report of them to the Authority as and when requested.
- (d) The Contractor shall permit records referred to in this Clause to be examined and copied by the Controller and other representatives of the Authority, and by [the Comptroller and Auditor General and his representatives].⁴
- (e) The records referred to in this Clause shall be retained for a period of at least [5] years after the Contractor's obligations under the Contract have come to an end.
- (f) Upon termination of the Contract, and in the event that the Authority wishes to enter into another contract for the operation and management of the Project, the Contractor shall (and shall ensure that the sub-contractors will) comply with all reasonable requests of the Authority to provide information relating to the Contractor's costs of operating and maintaining the Project.
- (g) The Contractor shall:
- (i) provide to the Authority on 31 March, 30 June, 30 September and 31 December each year a document listing all information provided by it to the Senior Lenders during the preceeding three month period and, at the request of the Authority, provide to the Authority any information provided by it to the Senior Lenders during the term of the Contract⁵ and any other information relating to the Project that the Authority may reasonably require;
 - (ii) provide to the Authority copies of its annual report and accounts within 30 days of publication;
 - (iii) provide to the Authority a copy of the [Senior Lenders' Financial Model]⁶ at Financial Close and (as the same may be amended) within 30 days of any amendment thereto;
 - (iv) promptly upon the occurrence of a [Financing Default]⁷ notify the Authority of such Financing Default; and
 - (v) use all reasonable endeavours to assist the Authority in its preparation of any report required by [Department] or HM Treasury, from time to time;

³ Others may be needed depending on the project.

⁴ Local authorities and Scotland have their own equivalent bodies.

⁵ This enables financial information such as audited accounts to be obtained. Alternatively, the precise financial information required can be listed.

⁶ This may be defined by reference to the Senior Financing Agreements as appropriate.

⁷ This should be defined by reference to the borrower defaults under the Senior Financing Agreements (and applies whether or not the Senior Lenders choose to accelerate their loan). Please note that this obligation is additional to the obligations of the Agent under clause 10(d) of the Direct Agreement (see Section 31.5).

- (h) The Authority may, in the circumstances referred to in paragraph (g) (iv) above (regardless of whether the Senior Lenders have exercised any enforcement or similar rights under the Senior Financing Agreements) require the Contractor to provide an Interim Project Report⁸ and to attend, and use all reasonable endeavours to ensure that the Senior Lenders attend, such meetings as the Authority may convene to discuss such Interim Project Report and the circumstances giving rise to it.

26.3 PERSONAL DATA

26.3.1 Suitable drafting is set out below:

26.3 Personal Data

- (a) In relation to all Personal Data, the Contractor shall at all times comply with the DPA as a data controller if necessary, including maintaining a valid and up to date registration or notification under the DPA covering the data processing to be performed in connection with the Service.
- (b) The Contractor and any sub-contractor shall only undertake processing of Personal Data reasonably required in connection with the Service and shall not transfer any Personal Data to any country or territory outside the European Economic Area.
- (c) The Contractor shall not disclose Personal Data to any third parties other than:
 - (i) to employees and sub-contractors to whom such disclosure is reasonably necessary in order for the Contractor to carry out the Service; or
 - (ii) to the extent required under a court order,provided that disclosure under paragraph (i) is made subject to written terms substantially the same as, and no less stringent than, the terms contained in this Clause 26.3 and that the Contractor shall give notice in writing to the Authority of any disclosure of Personal Data it or a sub-contractor is required to make under paragraph (ii) immediately it is aware of such a requirement.
- (d) The Contractor shall bring into effect and maintain all technical and organisational measures to prevent unauthorised or unlawful processing of Personal Data and accidental loss or destruction of, or damage to, Personal Data including but not limited to take reasonable steps to ensure the reliability of staff having access to the Personal Data.
- (e) The Authority may, at reasonable intervals, request a written description of the technical and organisational methods employed by the Contractor and/or the sub-contractors referred to in paragraph (d). Within [30] days of such a request, the Contractor shall supply written particulars of all such measures detailed to a reasonable level such that the Authority can determine whether or not, in connection with the Personal Data, it is compliant with the DPA.
- (f) The Contractor shall indemnify and keep indemnified the Authority against all losses, claims, damages, liabilities, costs and expense (including reasonable legal costs) incurred by it in respect of any breach of this Clause 26.3 caused by the Contractor or by any act or omission of any sub-contractor.⁹

“DPA”

means the Data Protection Act 1998.

⁸ The Authority should insert a definition of Interim Project Report, setting out in this the broad headings and issues which it requires it to cover.

⁹ See Section 24.3 (Indemnity).

“Personal Data”

means personal data as defined in the DPA which is supplied to the Contractor by the Authority or obtained by the Contractor in the course of performing the Service.

26.4 PUBLIC RELATIONS AND PUBLICITY

Suitable drafting is set out below:

26.4. Public Relations and Publicity

- (a) The Contractor shall not by itself, its employees or agents and procure that its sub-contractors shall not communicate with representatives of the press, television, radio or other communications media on any matter concerning the Contract without the prior written approval of the Authority.
- (b) No facilities to photograph or film in or upon any property used in relation to the Project shall be given or permitted by the Contractor unless the Authority has given its prior written approval.

26.5 CONFIDENTIALITY

The Contract should determine whether information provided by the Authority to the Contractor and vice versa is to be treated as confidential. It should also specify the extent to which details in the Contract itself are confidential.

26.6 GOVERNMENT OPENNESS

26.6.1 The relevant provision of the Freedom of Information Act 2000 (“FOIA”) came into force on 1 January 2005. Its underlying premise is that the approach to release of information should be based on the assumption that information should be released.

26.6.2 The requirements of Open Government suggest that PFI Contracts should be placed in the public domain as far as possible. Only “commercially sensitive” information, information the dissemination of which is contrary to the public interest or information which is personally private should be withheld. In the PFI context the key concern relates generally to “commercially sensitive” information and (for defence related projects particularly) issues of national security.

26.6.3 Extensive guidance on freedom of information is available from the Department of Constitutional Affairs and the OGC.¹⁰

26.7 RECOMMENDED APPROACH

26.7.1 The recommended approach is that as much information in the Contract as possible should be placed in the public domain and only information which is specifically identified as commercially sensitive by the Contractor or identified and justified by the Authority as sensitive for public interest (including national security) reasons should be excluded. The parties should aim to achieve a pragmatic balance between the public sector’s interest in transparency and the need for commercial confidentiality.

26.7.2 The Authority should make it clear at the start of a procurement that it is its intention to make the final Contract available to any relevant public sector body (e.g. the NHS Executive) in accordance with the assumptions of the FOIA (see Section 26.6 (Government Openness)).

¹⁰ See in particular, “Freedom of Information (Civil Procurement) Guidance” on the OGC website at www.ogc.gov.uk.

Access, however, to commercially sensitive information will be restricted in line with the particular confidentiality restrictions within the final Contract.

26.7.3 After short-listing, the Authority should negotiate with bidders as early as possible to define the scope of the information to be treated as commercially sensitive. The Authority should also agree with bidders when commercially sensitive matters will become non-sensitive to ensure maximum disclosure. Contracts should be structured to facilitate easy removal of commercially sensitive elements.

26.7.4 The focus for whether information should be agreed to be “commercially sensitive” should be of disclosure causing real prejudice to the interests (legal and/or commercial) of the parties.

26.8 NATURE OF COMMERCIALLY SENSITIVE INFORMATION

26.8.1 The commercially sensitive aspects of Contracts differ greatly from sector to sector, depending on the maturity of the market. What may be commercially sensitive in one context may not be in another and sensitivity may also decline over time.

26.8.2 For example, for standard contracts, the only commercially sensitive information may be the financial provisions (e.g. the price and the priced elements of the payment mechanism). Certain signed contracts have been lodged in the House of Commons library with only the money values blanked out and the Central IT Unit released copies of certain contracts on the same basis.

26.8.3 Contractors are usually keen to ensure that proprietary information and details of pricing are kept confidential, so that their competitors cannot obtain any commercial advantage over them, for example, in any future competition. Financiers are likely to want to ensure sensitive details of the financing (such as the pricing) are kept confidential from rivals and future borrowers and both of these interests are legitimate.

26.8.4 In some sectors, such as defence, the Authority may wish to keep certain contract details confidential to avoid prejudicing national security or other public interests. Other sectors may have their own particular sensitivities and certain information may need to be treated as confidential to avoid third party interference in the smooth running of the Contract.

26.9 RELATED MATTERS

26.9.1 Stock Exchanges have publicity requirements with which listed companies are required to comply. Companies raising finance through capital markets (e.g. through bond issues), in particular, must disclose details of Contracts and related documents. There are some exceptions to disclosure requirements, for example, where national security would be prejudiced. These type of disclosure requirements should be taken into account, particularly if it is anticipated that a bond issue will take place to refinance the Project after contract signature.

26.9.2 Authorities should recognise in any event that attempts to keep contractual terms confidential amongst the private sector and financial community are to some extent cosmetic, as details of signed contracts will often become known over time. The advantage of greater openness on the public sector side is that Authorities planning projects should benefit similarly from gaining knowledge of positions agreed by Contractors and financiers on projects similar to those planned and to gain the benefits of competition, there is some advantage in making positions known. If there is a public offering or wide syndication, the prospectus or information memorandum will usually contain a great deal of detail on the contents of the Contract and other documents.

26.9.3 Contractors should note that the National Audit Office will require access to all relevant information from the Contracts which it requires for its audit purposes, irrespective of whether it is confidential or sensitive. The National Audit Office may also publish any information (including key contract terms, the contract price and results of bid evaluations) in its reports to Parliament. The Contract should ensure that the Comptroller and Auditor General is entitled to examine the Contractor's records.

26.9.4 The Authority should make it a condition of it becoming involved in the underlying financing (such as entering into the Direct Agreement) that the Authority is entitled to receive from the Contractor a copy of any information memorandum, prospectus or other similar document containing information relating to the Project. Such information, where necessary, will be treated as Commercially Sensitive Information.

Required drafting is as follows:

26.9 Confidentiality

- (a) (i) The parties agree that provisions of this Contract and each Project Document¹¹ shall, subject to sub-paragraph (ii) below, not be treated as Confidential Information and may be disclosed without restriction.
 - (ii) Sub-paragraph (i) above shall not apply to provisions of this Contract or a Project Document¹² designated as Commercially Sensitive Information and listed in Part I of Schedule [] (Commercially Sensitive Information) to this Contract¹³ which shall, subject to sub-paragraph (b) below, be kept confidential for the periods specified in that Part.
 - (iii) The parties shall keep confidential all Confidential Information received by one party from the other party relating to this Contract and Project Documents or the Project and shall use all reasonable endeavours to prevent their employees and agents from making any disclosure to any person of any such Confidential Information.
- (b) Paragraphs (a) (ii) and (iii), shall not apply to:
- (i) any disclosure of information that is reasonably required by any person engaged in the performance of their obligations under the Contract for the performance of those obligations;
 - (ii) any matter which a party can demonstrate is already or becomes generally available and in the public domain otherwise than as a result of a breach of this Clause;
 - (iii) any disclosure to enable a determination to be made under Clause 28 (Dispute Resolution) or in connection with a dispute between the Contractor and any of its subcontractors;
 - (iv) any disclosure which is required pursuant to any statutory, legal (including any order of a court of competent jurisdiction) or Parliamentary obligation placed upon the party making the disclosure or the rules of any stock exchange or governmental or regulatory authority having the force of law or if not having the force of law, compliance with which is in accordance with the general

¹¹ See definition in clause 1.7.1.

¹² Sub-paragraphs (i) and (ii) deal with the Contract and Project Documents themselves and sub-paragraph (iii) deals with the provision of other information. In each case confidentiality provisions or materials can, subject to footnote 17 below, be specified by agreement in a schedule (see definition of Commercially Sensitive Information).

¹³ Authorities should keep this exemption strictly limited and should be mindful of FOIA and OGC guidance (see footnote 10 above) when agreeing what parts of the documents should be treated as Commercially Sensitive Information. Proper due diligence is required here in order to avoid the Authority being in a position where it is required to disclose information under FOIA which has been designated as Commercially Sensitive.

practice of persons subject to the stock exchange or governmental or regulatory authority concerned;

- (v) any disclosure of information which is already lawfully in the possession of the receiving party, prior to its disclosure by the disclosing party;
- (vi) any provision of information to the parties' own professional advisers or insurance advisers or to the Senior Lenders or the Senior Lenders' professional advisers or insurance advisers or, where it is proposed that a person should or may provide funds (whether directly or indirectly and whether by loan, equity participation or otherwise) to the Contractor to enable it to carry out its obligations under the Contract, or may wish to acquire shares in the Contractor [and/or Holdco] in accordance with the provisions of this Contract to that person or their respective professional advisers but only to the extent reasonably necessary to enable a decision to be taken on the proposal;
- (vii) any disclosure by the Authority of information relating to the design, construction, operation and maintenance of the Project and such other information as may be reasonably required for the purpose of conducting a due diligence exercise, to:
 - (A) any proposed new contractor, its advisers and lenders, should the Authority decide to retender the Contract; or
 - (B) any person in connection with [Clause 15.5 (Benchmarking)] or Clause [15.4] (Market Testing);
- (viii) any registration or recording of the Consents¹⁴ and property registration required;
- (ix) any disclosure of information by the Authority to any other department, office or agency of the Government or their respective advisers or to any person engaged in providing services to the Authority for any purpose related to or ancillary to the Contract; or
- (x) any disclosure for the purpose of:
 - (A) the examination and certification of the Authority's or the Contractor's accounts;
 - (B) any examination pursuant to [Section 6(1) of the National Audit Act 1983]¹⁵ of the economy, efficiency and effectiveness with which the Authority has used its resources;
 - (C) complying with a proper request from either party's insurance adviser, or insurer on placing or renewing any insurance policies; or
 - (D) (without prejudice to the generality of paragraph (b)(iv) above) compliance with the FOIA and/or the Environmental Information Regulations,

provided that, for the avoidance of doubt, neither paragraph (x) (D) nor paragraph (iv) above shall permit disclosure of Confidential Information otherwise prohibited by paragraph (a) (iii) above where that information is exempt from disclosure under Section 41 of the FOIA.

¹⁴ For example, any planning permission application.

¹⁵ The National Audit Office are the auditors for central government. The Audit Commission appoint auditors for local authorities and NHS Trusts in England and Wales (with the Accounts Commission performing the equivalent role to the Audit Commission in Scotland). Where the National Audit Office is not the appropriate auditor, all references to the National Audit Office in Clause 26 should be substituted with a reference to the appropriate auditor.

- (c) Where disclosure is permitted under paragraph (b), other than paragraphs (ii), (iv), (v), (viii) and (x), the party providing the information shall procure that the recipient of the information shall be subject to the same obligation of confidentiality as that contained in this Contract.
- (d) For the purposes of the [National Audit Act 1983 the Comptroller and Auditor General] may examine such documents as he may reasonably require which are owned, held or otherwise within the control of the Contractor and any sub-contractor and may require the Contractor and any sub-contractor to produce such oral or written explanations as he considers necessary. For the avoidance of doubt it is hereby declared that the carrying out of an examination under [Section 6(3)(d) of the National Audit Act 1983] in relation to the Contractor is not a function exercisable under this Agreement.
- (e) The Contractor shall not make use of the Contract or any information issued or provided by or on behalf of the Authority in connection with the Contract otherwise than for the purpose of the Contract, except with the written consent of the Authority.
- (f) Where the Contractor, in carrying out its obligations under the Contract, is provided with information relating to [people/users e.g. prisoners, patients, pupils], the Contractor shall not disclose or make use of any such information otherwise than for the purpose for which it was provided, unless the Contractor has sought the prior written consent of that [person/user e.g. prisoner, pupil, patient] and has obtained the prior written consent of the Authority.¹⁶
- (g) On or before the Expiry Date, the Contractor shall ensure that all documents or computer records in its possession, custody or control, which contain information relating to [people/users e.g. prisoners/patients/pupils] including any documents in the possession, custody or control of a sub-contractor, are delivered up to the Authority.
- (h) The parties acknowledge that the [National Audit Office] has the right to publish details of the Contract (including Commercially Sensitive Information) in its relevant reports to Parliament.
- (i) The provisions of this Clause 26 are without prejudice to the application of the Official Secrets Acts 1911 to 1989.

“Commercially Sensitive Information” means the sub-set of Confidential Information listed in column 1 of Part 1 (Commercially Sensitive Contractual Provisions) and column 1 of Part 2 (Commercially Sensitive Material) of Schedule [] (Commercially Sensitive Information) in each case for the period specified in column 2 of Parts 1 and 2 of Schedule [].

“Confidential Information” means:

- (a) information that ought to be considered as confidential (however it is conveyed or on whatever media it is stored) and may include information whose disclosure would, or would be likely to, prejudice the commercial interests of any person, trade secrets, Intellectual Property Rights and know-how of either party and all personal data and sensitive personal data within the meaning of the Data Protection Act 1988; and
- (b) Commercially Sensitive Information.¹⁷

¹⁶ See also Clause 26.3 (Personal Data Protection).

¹⁷ Any information or classes of information that the parties agree should be treated as Commercially Sensitive Information should be included in Part 2 of the Schedule entitled Commercially Sensitive Material. The Authority should be mindful of guidance on this issue when agreeing which information should be categorised as commercially sensitive. This can cover specific bid information (for specific periods) or other types of generic information but broad blanket categorisations are not appropriate – see footnotes 10 and 12 above.

“FOIA” means the Freedom of Information Act 2000 and any subordinate legislation (as defined in section 84 of the Freedom of Information Act 2000) made under the Freedom of Information Act 2000 from time to time together with any guidance and/or codes of practice issued by the Information Commissioner or relevant Government Department in relation to such Act.

“Information” has the meaning given under section 84 of the Freedom of Information Act 2000.

“Environmental Information Regulations” means the Environmental Information Regulations 2004 together with any guidance and/or codes of practice issued by the Information Commissioner or relevant Government Department in relation to such regulations.

“Fees Regulations” means The Freedom of Information and Data Protection (Appropriate Limit and Fees) Regulations 2004.

“Requests for Information” shall have the meaning set out in the FOIA or the Environmental Information Regulations as relevant (where the meaning set out for the term “request” shall apply).

26.10 FREEDOM OF INFORMATION

Recommended drafting for FOIA provisions is as follows:

26.10 Freedom of Information

- (a) The Contractor acknowledges that the Authority is subject to the requirements of the FOIA and the Environmental Information Regulations and shall facilitate the Authority’s compliance with its Information disclosure requirements pursuant to the same in the manner provided for in paragraphs (b) to (g) (inclusive) below.
- (b) Where the Authority receives a Request for Information in relation to Information that the Contractor is holding on its behalf¹⁸ and which the Authority does not hold itself¹⁹ the Authority shall refer to the Contractor such Request for Information that it receives as soon as practicable and in any event within [five] Business Days of receiving a Request for Information and the Contractor shall:
 - (i) provide the Authority with a copy of all such Information in the form that the Authority requires as soon as practicable and in any event within [ten] Business Days (or such other period as the Authority acting reasonably may specify) of the Authority’s request; and
 - (ii) provide all necessary assistance as reasonably requested by the Authority in connection with any such Information, to enable the Authority to respond to a Request for Information within the time for compliance set out in Section 10 of the FOIA or Regulation 5 of the Environmental Information Regulations.
- (c) Following notification under Clause 26.10 (b), and up until such time as the Contractor has provided the Authority with all the Information specified in Clause 26.10 (b) (i), the Contractor may make representations to the Authority as to whether or not or on what basis Information requested should be disclosed, and whether further information should

¹⁸ This should enable the Authority to comply with its obligations under the FOIA. If the Authority wished to go beyond this, for instance by referring in addition to other information or to information held by first tier subcontractors on behalf of the Contractor, this can be specified – but this may have cost/value for money implications.

¹⁹ Authorities may wish to retain responsibility where they themselves already have the relevant information.

reasonably be provided in order to identify and locate the information requested, provided always that the Authority shall be responsible for determining at its absolute discretion:-

- (i) whether Information is exempt from disclosure under the FOIA and the Environmental Information Regulations; and
- (ii) whether Information is to be disclosed in response to a Request for Information, and

in no event shall the Contractor respond directly, or allow its sub-contractors to respond directly, to a Request for Information unless expressly authorised to do so by the Authority.

- (d) The Contractor shall ensure that all Information held on behalf of the Authority is retained for disclosure for at least [] years (from the date it is acquired) and shall permit the Authority to inspect such Information as requested from time to time.
- (e) The Contractor shall transfer to the Authority any Request for Information received by the Contractor as soon as practicable and in any event within 2 Business Days of receiving it.
- (f) The Contractor acknowledges that any lists provided by him listing or outlining Confidential Information, are of indicative value only and that the Authority may nevertheless be obliged to disclose Confidential Information in accordance with the requirements of the FOIA and the Environmental Information Regulations.
- (g) In the event of a request from the Authority pursuant to clause 26.10 (b) above, the Contractor shall as soon as practicable, and in any event within [5] Business Days of receipt of such request, inform the Authority of the Contractor's estimated costs of complying with the request to the extent these would be recoverable if incurred by the Authority under Section 12(1)²⁰ of the FOIA and the Fees Regulations. Where such costs (either on their own or in conjunction with the Authority's own such costs in respect of such Request for Information) will exceed the appropriate limit referred to in Section 12(1) of the FOIA and as set out in the Fees Regulations (the "Appropriate Limit") the Authority shall inform the Contractor in writing whether or not it still requires the Contractor to comply with the request and where it does require the Contractor to comply with the request the 10 Business Days period for compliance shall be extended by such number of additional days for compliance as the Authority is entitled to under Section 10 of the FOIA. In such case, the Authority shall notify the Contractor of such additional days as soon as practicable after becoming aware of them and shall reimburse the Contractor for such costs as the Contractor incurs in complying with the request to the extent it is itself entitled to reimbursement of such costs in accordance with its own FOIA policy from time to time^{21 22}
- (h) The Contractor acknowledges that (notwithstanding the provisions of Clause 26) the Authority may, acting in accordance with the Department of Constitutional Affairs' Code of Practice on the Discharge of Functions of Public Authorities under Part I of the Freedom of Information Act 2000 (the "Code"), be obliged under the FOIA, or the Environmental

²⁰ If the Authority intends also to charge in respect of copying costs etc under Section 8 FOIA and paragraph 6 of the Fees Regulations and wishes to pass through the benefit of such charging to the Contractor, the Authority may consider extending these provisions to accommodate this. The Fees Regulations currently allows a rate of £25 per hour to be taken into account in determining whether the relevant threshold for costs under paragraph 4 of the Fees Regulations has been reached.

²¹ It is up to the parties to decide whether costs associated with any future change in the Authority's FOIA cost recovery policy should go through the Change procedure.

²² If the Environmental Information Regulations are relevant to the project, the parties may include broadly equivalent provisions in the Contact dealing with costs and based upon the Authority's policy towards reimbursement of such costs under Section 8 of the Environmental Information Regulations.

Information Regulations to disclose Information concerning the Contractor or the Project:-

- (i) in certain circumstances without consulting with the Contractor; or
- (ii) following consultation with the Contractor and having taken their views into account,

provided always that where (i) above applies the Authority shall, in accordance with the recommendations of the Code, draw this to the attention of the Contractor prior to any disclosure.

Schedule []

Commercially Sensitive Information

Part 1

Column 1

Column 2

Commercially Sensitive Contractual Provisions

**For period ending on date
below**

Part 2

Column 1

Column 2

Commercially Sensitive Material

**For period ending on date
below**

27 INTELLECTUAL PROPERTY RIGHTS

27.1 INTRODUCTION

27.1.1 In most projects, the Contractor will need to use some type of Intellectual Property (“IP”) in order to deliver the Service. The Contractor may use IP developed by a third party or by itself. Such IP may have a general application or may be specifically developed for the relevant Project. If the Contractor uses IP developed by and belonging to a third party, the Contractor will need a licence to use such IP.¹

27.1.2 The Contract must require the parties not to breach any terms of any licence to use IP and not to infringe the Intellectual Property Rights (“IPR”) of any owner of IP used. The Contract must set out what happens if any breach or infringement of IPR occurs.

27.1.3 The Authority does not need to own the IPR, though the Authority may inherit free, or have an option to purchase IPR which is the core to the continuity of the Service (e.g. specially written software). Irrespective of who “owns” the IP, however, the Contract must ensure that the Authority is able to use any IP required to provide the Service if it takes over the Service or employs/procures a third party to perform the Service (e.g. on expiry or early termination of the Contract).

27.1.4 Where IP and IPR are of central importance to the Contract (e.g. in certain defence projects, most notably equipment projects) further refinements and developments of the issues outlined in this Section may be appropriate.²

27.2 INFRINGEMENT OF IPR BY THE CONTRACTOR

27.2.1 The general principle is that any costs resulting from infringement by the Contractor of IPR should be borne by the Contractor. It should be responsible for any costs of the owner of the IPR and the Authority. This will normally require the Contractor to offer an indemnity to the Authority.

27.2.2 If the infringement or related legal action threatens the delivery of the Service, the Authority should be notified as soon as possible. The Authority should be obliged to provide reasonable assistance to the Contractor in defending any legal action, but this should not extend to meeting any costs of the Contractor’s defence.

27.3 INFRINGEMENT OF IPR BY THE AUTHORITY

27.3.1 If the Authority infringes IPR (either during the course of the Contract, other than when using IPR for the purpose of the Contract or where the infringement results from the act or omission of the Contractor, or after expiry or termination), it should generally bear any resulting costs. The Authority should bear the owner’s costs and any costs incurred by the Contractor (e.g. if sued by the owner or if it has to procure a licence of different IPR from another party). This will normally require the Authority to offer an indemnity to the Contractor.

¹ If the Authority owns IPR that will be required by the Contractor in order to carry out the Project, the Authority should consider how it intends to allow the Contractor to use such IPR during the term of the Contract.

² Reference should also be made to the ICT model Services Agreement and Guidance published for OGC on the PUK website at www.partnershipsuk.org.uk.

27.3.2 The Authority may contribute IP to the Project for the Contractor to use. If it does not own the relevant IPR, it must ensure that it is entitled to pass it on to the Contractor (e.g. by way of sub-licence). If the Authority infringes the owner's IPR by passing the relevant IP on to the Contractor, the Authority should be liable for any resulting costs unless Section 27.3.3 applies.

27.3.3 If the Contractor uses any IP which the Authority has brought into the Project, it should ensure that it is entitled to do so. It will be liable for any infringement by it unless it is unable (acting reasonably) to verify such matter.

27.4 RIGHTS TO IPR ON EXPIRY OR TERMINATION

27.4.1 The Contract will also need to deal with what happens to IPR on a termination (whether early (see Section 21 (Early Termination)) or on expiry of the Contract (see Section 20 (Termination of Assets on Expiry of Service Period))), particularly in circumstances in which software or similar assets have been developed for the specific project. Examples of this could be a simulator training project or a similar project, where if the Project is to be transferred to the Authority on a termination then IPR should also be transferred as the Project would be unworkable without this.

27.4.2 Generally, the Authority should be entitled to a free and perpetual licence of IPR specifically developed for the Project (e.g. specially written software) for use in that project only (either by it or an alternative provider of the Service). The Authority should not usually attempt to extend its right to use such IPR in other projects but should be entitled to negotiate a price for its use on other projects,³ having taken into account any development costs incurred in producing that software. Particular issues may arise on certain projects that make such licences impossible to obtain.

27.4.3 In respect of other IPR central to the Project such as third party software licences, the Contractor should ensure that the Authority is either entitled to a novation of such licences or has the right to obtain a licence of such software at commercial rates. It is for the Contractor to ensure that any licence it (or its sub-contractors) enters into reflects these requirements. If the Contractor is unable to ensure that the Authority will have the benefit of all necessary IPR, it must indemnify the Authority against any costs incurred due to such non-availability. For example, if the Contractor chooses to use proprietary software, it must bear the risk if the owner will not agree to licence such software to the Authority or replacement Contractor. Similarly, the Contractor must bear the risk of the owner of the relevant IPR being prevented from licensing such IPR to the Authority or replacement Contractor due to trade restrictions imposed by its Government. If the Contractor does not want to bear such risks, it should find alternative IPR which is capable of being licensed to the Authority.

27.4.4 In addition to ensuring that the Authority has the right to use IPR required to continue provision of the Service (e.g. on expiry, early termination or Authority step-in), arrangements should wherever possible be put in place to ensure that the Authority has immediate access to such IPR and any information required to operate it. For example, source codes of IT products should be held in escrow by an independent party (e.g. the National Computer Centre). It should be noted that an additional or new service provider will need access to IPR in advance of the Expiry Date or the commencement of its service contract in order to acquaint itself with the Service and allow a smooth handover and such access rights should be negotiated in advance, rather than left to be resolved on termination.

³ If it is likely that the Contractor will be able to commercially exploit any IPR developed for the Project, the Authority should consider whether or not revenues from IPR exploitation are likely to be significant and whether it should require the Contractor share any such revenues with the Authority.

28 DISPUTE RESOLUTION

28.1 INTRODUCTION

28.1.1 The Contract must specify a procedure for handling disputes under the terms of the Contract.

28.2 DISPUTE RESOLUTION PROCEDURE

28.2.1 As going through the courts may not be appropriate for the disputes that can arise under a PFI contract, an alternative formal dispute resolution procedure may offer a more efficient and cost-effective method of resolving disputes.

28.2.2 A common form of dispute resolution involves a three stage process as follows:

- the Authority and Contractor consult with each other for a fixed time period (possibly involving different levels of internal consultation) in an attempt to come to a mutually satisfactory agreement;
- if consultation fails, the parties may then (except in the case of certain types of dispute) put their case before an expert to decide. The expert is appointed from a panel (e.g. of construction or operation experts) whose appointment is regulated by the Contract. It may be appropriate in certain circumstances to substitute other forms of Alternative Dispute Resolution ("ADR")¹ for this type of expert determination. Disputes relating to the mechanics of price variations may go to a financial expert agreed between the parties at the time,² and
- if either party is dissatisfied with the expert's decision, it may refer the matter either to arbitration (itself a form of ADR) or to the courts for a final and binding decision. The method of appointing the arbitrator should be set out in the Contract.

28.2.3 It is often proposed that a fast-track dispute resolution process is included in the contract to deal with certain pressing issues. The drafting included below reflects the procedure set out in the Housing Grants, Construction and Regeneration Act 1996, so is, by nature, fast track and construction related.³

28.3 JOINDER OF SUB-CONTRACT DISPUTES

28.3.1 The Contractor and its Sub-Contractors may request the right to join their disputes into a dispute under the Contract if the same issues are involved. This should generally be resisted by the Authority as it will only increase the time and cost of the process for the Authority. The Authority should not automatically become embroiled in the Contractor's disputes with its Sub-Contractors, particularly as the Contractor should in any case ensure that, as far as possible,

¹ Other forms of ADR which may be considered include mediation, conciliation and neutral evaluation. These may not be appropriate where there are Project Documents which are subject to the Housing Grants, Construction and Regeneration Act 1996 – see footnote 7 below. Binding expert determination without recourse to the courts may also be appropriate in certain contracts with strong IT elements where the dispute is about a technical matter.

² To enable the financial expert to reach an appropriate resolution (particularly where the dispute concerns the pricing of a change in accordance with Section 13 (Change in Service) which may result in the Contractor implementing a change at a price it considers too low) suitable terms of reference should be agreed in advance and provided to the expert in accordance with the relevant approach taken to such changes in the Contract (see Section 5.2.3 (Calculation of Compensation)). As Section 5.2.3 (Calculation of Compensation) makes clear, the agreed approach will depend on the risk profile of the Project, and the pricing approach adopted in the Contracts and Sub-Contracts. See also footnote 9 below.

³ The specifics of defence projects may require particular treatment in defining a suitable dispute resolution procedure. See footnote 1 above and see the MOD standard form PFI Contract.

decisions under the Contract flow down the contractual chain (although see Section 28.4.3 below). This is achieved through proper structuring of the Sub-Contracts and is an issue on which financiers will insist. It may, however, be possible to agree joinder in relation to certain limited matters (such as disputes arising out of the Tests referred to in Section 3.6 (Acceptance and Service Commencement)).

28.3.2 The Authority should adopt a compromise position. This allows the Sub-Contractors the right to make written representations to the arbitrator/adjudicator as part of the Contractor's case in a dispute under the Contract where that dispute relates to issues in dispute under the relevant Sub-Contract. The arbitrator/adjudicator will not determine the Sub-Contract dispute itself, so in order for his decision on the Contract dispute to be binding on the Contractor and the Sub-Contractor, they must separately agree to be bound by the decision of the arbitrator/adjudicator in respect of that matter as between themselves.

28.4 HOUSING GRANTS, CONSTRUCTION AND REGENERATION ACT 1996

28.4.1 This Act came into force in May 1998 and affects Contracts with construction-type obligations (including maintenance). It gives Construction Sub-Contractors certain rights e.g. to receive staged payments according to work completed and sets out a fast track dispute resolution procedure.

28.4.2 It is not possible to contract out of the Act so its effect should be considered in relation to each contract in a PFI project. PFI contracts are specifically excluded, however, from the Act's application by virtue of Article 4 of the Construction Contracts (England and Wales) Exclusion Order 1998 (and Article 4 of the Construction Contracts (Scotland) Exclusion Order 1998) provided that they fulfil the conditions set out in that Article. For example, the Contract must state that it is entered into under the PFI (or, as the case may be, under a project applying similar principles). It may also be useful for the Contract to clarify which other conditions it fulfils to qualify as being excluded from the application of the Act.

28.4.3 This exclusion is not generally considered to extend to PFI Sub-Contracts. The result of this is that there is a risk that the Sub-Contractors are entitled to rights as against the Contractor (under the Act) (e.g. to receive a staged payment) to which the Contractor is not entitled as against the Authority (as the Act does not apply).⁴ The Contract should not be amended simply to conform with the Project Documents which are governed by the Act.

28.4.4 To the extent the Act applies to a PFI Sub-Contract,⁵ the Authority may be asked to accommodate reasonable approaches that are designed to deal with the effects of the Act, recognising that different Contractors and advisers will take different approaches to the issue. The Authority should, however ensure that its position is commercially the same as it would be were the Act not to apply to the PFI Sub-Contract concerned.

⁴ Contractors will be aware that "pay when paid" provisions (in relevant "construction contracts" under the Act) are rendered unenforceable by the Act. A well-managed Contractor should in any event be able to structure and run its Sub-Contracting arrangements so as to avoid payment mismatches occurring. Mismatches with the Contract on payments of construction price to the builder should not arise, since these are funded by the Senior Lenders (and equity) and are not funded through the Contract. There are some areas however where equivalent payments may be made under the Contract as under the subcontracts; these may cover payments for Compensation Events, payments for variations, termination payments, and payments of Unitary Charge relating to hard services. For these matters the Contractor will need to ensure that its notice periods are such that it can give notices and receive relevant confirmations or certificates or payments under the Contract in sufficient time for it to give its own confirmations or certificates or payments under its Sub-Contracts. It may also agree with its Sub-Contractors to pursue, if required, the equivalent issues under its head contract or allow the Sub-Contractor to do so as its agent or, in the event of a common dispute, it may agree that the written joinder provisions of Clause 28 (q) should apply.

⁵ See section 104 of the Act for the definition of a "construction contract" to assess the extent to which the Act applies to a PFI Sub-Contract.

28.5 DELAYS CAUSED BY DISPUTES

28.5.1 Contractors may try to include disputes between the Authority and the Contractor under the Contract in the list of Relief Events on the basis that they cannot continue work until the dispute is resolved. This issue arises during the construction phase in particular. This should not be allowed. The Contractor (and the Sub-Contractors) should not be permitted to “down tools” just because a dispute has arisen. If no other course of action can be taken (usually towards the end of the construction phase, but also at critical stages), then the issues involved can give rise to relief.

28.5.2 The Contractor must be under an obligation to carry on with the Service in accordance with the Authority’s wishes while any dispute is being carried on, even if this involves building or covering over construction works which may need rebuilding or opening up if the dispute is resolved in the Contractor’s favour. The Contractor must rely on the expert or arbitrator awarding adequate compensation if the dispute is resolved in the Contractor’s favour.

28.5.3 The Authority should recognise that if the dispute is resolved in the Contractor’s favour, the Authority will typically be liable for the Contractor’s costs. These could include any extra costs incurred in rebuilding (such as staff costs and materials costs) and any resulting costs incurred by the Contractor if a delay to Service Commencement results. Delays caused by the Authority failing to comply with the relevant dispute resolution procedure should be taken into account in the arbitrator’s determination.

Required drafting is as follows:

28 Dispute Resolution⁶

- (a) Any dispute arising in relation to any aspect of the Contract shall be resolved in accordance with this Clause.
- (b) If a dispute arises in relation to any aspect of this Contract, the Contractor and the Authority shall consult in good faith in an attempt to come to an agreement in relation to the disputed matter.⁷
- (c) Without prejudice to paragraph (b) above, either party may give the other notice of intention to refer the dispute to adjudication and the adjudicator shall be selected in accordance with paragraph (d) below.⁸
- (d) The Adjudicator nominated to consider a dispute referred to him shall be selected on a strictly rotational basis from the relevant panel of experts appointed in accordance with the following:
 - (i) there shall be two panels of experts, one in respect of construction matters (the “Construction Panel”) and one in respect of operational and maintenance matters (the “Operational Panel”).⁹ All the experts on each panel shall be

⁶ The terminology in Scotland will be different to that used in this Clause 28.

⁷ The parties may wish to incorporate some form of Alternative Dispute Resolution - if this is the case, government policy should be followed and the Treasury Solicitor’s Department or HMT should be consulted. Developments in the market on Alternative Dispute Resolution will be kept under review. Any such procedure however should not result in the overall timetable ceasing to be compliant with the Housing Act procedure. See footnote 13.

⁸ See footnotes 1 and 3 above.

⁹ The parties shall consider how they wish to deal with disputes of a financial (rather than construction or operational) nature and ensure the Contract contains appropriate provisions. The parties may want to appoint a panel of financial experts in the way set out in Clause 28(d) or may prefer to appoint a financial expert by mutual agreement at the time of the dispute. As currently drafted, financial disputes could be referred straight to arbitration (see Clause 28(1)(i)) so parties may prefer to include an intermediate level of dispute resolution. The parties should also consider the likelihood of overlapping disputes arising of both a construction and operational nature. If such disputes are likely, a procedure will need to be developed for deciding which of the Construction Panel or Operational Panel should preside over the dispute’s resolution.

wholly independent of the Contractor, the Authority, the relevant Sub-Contractor and any of the major competitors of the Contractor or relevant Sub-Contractor;

- (ii) the Construction Panel shall be comprised of [3] experts who shall be appointed jointly by the Contractor and the Authority. Such appointments shall take place within [28] days of the date of this Contract,¹⁰
 - (iii) the Operational Panel shall be comprised of [3] experts who shall be appointed jointly by the Contractor and the Authority. Such appointments shall take place on or before the Service Commencement Date,¹¹
 - (iv) if any member of a panel resigns during the term of the Contract, a replacement expert shall be appointed by the Contractor and the Authority as soon as practicable;
 - (v) if the Authority and the Contractor are unable to agree on the identity of the experts to be appointed to the panel(s), the President for the time being of the Chartered Institute of Arbitrators shall appoint such expert(s) within 30 days of any application for such appointment by either party.
- (e) Within 7 days of appointment in relation to a particular dispute, the Adjudicator shall require the parties to submit in writing their respective arguments. The Adjudicator shall, in his absolute discretion, consider whether a hearing is necessary in order to resolve the dispute.
 - (f) In any event, the Adjudicator shall provide to both parties his written decision on the dispute, within 28 days of appointment (or such other period as the parties may agree after the reference, or 42 days from the date of reference if the party which referred the dispute agrees). Unless the parties otherwise agree, the Adjudicator shall give reasons for his decision.¹² Unless and until revised, cancelled or varied by the Arbitrator, the Adjudicator's decision shall be binding on both parties who shall forthwith give effect to the decision.¹³
 - (g) The Adjudicator's costs of any reference shall be borne as the Adjudicator shall specify or, in default, equally by the parties. Each party shall bear its own costs arising out of the reference, including legal costs and the costs and expenses of any witnesses.
 - (h) The Adjudicator shall be deemed not to be an arbitrator but shall render his decision as an expert and the provisions of the Arbitration Act 1996 and the law relating to arbitration shall not apply to the Adjudicator or his determination or the procedure by which he reached his determination.
 - (i) The Adjudicator shall act impartially and may take the initiative in ascertaining the facts and the law. The Adjudicator shall have the power to open up, review and revise any opinion, certificate, instruction, determination or decision of whatever nature given or made under this Contract.¹⁴

¹⁰ It is essential that such appointments are made as soon as possible after Contract signature so that the panel is in place in time to deal with any construction disputes arising.

¹¹ If operational disputes are capable of arising prior to the Services Commencement Date, an earlier date should be specified for such appointments.

¹² The reverse can be specified. It is up to the parties to choose whether or not they wish reasons to be given. The parties should ensure that the relevant insurers and insurance policies will recognise the Adjudicator's decision and process claims accordingly if this is the case, as this could have important implications for both parties.

¹³ The timing of this process matches the fast track procedure set out in the Housing, Grants, Construction and Regeneration Act 1996. The fast track nature favours the claimant as the defendant will be under time pressure to prepare its case—see Clause 28(e). The parties should consider if the timing is appropriate for all types of dispute envisaged and adjust the standard drafting if required.

¹⁴ This should be the case unless the parties agree that any relevant opinion, certificate etc. should be binding and conclusive on the parties.

- (j) All information, data or documentation disclosed or delivered by a party to the Adjudicator in consequence of or in connection with his appointment as Adjudicator shall be treated as confidential. The Adjudicator shall not, save as permitted by Clause 26.9 (Confidentiality), disclose to any person or company any such information, data or documentation and all such information, data or documentation shall remain the property of the party disclosing or delivering the same and all copies shall be returned to such party on completion of the Adjudicator's work.
- (k) The Adjudicator is not liable for anything done or omitted in the discharge or purported discharge of his functions as Adjudicator unless the act or omission is in bad faith. Any employee or agent of the Adjudicator is similarly protected from liability.
- (l) If:
 - (i) there is any dispute in respect of matters referred to in [Section 13 (Change in Service)], [Clause 14 (Change in Law)], [Clause 15 (Price Variation)], Clause 21.1.3 (Compensation on Authority Default), [Section 21.2.5 (Compensation on Termination for Contractor Default)], Clause 21.3.4 (Compensation on Termination for Force Majeure), [Section 21.4.4 (Compensation on Termination for Corrupt Gifts and Fraud)] Clause 21.5.2 (Compensation on Voluntary Termination) [or, Clause 21.5.4 (Compensation on Termination on an Authority Break Point Date)]; or
 - (ii) either party is dissatisfied with or otherwise wishes to challenge the Adjudicator's decision made in accordance with Clause []; or
 - (iii) both parties agree,

then either party may (within [28] days of receipt of the Adjudicator's decision, where appropriate), notify the other party of its intention to refer the dispute to arbitration.¹⁵ Such notification shall invite the other party to concur in the appointment of a sole arbitrator who shall be a solicitor, barrister or arbitrator recognised by the Chartered Institute of Arbitrators of not less than 10 years' standing (the Arbitrator). If the parties are unable within 14 days to agree the identity of the Arbitrator either party may request the President of the Law Society to make the appointment.
- (m) The Arbitrator shall have the power to open up, review and revise any opinion, certificate, instruction, determination or decision of whatever nature given or made under this Contract, to vary or cancel the decision of the Adjudicator and, where appropriate, to order financial compensation to be paid by one party to the other. The arbitration shall take place in London.
- (n) The Arbitrator shall in his absolute discretion, make such procedural directions as he considers necessary such as ordering the parties to provide written submissions within such time period as he considers appropriate and/or to attend such hearings as he deems necessary.
- (o) The Arbitrator shall deliver his decision on any matter referred to him within 28 days of concluding any hearings which may have been held in connection with the matter and in any event within 3 months (or such other period as the parties may agree) of his appointment. The Arbitrator's decision shall be in writing and shall state his reasons for his decision. The decision of the Arbitrator shall be final and binding on both parties. The costs of the arbitration will be in the discretion of the Arbitrator.

¹⁵ The parties may incorporate provisions to go to court at this stage instead of arbitration if appropriate. In addition, the parties may wish to address expressly the right to apply to the courts for interlocutory relief at any stage in support of the adjudication or arbitration (assuming the arbitrator does not have such powers). If so, the need to appoint agents for service of process on overseas parties will arise.

- (p) The parties shall continue to comply with, observe and perform all their obligations hereunder regardless of the nature of the dispute and notwithstanding the referral of the dispute for resolution under this Clause and shall give effect forthwith to every decision of the Adjudicator and the Arbitrator delivered under this Clause.
- (q) If any dispute arising under this Contract raises issues which relate to:
 - (i) any dispute between the Contractor and the Construction Sub-Contractor arising under the Construction Sub-Contract or otherwise affects the relationship or rights of the Contractor and/or the Construction Sub-Contractor under the Construction Sub-Contract (the "Construction Sub-Contract Dispute"); or
 - (ii) any dispute between the Contractor and the Operating Sub-Contractor arising under the Operating Sub-Contract or otherwise affects the relationship or rights of the Contractor and/or the Operating Sub-Contractor under the Operating Sub-Contract (the "Operating Sub-Contract Dispute"),
 then the Contractor may include as part of its submissions made to the Adjudicator or to the Arbitrator, where the dispute is referred to arbitration, submissions made by the Construction Sub-Contractor or by the Operating Sub-Contractor as appropriate.
- (r) The Adjudicator or the Arbitrator, as appropriate, shall not have jurisdiction to determine the Construction Sub-Contract Dispute or the Operating Sub-Contract Dispute but the decision of the Adjudicator or the Arbitrator shall, subject to Clause 28(1), be binding on the Contractor and the Construction Sub-Contractor insofar as it determines the issues relating to the Construction Sub-Contract Dispute and on the Contractor and the Operating Sub-Contractor insofar as it determines the issues relating to the Operating Sub-Contract Dispute.
- (s) Any submissions made by the Construction Sub-Contractor or the Operating Sub-Contractor shall:
 - (i) be made within the time limits applicable to the delivery of submissions by the Contractor; and
 - (ii) concern only those matters which relate to the dispute between the Authority and the Contractor under this Contract.
- (t) Where the Construction Sub-Contractor or the Operating Sub-Contractor makes submissions in any reference before:
 - (i) the Adjudicator, the Adjudicator's costs of such reference shall be borne as the Adjudicator shall specify, or in default, one-third by the Authority and two-thirds by the Contractor; and
 - (ii) the Arbitrator, the costs of the arbitration shall be in the discretion of the Arbitrator.
- (u) The Authority shall have no liability to the Construction Sub-Contractor or the Operating Sub-Contractor arising out of or in connection with any decision of the Adjudicator or Arbitrator or in respect of the costs of the Construction Sub-Contractor or the Operating Sub-Contractor in participating in the resolution of any dispute under this Contract.
- (v) The Contractor shall not allow the Construction Sub-Contractor or the Operating Sub-Contractor access to any document relevant to the issues in dispute between the Authority and the Contractor save where:
 - (i) the document is relevant also to the issues relating to the Construction Sub-Contract Dispute or the Operating Sub-Contract Dispute as the case may be; and

- (ii) the Contractor has first delivered to the Authority a written undertaking from the Construction Sub-Contractor and/or the Operating Sub-Contractor (as appropriate) addressed to the Authority that they shall not use any such document otherwise than for the purpose of the dispute resolution proceedings under this Contract and that they shall not disclose such documents or any information contained therein to any third party other than the Adjudicator or Arbitrator or any professional adviser engaged by the Construction Sub-Contractor or the Operating Sub-Contractor (as appropriate) to advise in connection with the dispute.

29 AUTHORITY STEP-IN

29.1 INTRODUCTION

29.1.1 In some circumstances, the Authority may wish to take action itself in relation to the Service if there is a need to prevent or mitigate a serious risk to health, safety (person or property) or the environment or to discharge a statutory duty. Such a right may arise due to matters outside the scope of the work of the Contractor or may arise due to the Contractor being in breach of certain of its obligations under the Contract.

29.1.2 Such a right of the Authority is often referred to as “step-in” (and this is the terminology used here for that reason), as it involves the Authority taking over some or all of the obligations of the Contractor for a period. It should, however, be viewed as being entirely different in nature and purpose from a step-in by Senior Lenders under a direct agreement (see Section 31 (Direct Agreement and Senior Lenders)) and separate from the Contractor Default provisions (see Section 21.2 (Termination on Contractor Default)). Essentially, the focus of the right is a serious short term problem that can or must be solved quickly, where the Authority is in a better position to do this than the Contractor. The Authority should not in any situation be obliged to step-in.

29.2 STEP-IN – GENERAL

Required drafting for such a right of step-in is as follows:

29 Authority Step-In

- (a) If the Authority reasonably believes that it needs to take action in connection with the Service:
 - (i) because a serious risk exists to the health or safety of persons or property or to the environment;¹ and/or
 - (ii) to discharge a statutory duty,then the Authority shall be entitled to take action in accordance with paragraphs (b) to (e) below.
- (b) If paragraph (a) applies and the Authority wishes to take action, the Authority shall notify the Contractor in writing of the following:
 - (i) the action it wishes to take;
 - (ii) the reason for such action;
 - (iii) the date it wishes to commence such action;
 - (iv) the time period which it believes will be necessary for such action; and
 - (v) to the extent practicable, the effect on the Contractor and its obligation to provide the Service during the period such action is being taken.
- (c) Following service of such notice, the Authority shall take such action as notified under paragraph (b) above and any consequential additional action as it reasonably believes is necessary (together, the “**Required Action**”) and the Contractor shall give all reasonable assistance to the Authority while it is taking such Required Action.

¹ Other considerations may be important in other projects, such as those involving national security. The MOD will normally require a similar right to step-in under their provisions dealing with “Measures in a Crisis” (see MOD standard Form PFI contract clauses 71 and 73).

29.3 STEP-IN WITHOUT CONTRACTOR BREACH

29.3.1 If there has been no breach, in the circumstances set out above (i.e. those set out in Clause 29(a) (Authority Step-In)) the Authority should notify the Contractor that it plans to step-in and the extent of such step-in. To the extent the Authority steps in, it will be effectively removing any obligations affected by such step-in from the Contractor and performing them itself.

29.3.2 During its step-in, as the Authority needs to act for reasons external to the Contract, the Authority should pay for the Service as if the Service had been fully performed, subject only to any deductions to be made in respect of parts of the Service still provided by the Contractor (e.g. to reflect performance on that part) and unaffected by the Authority's step-in.² To the extent aspects of the Service are affected by the Authority's step-in, the Authority should make full payment in respect of such aspects and the Contractor's obligation to perform such part of the Services should be suspended. Payment should also be conditional upon the Contractor agreeing to provide reasonable assistance to the Authority at this time (provided the Authority reimburses the Contractor for any extra costs it incurs).

29.3.3 The Authority should bear all its own costs incurred by stepping-in, in this circumstance.

Required drafting for the circumstances in which Clause 29 (a) above applies is as follows:

- (d) If the Contractor is not in breach of its obligations under the Contract, then for so long as and to the extent that the Required Action is taken, and this prevents the Contractor from providing any part of the Service:
 - (i) the Contractor shall be relieved from its obligations to provide such part of the Service; and
 - (ii) in respect of the period in which the Authority is taking the Required Action and provided that the Contractor provides the Authority with reasonable assistance (such assistance to be at the expense of the Authority to the extent incremental costs are incurred), the Unitary Charge due from the Authority to the Contractor shall equal the amount the Contractor would receive if it were satisfying all its obligations and providing the Service affected by the Required Action in full over that period.³

29.4 STEP-IN ON CONTRACTOR BREACH

29.4.1 If the Contractor is in breach of an obligation under the Contract, the Authority should notify the Contractor of such breach. This will generally occur through the monitoring arrangements and, in such circumstances, it is then up to the Contractor to rectify the breach within the agreed timetable.

29.4.2 If the breach gives rise to a need for the Authority to step-in in the circumstances set out above (i.e. those set out in Clause 29 (a) (Authority Step-In)) and the Contractor has failed to remedy the breach within the agreed time period, the Authority should have the right to step-in and carry out such rectification itself (for example, using a third party) at the Contractor's expense.

29.4.3 Where the Authority steps-in upon Contractor breach, the Authority should continue to pay the Contractor as where there is no breach (see Section 29.3.2). In addition, subject to Section 29.4.4 below, the full Unitary Charge should be paid for all aspects of the Service that are

² The parties will need to consider appropriate alternative arrangements for projects involving usage-based payment schemes based on third party revenue. See also footnote 3 below.

³ The parties will, to the extent relevant, need to consider how an appropriate forecast for any third party income can be made.

affected by the Authority's step-in, subject again here to the obligation on the Contractor to provide reasonable assistance to the Authority. The Contractor's obligation to perform such part of the Services should be suspended, though any existing right of the Authority to terminate for breach by the Contractor should not be affected.

29.4.4 The Authority should, however, be entitled to set off any costs it incurs in stepping-in such circumstances (i.e. for both costs of work and advice and for time devoted to running the operations) against the Unitary Charge payable to the Contractor. The Contractor should be relieved of its obligations to continue the running of the relevant part of the operation concerned while the Authority has stepped in.

Required drafting is as follows:

- (e) If the Required Action is taken as a result of a breach of the obligations of the Contractor under the Contract, then for so long as and to the extent that the Required Action is taken, and this prevents the Contractor from providing any part of the Service:
 - (i) the Contractor shall be relieved of its obligations to provide such part of the Service; and
 - (ii) in respect of the period in which the Authority is taking Required Action, the Unitary Charge due from the Authority to the Contractor shall equal the amount the Contractor would receive if it were satisfying all its obligations and providing the Service affected by the Required Action in full over that period, **less** an amount equal to all the Authority's costs of operation in taking the Required Action.

29.4.5 The Authority should behave in a reasonable manner, taking into account the relevant circumstances (e.g. it should try to avoid action which would detrimentally affect any compensation payable to the Contractor on a termination) but an indemnity is only appropriate where the Contractor is not in breach.

29.4.6 The rights referred to here should not be used as a means to undermine the carefully structured termination arrangements and should tie in with such arrangements. If the breach subsists following the Authority's step-in, the Authority should be entitled to terminate for Contractor Default (see Section 21.2 (Termination on Contractor Default)) subject to any rights the Senior Lenders may have under the Direct Agreement (see Section 31 (Direct Agreement and Senior Lenders)).

29.5 RELATED ISSUES

29.5.1 Having stepped-in, in circumstances where there is no breach by the Contractor, the Authority should act in accordance with good industry practice and to the extent there is a failure to do so, then it should indemnify the Contractor for any effects (including for any detrimental effect on any termination payment). Liability amounts should be outside any indemnity cap (for both parties).

29.5.2 The Authority should not be particularly concerned about such an indemnity being required as the price for a right of step-in. This is because to the extent the Contractor is not in breach the Authority should honour the contractual structure and risk allocation in the Contract. If the Contractor is in breach, then the termination provisions should ordinarily be sufficient to protect the Authority (with no indemnity) without any additional involvement of the Authority through step-in.

29.6 RIGHTS OF ACCESS

29.6.1 An issue related to step-in rights (and at times confused with them) is that of rights of access of the Authority to the facilities.

29.6.2 This right exists in part to give the Authority the ability to monitor performance (see Section 10 (Payment Mechanism Management and Monitoring)) and carry out spot checks, to the extent required by the Contract.

Required drafting to deal with this is as follows:

Rights of Access

- (a) The Authority or a representative of the Authority may enter upon any property used by the Contractor to perform the Service, to inspect the construction, operation and maintenance of the Project and to monitor compliance by the Contractor with its obligations.
- (b) The Authority and a representative of the Authority may at all times enter upon any property used by the Contractor as training or workshop facilities and places where work is being prepared or materials being obtained for the Project.
- (c) The Contractor shall procure that satisfactory facilities are made available to the Authority and any representative of the Authority and that reasonable assistance is given for the purposes of paragraphs (a) and (b) above, subject to the Contractor's and Sub-Contractors' construction or operational requirements not being adversely affected and to reimbursement of any reasonable costs or expenses of the Contractor.
- (d) If the Authority is or becomes aware of a breach by the Contractor of its obligations under Clause 11.1 (Maintenance) then the Authority may exercise its right of access and remedy such breach and shall be entitled to recover any costs or expenses incurred from the Contractor as a debt.⁴
- (e) The Authority and its representative shall at all times comply with any health and safety requirements when exercising its rights under this Clause.
- (f) If the Authority or its representative causes material damage to any asset⁵ in exercising any right under this Clause, then the Authority shall be liable to the Contractor for the reasonable costs directly caused by such damage.

⁴ The Authority should be careful in exercising this right owing to paragraph (f) and should not interfere with the obligations of the Contractor but instead rely on its other rights under the Contract.

⁵ These are the physical assets referred to in the definition of "Assets".

30 MISCELLANEOUS PROVISIONS

30.1 The Contract will also contain a number of relatively standard positions. The following suggests how some of these should be drafted:

30.1 Waiver

- (a) No term or provision of this Contract shall be considered as waived by any party to this Contract unless a waiver is given in writing by that party.
- (b) No waiver under paragraph (a) shall be a waiver of a past or future default or breach, nor shall it amend, delete or add to the terms, conditions or provisions of this Contract unless (and then only to the extent) expressly stated in that waiver.

30.2 Severability

If any term, condition or provision contained in this Contract shall be held to be invalid, unlawful or unenforceable to any extent, such term, condition or provision shall not affect the validity, legality or enforceability of the remaining parts of this Contract.

30.3 Counterparts

This Contract may be executed in any number of counterparts, all of which when taken together shall constitute one and the same instrument.

30.4 Law of the Contract and Jurisdiction

The Contract shall be governed by the laws of England and Wales¹ [and subject to Clause 28 (Dispute Resolution), the parties submit to the exclusive jurisdiction of the courts of England and Wales].²

30.5 Third Party Rights

No term of this Contract is enforceable under the Contracts (Rights of Third Parties) Act, 1999 by a person who is not a party to this Contract.³

30.6 Interest on Late Payments

The parties will pay interest on any amount payable under this Contract not paid on the due date, for the period from that date to the date of payment at a rate equal to []% above [].⁴

30.7 Continuing Obligations

Save as otherwise expressly provided in this Contract or as already taken into account in the calculation of any Termination Sum or other payment of compensation on termination pursuant to this Contract:

- (a) termination of the Service Period shall be without prejudice to any accrued rights and obligations under this Contract as at the Termination Date; and
- (b) termination of the Service Period shall not affect the continuing rights of the Authority and the Contractor under Clauses []⁵ or under any other provision of this Contract

¹ This may require amendment for Scottish and Northern Ireland projects.

² This is not strictly necessary where no foreign element exists (it rarely does in a PFI contract).

³ This may require amendment for Scottish and Northern Ireland projects.

⁴ This will relate to both disputed and undisputed amounts and should, where relevant, take into account the Late Payments of Commercial Debts (Interest) Act 1998 provisions (see Section 7.2.3 above) and the costs of the Senior Debt at that time.

⁵ The parties will need to specify those Contract provisions intended to survive termination or expiry of the Contract. Usually, these will include the provisions relating to restrictions on Authority assignment (Clause 17.3), information and confidentiality (Clause 26), dispute resolution (Clause 28), indemnities, guarantees and contractual claims (Clause 24), personal data (Clause 26.3), public relations and

which is expressed to survive termination or which is required to give effect to such termination or the consequences of such termination.

31 DIRECT AGREEMENT AND SENIOR LENDERS

31.1 INTRODUCTION

31.1.1 A Direct Agreement referred to in this guidance is an agreement between the Authority and Senior Lenders that deals with the relationship between these interested parties following a termination or threatened termination for Contractor Default (see Section 21.2 (Termination on Contractor Default)). As stated in Section 29 (Authority Step-In), it is entirely different to the rights described in that Section.

31.1.2 The concern of the Senior Lenders is that they have financed the Project on the basis of projected cash flows and if the Contract (under which these cash flows are agreed to be paid) is terminated, they will only have rights against the Sub-Contractors and to amounts in the bank accounts of the Contractor as security for their financing. They will not, typically, have any rights to sell the Assets, as would be the case in many types of secured financings. In many projects, recovery of amounts by the Senior Lenders making claims under the Project Documents will not lead to full repayment. Typically the Senior Lenders will only recover the amount invested after acceptance of the facility by the Authority, and through the successful operation of the project and the payment of Unitary Charge over the life of the project. The Senior Lenders, and their technical advisers, will closely monitor the Works to ensure they are built on time and to specification, and will monitor the delivery of Services, to ensure the Unitary Charge is paid without deductions. In this way the interests of the Senior Lenders, to ensure that the Contractor performs its obligations, are broadly aligned with those of the Authority.

31.1.3 Direct Agreements should be used for project financed projects (but should not be needed for corporately financed projects) and such documents can be seen as advantageous to the public sector, in that they give Senior Lenders an opportunity to “revive” the Project and, therefore, to avoid the disruption that invariably follows termination. If the Project can be restored with minimal disruption to the Service and there is no need for the Authority to get involved to ensure that this occurs, then both the Authority and the Senior Lenders benefit.

31.1.4 The key issues are: when the Senior Lenders should be permitted to step-in, the extent to which the Senior Lenders should be obliged to assume liabilities that have been or are being incurred by the Contractor and the extent to which they are given the opportunity to rectify a breach on behalf of the Contractor. The approach taken in this guidance is very closely related to the approach taken in Section 21.2 (Termination on Contractor Default).

31.1.5 Other issues relating to this arise, such as for how long any liability of the Senior Lenders should continue, what rights of termination exist on a step-in and what rights of “sale” or replacement of Sub-Contractors the Senior Lenders should have.

31.2 LIABILITY OF SENIOR LENDERS

31.2.1 It could be argued that to the extent the Senior Lenders “step-in” (i.e. obtain rights under the Contract) then they should be liable for obligations to the same extent as the Contractor. On some early projects this led to the development of “step-in undertakings”, under which Senior Lenders agreed to accept a degree of liability (invariably capped) as the price of their attempt to save the Project.

31.2.2 Other projects attempted to follow more closely the then existing structure for insolvencies and work-outs in the UK, namely that of an administrative receivership appointment

and sale, on the basis that the interests of all parties were best served by following a well established procedure that allows an entity to be appointed to take over the decision making rights of the Contractor without immediately being forced to sign up to either a limited quantified or unlimited liability.

31.2.3 A standard approach has now been developed, to the effect that the Senior Lenders should be given an opportunity to rectify any defaults and maximise any realisation without having to provide a “step-in undertaking” to the Authority. This approach is very closely linked to the approach taken in Section 21.2 (Termination on Contractor Default) as if the situation worsens to a sufficient degree (e.g. claims arise) during the Senior Lenders’ period of “step-in”, the Authority may terminate the Contract and such liability will be reflected in the termination compensation payable to the Contractor.

31.3 REQUIRED APPROACH

31.3.1 This approach distinguishes between the Contractor and the Senior Lenders even on step-in. The Senior Lenders must agree to sign up and pay for any liability (e.g. any amounts owing to the Authority) at the time of step-in and take steps to rectify breaches. In implementing rectification of breaches under the Contract some time and flexibility should be given. Nevertheless, the Contractor will always remain liable under the Contract and, to the extent a new breach occurs during the period of step-in, then termination can still occur.

31.3.2 Following, or simultaneously with, the issue of a Termination Notice under the Contract, the Authority will issue a Termination Notice to the Agent. This will trigger the running of a period which, if the Senior Lenders decide not to step-in, will allow the Contract to terminate. Within 30 days of issuing the Termination Notice, the Authority must also notify the Agent of the liabilities to be discharged by the Senior Lenders on step-in. If the Senior Lenders wish to step-in, then the liability to be discharged must be paid to allow step-in to occur (see Clause 6(b) of the Direct Agreement for detailed provisions).

31.3.3 A similar procedure can apply if no Termination Notice is in fact issued, but the Senior Lenders have accelerated the maturity of their debt and demanded repayment. These provisions are set out in Clauses 3 (No Termination Without Notice), 5 (Representative) and 6(b) of the Direct Agreement.

31.3.4 During the step-in period, the Senior Lenders are incentivised to ensure that a remedial programme is implemented in relation to antecedent breaches and that no new breaches occur. If antecedent breaches are not remedied or new breaches occur, then a right to termination can arise again.

31.3.5 The Direct Agreement also provides that the effects of the step-in can come to an end if the Senior Lenders step-out or a novation occurs. If the Contract continues by way of a novation, this does not mean that the parties will not amend the Contract in certain respects. For example, the parties may agree that the performance and payment mechanism are not incentivising the parties correctly (see Section 7.5 (Calibration)) and so require it to be amended. This will depend in part on the extent to which the mechanism concerned is untested and/or capable of automatic recalibration (see Section 7.7 (Flexibility)).

31.3.6 If the Senior Lenders cannot rectify the default or save the Project, then termination will occur in accordance with Clauses 21.2.8 (Retendering Procedure) or 21.2.9 (No Retendering Procedure) of the Contract, depending on what steps have been taken by Senior Lenders to realise a value from the project. If any undischarged claims are owing from the Contractor, then they can be set off under Clause 12 (Set-off).

31.3.7 The advantage of the above approach is that the Senior Lenders are clearly aware when they make the decision whether or not to step-in what liabilities are being accepted.¹ At the same time, the Authority retains the right to terminate if any breach occurs or the Senior Lenders are not making sufficient effort to rectify the antecedent breaches and so it is in substantially the same position after step-in as it was before.

31.3.8 In return for a payment being made to the Contractor (whether under Clause 21.2.8 (Retendering Procedure) or Clause 21.2.9 (No Retendering Procedure)), the Senior Lenders should agree to release any security over the Assets (other than charges over bank accounts and counterparty claims (including claims against the Authority under the Contract and the Sub-Contractors under the Sub-Contracts)). See further Section 31.6 (Direct Agreement).

31.4 PERFORMANCE POINT ACCRUAL WHEN STEPPED IN

31.4.1 One key point is the extent to which performance points can continue to accrue when the Senior Lenders have stepped in.

31.4.2 The relevant approach depends in part on the issues referred to in Section 24.6 (Damages Claims) and the likelihood of any claims arising. To the extent the performance points accrual rate reflects the loss to the Authority, then by performance points being incurred, the Authority is protected. Its main concern in such circumstances is to ensure that it is not paying for the Service if it is not being provided.

31.4.3 To the extent this is the case, then relief from termination should be given for an extended period to allow rectification to occur, so that a significant period can be given to allow implementation of the rectification programme. Sufficient flexibility should be included in the Step-In Period so that default is not an inevitable consequence (for example, if one more penalty point triggers a termination, the Senior Lenders will be reluctant to step-in) and time is given to rectify, so allowing the Senior Lenders the opportunity to rectify.

31.4.4 The approach taken is that performance points should continue to accrue during the Step-In Period but that during any Step-In Period there should be a suspension (but not cancellation) of any performance points that accrued prior to the Step-In Date, but only for the purposes of triggering a termination (i.e. not in accruing deductions from the Unitary Charge). Although performance points will accrue during the Step-In Period, the Authority should not be able to terminate the Contract if the Senior Lenders are using reasonable endeavours to rectify any breach that arose prior to the Step-In Date but which is continuing. If the Senior Lenders subsequently step-out, the suspension of those performance points should be lifted.² If the Authority does not have this protection and the Senior Lenders step-out because they no longer wish to rescue the Project, the Authority will need those points that accrued prior to the Step-In Date to be taken into account so as to ensure that the Authority has the ability to terminate the Contract. If the Step-In Period ends because of a transfer of the Contract to a Suitable Substitute Contractor, any accrued performance points will be cancelled for the purposes of triggering a termination.

¹ Unlike in some other models, the Senior Lenders have no liability to the Authority during the step-in period (but the step-in period may end and the Contract may be terminated if new payment or other defaults arise during the step-in period, or if "post notified" debts are not paid – see Clause 6(b)). Similarly, the Senior Lenders can step out at any time without having any liability to the Authority. This does not prejudice the Authority as it is protected in the knowledge that if the situation worsens (e.g. claims arise) as a result, then this will be reflected in compensation payable on Contractor Default.

² See Section 9.5 (Consequences of Poor Performance). The "wipe clean" of deductions for termination purposes should be limited to two occasions during the life of the Contract.

31.4.5 To the extent that a rectification programme is being implemented (and so no termination right exists) it is possible that a refinancing may be required to incorporate, for example, new working capital.

31.5 LIABILITY FOR INDEMNITY CLAIMS OR CLAIMS FOR DAMAGES

31.5.1 It has been argued in some cases that the Authority should at least retain the right to recover against the Senior Lenders (when stepped-in) for any damages the Senior Lenders caused when stepped-in. To the extent that any damage or claims (e.g. from third parties) arise in relation to the Contract, then the damage or claims concerned will, in most cases be reflected in the termination compensation payable.

31.6 DIRECT AGREEMENT

31.6.1 Required minimum drafting for a direct agreement is set out below. Explanatory guidance is set out in the footnotes.

THIS AGREEMENT³ IS MADE ON [], []

BETWEEN:

- (1) [RELEVANT DEPARTMENT OR GOVERNMENT BODY] (the “Authority”);
- (2) [] (the “Agent” for the Senior Lenders⁴); and
- (3) [PROJECT COMPANY] (the “Contractor”).

IT IS AGREED AS FOLLOWS:

1 INTERPRETATION

(a) In this Agreement, unless the context otherwise requires:

“Appointed Representative”

means a Representative that has assumed the Contractor’s rights under the Contract under Clause 5(a).

[“Credit Agreement”

means the [] credit agreement dated [] between the Contractor, the Agent and various Senior Lenders and financial institutions.]

“Contract”⁵

“Contractor Default”

shall have the meaning given to it in the Contract.

“Event of Default”

shall have the meaning given to it in the Credit Agreement.

³ This draft deals with the step-in mechanics and novation. Other issues may also require inclusion in Direct Agreements if appropriate (such as specific detail relating to specific accounts into which payments are to be made and payment of insurance proceeds (see Section 25 (Insurance)). The Direct Agreement may not be used however as a device to reallocate risks which have already been allocated between the Authority and its bidder in the Contract.

⁴ The reference to “Senior Lenders” is intended to track the definition in the Financing Agreements. To the extent bonds are used, minor drafting changes will be needed (for example to refer to the “Trustee” rather than the “Agent” and to “Bondholders” rather than “Senior Lenders”). The approach taken will not otherwise differ. When a monoline insurer is involved as part of the Project, key decisions taken will be taken by the monoline insurer, rather than the bondholders and the drafting should reflect this. Similarly, it may be that the security is held by a trustee for the financiers (usually called the “Security Trustee”). If so, then the drafting will require conforming.

⁵ As defined in Section 1.7 (Interpretation).

“Fair Value”

means the amount at which an asset or liability could be exchanged in an arm's length transaction between informed and willing parties, other than in a forced liquidation or sale.

“Liquid Market”

shall bear the meaning given to it in the Contract.

“Representative”⁶

means

- (a) the Agent, any Senior Lender and/or any of their Affiliates;⁷
- (b) an administrator, administrative receiver,⁸ receiver or receiver and manager of the Contractor appointed under the [Security Documents];⁹
- (c) a person directly or indirectly owned or controlled by the Agent and/or any Senior Lender(s); or
- (d) any other person approved by the Authority (such approval not to be unreasonably withheld or delayed).

“Required Period”

means,¹⁰ subject to Clause 4 (No Liquid Market) the period starting on the date of a Termination Notice and:

- (a) during the construction phase ending [120] days later; and
- (b) during the operating phase ending [90] days later.

“Step-In Date”

means the date on which the Agent takes any action under Clause 5(a).

“Step-In Period”

means the period from the Step-In Date up to and including the earlier of:

- (a) the Step-Out Date;
- (b) the date of any transfer under Clause 8;
- (c) the date of any termination for breach under Clause 6; and
- (d) the date of expiry of the Contract.

“Step-Out Date”

means the date falling [30]¹¹ days after the date of the notice given under Clause 7 (Step-Out).

⁶ In the past, some Authorities have taken the view that it is inappropriate to have an administrator, receiver, manager or an administrative receiver over the Contractor or its assets. Provided that the right to terminate the Contract for non-performance is preserved during this period and the operational assets of the Project are protected and preserved for the Authority (see Section 31.6.5 any such concern is misplaced.

⁷ See the definition in Clause 1.7.1 (Definitions).

⁸ This assumes the Senior Lenders have valid security over all or substantially all of the assets of the Contractor, entitling them to appoint an administrative receiver.

⁹ To be defined, but Senior Lenders will expect the security referred to in footnote 8 above.

¹⁰ The time periods will be subject to the specific requirements of particular projects, but these are likely to be appropriate for many projects that have a split between these phases. In practical terms, since the Senior Lenders will be funding the Project while they are making the decision whether or not to step-in and the liability of the Senior Lenders while stepped-in is clearly limited in this agreement, provided the Project is not technically complex or does not involve a large banking syndicate 90 days may be sufficient even during the construction phase.

“Suitable Substitute Contractor”

means a person approved by the Authority (such approval not to be unreasonably withheld or delayed) as:¹²

- (a) having the legal capacity, power and authority to become a party to and perform the obligations of the Contractor under the Contract; and
- (b) employing persons having the appropriate qualifications, experience and technical competence and having the resources available to it (including committed financial resources and sub-contracts) which are sufficient to enable it to perform the obligations of the Contractor under the Contract.

“Termination Notice”

means a notice given by the Authority to the Agent under Clause 3(a).

- (b) [Relevant parts of Clause 1.7.2 (Interpretation) of the Contract should be included here with suitable amendments where necessary].
- (c) Capitalised terms defined in the Credit Agreement have the same meaning in this Agreement.

2 CONSENT TO SECURITY

- (a) The Authority acknowledges notice of, and consents to, the security interest granted over the Contractor’s rights under the Contract effected by the Contractor in favour of the Senior Lenders under the Security Document.¹³
- (b) The Authority confirms that it has not received notice of any other security interest granted over the Contractor’s rights under the Contract.¹⁴

3 NOTICE OF TERMINATION AND EXISTING LIABILITIES

The Authority shall not terminate or give notice terminating the Contract¹⁵ on the grounds of Contractor Default without giving to the Agent.

- (a) at least the Required Period of prior written notice stating:
 - (i) the proposed Termination Date; and
 - (ii) the grounds for termination in reasonable detail, and
- (b) not later than the date falling 30 days after the date of a Termination Notice or (if earlier) the date falling 30 days after the date on which the Agent informs the

¹¹ This will depend on the time required by the Authority to put in place alternative measures to provide the Service.

¹² This definition applies to the criteria required for a new Contractor. To the extent there are rights of veto for the Authority in the Contract on replacements to Sub-Contractors and transfers of shares (see Sections 16.1 (Control over Sub-Contractors) and 18 (Change of Ownership)), Senior Lenders will seek to impose criteria (such as the above). Thought should always be given to including any such criteria in the Contract and, to the extent they are included, these are appropriate limits. Criteria that are not objective are very unlikely to be “bankable”. Other criteria may be appropriate in particular cases (for instance, if security or national security is an issue). Departments may require, for example, that directors of the Contractor have not committed a criminal offence. These requirements should focus on key requirements for a Contractor in that project (as, for example, a road traffic offence or a spent conviction may have little or no relevance). Similar considerations apply to those in Section 16 (Sub-Contracting, Employees and Documentary Changes).

¹³ This should restrict the ability of the Senior Lenders to transfer in breach of Clause 9 (Novation).

¹⁴ Departments will sometimes argue that they may not be aware of such notices. The correct view is that they should be and so should be able to make this confirmation.

¹⁵ The termination events in the Contract can be distinguished between for these purposes (for example, treating an insolvency default differently from a performance default), but if the Project can be rescued by the Senior Lenders then there is no good reason to draw such a distinction. This agreement also assumes that if the Contract is to be terminated in circumstances in which the Senior Lenders will be repaid in full (e.g. for corrupt gifts or force majeure) then the Senior Lenders will not want to exercise their rights under this Agreement. The Direct Agreement should also restrict the Authority’s right to terminate other agreements ancillary to this Agreement (e.g. a lease of land on which the Project is built).

Authority that an Event of Default.¹⁶ has occurred, a notice containing details of any amount owed by the Contractor to the Authority, and any other existing liabilities or unperformed obligations¹⁷ of which the Authority is aware (having made reasonable enquiry):

- (i) at the time of the Termination Notice or the notification of an Event of Default; and/or
- (ii) which will fall due on or prior to the end of the Required Period, under the Contract.¹⁸

4 NO LIQUID MARKET

- (a) At any time during the Required Period¹⁹ the Agent may issue a written notice (the “**No Liquid Market Notice**”) to the Authority setting out the reasons why the Agent does not believe that a Liquid Market exists.
- (b) On or before the date falling 14 days after the date on which a No Liquid Market Notice is received by the Authority, the Authority shall notify the Agent of its opinion as to whether or not a Liquid Market exists. Where the Authority believes that a Liquid Market does exist, such notice shall set out the reasons for the Authority's belief. If the parties do not agree whether or not a Liquid Market exists, then either party may refer the dispute to be determined in accordance with Clause 28 (Dispute Resolution).²⁰
- (c) If the parties agree or it is determined in accordance with Clause 28 (Dispute Resolution) that no Liquid Market exists, the Contract shall automatically terminate and the provisions of Clause 21.2.9 (No Retendering Procedure) shall apply.²¹
- (d) If any dispute relating to this Clause 4 is determined under Clause 28 (Dispute Resolution), the Required Period shall be extended by the period of time spent determining such dispute under Clause 28 (Dispute Resolution).

5 REPRESENTATIVE

- (a) Without prejudice to the Agent's rights under the Security Documents, at any time:
 - (i) during which an Event of Default²² is subsisting (whether or not a Termination Notice has been served); or
 - (ii) during the Required Period,²³

¹⁶ See footnote 22, as to whether this reference should be to an Enforcement Event.

¹⁷ Both parties should have a clear understanding of what these liabilities are, as it is likely that an increase in debt facilities will be needed to rectify defaults or cover interest that accrues. Care should be taken to ensure that the Authority does not intervene to specify how unperformed liabilities should be performed (e.g. following a request for conditions surveys), but instead give information on the default that led to termination and any other breaches of which it is reasonably aware.

¹⁸ This method is used instead of to requiring a step-in undertaking. A step-in undertaking is an undertaking from the Senior Lenders or other financiers to meet certain obligations, usually existing as at the date of step-in (and in some cases those that arise later). Even a capped liability during the Step-In Period could discourage the Senior Lenders or other financiers from stepping-in and for that reason this approach is not taken here.

¹⁹ The Agent should only be permitted to issue a No Liquid Market Notice to the Authority during the Required Period. Any dispute as to whether or not a Liquid Market exists after the last day of the Required Period should be determined in accordance with Clause 21.2.7 (Retendering Election) of the Contract.

²⁰ Any dispute should be determined under the dispute resolution procedure (see Section 28.2.3). The dispute resolution procedure in the Contract will need to apply *mutatis mutandis* to the Direct Agreement.

²¹ The compensation payable to the Contractor in such circumstances will be determined in accordance with the procedure set out in Clause 21.2.9 (No Retendering Procedure).

²² This should be defined in the Credit Agreement and this drafting assumes that the occurrence of an Event of Default will allow the Senior Lenders to enforce their security. If the Contractor has negotiated that the security is not enforced until the debt is actually accelerated, the Contractor should be permitted to change references from Event of Default to “Enforcement Event”. It is, in any event, unlikely that Senior Lenders will wish to step-in unless the Project is in serious difficulties.

the Agent may procure that a Representative assumes, jointly and severally with the Contractor, all of the Contractor's rights under the Contract.

- (b) The Agent shall give the Authority [5]²⁴ days prior notice of any action to be taken by it referred to in this Clause 5.

6 STEP-IN PERIOD

- (a) Without prejudice to Clause 3 (No Termination Without Notice), but subject to paragraph (b) below, the Authority shall not terminate the Contract during the Step-In Period on grounds:

- (i) that the Agent has taken any action referred to in Clause 5 (Representative) or enforced any Security Document(s); or
- (ii) arising prior to the Step-In Date²⁵ of which the Authority is aware (having made reasonable enquiry and whether or not continuing at the Step-In Date); or
- (iii) arising solely in relation to the Contractor,²⁶

unless, in the case of paragraph (ii) above:

- (A) the grounds arose during the [construction phase],²⁷ and construction is not completed on or before the date falling [12]²⁸ months after the date on which the Authority would have been entitled to terminate the Contract for non-completion;²⁹ or
- (B) the grounds arose during the [operation phase], and neither the Appointed Representative nor the Contractor is using all reasonable endeavours (including implementation of any remedial programme)³⁰ to remedy any breach of the Contract that:
- (1) arose prior to the Step-In Date; and
 - (2) is continuing (and capable of remedy); and
 - (3) would have entitled the Authority to terminate the Contract.

²³ The Authority should ensure that during this period it has preserved the right in the Contract to enter on the property and restore problems that need an emergency fix (through rights of access). Its rights of termination against the contractor with the Senior Lenders "stepped-in" are sufficient to protect it during the "step-in" period (provided the Contract has been negotiated correctly).

²⁴ It is unlikely that a longer period will be needed.

²⁵ To the extent a right to terminate would otherwise arise, a right to terminate should arise for a 'latent defect' (i.e. one that could not reasonably be expected to have been discovered) becoming an 'actual defect'. That is, notwithstanding the discovery of a latent defect that existed prior to the Step-In Date, it should be treated as arising after that date. Latent defects are likely to be dealt with in the Contract (see Section 6.5 (Latent Defects Risk)) and are project specific.

²⁶ For example, insolvency of the Contractor.

²⁷ It is acknowledged that in the provision of the Service it is not always clear when the construction phase ends as the construction of an asset will be to facilitate the provision of the Service and without the ancillary support (for example, in a prison the regime being set up and approved) the Service will not be ready to start. Similarly in a phased development, the two phases will usually overlap. The key determinant will, of course, be the extent to which failure to complete construction of either phase will lead to termination (thereby preventing Service Commencement), in which case paragraph (A) will apply. If the failure is in the delivery of the Service from a completed facility then paragraph (B) will apply.

²⁸ Time periods will depend on a number of issues, including the nature of the Project and the length of the construction phase. If there is no critical need for the project to commence by a certain date or parties believe the financial incentives are sufficiently strong, then (B) can also apply to terminations in the construction phase.

²⁹ See footnote 27 above.

³⁰ Prior to any step-in by the Senior Lenders, it is likely that the Authority will be asked to approve a remedial programme in respect of rectification works that the Senior Lenders are proposing in an attempt to rescue the Project. Such an approach is only acceptable provided that the Authority does not assume any additional risk by virtue of giving such approval, i.e. the purpose of the remedial programme should be purely to assist the Senior Lenders in a defence of a claim by the Authority that the Senior Lenders are in breach of Clause 6(a)(iii)(B) as they are not using reasonable endeavours to rectify the relevant breach of the Contract.

- (b) The Authority shall be entitled to terminate the Contract by written notice to the Contractor and the Appointed Representative:
 - (i) if any amount referred to in Clause 3(b)(i) above has not been paid to the Authority on or before the Step-In Date;
 - (ii) if any amount referred to in Clause 3(b)(ii) has not been paid on or before the last day of the Required Period;
 - (iii) if amounts, of which the Authority was not aware (having made reasonable enquiry) at the time of the Termination Notice or the Event of Default, subsequently become payable and are not discharged on or before the date falling [30] days after the date on which the liability for these amounts is notified to the Agent; or
 - (iv) on grounds arising after the Step-In Date in accordance with the terms of the Contract provided that for the purposes of termination under the Contract, [warning notices, deductions and/or penalty points] that arose prior to the Step-In Date shall not be taken into account during the Step-In Period but shall be taken into account after the Step-Out Date.³¹
- (c) The Authority shall deal with the Appointed Representative and not the Contractor during the Step-In Period.

7 STEP-OUT

- (a) The Appointed Representative will, on [30] days' prior written notice from the Agent or the Appointed Representative to the Authority, be released from all of its obligations and liabilities to the Authority under the Contract arising prior to the Step-Out Date and rights of the Appointed Representative against the Authority will be cancelled.³²
- (b) The Contractor shall continue to be bound by the terms of the Contract, notwithstanding the occurrence of the Step-Out Date.³³

8 NOVATION

- (a) Subject to Clause 8 (b), at any time:
 - (i) during which an Event of Default³⁴ is subsisting; or
 - (ii) during the Step-In Period,

the Agent may, on [30] days' prior written notice to the Authority and any Appointed Representative, procure the transfer of the Contractor's rights and liabilities under the Contract to a Suitable Substitute Contractor.
- (b) The Authority shall notify the Agent as to whether any person to whom the Agent proposes to transfer the Contractor's rights and liabilities under the Contract is a Suitable Substitute Contractor, on or before the date falling [30] days after the date of receipt of all information reasonably required by the Authority to decide whether the proposed transferee is a Suitable Substitute Contractor.³⁵

³¹ See Section 31.4.4 (Performance Point Accrual when Stepped-In).

³² Any undischarged liabilities are reflected in the payments under Clause 21.2.8 (Retendering Procedure) and Clause 21.2.9 (No Retendering Procedure).

³³ See Section 31.4.4 (Performance Point Accrual when Stepped-In).

³⁴ See footnote 22 above. The same point applies here.

³⁵ The Authority would be reasonable in withholding its consent if there are outstanding unremedied breaches with no proposed remedial programme.

- (c) The Authority shall not unreasonably withhold or delay its decision on whether the proposed transferee is a Suitable Substitute Contractor.³⁶
- (d) On any transfer referred to in Clause 8(a) becoming effective:
 - (i) the Contractor shall be released from any obligations arising under or in connection with the Contract from that date and the new Contractor shall become liable for obligations arising on or after that date;
 - (ii) any accrued [performance points and/or warning notices] incurred under the Contract shall, for the purposes of termination only, and without prejudice to the rights of the Authority to make financial deductions, be cancelled;
 - (iii) any then subsisting ground for termination of the Contract by the Authority shall be deemed to have no effect and any subsisting Termination Notice shall be automatically revoked; and
 - (iv) the Authority shall enter into a direct agreement with the Senior Lenders lending to the new Contractor on substantially the same terms as this Agreement.

9 INSURANCE PROCEEDS

Notwithstanding the other provisions of this Agreement and the terms and conditions of the Senior Financing Agreements, the Agent shall only permit amounts to be released from the Joint Insurance Account in accordance with the requirements of [Clause 25.6 (Reinstatement)] of the Contract³⁷ and shall not exercise any rights under the Senior Financing Agreements or take any other steps to prevent amounts being released from the Joint Insurance Account in accordance with [Clause 25.6 (Reinstatement)] of the Contract.

10 MISCELLANEOUS

- (a) The Authority shall at the Contractor's expense, take whatever action the Agent, an Appointed Representative or a Representative taking a transfer in accordance with Clause 8(a) may require for perfecting any transfer or release under Clauses 5 (Representative), 7 (Step-Out) and 8 (Novation) including the execution of any transfer or assignment, and the giving of any notice, order or direction and the making of any registration which, in each case, the Agent, Appointed Representative or Representative reasonably requires.
- (b) The Authority shall not take any action to wind up, appoint an administrator or sanction a voluntary arrangement (or similar) in relation to the Contractor.
- (c) This Agreement shall remain in effect until the date on which all amounts which may be or become owing by the Authority to the Contractor under [Section 21 (Early Termination)] of the Contract have been irrevocably paid in full, [whereupon the Agent agrees on behalf of itself and the Senior Lenders to release any security granted in their favour over the Assets which has not previously been assigned to the Authority].³⁸

³⁶ At the time of any proposed novation, the Authority should ensure that it is a condition of the novation that any unpaid amounts owed to it by the Contractor (e.g. amounts claimed under the indemnity provision) are satisfied in full.

³⁷ Under the terms of the Senior Financing Agreements, the Senior Lenders will take security over all of the assets of the Contractor, including the Contractor's interests in the Joint Insurance Account. However, the Senior Lenders should accept that any proceeds standing to the credit of the Joint Insurance Account should be applied in reinstatement of the assets except where no reinstatement is required as a result of Section 25.6 (even if the Contract has terminated) and accordingly the Authority should not agree to any request from the Senior Lenders for the Authority to grant security to the Senior Lenders over its interests in the Joint Insurance Account.

³⁸ If the Assets revert to the Authority on early termination of the Contract and the Authority has the right and elects to pay early termination compensation amounts in instalments, the Senior Lenders should release any security held over the Assets on termination so as to allow the unencumbered Assets to be transferred to the Authority. See Section 31.3.8 in relation to which Assets the Senior Lenders should not be required to release their security over.

- (d) The Agent, in respect of paragraphs (i), (ii) and (iii), and the Contractor in respect of paragraph (iv), shall promptly notify the Authority of:
 - (i) any decisions to accelerate the maturity of any amounts owing by the Contractor to the Senior Lenders under the Credit Agreement and/or demand repayment;³⁹
 - (ii) the date referred to in paragraph (c) above on or before the date falling 30 days after its occurrence;
 - (iii) the details and amount of any proposed Additional Permitted Borrowing, including:
 - (a) the circumstances giving rise to it and reasons for it; and
 - (b) the terms on which it will be borrowed; and
 - (iv) on the first Business Day of each calendar month during which any Additional Permitted Borrowing is, or may be, subsisting, the amount outstanding under the Senior Financing Agreements (as the same may be amended (whether or not with the approval of the Authority)), and, to the extent it is aware (having made reasonable and proper enquiry):
 - (a) the amount of any Distribution made by the Contractor; and
 - (b) the amount of any credit balance on any account of the Contractor;⁴⁰
- (e) The Contractor joins in this Agreement to acknowledge and consent to the arrangements set out and agrees not knowingly to do or omit to do anything that may prevent any party from enforcing its rights under this Agreement.⁴¹
- (f) For the avoidance of doubt, if there is any conflict or inconsistency between the provisions of this Agreement and the Contract, the provisions of this Agreement shall prevail.⁴²
- (g) The Agent agrees on behalf of itself and the Senior Lenders that [include relevant “boiler plate” from the Contract].⁴³

11 ASSIGNMENT

- (a) No party to this Agreement may assign or transfer any part of its rights or obligations under the Agreement, save that:
 - (i) the Agent may assign or transfer its rights and obligations under this Agreement to a successor Agent in accordance with the Senior Financing Agreements without the consent of the Authority;
 - (ii) any Senior Lender may assign or transfer its rights under the Senior Financing Agreements in accordance with the terms of the Senior Financing Agreements; and

³⁹ See footnote 22 above. Even if the trigger for step-in is demand for the repayment of Senior Debt, earlier enforcement steps should be notified.

⁴⁰ For a bond transaction, 10(d)(iv) may be replaced by a new clause if the Authority thinks this appropriate. See Section 36 (Bond Finance).

⁴¹ It is also good practice for the Contractor to appoint the Authority as its attorney to sign any required novation documentation so that, if novation occurs, it does so as smoothly as possible.

⁴² For example, provisions relating to termination and compensation will cut across the provisions of this Agreement.

⁴³ These provisions should be consistent with the provisions of the Contract and impose an equivalent but separate liability on the Senior Lenders to that to which the Contractor is subject.

- (iii) the Authority may assign, novate or otherwise transfer its rights and/or obligations under this Agreement to any person that the Authority assigns, novates or otherwise transfer its rights and/or obligations under the Contract in accordance with Clause 17.3 of the Contract.
- (b) If paragraph (a)(i) applies then the Authority shall enter into a direct agreement with the new Agent on substantially the same terms as this Agreement.

12 GOVERNING LAW

This Agreement is governed by the laws of England and Wales.⁴⁴

31.7 SUBORDINATION AND RELATED PROVISIONS

31.7.1 A number of projects have been closing in the PFI market where Senior Lenders have sought to add blanket subordination provisions to the form of the Direct Agreement which, in extreme cases, might act to negate the benefit of the Authority's own direct agreements with key Sub-Contractors and consultants.

31.7.2 An Authority should have no wish to upset the normal arrangements which Senior Lenders enter into or to upset the Senior Lenders' incentives to take responsibility for monitoring the Contractor (and where necessary to take control of its affairs and sub-contracts); equally however it will wish to be able to preserve continuity of services and build, and will not want the benefit of its own step-in arrangements negated. There should ordinarily be no conflict between the interests of the Senior Lenders and of the Authority - both of whom will want to ensure continued Service provision.

31.7.3 If, however, for some reason Senior Lenders do not choose to exercise their rights under their direct agreements with key Sub-Contractors and consultants, or having exercised such rights have stepped out, the Authority may wish to exercise its own rights under its own direct agreements to preserve continuity of Service, for instance, with a valued non-defaulting Sub-Contractor. Blanket subordination provisions, preventing the Authority from exercising its rights until the Senior Debt is fully paid out, might preclude this.

31.7.4 Set out below is some suitable drafting which Authorities may find helpful. For periods after Project termination, where notice periods allowing Senior Lenders to step in have elapsed and they have chosen not to step in to Sub-Contracts, the Authority may step-in (though the Senior Lenders' own claims against sub-contractors may be preserved). In the period prior to project termination before the notice period to Senior Lenders may have elapsed, the Authority may agree not to step in to subcontracts but may still wish to be able to fund them to prevent their termination. This is likely to be a remote and short term contingency prior to Project termination.

31.7.5 An Authority will also wish to ensure that the operational assets which the Authority needs to complete or operate the Project pass across from the Contractor to the Authority on a termination – so as to ensure continuity of service. These principles are set out in Section 31.3.8 and Section 21 (Early Termination) and the Senior Lenders' security arrangements should not overturn them. This should not be a concern for the Senior Lenders (whose main interest should be the Termination Sum or the cash sum paid in the market for the Project on a default). It is in the interests of the Senior Lenders that the Project remains operational and can be sold in the market for its maximum value. Their real security is in the cash flow (or termination sum) rather than in assets. The operational assets involved are not likely to be major items in most Projects.

⁴⁴ Scottish PFI projects will have direct agreements governed by Scottish law since they are widely regarded as operating in parallel with Scottish law governed Contracts (even if the Financing Agreements are English law governed). Northern Ireland projects will also normally be governed by local law.

Suitable drafting is as follows:

31.7 Authority rights under Direct Agreements [and Appointments]

31.7.1 Notwithstanding any provision in the Authority Direct Agreements [and/or the Appointments] to the contrary, the Authority agrees that, subject to Clauses 31.7.2 and 31.7.3, it will not, in respect of any particular Authority Direct Agreement [or Appointment], exercise or seek to exercise any of its step-in rights or other rights under such agreement or until the earlier of:

- (a) the Senior Debt Discharge Date; or
- (b) the date on which the Agent has given its written consent to such exercise; or
- (c) the time when in respect of any such Authority Direct Agreement [or Appointment] either:
 - (i) the Senior Lenders have failed to exercise any corresponding right to such Authority Direct Agreement [or Appointment] under their own Security Documents and the time for exercising such right has ended in accordance with the terms thereof; or
 - (ii) the Agent has confirmed in writing to the Authority (following any request from the Authority for such confirmation, to which the Agent shall be obliged to respond promptly) that it does not intend to exercise any of its rights under the relevant Security Document or that it has no further claim thereunder; or
 - (iii) the Senior Lenders have stepped in to, or otherwise, directly or indirectly, taken control over the rights of the Contractor under, such agreement (in accordance with their rights under their Security Documents) and then stepped out from, or otherwise relinquished control of such rights under or in connection with such agreement.

31.7.2 In addition to its rights under Clause 31.7.1, where the Contract has not been terminated but a counterparty has a right to terminate its sub-contract [or Appointment] for breach by the Contractor of the terms of such sub-contract [or Appointment], the Authority may pay directly, or undertake to make a payment directly to the counterparty concerned, amounts due pursuant to the sub-contract [or Appointment] and may set off any such sums against any payments payable by the Authority to the Contractor under the Contract, so as to satisfy them pro tanto, provided always that the Authority shall not exercise its rights under this clause 2.2 in respect of any particular such sub-contract [or Appointment] in circumstances where the Senior Lenders have stepped in to, or otherwise, directly or indirectly, taken control over, the relevant sub-contract [or Appointment] and not stepped out of it or otherwise relinquished such control.⁴⁵

⁴⁵ This provision deals with the period prior to any project termination, and may include, for instance, a period when the Authority wishes to terminate and has given the required period of notice to Senior Lenders (e.g. 90 or 120 days) under Clause 3. It will be for Authorities or Departments (as relevant) to determine on a Project or sector basis the provisions of this Clause 31.7.2 and of the Direct Agreement whether or not they think it appropriate to further qualify or limit their ability to set off such payments. Clearly the preferred position for the public sector will be to retain the ability to "set off" any such payment to sub-contractors so as to reduce the unitary charge, (and avoid "double payment") and Authorities will want to achieve this. Senior Lenders, may however argue that set off should be limited or qualified, for example, by reference to a period, or made dependent on the Senior Lenders' own attempts to preserve continuity of Service (see below).

31.7.3 In addition to its rights under Clause 31.7.1, where the Contract has been terminated, the Authority shall from the Termination Date be able to exercise any of its step-in rights or other rights under or in respect of any of the Authority Direct Agreements [or the Appointments]; however, notwithstanding the terms of the Authority Direct Agreements [or Appointments] or any other provisions of this Clause 31.7.3, each of the relevant sub-contractors [or the counterparties to the relevant Appointment] (and any guarantors thereof as relevant) shall remain responsible, and be liable, to the Contractor in respect of all costs, claims, damages, losses and liabilities which shall have arisen out of or in connection with the relevant sub-contracts [or Appointments] in respect of the period prior to the Termination Date in relation to which the Agent acting on behalf of the Contractor or the Senior Lenders shall retain the benefit of all and any rights to all such costs, claims, damage, losses and liabilities.

31.7.4 Except in accordance with the provisions of Clauses 31.7.1 to 31.7.3 (inclusive) and 31.6 the Authority shall not, prior to the Senior Debt Discharge Date:

- (a) claim, recover, retain or receive (or seek to claim, recover, retain or receive) any amount under the Authority Direct Agreements [or the Appointments] in respect of a loss for which a sub-contractor or relevant counterparty is also liable to the Senior Lenders;
- (b) take any action to wind-up, appoint an administrator, seek an interim order appointee (under paragraph 3(b) Schedule B1 of the Insolvency Act 1986 (as amended)), or sanction a voluntary arrangement (or similar) in relation to the Contractor; or⁴⁶
- (c) save with the prior written consent of the Agent, compete on grounds (whether in whole or in part) relating to the Project (by virtue of a claim under any of the Authority Direct Agreements, [the Appointments], the Contract or any other Project Document or otherwise) with the rights of the Senior Lenders on any formal insolvency of any sub-contractor, [any counterparty to any Appointment] or the Contractor, nor claim to be subrogated to any rights of any Senior Lenders.

31.7.5 The Authority agrees and undertakes that if it receives any amount in contravention of the provisions of Clause 31.7 above, it will promptly turn the same over to the Agent and pending such payment, hold the same on trust for the Agent and the Senior Lenders.

31.7.6 Notwithstanding the terms of the Contract and Security Documents, the Agent agrees that the Authority may exercise its rights to have transferred to it or its nominee any Unrestricted Assets following the Termination Date and the Agent

"[or unless the Authority reasonably believes that the Senior Lenders are not seeking to preserve continuity of service or build obligation (as relevant) under the relevant Sub-Contract [or continuity of [] under the Appointment] with reasonable diligence (or under any equivalent service or build obligation under the Contract)]"

Any further subordination protection in any event should never extend beyond senior debt service (so as to benefit junior lenders or equity) or to impinge on the Authority's rights to step into the Project Agreement under Section 29 (Authority Step-in).

For periods after project termination Authorities will have the benefit of the standard netting and rectification cost provisions (See Section 12 (Set-off)).

⁴⁶ Note: this would be instead of Clause 10(b) of the Direct Agreement - See Section 31.6 (Direct Agreement and Senior Lenders).

will not exercise or seek to exercise any enforcement rights, and shall, on or before the date any Unrestricted Assets are transferred to the Authority or its nominee, as the case may be, release its security over them.

31.7.7 Notwithstanding any terms of the Financing Agreements, the parties agree and shall, to the extent it is within their power, direct that all insurance proceeds receivable or received by the Contractor under the insurances referred to in Clause [] of the Contract (Insurance) shall be paid directly into the Insurance Proceeds Account and applied in accordance with the Contract.⁴⁶

Definitions

"Authority Direct Agreements"

means [•];⁴⁷

"Senior Debt Discharge Date"

means the date on which all amounts owing by the Contractor to the Senior Lenders under the Senior Financing Agreements have been irrevocably paid in full;

"Unrestricted Assets"

means those Assets, excluding any revenues or cash balances or claims outstanding at the date of transfer under any Sub-Contract [or Appointment], which are required by the Authority or its nominee or any replacement of the Contractor for the purposes of the construction, operation or maintenance of the Facilities following termination assuming such construction, operation or maintenance is carried out on terms substantially the same as the terms of the Contract;

The following terms have the meaning given to them in the Contract:

["Appointments"]⁴⁸

["Facilities"]

The following term shall have the meaning given to it in the Credit Agreement:

["Security Documents"]

⁴⁶ If preferred, this could be inserted in paragraph 9 of the Direct Agreement.

⁴⁷ Reference Authority's direct agreements with sub-contractors.

⁴⁸ Reference Authority's direct agreements, if any, with members of the professional team.

32 COMPETITIVE DIALOGUE AND COMMITMENT LETTERS

32.1 EU PROCUREMENT LAW

32.1.1 The European law relating to public procurement, including PFI, was changed by the European Council's Directive on the Co-ordination of Procedures for the Award of Public Contracts, Public Supply Contracts and Public Service Contracts dated 31 March 2004.¹ This directive introduced the competitive dialogue procedure for use in particularly complex contracts like PFI. Regulations implementing this directive into English law came into effect from 31 January 2006.²

The main features of the competitive dialogue procedure are:

- dialogue is allowed with selected suppliers to identify and define solutions to meet the needs and requirement of the Authority;
- dialogue may be conducted in successive stages, with the aim of reducing the number of solutions/bidders;
- the award is made only on the most economically advantageous tender criteria; and
- there are explicit rules limiting post-final tender and post-award changes to the bid.

The OGC produced guidance³ on the competitive dialogue procedure in January 2006. This set out that competitive dialogue is intended for use in complex projects and that the competitive negotiated procedure should only be used in very exceptional circumstances. Further guidance is becoming available on a sector by sector basis.⁴

32.1.2 The competitive dialogue procedure will be used for most mainstream PFI procurements in mature markets whilst negotiated procedure remains available for exceptional circumstances⁵. Authorities should in future do greater "front end" work: engaging and informing the market; developing robust project governance; planning their procurement; developing their specification; being clear of their requirements; preparing their data; checking their property interests; commissioning relevant surveys (which may be relied upon by bidders); issuing well developed contracts at the start of the dialogue; and, ensuring they have in place adequate project governance arrangements such that relevant internal approvals are obtained prior to closing the dialogue. Not only is this likely to lead to a more efficient quicker procurement, it will help achieve compliance with the requirements of the competitive dialogue process.

32.1.3 Under the new competitive dialogue procedure, all substantial aspects of the bid need to be agreed before conclusion of the dialogue. The dialogue process should be used to identify the best means of satisfying the Authority's needs. The dialogue should continue until the Authority

¹ Directive 2004/18/EC.

² The Public Contract Regulations 2006 (S.I. 2006 No5), regulation 18.

³ See www.ogc.gov.uk/documents/guide/competitivedialogue.pdf.

⁴ See (a) "How to Conduct a Competitive Procurement" January 2006 on Partnerships for Schools website, (b) The Department of Health "The Private Finance Initiative How to Conduct a Competitive Dialogue Procedure" November 2006 consultation draft on the DoH web site, (c) 4ps A Map of the PFI process using Competitive Dialogue June 2006 (and related Competitive Dialogue Process diagram November 2006) on the 4ps website.

⁵ Authorities should however seek their own legal advice on a project by project basis and should refer to any relevant guidance from their Private Finance Units.

has identified and defined its requirements with sufficient precision to enable final bids (which meet those requirements) to be made. At that time the Authority should be able to identify one or more solutions to its requirements (since, as a result of the separate dialogues, different solutions may have been developed). A call for final bids should then be made and the winning bidder selected. After final bids have been submitted, it is only permissible to clarify, specify and fine tune. This does not necessarily mean that the Contract has to be complete in every detail at this stage, but it does mean that, after this time, no changes may be made to the basic features of the bid which are likely to distort competition or have a discriminatory effect. It is just as important that the Authority adheres to this rule as the bidder. This means that effectively, the Authority's own project decision-making must be complete by the call for final bids and there can be no further changes to the Project arising from further approvals process.

32.1.4 Effective project governance arrangements will help to minimise the risk of failure to comply with the requirements of the competitive dialogue procedure. Maintaining project governance structures and forums throughout the procurement will provide project direction and should ensure that approvals – for example with regards to the requirement and affordability – are in place at the required points in the competitive dialogue process. Additionally project governance structures will assist with project reporting and stakeholder management and hence reduce the likelihood that late changes will need to be introduced. If Authorities implement appropriate project governance frameworks, prepare for their procurements as outlined in Section 32.1.2, and manage their dialogues effectively, they should not need to budget any more time to complete a competitive dialogue procurement than a competitive negotiated procurement.

32.1.5 It is to be expected that some parts of the Contract will still need to be clarified or confirmed post-award. This is permissible provided that it does not have the effect of modifying substantial aspects of the bid, distorting competition or causing discrimination. For example, at award discussion the final detailed design may not be completed, detailed planning permission may not yet have been granted, detailed site surveys may still need to be done, and the final swap rate (which determines the Unitary Charge) may not be fixed until Financial Close. Where such aspects remain to be completed it is important that the Contract, or rules of the tender, lays down a clear and non-discriminatory mechanic governing the finalisation of these issues. Further guidance on this may be available on a sector-by-sector basis.⁶

33.1.6 Under the standstill provisions contained in The Public Contracts Regulations 2006 (regulation 32), an Authority must allow a mandatory minimum ten-day standstill⁷ period between the notification of a contract award decision and the entry into of the Contract. In addition, the rejected bidder may request a debrief and conditions relating to the provision of information apply within this standstill period.⁸

32.2 ENSURING COMMITMENT

32.2.1 The Authority must manage and control the final stage to Contract close following the appointment of the winning bidder. In the past, this has been the stage where project timetables have been most vulnerable to slippage. The Authority will be under pressure to adhere to timetables for Contract signature that are expected (by the end user and/or the relevant Government department) to be delivered on time.

⁶ See footnote 2 above.

⁷ See OGC guidance on the standstill period on its website at www.ogc.gov.uk.

⁸ Good practice would see projects maintaining a "procurement file" of key decisions and information which could then form the basis for the debrief.

32.2.2 To address the above concerns, the Authority should seek to ensure that each final bidder provides sufficient information so that the Authority can evaluate the length of time that it is likely to take to achieve Contract signature following appointment of the winning bidder. Accordingly, each bidder's final bid submission should set out:

- any final changes to the Contract (and any other draft contracts provided to the bidders) and the reasons for them (although the dialogue procedure should ensure there are no surprises here);
- representations as to how well developed the bidder's Sub-Contracts and finance documents (to the extent relevant where a funding competition is being held) are, and confirmation that, in any event, finalisation of the Sub-Contracts and finance documents (to the extent relevant where a funding competition is being held) will not result in any request to amend the Contract; and
- an estimate of the amount of time that the bidder and the Senior Lenders (to the extent relevant where a funding competition is being held)) believes it will take to reach Financial Close following the appointment of the winning bidder.

If a funding competition is being held, the bidder will, at this stage, then be in a position to launch its pre-planned funding competition. Where a funding competition is being held the parties should refer to HMT's Draft Outline Guidance "*Preferred Bidder Debt Funding Competitions*" dated August 2006.⁹

32.2.3 To reinforce the above, Authorities should require a written commitment, from all parties, to the Contract terms and in particular the payment mechanism. This is achieved by the Authority providing a letter to the winning bidder, to be countersigned by the bidder, its lenders (to the extent relevant where a funding competition is being held) and Sub-Contractors in which the parties confirm their acceptance of and commitment to the draft Contract. The letter will also set out any issues of clarification or confirmation, which remain (though no points of negotiation should remain – see Section 32.1.2). Appointment of the winning bidder will be conditional on signature of the commitment letter.

32.3 REQUIRED APPROACH

32.3.1 The form of commitment letter to be included in ITPD documentation to be countersigned by the winning bidder, its lenders (if relevant) and Sub-Contractors is set out below as required drafting:

[ON LETTERHEAD OF AUTHORITY]

[Date]

[Name and Address of Bidder]

Dear [BIDDER CONTACT]

[PROJECT HEADING]

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

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

⁹ See HMT website at www.hm-treasury.gov.uk.

1. The Unitary Charge set out within your bid is fixed by reference to your design and services proposals and on the assumption that financial close occurs on or before [●] (“Expected Date of Financial Close”). If financial close occurs after that date then your construction price will be increased only by movements in the [●] index from (but excluding) the Expected Date of Financial Close up to (but including) [●] and thereafter increased in accordance with your proposal included in [REFERENCE] of your Bid submission of [DATE]. The Authority will take the risk of any movement in [LIBOR][applicable interest rates] [relevant index] between [DATE OF BID SUBMISSION] and financial close.¹⁰ The benefit of any reduction in [LIBOR] [applicable interest rates] [relevant index] (including the buffer) will be passed in full to the Authority.
- 2.(a) Subject to paragraph (b) below the Unitary Charges set out within your bid as representing the price payable for taking out and maintaining the [Required Insurances] as that term is used in the draft contract terms (“Insurance Costs”) is fixed up to and including the Expected Date of Financial Close. From but excluding the date of Expected Financial Close Insurance Costs may be increased but only to the extent required as a consequence of any increase in the sum insured following any increase in the construction price allowed in accordance with paragraph 1 above. Any adjustment will be at the following rate [Bidder to specify].

(b) Insurance Costs may also be revised if (i) any risk to be insured under the Required Insurances becomes Uninsurable (as such terms are used in the draft Contract terms).
3. As regards the draft Contract terms, we are pleased that, [subject to the points of clarification and confirmation specified at paragraph 4 below], you have confirmed your acceptance to these terms. Again, we would ask for your confirmation by way of countersignature of this letter that, subject to the points of clarification and confirmation specified at paragraph 4 below, you have accepted the draft Project Contract [*refer to version and date*] [and [*refer to other relevant project documents*]] as issued to you.
4. The points of clarification and confirmation that remain are set out below:
5. As regards the draft payment mechanism, we would ask you to confirm, again by counter signature of this letter, that you have accepted the current draft in its entirety [subject only to any points specified at paragraph 4 above].

Yours sincerely

.....
[SIGNED ON BEHALF OF AUTHORITY]

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

.....
[SIGNED ON BEHALF OF SUB-CONTRACTORS]

¹⁰ Unless otherwise agreed (see further HMT’s Application Note *Interest Rate and Inflation Risk in PFI Contracts* (May 2006)). Where a funding competition is being held this may need amendment depending on arrangements between the Authority and the bidder.

33 DUE DILIGENCE OVER SUB-CONTRACTS AND FINANCING DOCUMENTS

33.1 INTRODUCTION

33.1.1 Although the Authority should not generally seek to interfere in the management of the Contractor's affairs,¹ the Authority should ensure that it understands how the Contractor is seeking to deliver the Service (both in terms of sub-contractual arrangements and financing), and be comfortable that those arrangements are (on an ongoing basis) sufficient to allow the Contractor to deliver the Service. Ultimately, termination of the Contract will always be the last resort for the Authority and such a remedy is no substitute for a thorough understanding and assessment by the Authority of how the Contractor proposes to deliver the Service to it.

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

- the amount of compensation payable to the Contractor on early termination will (except in the case of Contractor default) have reference to the amounts owed by the Contractor to its lenders under the financing documents. The Authority should therefore understand what those amounts will be and, in particular, understand how any breakage costs will be calculated.²
- the Authority may be seeking to retain the right to take over the Contractor's Sub-Contracts in the event of termination of the Contract or, more significantly, may have the benefit of a collateral warranty from the relevant Sub-Contractor. The Authority should conduct due diligence under the relevant Sub-Contracts to ensure that the principles agreed in the Contract are not undermined in the Sub-Contracts (i.e. the Sub-Contracts and the Contract are consistent); and
- the financing documents should reflect the terms of the financial model agreed at Financial Close. To the extent that there are discrepancies between the two, the Authority should make itself comfortable that the discrepancy is justified.

33.2 FINANCING DOCUMENTS

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

- **Interest rate ratchets** – it is common for the interest rate margin to reduce after the Service Commencement Date. The Authority should ensure that any reduction in margin reflects that set out in the financial model.
- **Maintenance and other reserving mechanisms** – the Authority should review the Senior Lenders' requirements in respect of the funding of the maintenance and other reserve accounts and be comfortable with the levels required. Moreover, the Authority

¹ But see Clauses 16.4 (Changes to Project Documents and Financing Agreements).

² See Section 21.1.3.7 (Compensation on Termination for Authority Default).

should confirm that upon early release of reserving requirements, such release would be caught by the refinancing sharing mechanism.³

- **Letters of Credit** – financing documents frequently allow the Contractor to withdraw the proceeds of reserve accounts and replace them with letters of credit (in a form agreed at financial close). Whilst the Authority should not object to such mechanisms in principle, it is important to ensure that the benefit of any such letters of credit are taken into account in the calculation of compensation on termination and that:
 - (a) the amount capable of being claimed under the relevant letter of credit is set-off from the amount paid by the Authority to the Contractor. Without such protection, the Contractor will effectively be paid twice; and
 - (b) the letter of credit does not automatically terminate on termination of the Contract. The effect of automatic termination of the letter of credit will be that the Authority pays a higher compensation amount.

Accordingly, the Authority should require a pre-agreed form of letter of credit to be included in the financing documents if the Senior Financing Agreements contain a mechanism for replacing reserve accounts with letters of credit. Releases of letters of credit should be treated in the same way as releases of funds from reserve accounts under the Refinancing provisions.

- **Breakage Costs** – the Authority must understand how any breakage costs are calculated under the financing documents. Breakage costs under interest rate hedging agreements (typically documented under the ISDA standard form agreement) should be calculated using the “Second Method and Market Quotation” formula which ensures that the breakage cost payable by the Authority is the “net” amount payable by the Contractor to the bank(s) after taking into account amounts owed by the bank(s) to the Contractor (“Second Method”) and competitive (“Market Quotation”). Excessive break costs on termination of hedging arrangements should be avoided (see further Section 1 footnote 8)⁴. In addition, Authorities should understand and approve the amortisation profiles of the Contractor’s finance arrangements, since this will determine the level of potential termination payments applicable across the life of the Contract.

33.3 SUB-CONTRACTS

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

- **Term of Contract** – without prejudice to any market testing mechanism set out in the Contract, if the term of the relevant Sub-Contract does not reflect the period that the Service is required to be provided for under the Contract, the Authority should consider the level of protection it has in the Contract relating to controlling the identity of any Sub-Contractors⁵

³ See Section 34 (Refinancing).

⁴ See also HMT Guidance “*Interest rate and Inflation risks in PFI Transactions*” of April 2006, at www.hm-treasury.gov.uk.

⁵ See Section 16.1 (Control over Sub-Contractors).

- **Liquidated Damages** – if the Contract requires the Contractor to pay liquidated damages to the Authority for late delivery of the Service, the Authority should ensure that the Contractor is sufficiently financially robust so as to meet such obligations, taking account of terms of Sub-Contracts and claims of the Senior Lenders. This is essential because if the terms of the Contract and the Sub-Contracts are materially different, the Authority could be exposed (i.e. if the Contractor is unable to claim from the Sub-Contractor then the Contractor may be unable to pay the Authority).
- **Collateral Warranties** – if the Authority has the benefit of collateral warranties from Sub-Contractors then it will need to ensure that it is comfortable with the terms of the relevant Sub-Contract. To the extent that the Authority is able to pursue the Sub-Contractor under the collateral warranty for failure to perform the Sub-Contract, the Authority will, by definition, only be able to pursue the Sub-Contractor for non-performance of the Sub-Contract, and not non-performance of the Contract by the Contractor. Accordingly, the Authority should consider the extent of any risks which are not passed to a Sub-Contractor by the Contractor and ensure that the Contractor is sufficiently financially robust so as to meet any liabilities that may occur if such risks occur.
- **Breakage Costs** – The Authority should review carefully any break costs payable on early termination of the Sub-Contract since it is potentially liable for these in various termination scenarios. If it is not satisfied with these, then its exposure to them under the Contract should be capped. See further Section 21.1.3.7, the definition of Sub-Contractor Breakage Costs at Clause 21.2.2 and the limit on termination payments at Clause 22.3.

34 REFINANCING

34.1 INTRODUCTION

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

- Refinancings carried out in accordance with this guidance can be of benefit to both the Contractor and the Authority; accordingly, proposals for refinancings made by the Contractor should be welcomed and considered positively by the Authority.
- A refinancing will normally constitute a material change to the financial and economic structure of a PFI project as originally agreed at Financial Close between the Authority and the Contractor. An Authority should therefore have the right to be fully informed of any refinancing, and approval rights over refinancings other than those which were part of the original Financial Close Base Case financing plan or do not lead to a gain for investors compared to the original Base Case.
- A long term contractual commitment by an Authority to purchase a service, at a pre-determined price, with contractual certainty for financiers through, for example, the operation of termination provisions, is likely to be central to the original financing of the Project and to any refinancing gain arising. The Contractor could not itself achieve such fine terms of finance, particularly as regards gearing and pricing, without such Contract terms. The Authority has a natural right to share in gains which are made possible by the strength of this contractual credit.
- An increase in returns to investors in the Contractor due to improved efficiency or performance, over and above what was anticipated when the Contract was let should be for the investors' account unless it falls within the scope of benchmarking, market testing, upside sharing or similar provisions of the Contract. However, improvements to loan margins, and beneficial changes to the term and leverage of any debt finance raised to fund the project are not viewed as mainly due to efficiency improvements and, consequently, any benefits that arise from such changes should be shared between the Authority and investors.
- As the PFI/PPP market matures and its stability is assured, finer terms have and should continue to become available. In the broadest sense, both the public sector and the private sector will contribute in bringing about this improvement. Through refinancings, projects are able to gain access to these finer terms as they become available and, given their joint contribution to this state of affairs, both the public sector (in this case the Authority) and the private sector (in this case investors in the Contractor) should share in the benefits arising. The Public Accounts Committee has highlighted the importance of the public sector sharing equitably in "windfall gains" associated with a PFI project. This has particular relevance to changes in available terms of finance which are often heavily influenced by factors external to the Project.
- A 50:50 sharing of refinancing gains between the Authority and the Contractor gives a reasonable balance between these factors.
- Refinancing gains should be measured by reference to the Project as it is performing at the time of refinancing, to enable the investors to benefit from improvements in efficiencies achieved by the Contractor to date and forecast to be achieved in the future; but if the Project is performing below the levels projected in the original Financial Close Base Case financial model, the investors are entitled to apply the benefits of refinancing to restore this Base Case projected performance prior to sharing with the Authority.

34.1.2 This Section takes account of the NAO report "The Refinancing of the Fazakerley PFI Prison Contract" published in June 2000, as well as subsequent recommendations of the House

of Commons Public Accounts Select Committee and HMT's Application Note dated 9 February 2005 entitled "*Value for Money in Refinancing*" on the HMT website.

34.2 WHAT IS A REFINANCING?

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

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

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

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

34.2.4 Refinancing is likely to be a matter for consideration by the Authority at different times during the life of a Project, notably when developing Contract terms in advance of the competition, when appraising bids submitted in response to the ITPD and during the Contract period itself. The complexity of refinancings means that it is important that Authorities seek appropriate advice when considering the subject and they should consult with their respective sponsoring Departments, Private Finance Units or HMT if there is any doubt about how the principles can best be applied in individual projects. It is also very likely that Authorities will need to seek the assistance of appropriate external advisers in respect of the financial and legal issues arising from refinancings both to ensure that this Guidance is properly reflected in project documentation and in any negotiations with the private sector on proposed refinancings.

34.3 AUTHORITY CONSENT

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

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

- increase the risk facing the Authority without conferring on it commensurate reward;
- reduce incentives for the Contractor to achieve sustained service standards, particularly in later years;

- undermine the financial stability of the Contractor, thereby endangering the provision of services.

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

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

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

34.3.6 Where a proposed refinancing involves an increase in termination liabilities, Contractors will need to secure the Authority's consent both to the refinancing itself and to the change in termination liabilities as these rights are separate and distinct.¹ In practice, many Authorities are likely to consider the Contractor's proposals on both a refinancing and any changes in termination liabilities concurrently. An Authority should not use its separate approval rights over increases in termination liabilities to agree a greater than 50% share of the refinancing gain. In consequence, an Authority will be unlikely to agree to a refinancing that increases its termination liabilities unless the additional refinancing gain available to be shared, relative to a refinancing which does not involve such increase in termination liabilities, is judged to represent better value. See generally HMT's application note dated 9 February 2005 entitled "*Value for Money in Refinancing*" on the HMT website.

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

34.4 EXEMPTIONS

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

34.4.1 Junior Capital

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

¹ See Section 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements).

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

34.4.2 Base Case Refinancings

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

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

34.4.3 Corporate Finance

34.4.3.1 Transactions originally undertaken on a strictly corporate finance basis should not be subject to the Refinancing provisions contained within this Section. The Authority (and its advisers) will need to conduct due diligence over the structure and nature of a bid being put forward on a “corporate finance” basis to satisfy itself that the funding solution being proposed is a corporate financing and not a structure designed to bypass the Refinancing provisions. Bids should be reviewed on a case by case basis against the criteria set out in Section 37.2.5.

34.4.3.2 This exemption from Refinancing Gain sharing applies only to the extent that such corporate finance arrangements are implemented at Financial Close (see Section 37 (Corporate Finance)).

34.4.4 Interest Rate Hedging

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

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

34.4.5 Taxation and Accounting Policies

34.4.5.1 Changes in taxation or in the Contractor’s accounting policies, such as depreciation are not considered to be Refinancings.⁴ However, Authorities and their advisers must take care to

³ In practical terms, a bid that includes a Unitary Charge that takes into account future refinancings may produce a higher Threshold Equity IRR than one that does not.

⁴ See Section 14.9 (Changes in Tax Law) for a discussion of how changes in taxation should be addressed in the Contract.

ensure that the tax and accounting assumptions within bids are not unduly conservative or likely to change, for example under codes of practice already announced by the professional accounting authorities, but not yet implemented or by reference to precedents already agreed with HMRC which may be applicable to the Contractor.

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

34.4.6 Qualifying Bank Transactions

34.4.6.1 In recognition of Senior Lenders' concerns, provision has been included within the definition of Exempt Refinancing for bank to bank transactions, and similar, which are undertaken by Senior Lenders in the normal course of their business. The common purpose of all these transactions is to permit such Senior Lenders to manage their assets (in this case a loan to the Contractor). Hence transfers, syndications and sub-participations of loans may qualify as bank transactions which are exempt from refinancing gain sharing. This may include securitisation of loans.

34.4.6.2 However any transaction involving Senior Debt (including securitisation) which has the intended effect of giving a direct or indirect economic gain to a party in its capacity as an equity holder (including any Shareholder, Subordinated Lender, guarantor, beneficial interest holder or equivalent) in the Contractor (or its Associated Companies) is clearly not a bank to bank or equivalent transaction. Accordingly it should not fall within the definition of Qualifying Bank Transaction, and thus not benefit from that exemption from the Refinancing Gain sharing provisions.

34.5 METHOD OF CALCULATING, SHARING AND PAYING BENEFITS

34.5.1 The Contract should include the provisions in Section 34.8 below which specify how the benefits of any refinancing will be determined and shared between the Authority and investors in the Contractor. These provisions do not set out the detailed basis and method of calculating the gains, as these will vary from project to project and so need to be agreed between the parties at the time of the refinancing.

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

34.5.1 Calculation

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

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

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

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

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

34.5.2 Discount Rate

34.5.2.1 The discount rate to be used in the calculation set out in Section 34.5.1 is the original base case equity internal rate of return (IRR),⁵ since:

- this is the Threshold Equity IRR used for sharing the Refinancing Gain (see Section 34.5.3);
- if the investors did not undertake the Refinancing, this is the rate they would be earning from capital invested in the project, so the benefit of refinancing should be evaluated against that benchmark; and
- it is the effect of the Refinancing on equity returns which is being measured.

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

- the Equity IRR expected by investors in the project at the time of refinancing;
- the Project IRR; or
- Senior Debt interest rate.

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

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

34.5.2.5 Similarly, using the debt interest rate as a discount rate is also inappropriate, because in many cases this would lead to an artificial reduction of the Refinancing Gain to zero.⁶

34.5.3 Sharing

34.5.3.1 The Refinancing Gain should be shared 50:50 between the Authority and the Contractor. However the sharing of the Refinancing Gain with the Authority should only apply if the projected performance of the Project, at the time of refinancing, is above that included in the original Financial Close Base Case financial model.

34.5.3.2 In consequence, the original Base Case investor rate of return (i.e. the Threshold Equity IRR) is of key significance to the Authority which, during the course of its due diligence, must satisfy itself of the reasonableness of this figure as the key threshold above which Refinancing Gain sharing applies. This may be a critical issue if competition has been weak, such that either the Base Case return is higher than can be justified or, conversely, the return is artificially

⁵ This should be the "blended" equity IRR – i.e. including both share capital and shareholder subordinated debt. If projects are calculated on a nominal basis then the IRR used should also be a nominal rate. The IRR used should be on the post-tax basis i.e. post tax of Contractor, but pre tax of Shareholders or Senior Lenders (see HMT's "Guidance Note in the Use of IRRs in PFI Contracts, at www.hm-treasury.gov.uk).

⁶ Because the NPV of a series of future debt interest and principal payments, discounted at the debt interest rate, and deducting the original debt amount, is zero.

depressed by the use of overly conservative assumptions (for example in relation to accounting policies, changes to which are exempt from gain sharing (see Section 35.4.5 above)).

34.5.4 Payment

34.5.4.1 The Authority's share should be taken as:

- (i) a cash sum at the time of Refinancing; and/or
- (ii) by a reduced Unitary Charge.

34.5.4.2 In determining the appropriate form of Refinancing Gain sharing, the Authority should consider the value for money implications of taking it in a lump sum or over time (see further Guidance Note "*Calculation of the Authority's share of a Refinancing Gain*").

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

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

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

34.6 AUDIT RIGHTS AND TRANSACTION COSTS

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

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

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

34.7 JOINT VENTURE PFI PROJECTS

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

34.8 MODEL REFINANCING PROVISIONS

34.8.1 Required drafting (including definitions) is as follows:

34 Refinancing

- 34.1 The Contractor shall obtain the Authority's prior written consent to any Qualifying Refinancing and both the Authority and the Contractor shall at all times act in good faith with respect to any Refinancing.⁷
- 34.2 The Authority shall be entitled to receive a 50 per cent share of any Refinancing Gain arising from a Qualifying Refinancing.
- 34.3 The Authority shall not withhold or delay its consent to a Qualifying Refinancing to obtain a greater than 50 per cent share of the Refinancing Gain.⁸
- 34.4 The Contractor shall promptly provide the Authority with full details of any proposed Qualifying Refinancing, including a copy of the proposed financial model relating to it (if any) and the basis for the assumptions used in the proposed financial model. The Authority shall (before, during and at any time after any Refinancing) have unrestricted rights of audit over any financial model and documentation (including any aspect of the calculation of the Refinancing Gain) used in connection with that Refinancing (whether that Refinancing is a Qualifying Refinancing or not).
- 34.5 The Authority shall have the right to elect to receive its share of any Refinancing Gain as:
- (a) a single payment in an amount less than or equal to any Distribution⁹ made on or about the date of the Refinancing;
 - (b) a reduction in the Unitary Charge over the remaining term of the Contract; or
 - (c) a combination of any of the above.
- 34.6 The Authority and the Contractor will negotiate in good faith to agree the basis and method of calculation of the Refinancing Gain and payment of the Authority's share of the Refinancing Gain (taking into account how the Authority has elected to receive its share of the Refinancing Gain under Clause 34.5 above). If the parties fail to agree the basis and method of calculation of the Refinancing Gain or the payment of the Authority's share, the dispute shall be determined in accordance with Clause 28 (Dispute Resolution).¹⁰
- 34.7 The Refinancing Gain shall be calculated after taking into account the reasonable and proper professional costs that each party directly incurs in relation to the Qualifying Refinancing and on the basis that all reasonable and proper professional costs incurred by the Authority will be paid to the Authority by the Contractor within 28 days of any Qualifying Refinancing.
- 34.8 Without prejudice to the other provisions of this Clause 34, the Contractor shall (a) notify the Authority of all Notifiable Financings on becoming aware of the same and again when they are entered into and provide full details of the same and (b) include a provision in the Financing Agreements whereby it is entitled to be informed of any

⁷ The Authority may terminate the Contract for a wilful breach of this clause. In such circumstances, the amount of compensation payable to the Contractor shall be the same as that paid to the Contractor if the Contract is terminated under Clause 21.5 (Termination on Corrupt Gifts or Fraud). See Section 21.6 (Termination for Breach of the Refinancing Provisions).

⁸ Please see Section 22.3 (Changes to Financing Agreements and Project Documents) in relation to requests made to the Authority for increases in its termination liabilities.

⁹ Any Distributions projected to be made after the Refinancing will be net of any payment to be made to the Authority on or about the date of the Refinancing. If a Distribution is made on or about the date of the Refinancing which would have been made if the Refinancing had not occurred, the amount of that Distribution will not be taken into account for the purposes of paragraph (a).

¹⁰ Any dispute should be determined under the dispute resolution process (see Section 28.3).

proposals which the Senior Lenders may have to refinance the Financing Agreements.

“Distribution”

means:

- (a) whether in cash or in kind, any:
 - (i) dividend or other distribution in respect of share capital;
 - (ii) reduction of capital, redemption or purchase of shares or any other reorganisation or variation to share capital;
 - (iii) payments under the Subordinated Financing Agreements (whether of principal, interest, breakage costs or otherwise);
 - (iv) payment, loan, contractual arrangement or transfer of assets or rights to the extent (in each case) it was put in place after Financial Close and was neither in the ordinary course of business nor on reasonable commercial terms; or
 - (v) the receipt of any other benefit which is not received in the ordinary course of business and on reasonable commercial terms; or
- (b) the early release of any Contingent Funding Liabilities, the amount of such release being deemed to be a gain for the purposes of any calculation of Refinancing Gain;

“EEA”

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

“Equity IRR”

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

“Exempt Refinancing”¹¹

means:

- (a) any Refinancing that was fully taken into account in the calculation of the Unitary Charge¹²;
- (b) a change in taxation or change in accounting treatment;
- (c) the exercise of rights, waivers, consents and similar actions which relate to day to day administrative and supervisory matters, and which are in respect of:
 - (i) breach of representations and warranties or undertakings;
 - (ii) movement of monies between the Project Accounts in accordance with the terms of the Senior Financing Agreements as at Financial Close;
 - (iii) late or non-provision of information, consents or licences;
 - (iv) amendments to Sub-Contracts;

¹¹ To the extent a Holdco is used, an equivalent exemption will need to be reflected in the drafting.

¹² See Section 34.4.2 above.

- (v) approval of revised technical and economic assumptions for financial model runs (to the extent required for forecasts under the Financing Agreements);
 - (vi) restrictions imposed by the Senior Lenders on the dates at which the Senior Debt can be advanced to the Contractor under the Senior Financing Agreements and/or amounts released from the [Escrow Account] during the [Initial Availability Period], each as defined in the Senior Financing Agreements¹³ and which are given as a result of any failure by the Contractor to ensure that the construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;
 - (vii) changes to milestones for drawdown and/or amounts released from the [Escrow Account] during the [Initial Availability Period] set out in the Senior Financing Agreements and which are given as a result of any failure by the Contractor to ensure that construction work is performed in accordance with the agreed construction programme and which are notified in writing by the Contractor or the Senior Lenders to the Authority prior to being given;
 - (viii) failure by the Contractor to obtain any consent by statutory bodies required by the Senior Financing Agreements; or
 - (ix) voting by the Senior Lenders and the voting arrangements between the Senior Lenders in respect of the levels of approval required by them under the Senior Financing Agreements;
- (d) any amendment, variation or supplement of any agreement approved by the Authority as part of any Qualifying Variation under this Agreement;
 - (e) any sale of shares in the Contractor [or Holdco] by the shareholders or securitisation of the existing rights and/or interests attaching to shares in the Contractor [or Holdco] provided that this paragraph (e) shall, in respect of shares in Holdco, only apply for so long as Holdco holds 100% of the issued share capital of the Contractor];¹⁴
 - (f) any sale or transfer of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements or securitisation of the Subordinated Lenders' existing rights and/or interests under the Subordinated Financing Agreements; or¹⁵
 - (g) any Qualifying Bank Transaction;

“Financial Close”

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

“Insurance Undertaking”

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

“Net Present Value”

¹³ These definitions should follow those contained in the Senior Financing Agreements – the Initial Availability Period being the construction phase drawdown period. These will need to be checked.

¹⁴ This Clause therefore means that any grant of new rights over the Contractor's assets, cashflows or contracts in conjunction with this transfer would not be exempt.

¹⁵ See footnote 14.

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

“Notifiable Financings”

means any Refinancing described in paragraph (a) or (c) of the definition of Refinancing and any other arrangement which has or would have a similar effect or which has or would have the effect of limiting the Contractor’s or any Associated Company’s ability to carry out any such arrangement;

“Pre-Refinancing Equity IRR”

means the nominal post-tax (i.e. post-tax with respect to the Contractor, pre-tax with respect to Shareholders) Equity IRR calculated immediately prior to the Refinancing;

“Project Accounts”

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

“Qualifying Bank Transaction”¹⁶

means:

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

“Qualifying Institution”

means:

[];¹⁷

¹⁶ A broad purposive approach shall be taken to the interpretation of this Clause 34. Any attempt by banks to attempt to conceal refinancings behind elaborate avoidance structures will be regarded as a serious breach of these provisions and dealt with accordingly.

¹⁷ If there are particular institutions which for particular reasons do not come within the other heads of Qualifying Bank Transaction, bidders may propose to the Authority that such institutions be included as Qualifying Institutions. In the light of the broad drafting of the other

“Qualifying Refinancing”

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

“Refinancing”

means:

- (a) any amendment, variation, novation, supplement or replacement of any Financing Agreement (other than any Subordinated Financing Agreement);
- (b) the exercise of any right, or the grant of any waiver or consent, under any Financing Agreement (other than any Subordinated Financing Agreement);
- (c) the disposition of any rights or interests in, or the creation of any rights of participation in respect of, the Financing Agreements (other than the Subordinated Financing Agreements) or the creation or granting of any other form of benefit or interest in either the Financing Agreements (other than the Subordinated Financing Agreements) or the contracts, revenues or assets of the Contractor whether by way of security or otherwise; or
- (d) any other arrangement put in place by the Contractor or another person which has an effect which is similar to any of (a)-(c) above or which has the effect of limiting the Contractor's or any Associated Company's ability to carry out any of (a)-(c) above;

“Refinancing Gain”

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

- A = the Net Present Value of the Distributions projected immediately prior to the Refinancing (taking into account the effect of the Refinancing and using the Base Case as updated (including as to the performance of the Project) so as to be current immediately prior to the Refinancing) to be made to each Relevant Person over the remaining term of the Contract following the Refinancing;
- B = the Net Present Value of the Distributions projected immediately prior to the Refinancing (but without taking into account the effect of the Refinancing and using the Base Case as updated (including as to the performance of the Project) so as to be current immediately prior to the Refinancing) to be made to each Relevant Person over the remaining term of the Contract following the Refinancing; and
- C = any adjustment required to raise the Pre-Refinancing Equity IRR to the Threshold Equity IRR;

provisions in the definition of Qualifying Bank Transaction, any such proposal must be specific and limited. Broad group definitions will not be entertained. For a listed bond transaction, however, the following may be inserted:

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

“Regulated Collective Investment Scheme”

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

“Relevant Person”

means a Shareholder and any of its Affiliates;

“Shareholder”

means any person from time to time holding share capital in the Contractor or [Holdco¹⁸];

“Threshold Equity IRR”

means [•]%;¹⁹

¹⁸ This definition should include any intermediate special purpose company between the Contractor and the investors in the Project. If the Contractor is a partnership or other legal entity, the definition should be revised so as to include all equity investors such as the General Partner and Limited Partner in the case of a Limited Liability Partnership.

¹⁹ This is the nominal post-tax (i.e. post tax with respect to the Contractor, pre-tax with respect to the shareholders in the Contractor). Equity IRR set out in the Base Case, which excludes the effects of any anticipated refinancing.

35 FINANCIAL ROBUSTNESS: CONTRACTOR DISTRESS

35.1 STRUCTURAL PROTECTION FROM THE CONSEQUENCES OF CONTRACTOR DISTRESS

35.1.1 PFI Contracts are structured so that the private sector is responsible for the delivery of services on time, on budget and according to specification. Such structuring helps to insulate Authorities from the consequences of a Contractor's financial difficulties. The key elements of such structuring are:

- **Fixed Price Contracts** - the Unitary Charge is fixed at Financial Close and thereafter changes only for agreed indexation, value testing, Change of Law, Service Change or upon the occurrence of a Compensation Event. It does not increase for Contractor delay or failure or for Contractor under-estimation of the actual outturn cost of delivery of the Services.
- **Multiple Stakeholders** - both Shareholders and Senior Lenders are financially incentivised to manage and resolve difficulties, which may arise within projects, since their returns are dependent on the successful delivery of the Project (rather than the balance sheet of the Contractor).¹
- **Fixed Term Contracts** – the length of the Contract is fixed, so that the private sector investors have a finite period over which to make a return on their investment (in the case of the Shareholders) and to achieve repayment of debt (in the case of Senior Lenders). The private sector is therefore incentivised to ensure that Services commence on time and remain available for the required period. Given this risk allocation the private sector will take responsibility for managing financial difficulties of the Contractor or its Sub-Contractors to the extent they impact on delivery of the project.
- **No Service No Payment** – this principle means that no payment of Unitary Charge is made until the Works have been constructed in accordance with the Authority's requirements and are available for use. The principle of "no service no payment" allocates to the private sector the risk of late delivery or non-completion, or delivery of an asset outside the pre-agreed contractual specification, and thus helps insulate the Authority from problems in the construction period. During the operational period, if full Services are not provided, the Authority will not make full payments (or potentially any payment) and is therefore not at risk of providing financial support to the Contractor.
- **Senior Lenders' Due Diligence** - Senior Lenders (assuming the funding is provided on a project finance basis) will undertake substantial due diligence in order to ensure, amongst other things, the financial robustness of the project structure, that the Contractor's obligations have been contractually passed to the Sub-Contractors or otherwise suitably insured, and that the Sub-Contractors are able to meet their obligations under the Sub-Contracts. Characteristically this would involve testing the financial model against various distress scenarios.

35.1.2 The structure of PFI contracts will help ensure that the risk of delays and increases in costs are allocated to the private sector. There are however a number of structuring and

¹ This guidance assumes the Project is being financed on a project finance basis. If this is not the case, different principles may apply (see Section 37 (Corporate Finance)).

management measures that Authorities should implement to ensure that their PFI project operates effectively in circumstances of Contractor distress.

35.2 FINANCIAL AND STRUCTURING ROBUSTNESS

35.2.1 Any bid should be examined from the perspective of how resilient the proposed project structure is to the Contractor or the Sub-Contractor experiencing financial distress. Relevant issues to consider include:

- **Overall Project Structure** - Different project structures have an impact on financial robustness. For example, projects structured on a limited recourse basis (as for standard project finance) will necessitate careful structuring as the ability of the Contractor to absorb the cost of crystallised Project risks is limited.

In corporate-financed deals where the Contract is entered into with a corporate entity with a significant balance sheet, the long-term financial standing of the Contractor will be of relevance and as such credit enhancement in the form of guarantees, bonds or letters of credit will normally be required. Such credit enhancement may be required at Contract signature or post-Contract signature on the occurrence of certain events e.g. downgrading in the Contractor's credit standing (see also Financial Robustness of Equity Providers and Sub-Contractors below).

- **Financial Robustness of the SPV or Other Proposed Contractor Company** - An Authority should analyse bidder sources and terms of funding including whether contingent equity and/or standby facilities are in place, reserve account levels, gearing,² cover ratios (which are essentially measures of available cash within a project, whether on an annual basis or over the full length of the Contract) and liquidity.
- **Sub-Contractors and Sub-Contractor Interfaces** - As well as the pass down of obligations from the Contractor to its Sub-Contractors, Authorities should also seek to ensure that the allocation of risks as between the key Sub-Contracts (i.e. construction and FM contracts) is largely market standard (taking professional advice as appropriate). For example, an arrangement whereby the FM Sub-Contractor takes defects liability risk for construction work would be regarded as unusual. Non-market standard Sub-Contracts do cause additional difficulties, where the Contractor or the Sub-Contractor experiences financial difficulties, as any replacement Sub-Contractor would be likely to contract only on the basis of different contractual terms. Accordingly the Contractor itself may assume risks previously borne by the Sub-Contractor that is being replaced, with consequential destabilising effects on the Project.³
- **Strong Contractor Management** - the Contractor should manage its Sub-Contractors robustly to ensure delivery of the Contract. Authorities should consider whether the Contractor is appropriately staffed to perform such functions and whether it has management services provided to it or will be actively supported by its shareholders.
- **Financial Robustness of Equity Providers and Sub-Contractors** - Authorities should assess the robustness of equity providers (where they have ongoing funding obligations) and Sub-Contractors, considering issues such as that party's importance to the Project, ease of replacement, credit ratings, length of time and level of overall exposure to that party, and whether parent company guarantees or some other form of performance or financial support is being or should be proposed. Where credit enhancement is considered appropriate, Authorities will need to:
 - balance the cost of providing the enhancement against the risk of a substantial deterioration in the financial standing of the relevant party;

² For example a high gearing could mean that the Contractor has little ability to absorb the costs of the crystallisation of project risks unless the Contractor has access to other sources of funding.

³ The issue of non-standard risk allocation between key Sub-Contractors is of perhaps of particular relevance where the bidder is proposing an integrated approach to a project (i.e. where it will be contributing equity, constructing the asset and providing facilities management services to the Contractor).

- consider the form of the enhancement (e.g. on-demand bonds will be more costly although payment of the full amount of the claim is more certain when compared to other instruments);
 - consider the identity of the issuer of such credit enhancement, bearing in mind that the credit standing of a corporate may be susceptible to greater fluctuations than banks or other financial entities;
 - consider the timing for the issue of the credit enhancement – if credit enhancement is only required once the party is in difficulties, it may at that stage be unable to procure its issue; and
 - consider the application of the proceeds of any credit enhancement.
- **Appropriate pricing of Works and Services** - Authorities should ensure bidders have reasonable cost assumptions in their financial models (e.g. underestimating costs may lead the Contractor to compromise full service delivery or result in financial difficulty).
 - **Third Party Income** - Authorities should be cautious of over-optimistic assumptions of third party income in the financial model; if such income does not materialise this may destabilise the economic basis of the Project. Unrealistic third party income assumptions can also raise transferability issues. For example, where the economics of a project are dependent on levels of third party income guaranteed under a Sub-Contract, any replacement Sub-Contractor would need to be comfortable with generating the same levels of third party income or the risk will revert to the Contractor.
 - **Capital Contributions:-** Capital contributions by the Authority towards project costs should not ordinarily be included as part of the structure of a project, to ensure the normal PFI incentives are not distorted. Section 3.9 sets out further details concerning Authority capital contributions and the impact this has on projects.

35.2.2 A bid does of course need to be looked at in the context of a number of evaluation criteria other than financial robustness, for example quality and price. It is possible for one bid to be cheaper in terms of the Unitary Charge but also more prone to failure and consequentially worse value for money. Authorities must consider financial and structural robustness as part of their evaluation, and a project with a high risk of failure should be regarded as unacceptable.⁴

35.3 CONTRACTUAL PROTECTION

35.3.1 In addition to the structural protection as set out in Section 35.1 above afforded by PFI contracts, a number of key contractual provisions provide Authorities with protection in circumstances of Contractor distress. Such key Contract provisions are:

- **Change of Ownership provisions** - These provisions would usually provide, subject to certain exceptions, that the ownership of the Contractor (and Holdco, if relevant) is fixed throughout the Construction Period and the defects liability period (usually one year post-construction completion). By fixing the ownership of the Sub-Contractor, the Authority ensures that the bidding consortium which it selects to deliver the Project is maintained, and that key shareholders (one of whom may be the Construction Sub-Contractor) are incentivised to ensure that the Project is delivered in accordance with requirements of the Contract. Section 18 provides further details on Change of Ownership together with drafting for such provisions.

⁴ See further HMT "*Value for Money Assessment Guidance*" November 2006 from section 5.35 onwards, published on HMT website at www.hm-treasury.gov.uk.

- **Additional Permitted Borrowings** - the Additional Permitted Borrowing regime affords Senior Lenders the ability to provide limited additional funding to the Contractor where the Project is in difficulty (whether in the construction or operational period) without the consent of the Authority. Such additional loans do not affect the Unitary Charge but are taken into account as part of the Authority's liabilities if the Project is terminated for Authority Default, Voluntary Termination, Force Majeure or Corrupt Gifts or at an Authority Break Point Date.
- **Defaults and Termination** - On termination, the Contractor will commonly, broadly, be paid the market value of the Contract. There is no guarantee that this will be sufficient to pay out the Senior Lenders, therefore they are incentivised to also ensure that the project does not fail and that its market value is maintained. Authorities should ensure that the payment mechanism is calibrated so that the accumulation of points, deductions and default triggers appropriately incentivise performance.
- **Construction Period** - During the construction period, where, in projects without any early service provision, the payment mechanism may not be relevant, the Authority's contractual remedies are its termination rights under the Contract. They may arise following failure to start Works by a certain date, abandonment of the Contract or failure to meet the acceptance criteria applicable to the Works by the long-stop date, among other circumstances. Contracts do not generally include termination triggers relating to Sub-Contractors, since the Contractor assumes the risk of managing Sub-Contractor performance. However the Authority may insert provisions requiring the Contractor to replace a defaulting building Sub-Contractor (breach of which could lead to a Contractor Default).
- **Information Rights** - Section 26 (Information and Confidentiality) contains information rights for the Authority, including rights to receive:
 - the annual reports and accounts of the Contractor;
 - a notification requirement where a Financing Default has occurred under the Senior Financing Agreements and, following such default, a right to request the production of an Interim Project Report and meetings with the Contractor and the Senior Lenders to discuss such report; and
 - other information relating to the Project which it may reasonably request.

This information may provide early warning of Contractor distress to the Authority.

- **Step-in Rights** - Contracts allow Senior Lenders to step-in (giving them the opportunity to resolve difficulties in order to preserve the value of their investment) and replace the Contractor with a new Contractor. The Authority also has step-in rights which allow it, in certain circumstances, to substitute performance of the Contractor's obligations under the Contract or (subject to prior rights of the Senior Lenders) to take over management of key Sub-Contractors.⁵

35.4 RECOGNISING CONTRACTOR DISTRESS

35.4.1 A robustly-structured project will help to minimise the impact of Contractor distress on users and on the Authority's own finances. It is nevertheless important that Authorities recognise signs of Contractor distress as early as possible.

35.4.2 At a general level indicators of Contractor distress include:

⁵ See Section 29 (Authority Step-in) and Section 31 (Direct Agreement and Senior Lenders) for further details on Authority step-in rights.

- reports in the media concerning the deterioration of a company's financial health;
- annual accounts showing deteriorating finances;
- profit warnings issued by, or erratic share price movements relating to, corporate entities involved in the Project such as shareholders, Sub-Contractors or their related companies; and
- a downgrade in the crediting rating of a shareholder, Sub-Contractor or related company's credit rating.

35.4.3 At project level, indicators of Contractor distress include:

- **Delay in works** - Reduced or minimal site activity resulting in the programme of works being delayed (for example a failure to meet interim or final construction milestones).
- **Late payment/failure to pay** - Late payment or failure to pay sub-contractors of the Sub-Contractor whether during the construction or operation phase. There may of course be other reasons for non-payment, such as a genuine dispute regarding payment. In such circumstances the Authority should check whether there has been a history of late or non-payment. The Authority should seek to corroborate whether the issues arising within its project are arising on other projects being developed by the same Contractor.
- **Performance issues within the Contract** - Regular Service underperformance, particularly where the performance relates to matters that require a potentially large amount of capital expenditure such as obligations relating to lifecycle maintenance or rectification of snagging issues.
- **Increase in disputes** - Financial distress may cause the Contractor to take a more formal contractual approach to its relationship with the Authority; this may manifest itself in established working methods between the Contract and the Authority being changed so that, for example, additional payments are required for Services which were historically regarded as being within the agreed Services specification. Authorities may also see an increase in referrals to dispute resolution procedures or litigation.
- **Staff changes** - Unexpected staff changes (particularly senior management), especially where this is also occurring on other projects where the Contractor is involved. Further indicators of distress may include where staff are replaced by workers who are on short term contracts (such as consultants) or headcount of staff is reduced.
- **Breaches under Financing Agreements** - failure to pay amounts due under the Senior Financing Agreements or the financial agreements entered into by a shareholder or a Sub-Contractor. The extent and frequency of the non-payment will need to be considered so as to get a clearer indication of the degree of financial difficulties.
- **Restructuring proposals** - proposals to restructure/refinance the Project (although such proposals might be inspired by a range of financial or operational drivers). This is particularly apparent where the transaction is presented as a 'rescue refinancing', in which case the Authority may not have the same consent rights which it would have for a non-rescue refinancing – see Section 34 (Refinancing). More generally, whilst financial restructuring can be complex, the Authority should be aware of restructuring motivated by a lack of resources (evidenced for example by a request from the Contractor for additional resources or a relaxation of the payment mechanism).

35.4.5 Where review against the above, and any other indicators identified by an Authority, indicates that there is Contractor distress, the Authority should consider: how significant the distress, how it is being approached by the Contractor, and what further information the Authority might seek from the Contractor or elsewhere.

35.5 MANAGING CONTRACTOR DISTRESS

35.5.1 If a project is experiencing Contractor distress there are a number of practical measures that Authorities may adopt to help manage and resolve issues. Such measures include:

- **Advice** - It is important that Authorities promptly contact their departments' Private Finance Unit and HMT's Operational Taskforce, which has direct experience of dealing with issues arising from Contractor distress. Authorities should also obtain appropriately experienced technical, legal and/or financial advice at an early stage.
- **Information Flows** - It is important to establish clear lines of communication with Shareholders, the Contractor, the Senior Lenders and the users of the Service.
- **Records of Project Documentation** - Contract distress scenarios may involve dispute resolution and litigation. To assist in these procedures it is important at all times and in particular throughout a Contractor distress situation to keep up-to-date records of all contractual documentation, records of agreements amending the Contract and records of works undertaken.
- **Scenario Planning** - The Authority together with the Contractor, Shareholders and the Senior Lenders should set out clear plans for the resolution of difficulties arising from Contractor distress. Such plans should also cover scenarios where the Contractor or the relevant Sub-Contractor enters into a formal insolvency procedure.
- **Joined-up Approach** - A contractual counterparty that is experiencing Contractor distress may be involved in a number of PFI projects and in such instances it will be beneficial for the different Authorities to adopt a joined-up approach. A collective position on common issues will further strengthen the public sector negotiating position. Departmental Private Finance Units should be ready to help facilitate a joined-up public sector approach.

35.5.2 Furthermore, specific contractual issues may arise in circumstances of Contractor distress, including:

- **Consideration of Waivers** - The private sector may request the Authority to waive its rights under the Contract – for example where a termination right has arisen. Such a request may arise in the context of a standstill arrangement (which is an arrangement whereby parties, such as the Senior Lenders, who may exercise rights arising from an event of default occurring under the Financing Agreements, agree to a conditional suspension of those rights while a plan for resolving difficulties in the Project is implemented). An Authority should consider carefully whether the waiver of any of its rights would be appropriate, and whether this would have any legal effect on the Contract (obtaining legal advice where necessary). In circumstances where it does consider it appropriate, any waiver granted should be specific and time limited. The Authority should also consider whether it is appropriate to place other conditions on the grant of the waiver, which may relate to more general issues concerning the Project.
- **Termination Rights** - Where an Authority is considering exercising termination rights, it should consider the consequences of exercising such rights and the plans that will need to be implemented in order to ensure that works/services are continued. It should consider whether the Senior Lenders are preparing, pursuant to their rights under the Direct Agreement, to step-in following the termination notice. The Direct Agreement will also provide for a period of time during which the Senior Lenders may consider stepping-in. The Authority should ensure that the Senior Lenders have in place plans to protect the site during such period; the financial incentive will be on the Senior Lenders to do so. Senior Lenders will generally seek to avoid a termination notice being issued under the

Contract, because of the reduced recoveries that actual termination might bring as compared to rescuing the Project outside the formal termination process.

36 BOND FINANCE

36.1 INTRODUCTION

36.1.1 A bond is a negotiable debt instrument that pays the bondholder a rate of interest on the face value of the bond. The bond markets offer a source of long-dated debt and, accordingly, it is now commonplace for bidders on larger PFI projects to consider raising money in this market as an alternative to (or in addition to) the banking sector.

36.1.2 Bonds can be issued on various different terms. The principal amount of the bond can be repaid either in full on final maturity (a “bullet bond”) or, more commonly for PFI projects, in instalments according to an agreed amortisation schedule. Interest may be fixed rate (the interest rate is set on issuance and does not vary) or floating rate (the interest rate varies with a money market reference rate, such as LIBOR, and is reset at the beginning of each interest period). In addition, bonds (usually only fixed rate bonds) may be index-linked, so that payments of principal and interest escalate according to movements in a selected index, commonly the United Kingdom Retail Price Index (all items).

36.1.3 Bond issues may be public, meaning they are listed on a stock exchange (and therefore are more widely available). Alternatively, they may be distributed by way of a private placement. This will involve an offer to a very limited number of (occasionally sole) investors.¹ Private placements are often unlisted, and if so need not comply with listing authority’s disclosure rules, therefore requiring less disclosure than a public offering.

36.1.4 Almost all public PFI bond issues are rated by one or more rating agencies. This provides a transparent assessment of the underlying credit quality of the issuer, and when combined with the relative standardisation of bond terms and conditions it assists in the tradeability of bonds. The underlying credit rating of PFI projects is usually at the lower end of “investment grade”, in the range of BBB-/Baa3 to BBB+/Baa1.

36.1.5 In order to reduce the cost of raising debt, most PFI bonds to date have been “wrapped”: scheduled payments of principal and interest are guaranteed (in return for a fee) by a monoline insurer.² As a result of the guarantee (or “credit wrap”) the bonds are themselves rated according to the rating of the monoline, typically AAA/Aaa. This has tended to offer a more affordable financing solution to the Contractor even once the cost of the credit wrap is considered.

36.1.6 Bond transactions require specific documentation. The primary selling document is the Prospectus, which sets out all the information that the issuer of the bonds believes is material to any potential bondholders’ decision to invest. It contains the terms and conditions of the bond, together with a description of the issuer and the project. If the bond issue is listed, the Prospectus must comply with the relevant listing authority’s rules. There will also be a bond trust deed, setting out the rights of the bondholders, and a subscription agreement, obliging the bond managers to subscribe for the bonds at the issue price.

36.1.7 In addition, as bond proceeds are usually received in a lump sum at Financial Close, but the expenditure profile may vary, the proceeds are often deposited with a highly rated bank until required, through a fixed-rate deposit known as a “Guaranteed Investment Contract”.³

¹ It is of course important to ensure that a transparent, competitive process is adopted to price the bonds.

² A monoline insurer is a specialist insurer whose only line of business is financial guarantees.

³ As regards hedging more generally, see HMT Guidance “*Interest rate and inflation risks on PFI transactions*” of April 2006. HMT website at www.hm-treasury.gov.uk.

36.2 PRINCIPAL CHANGES TO THE CONTRACT FOR BOND FINANCE

36.2.1 This Section provides an explanation of the principal changes to the Contract required where bond finance is used. Where permissible amendments to provisions are outlined, no derogation approval is needed if these are made.

36.2.2 A definition for Bonds should be included.

“Bonds”

means the [] bonds due [] of the Issuer, issued at Financial Close, in the aggregate principal amount of [];

Issuer

36.2.3 It is common for bonds to be issued by a special purpose public limited company (the “Issuer”), separate from the Contractor. Commonly, both the Issuer and the Contractor have the same 100% holding company, Holdco. It may be simpler in these cases to include a definition of “Obligors”, to include the Contractor, the Issuer and Holdco, and to use this definition as appropriate. If the Issuer is a separate entity to the Contractor, this requires various changes to Contract drafting, as set out below.

36.2.4 A definition for Issuer should be included.

36.2.5 The Issuer must also, as a required drafting matter, be referenced alongside the Contractor in all appropriate provisions of the Contract, including:

- the definition of Associated Company (Section 1.7.1);
- the definition of Financing Agreements (Section 1.7.1);
- the definition of Permitted Borrowing (Section 1.7.1);
- the definition of Senior Lender (Section 1.7.1);
- the definition of Shareholders (Section 1.7.1);
- in all definitions relating to the calculation of the compensation sums, where the cash balances and assets of the Contractor are taken into account (including in the definition of “Adjusted Estimated Fair Value of the Contract” (paragraphs (i) and (ii)), in the definition of “Adjusted Highest Compliant Tender Price” (paragraphs (i) and (ii)), and in the definitions of “Base Senior Debt Termination Amount” and “Revised Senior Debt Termination Amount” (see below)) (Section 1.7.1);
- the change of ownership provisions (Section 17);
- the insolvency defaults (Section 20.2.2.1(c) to (f));
- the information and confidentiality provisions (Section 26);
- paragraphs (c) and (d) of the definition of Refinancing (Section 34.7); and
- the definition of Relevant Person (Section 34.8.1).

Financing Agreements

36.2.6 As noted above, the definition of “Financing Agreements” should be amended to include reference to the Issuer and its Associated Companies alongside existing references to the Contractor.

36.2.7 The definition of Senior Financing Agreements must include the relevant bond documentation, alongside any other finance agreements. These may include the Bonds, the bond trust deed, the subscription agreement and any guaranteed investment contract, alongside the security documents, the collateral deed, intercreditor agreements, and any hedging documents. Where the bonds are “wrapped”, the financial guarantee(s) and related guarantee and indemnity agreement should also be included. Each such document should be defined in the Contract.

36.2.8 The Prospectus is not usually included as it is not a contractual document. In addition the on-loan documents, under which the bond and other finance proceeds are passed from the Issuer to the Contractor, should generally not be included. If they are, care must be taken to ensure that no payments in respect of them are included in any termination payment.

36.2.9 Careful due diligence should be done by the Authority’s financial and legal advisers to ensure that any fees or break costs are appropriate to be covered in the various (non-Contractor default) termination scenarios (and, if not, are carved out) and that there is no double counting between the various instruments (or coverage of costs other than those to the external finance market).

36.2.10 If preferred, the definition of “Senior Lender” could be extended specifically to include the relevant parties to the Senior Financing Agreements.

Agent

36.2.11 The standard definition of “Agent” may be substituted by a definition of Credit Provider or Bond Trustee or similar, being the finance party that controls the rights of the Senior Lenders. It may be in some circumstances that more than one entity will wish to have the rights normally afforded to the Agent. For example, both the Credit Provider and the Security Trustee would normally receive all notifications usually provided to an Agent.

Permitted Borrowing

36.2.12 Bonds that are issued and sold at Financial Close should be deemed Permitted Borrowing. Variation bonds (to finance future variations to the Contract) may form part of the bond arrangements. If these are effectively committed facilities (and sold at Financial Close, thus raising actual funding) then they would be treated as any other part of the Senior Debt and should fall within the Permitted Borrowing definition. Often however variation bonds are not “committed”, and are not sold at Financial Close. Instead they are issued under the main bond documentation, and thus can be sold without a new Prospectus or trust deed being required, but are held by the Issuer and therefore do not accrue interest until additional funds are needed and they are sold to the market. Listing authorities impose limitations on the amount of variation bonds that can be dealt with in this way. These uncommitted variation bonds should not be treated as Permitted Borrowings. If they are subsequently sold as part of an agreed variation, they can at such time be re-categorised as Permitted Borrowing.

36.2.13 If rescue bonds are proposed from the outset, a similar analysis would apply (but these could qualify as Additional Permitted Borrowing).

36.2.14 The definition of Original Senior Commitment (from which Additional Permitted Borrowing Limit is calculated) should only include amounts in respect of bonds which have been issued and sold.

“Original Senior Commitment”

means the [amount of principal issued and outstanding in respect of the Bonds]/[gross proceeds of the issue of the Bonds] as at Financial Close, [other than the [principal

issued and outstanding in respect of the Variation Bonds]/[proceeds of the issue of the Variation Bonds]];⁴

36.2.15 The amount referred to in limb (b)(ii) of the definition of Additional Permitted Borrowing Limit should not be indexed, even where the bonds are index-linked, and this definition should be amended as necessary.

36.2.16 These changes assume that any bonds will be issued at par (not at a discount or a premium). If an issue is not at par, financial advice should be taken as to further changes that might be needed.

Termination payments and the Spens Clause

36.2.17 Terms and conditions in the long-term sterling market for most borrowers (corporate as well as project-related) typically contain break-cost provisions, applicable in the event of early repayment or acceleration of the bonds (known as the “Spens” or “Make-whole” formula). In the long-term sterling market, the Spens formula has historically operated such that on an early redemption of the bonds, the bondholders are broadly paid an amount equal to the higher of the outstanding principal on the bond and the foregone coupon (interest and principal) on the bonds, discounted at a rate equal to the gross redemption yield on a Treasury Gilt of comparable weighted average life to the bond. This level of compensation is set to allow the bondholder to attain the same return by reinvesting in risk free gilts.

36.2.18 In the PFI context HMT’s April 2006 “*Guidance on the Application of Spens clauses in PFI transactions*” must be followed, according to which the Authority may pay the full amount due under a Spens formula as above on an Authority Default, a modified Spens formula on an Authority Voluntary Termination (including termination on an Authority Break Point Date), and no Spens formula payment on any other termination. These are required drafting provisions for bond-financed projects. Drafting is set out below:

“Make-Whole Payment”

means:

(a) in relation to termination of the Contract under Clause [] (Termination on Authority Default), the Make-Whole payment to be made pursuant to and in accordance with Condition [] of the Bonds;

(b) in relation to termination of the Contract under Clause [] (Voluntary Termination by the Authority) [or Clause [] (Termination on an Authority Break Point Date)], the modified Make-Whole payment to be made pursuant to and in accordance with Condition [] of the Bonds; and

(c) in relation to termination of the Contract in any other circumstances, zero.

36.2.19 The Authority’s financial and legal advisers must do a due diligence review of the bond arrangements and, in particular, their Spens provisions and the discount rate used⁵. The contingent liabilities inherent in the Spens clause should be taken into account in the Authority’s overall assessment of value for money.

36.2.20 Where a monoline guarantee is in place, Authorities should note that the full guarantee fee will usually be due to the monoline in the event of early termination of the project for whatever reason. If the Contractor has already paid the full fee to the monoline, it will not be repayable. Further, if the full fee was to be paid in instalments over the life of the bonds, on early termination the compensation payable by the Authority may include any fee unpaid to the monoline insurer.

⁴ Proceeds of uncommitted variation bonds should be excluded. Where committed variation bonds are issued, the face value of these bonds should be included in this definition.

⁵ HMT’s April 2006 “*Guidance on the Application of Spens clauses in PFI transactions*” and May 2006 “*Interest-rate and inflation risks in PFI Contracts*” should be followed. For both see HMT web site at www.hm-treasury.gov.uk.

This is an important difference of practice between bond and bank markets, as bank borrowers are generally not expected to pay future risk margins foregone to banks whose loans are repaid early.

36.2.21 The definitions of “Base Senior Debt Termination Amount” and “Revised Senior Debt Termination Amount” should be revised specifically to refer to the Make-Whole Payment. Suggested changes are outlined below, with additions underlined.

"Base Senior Debt Termination Amount"

means, subject to Clause 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements):

- (a) all amounts outstanding at the Termination Date, including interest and Default Interest accrued⁶ as at that date, from the [Contractor and/or the Issuer⁷ to the Senior Lenders in respect of Permitted Borrowing⁸ (other than in respect of Additional Permitted Borrowing) and
- (b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs⁹ (including for the avoidance of doubt any Make-Whole Payment), payable by the [Contractor and/or the Issuer to the Senior Lenders¹⁰ as a result of a prepayment in respect of Permitted Borrowing (other than in respect of Additional Permitted Borrowing), or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract, subject to the [Contractor, the Issuer and the Senior Lenders mitigating all such costs to the extent reasonably possible [(unless the amount, or the formula for determining the amount, of such costs is fixed in advance under the terms of the relevant Senior Financing Agreements)],¹¹

less, to the extent it is a positive amount, the aggregate of (without double counting in relation to the calculation of the Base Senior Debt Termination Amount or the amounts below):

- (i) all credit balances on any bank accounts (but excluding the Joint Insurance Account) held by or on behalf of the Contractor and/or the Issuer [and/or Holdco]¹² on the Termination Date;
- (ii) any amounts claimable on or after the Termination Date in respect of Contingent Funding Liabilities;
- (iii) all amounts, including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the Senior Lenders

⁶ Consideration may be given as to whether some specific reference to an indexation amount/ bond condition is appropriate here for an indexed bond.

⁷ Inclusion of the Contractor will depend on whether the Contractor is a party to any Senior Financing Agreements but see Section 36.2.8.

⁸ This assumes a check has been made by the Authority's advisers that the provisions of the Senior Financing Agreements do not include unusual provisions that could artificially inflate amounts advances beyond those provisions that are market standard. See Section 33 (Due Diligence over Sub-Contracts and Financing Agreements).

⁹ This is intended to cover net breakage costs if the compensation is not paid on an interest payment date. Authorities may consider whether they should exclude any future profit element from the calculation of costs of early termination of interest hedging arrangements where the termination is for force majeure, breach of refinancing, corrupt gifts and uninsurability. See footnote 8 below.

¹⁰ This assumes the Senior Lenders are the only parties to any interest rate hedging agreements (this will not necessarily be the case) and are compliant with the agreed hedging policy.

¹¹ Authorities should consider whether it would be appropriate in the context of the Project to include this language. Advisers should check any such terms in the Senior Finance Agreements carefully.

¹² If the Senior Lenders have security over bank accounts in Holdco (or any other company), then Holdco (or such other company) needs to be referenced here.

to the [Contractor and/or the] Issuer as a result of prepayment of amounts outstanding in respect of Permitted Borrowing (other than in respect of Additional Permitted Borrowing), or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract; and

- (iv) all other amounts received by the Senior Lenders on or after the Termination Date and before the date on which any compensation is payable by the Authority to the Contractor as a result of enforcing any other rights they may have;

“Revised Senior Debt Termination Amount”

means, subject to Clause 22.3 (Certainty of Compensation Payment Amounts and Changes to Financing Agreements)

- (a) all amounts outstanding at the Termination Date, including interest and (other than in respect of Additional Permitted Borrowing) Default Interest accrued¹³ as at that date, from the [Contractor and/or the] Issuer¹⁴ to the Senior Lenders in respect of Permitted Borrowing; and
- (b) all amounts including costs of early termination of interest rate hedging arrangements and other breakage costs (including for the avoidance of doubt any Make-Whole Payment), payable by the [Contractor and/or the] Issuer to the Senior Lenders as a result of a prepayment in respect of Permitted Borrowing, or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract, subject to the [Contractor, the] Issuer and the Senior Lenders mitigating all such costs to the extent reasonably possible [(unless the amount, or the formula for determining the amount, of such costs is fixed in advance under the terms of the relevant Senior Financing Agreements)]¹⁵,

less, to the extent it is a positive amount, the aggregate of (without double counting in relation to the calculation of the Revised Senior Debt Termination Amount or the amounts below) :

- (i) all credit balances on any bank accounts (but excluding the Joint Insurance Account) held by or on behalf of the Contractor and/or the Issuer [and/or Holdco]¹² on the Termination Date;
- (ii) any amounts claimable on or after the Termination Date in respect of Contingent Funding Liabilities;
- (iii) all amounts, including costs of early termination of interest rate hedging arrangements and other breakage costs, payable by the Senior Lenders to the [Contractor and/or the] Issuer as a result of prepayment of amounts outstanding in respect of Permitted Borrowing), or, in the case of early termination of interest rate hedging arrangements only, as a result of termination of this Contract;
- (iv) all other amounts received by the Senior Lenders on or after the Termination Date and before the date on which any compensation is payable by the Authority to the Contractor as a result of enforcing any other rights they may have; and
- (v) all APB Distributions;

¹³ Consideration may be given as to whether some specific reference to an indexation amount/or related bond condition is appropriate here for an indexed bond.

¹⁴ Inclusion of the Contractor will depend on whether the Contractor is a party to any Senior Financing Agreements, but see Section 36.2.8.

¹⁵ Authorities should consider whether it would be appropriate in the context of the project to include this language. Advisers should check any such term in the Senior Finance Agreements carefully.

Direct Agreement

36.2.22 In the Direct Agreement (see Section 31.5), Clause 10 (d) (iv) may be amended to reflect the different reporting arrangements for a bond financing, as follows:

10 (d)(iv) [The Contractor shall promptly notify the Authority] on each [Payment Date]¹⁶ on which any Additional Permitted Borrowing is, or may be, subsisting, the Amount outstanding under the Senior Financing Agreements and to the extent it is aware (having made reasonable and proper enquiry):

(a) on each [Payment Date] and the first Business Day of each calendar month following a Distribution, the amount of any Distribution made by the Contractor; and

(b) on each [Payment Date] and on the first Business Day of each calendar month following 5 Business Days written notice from the Authority, the amount of any credit balance on any account of the Contractor.

36.2.23 Authority legal advisers will need to check the relevant bond documentation to ensure that the obligations of the representative of the Senior Lenders (which may be a trustee) under the Direct Agreement (for instance, any covenants to act reasonably) flow through to the party or parties which will direct such representative (for example, a monoline insurer or the bondholders).

Refinancing

36.2.24 In the refinancing provisions, the definition of Qualifying Institution from footnote 19 of Section 34.8 (Model Refinancing Provisions) should be used, to reflect the transferable nature of bonds in the market. This allows for ordinary market dealings in the bonds to be classed as an Exempt Refinancing, outside the refinancing gain provisions.

¹⁶ To correspond with Bond payment dates.

37 CORPORATE FINANCE

37.1 INTRODUCTION

37.1.1 As discussed in Section 1.3 (Assumptions), the general assumptions behind this guidance are that a SPV contracts with the public sector, with Sub-Contractors providing the actual performance on its behalf, and makes use of a significant level of limited-recourse debt to finance the Project. This structure is known as ‘project finance’, meaning that the debt financing (provided by banks or the bond market) is raised on a project-specific basis, relies primarily on the PFI Contract and the various Sub-Contracts for security, and on the specific project cash flows for repayment.

37.1.2 However, “corporate finance”, where the funding is raised based on the credit strength of the Contractor’s or its parent company’s general (non project-specific) business and balance sheet, also plays a role in some PFI transactions.

37.1.3 The differences between project and corporate finance (discussed in Section 37.2 below) mean that some aspects of this guidance will not be fully applicable to corporate-financed transactions. A number of issues follow from this:

- procurement implications, where some or all bidders may choose to use corporate finance (see Section 37.3 below);
- evaluation of corporate-financed bids (see Section 37.4 below);
- required amendments to standard drafting, especially as to Unitary Charge adjustments, insurances, refinancing and termination provisions, where a bidder wishes to use corporate finance (see Section 37.5 below);
- situations where a Contractor proposes to change from corporate to project finance, or *vice-versa*, at some time after Financial Close (see Section 37.6 below); and
- ‘variant’ structures which fall between corporate and project finance (see Section 37.7 below).

37.2 PROJECT AND CORPORATE FINANCE

37.2.1 The majority of PFI projects involving an initial capital investment of more than £10 million have been based on a project-finance structure. This is due principally to the following factors:

- the amount of finance required to meet the investment needs of many PFI projects is beyond the balance-sheet capacity of many of the individual companies bidding for these projects. Typically therefore consortiums of financial and industry investors bid for PFI projects through SPVs (whose financing will normally be off the investors’ balance sheets);
- low average cost of capital with project finance, as a high proportion of the funding (typically 90% or more) is derived from debt rather than higher-cost equity;¹
- the project finance markets can provide long-term finance to match the long-term service delivery requirements of many Contracts, whereas few individual companies bidding for

¹ Notwithstanding that there is a theoretical position that gearing might not affect the overall cost of funding.

PFI projects can support such long-term finance; and

- PFI payment mechanisms are based on Unitary Charges which are payable over the full period of service delivery and are linked to standards of service performance. Such long-term predictable revenues are a common characteristic of project finance transactions and the project finance market is thus familiar with and able to fund such arrangements.

37.2.2 However transactions are also financed using the balance-sheet resources of the contractors, *i.e.* using corporate finance, which is not project-specific but relies on the overall financial strength of the contractor.

37.2.3 Corporate finance may be used by a bidder:

- where there is a single bidder instead of a bidding consortium;
- where the bidder has a strong balance sheet, and uses corporate finance for new projects as part of its normal business model;
- where it is cost-effective, such as for smaller transactions where the reduced transaction costs make it more cost-effective than project finance (which has relatively high fixed transaction costs); or
- where it gives greater flexibility for the investor or the Authority compared to project finance.

37.2.4 Although used in the past mainly for smaller (below £10 million) transactions, more recently corporate finance has also been used in some sectors for large transactions. It should be noted however that transactions below £20 million capital value should not be pursued through a PFI route.

37.2.5 Defining characteristics of corporate finance are:

- the entity with which the Authority signs the Contract is a prime contractor with credible financial standing or is supported by equivalent guarantees from a member of its group which impart financial strength to the entity;
- no references to third-party finance, or associated features such as interest-rate hedging (whether equity, debt or other forms of finance), appear within the Contract or other documents or letters entered into by the Authority;
- there is no third-party creditor due-diligence process;
- no assignments, acknowledgements or other documentation are given by the Authority in favour of or for the benefit of the Contractor's funders;
- there is no direct agreement between the Authority and the Contractor's funders; and
- there is no movement in the bid price once the bid has been submitted because of changes in market rates.

37.2.6 Where all the characteristics set out in Section 37.2.5 are present the funding can qualify as Corporate Finance, and the Contract amendments set out in Section 37.5, and the procurement changes set out in Section 37.4 should be applied. Where some but not all such characteristics are present, the Project has a "variant" structure (see Section 37.7) and amendments and procurement changes should be applied as appropriate to deal with corporate finance aspects of the funding. Authorities should seek advice in this regard.

37.2.7 Corporate finance, if chosen by bidders, may provide equally good performance incentives and value-for-money drivers as project finance, so long as the principles underlying this guidance are followed. The key principle is that private-sector capital must be at risk during

the long-term delivery of outputs specified by the public sector in the Contract. The form of private-sector capital is, in this sense, secondary so long as risks are transferred cost-effectively.

37.3 CORPORATE FINANCE – PROCUREMENT IMPLICATIONS

37.3.1 If some bidders propose to use project finance and some corporate finance, the latter will have to bid against a Contract that takes account of the changes set out in Section 37.5.

37.3.2 It may not be necessary for bidders using corporate finance to provide bank commitment letters (see Section 32 (Competitive Dialogue and Commitment Letters)), although comfort around availability of funding will still be required.

37.3.3 To the extent that no project-specific external debt is being provided, a formal funding competition is not relevant.²

37.3.4 The Authority should not automatically be assumed to be responsible for interest-rate movements between bid and Financial Close (see Section 37.4.3).

37.4 CORPORATE FINANCE – EVALUATION IMPLICATIONS

37.4.1 Project finance can bring a number of benefits for an Authority such as:

- systematic and rigorous techniques for credit analysis are central to project finance, and play an important role in achieving value-for-money risk transfer to the private sector;
- the SPV is bankruptcy-remote, and hence the project can survive the insolvency of the Shareholders. Often SPVs have a higher long-term credit rating than that of many individual construction or facilities-management contractors in the UK market; and
- the cash flows of the SPV can be predominantly based on actual contracts with suppliers and lenders. These figures are then used to model and calculate the Unitary Charge, and this process is subject to due diligence from the Senior Lenders and the Authority. This degree of challenge leads to improved transparency in PFI contract pricing, costs and returns, as central corporate overhead costs (which cannot easily be challenged) are not part-allocated to an individual PFI project.

37.4.2 It is therefore important for the Authority to ensure that the use of corporate finance:

- does not preclude sufficient analysis of the Project, i.e. given the absence of third-party lenders the Authority will have to pay special attention to the due-diligence process;
- does not reduce the financial robustness of the private-sector counterparty to the Contract (i.e. this is no worse than a project finance SPV), which means that the Contractor under the Contract must be highly creditworthy (perhaps demonstrated by a good credit rating) or be guaranteed by a creditworthy group company; and
- does not result in the Authority being inadequately informed about the costs, cash flows and returns of the transaction.

37.4.3 Evaluation of corporate-financed proposals should also take into account:

- the greater simplicity, speed and lower transaction costs of using corporate finance;

² HMT, *Preferred Bidder Debt Funding Competitions – Draft outline guidance for feedback* (August 2006).

- the fixed-price nature of bids, e.g. with no adjustment for interest-rate movements between bid and Financial Close;³
- the relative flexibility of the funding arrangements, especially as to major changes and Authority Voluntary Termination;
- the loss of share in any Refinancing Gains, if an exemption from sharing applies;
- the potential loss of transparency of Sub-Contracting arrangements. However, it should be noted that the Authority should always satisfy itself about the suitability of the proposed Sub-Contracting arrangements regardless of whether project or corporate finance is used;
- any project-specific provisions to protect the Authority's position, such as a requirement for the Contractor or its guarantor to maintain a certain credit rating, the use of escrow accounts to ensure Sub-Contractors are paid, or additional credit enhancement such as performance bonds or standby letters of credit;⁴
- the process by which poor performance can be remedied, by replacing Sub-Contractors or otherwise;
- the absence of lenders who may step in and rescue the project should it get into difficulty, so ensuring continued Service provision; and
- the absence of specific liability for the Authority to repay senior debt (or associated breakage costs) on termination (see 37.5.5).

37.5 AMENDMENTS TO STANDARD DRAFTING

37.5.1 Various sections of this guidance, and consequent standard drafting, require amendment to deal with a corporate finance structure:

- Unitary Charge adjustment (see Section 37.5.2):
- insurance (see Section 37.5.3):
- refinancing (see Section 37.5.4);
- early termination (see Section 37.5.5);
- Direct Agreement (see Section 37.5.7); and
- various definitions which are not required where corporate finance is used (see Section 37.5.7).

37.5.2 Unitary Charge Adjustment

37.5.2.1 Section 5.2.3 (Calculation of Compensation) sets out the basis for adjusting the Unitary Charge to take account of Compensation Events, Authority changes in Service, or Qualifying Changes in Law.

37.5.2.2 Where this would have involved returning the senior debt loan-life cover ratio and Equity IRR to their original values, this approach will not work for corporate finance as there is no identifiable senior debt.

³ See HMT, *Application Note: Interest-rate & Inflation Risks in PFI Contracts*, May 2006, especially section 2.3, for further discussion of movements in bid prices before financial close.

⁴ See Section 35 (Financial Robustness: Contractor Distress) and, for further background, Schedule 7.4 of the Office of Government Commerce's "ICT Services Agreement", version 2.0 issued in September 2006, which also includes provisions designed to improve the position of the Authority should the Contractor encounter financial distress.

37.5.2.3 The alternative methods set out in Section 5.2.3 (Calculation of Compensation), namely a lump-sum payment, or payment on an annuity basis, can be adopted. Otherwise, the calculation can be performed by returning the Project IRR to its original value.

37.5.3 Insurance

37.5.3.1 Corporate finance may result in insurances required under the Contract being covered by a corporate policy (i.e. a policy covering the activities of a company or group of companies, or covering a group of projects, but not specific to the Project), which may produce a cost saving which can be reflected in the Unitary Charge. However, the Contract will still need to have a Required Insurances Schedule as if the project were being insured on a project basis (see Section 25.2 (Authority's Requirements)).

37.5.3.2 Although it is important that the bidder is able to demonstrate transparency in terms and pricing, it is unlikely to be practical to apply the Insurance Premium Risk Sharing principles used within project-financed Contracts (see Section 25.8) to a corporate-financed Contract, as it is unlikely to be possible to determine the change in premium attributable to the relevant project.

37.5.3.3 If the Project is corporate-financed and it is proposed that the corporate insurance programme is used to provide insurance, the Authority may not be afforded certain protections available when insurance is placed on a project basis. If this is the case, it will be necessary for appropriate alternative arrangements to be agreed between the parties in order to ensure that the Authority is adequately protected. The most material issues are likely to be as follows:

- the concept of uninsurability (see Section 25.9) relates only to causes which affect the insurance market as a whole. Accordingly, where corporate insurance policies are used any uninsurability protection afforded should relate to the unavailability of insurance for the Project as a consequence of market-wide events;
- if the Project is project financed, should the Contractor fail to renew insurances it is possible for the Authority to make the payment and recover the cost from the Contractor. This is unlikely to be practicable where insurance is placed on a corporate basis. However, to the extent that the Authority has an insurable interest in the project, it could itself take out a new substitute project-specific insurance policy if the corporate insurance is not renewed. In such circumstances, the Authority must have the right under the Contract to recover the costs of the substitute insurance from the Contractor;
- corporate insurance programmes generally carry significantly higher insurance deductibles (see Section 25.11.5) than project-specific policies. The Authority will need to ensure that the deductibles are appropriately limited in the Required Insurance Schedule so it is not excessively exposed;
- the Authority will need to ensure that the maximum indemnity cover under a corporate insurance programme is adequate for the Project, particularly where cover limits are on an aggregated basis across all of the Contractor's activities;
- a number of the endorsements typically agreed with insurers to protect the Authority may no longer be available, including the Authority being named as a co-insured. However, the Authority should always be named as a co-insured under the material damage insurance, so it can claim directly should the Contractor elect not to do so. For other Required Insurances, if the Authority cannot be named, the Authority and its insurance adviser should consider other measures. In particular, the third-party liability policies must include (i) an appropriately-worded 'indemnity to principals' clause, and (ii) a waiver of subrogation for the benefit of the Authority;
- a notification of cancellation endorsement is unlikely to be available. Instead the Contract must require the Contractor to provide immediate notification to the Authority of any cancellation or material change in the terms and conditions of the policy. There should be a similar obligation on the Contractor's broker within the Broker's Letter of Undertaking;

- with the exception of the third-party liability policy (for which claims will be paid by insurers directly to the aggrieved party), corporate insurance policies are likely to name the Contractor as the sole loss payee. For material damage insurance, the insurance proceeds should be paid directly into the Joint Insurance Account (see Section 25.6). In this case, insurers must confirm their acceptance of the reinstatement provisions. If insurers are unwilling to pay other insurances into the Joint Insurance Account, the Contract should specify that they are paid into the Joint Insurance Account upon receipt by the Contractor, with such proceeds being held on trust for the benefit of the Authority prior to any such transfer; and
- the corporate insurance policies are unlikely to be available for scrutiny by the Authority. If specific policy information is required by the Authority which is not contained in the cover notes (for example, premium information), this will need to be made available by the Contractor and specific provisions for this incorporated in the drafting.

37.5.4.4 As there is no Senior Debt, the Economic Test drafting in Clause 25.6 (Economic Test) will not be required, and reference to this Economic Test in Clause 25.5 (Reinstatement) can be deleted.

37.5.4 Refinancing

37.5.4.1 As there is no project-specific debt arranged within a corporate-financed project, the standard drafting relating to Authority consent for Refinancings and sharing in Refinancing Gains, as set out in Section 34 (Refinancing), could, in principle, be deleted in its entirety. However, in practice very few projects meet the full requirements of a corporate finance classification (see 37.2.5). Considerable care must be exercised by Authorities, particularly having regard for the variants to corporate finance which may be proposed (see 37.7). If there is any doubt concerning whether the corporate finance classification applies to a project then generally the prudent approach will be to include the standard refinancing drafting, although amendments to such drafting may be necessary (any such amendments will be derogations from required drafting and will need to be approved by HMT).

37.5.5 Early Termination

37.5.5.1 The effect of corporate finance on each of the scenarios set out in Section 21 (Early Termination), where the Authority is required to pay compensation on termination, is considered below.

(a) *Compensation on Termination for Authority Default (Section 21.1.3) or Voluntary Termination (Section 21.5.3)*

37.5.5.2 The provisions of Section 21.1.3 need to be adapted for corporate finance in two respects:

- deletion of references to debt repayments (Section 37.5.5.3); and
- adjustment of the equity compensation provisions (37.5.5.4-37.5.5.5).

References to redundancy payments and Sub-Contractor Breakage Costs are not affected.

37.5.5.3 References to payment of senior debt, whether the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (i.e. including Additional Permitted Borrowings), should be deleted.

37.5.5.4 None of the options for payment of equity, namely: (i) Base Case Equity IRR to the Termination Date; (ii) market value of the Contractor's share capital; and (iii) present value of the Base Case equity return over the remainder of the Contract term (see Section 21.1.3.6), is directly applicable in the case of corporate finance, where the business of the Contractor may not

be limited to the project, and its results can be distorted by internal group transfers.

37.5.5.5 The appropriate approach is therefore to use the value of the Contract as a basis for compensation. This can be calculated in one of two ways:

- open market value of the Contract. This parallels option (ii) above as applied to project-financed cases; or
- the net present value (discounted at the pre-tax Base Case project IRR) of future Unitary Charges⁵ as shown in the Base Case less future operating costs (including the provision for corporate overhead costs) and future capital expenditures as shown in the Base Case. This parallels payment option (iii) above as applied to project-financed cases. The pre-tax IRR should be used here as there is no allowance for tax in the calculation, and a nominal rate should be used on the assumption that the Base Case shows nominal cash flows.

As with project finance, bidders should bid which of the two approaches they prefer.

37.5.5.6 Required drafting is as follows:

[21.1.3] Compensation on Termination for Authority Default

On termination of the Contract under Clause [21.1.2] (Termination on Authority Default) the Authority shall pay the Contractor the “Authority Default Termination Sum” in accordance with [Section 22 (Calculation and Payment of Early Termination Payment)] on the Termination Date. The Authority Default Termination Sum shall be an amount equal to the aggregate of:

- (i) redundancy payments for employees of the Contractor that have been or will be reasonably incurred by the Contractor as a direct result of termination of this Contract and any Sub-Contractor Breakage Costs; and

either

- (ii) [the amount for which the Contract could have been sold on an open market basis assuming [that there is no default by the Authority but otherwise that the actual state of affairs of the Contractor and the Project is taken into account]]

or

- (ii) [(A) all amounts of Unitary Charge shown in the Base Case as payable by the Authority⁶ from the Termination Date, each amount discounted back at the nominal pre-tax Project IRR from the date on which it is shown to be payable in the Base Case to the Termination Date *less*
- (B) the aggregate of all capital expenditure and operating costs shown in the Base Case to be incurred from the Termination Date discounted back at the nominal pre-tax Project IRR from the date on which such expenditure is shown to be incurred in the Base Case to the Termination Date.]

⁵ See also Section 7.4.7 regarding the implications of income sources other than the Unitary Charge for termination arrangements (and for other areas of the Contract).

⁶ Third party income as shown in the Base Case may also be referenced here.

“nominal pre-tax Project IRR”

means [●] %.

37.5.5.7 Where provisions set out in Clauses 21.5.4 (Termination on an Authority Break Point Date) and 21.5.5 (Compensation on Termination on an Authority Break Point Date) are included, the reference to Clause 21.1.3 (a) (iii) should be amended to Clause 21.1.3 (ii).

(b) Compensation on Termination for Contractor Default (Sections [21.2.5-21.2.9])

37.5.5.8 The provisions relating to Contractor default do not require substantial amendment, because these are already based on the value of the Contract.

37.5.5.9 However where the Contract is being retendered, as set out in Sections 21.2.7 (Retendering Election and Liquid Market) and 21.2.8 (Retendering Procedure), it may be disadvantageous for both the Authority and the Contractor for this to be done on the basis of a corporate-financed Contract if bidders wish to use project finance. This may discourage bidders from bidding and so produce a lower winning bid price, or leave the Authority with a less beneficial Contract than it might have been had a project-finance structure been used.

37.5.5.10 The following amendment may be made to the definition of “New Contract” set out in 20.2.8.9 to deal with this:

Insert new paragraph (d), as follows (and change) the current (d) to (e):

“(d) any amendments which parties interested in entering into a New Contract propose as required in order for the arrangements to deliver the New Contract to be financed on a project finance basis, any such amendments to be considered at the Authority’s discretion; and”

37.5.5.11 The standard definition of “Liquid Market” includes a reference to a vehicle controlled and established by the Senior Lenders specifically for the purposes of the project being excluded for the purposes of determining the existence of a “Liquid Market”. Such a reference is redundant for a corporately-financed projects and should be deleted.

(c) Compensation on Termination for Force Majeure (Section 21.3.2)

37.5.5.12 Again references to debt repayment are not required, and compensation is thus calculated as:

Capital expenditure and operating expenditure (in nominal cash terms), to the Termination Date,, to be no greater than the amounts for such expenditure shown in the Base Case

minus

total Unitary Charge paid to the Termination Date

plus

redundancy and Sub-Contractor breakage costs.

37.5.5.13 Required drafting is as follows:

21.3.2 Compensation on Termination for Force Majeure

(a) On termination of the Contract under Clause 21.3 (Termination on Force Majeure) the Authority shall pay to the Contractor the "Force Majeure Termination Sum" in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].

(b) The Force Majeure Termination Sum shall be the amount equal to:

- (i) the aggregate of capital expenditure and operating costs incurred as at the Termination Date, such expenditure in each case being no greater than the amounts shown for such expenditure in the Base Case *less*
- (ii) total Unitary Charges paid to the Termination Date; *plus*
- (iii) redundancy payments for employees of the Contractor that have been or will be reasonably incurred by the Contractor as a direct result of termination of the Contract and any Sub-Contractor Breakage Costs.

(c) If (i) less (ii) is less than zero then for the purposes of the calculation in paragraph (b) it shall be deemed to be zero.

(d) Such amount shall be determined and paid in accordance with [Section 22 (Calculation and Payment of Early Termination Payments)].

(d) Compensation on Termination for Corrupt Gifts and Fraud (Section 21.4.3)

37.5.5.14 No compensation is payable.

37.5.5.15 Required drafting is as follows:

21.4.4 Compensation on Termination for Corrupt Gifts and Fraud

On termination of the Contract in accordance with Clause 21.4.3 (Termination for Corrupt Gifts and Fraud), the Authority shall not be obliged to pay a Termination Sum to the Contractor.

(e) Termination for Breach of the Refinancing Provisions (Section 21.6)

37.5.5.16 If the Refinancing provisions do not apply, due to full satisfaction of the relevant corporate finance criteria (see Sections 37.2.5, 37.2.6 and 37.5.4), it follows that termination for breach of these provisions does not apply.

37.5.5.17 In such cases, Clauses 21.6.1 and 21.6.2 (Termination for Breach of the Refinancing Provisions) and 21.6.2 (Compensation on Termination for Breach of the Refinancing Provisions) can be deleted.

(f) Consequential changes

37.5.5.18 In addition to the changes to the calculation of compensation on termination discussed above, where corporate finance is used the required drafting contained in Section 22 (Calculation and Payment of Early Termination Payments) requires modification. Clause 22.3 (Changes to Financing Agreements and Project Documents) is not required where there are no Financing Agreements (but should be retained insofar as it applies to Project Documents), Clause 22.4 (Set-off on Termination) is not required as it serves only to protect Senior Lenders, and the drafting in Clause 22.5 (Method of Payment) will require an alternative source for an appropriate 'Senior Debt Rate' and references to Base Senior Debt Termination Amount, Revised Senior Debt Termination Amount, Outstanding Principal and Senior Credit Agreement should be

removed.

37.5.6 Direct Agreement

37.5.6.1 There will be no Direct Agreement (see Section 37.2.3) – therefore the provisions set out in Section 31 (Direct Agreement and Senior Lenders) are not relevant.

37.5.7 Definitions not required when Corporate Finance is used

37.5.7.1 There are a number of definitions not required when corporate finance is used, as follows. These, together with all references thereto, can be removed:

- Additional Permitted Borrowing;
- Additional Permitted Borrowings Limit;
- Agent;
- APB Distribution;
- Base Senior Debt Termination Amount;
- Default Interest;
- Direct Agreement;
- Financing Agreements;
- Initial Financing Agreements;
- Junior Debt;
- Original Senior Commitment;
- Permitted Borrowing;
- Revised Senior Debt Termination Amount;
- Senior Debt;
- Senior Financing Agreements;
- Senior Lender;
- Subordinated Financing Agreements; and
- Subordinated Lender.

37.5.7.2 The reference in the definition of Financial Close to Senior Financing Agreements should be deleted. It may be appropriate to refer to the date of the Contract.

37.6 CHANGES BETWEEN PROJECT AND CORPORATE FINANCE

37.6.1 Change from Project to Corporate Finance

37.6.1.1 A change from project to corporate finance may occur for a number of reasons, including: (i) the owner of the Contractor wishes to deploy its balance sheet in this way; (ii) a new investor acquiring the Contractor may prefer to use its own balance sheet to finance the project; or (iii) because several separate projects are being combined together for financing purposes to create a “synthetic corporate”. This change is not something that can be provided for in advance in the Contract in any greater detail than that of the standard Refinancing provisions, and would have to be considered based on the detailed proposals at the time.

37.6.1.2 Such a change when it does occur will constitute a Refinancing, for which Authority consent will be required. In evaluating whether to give its consent, the Authority should consider the issues set out in Section 37.4 above and, if consent is given, the Contract should be amended as set out in Section 37.5.

37.6.1.3 The Authority should also expect to receive a share of the Refinancing Gain which would result from the change to corporate finance. Calculation of this is likely to be more complex than that set out in Section 34.5 (Method of Calculating, Sharing and Paying Benefits), and the Authority should take appropriate financial advice before proceeding.

37.6.1.4 It should be noted that these principles apply both to an explicit change from project to corporate finance and to a 'synthetic' change where, for example, the original project finance loan is left in place, but the cash flows (and relevant security) from it are passed to new lenders at a corporate level for the benefit, whether direct or indirect, of equity in the project (see Section 34 (Refinancing)).

37.6.2 Change from Corporate to Project Finance

37.6.2.1 This is a scenario which may arise because the bidder is prepared to finance construction of the Project using its own balance sheet, but may then wish to have the option to switch to more cost-effective project finance once the Project is completed and operating successfully, perhaps also selling a share of the equity at that time in order to take the project off its balance sheet as well. If not envisaged as part of the documentation at Financial Close, the introduction of limited recourse (*i.e.* project-specific) funding is likely to require Authority consent, as the new lenders may require a direct agreement and changes to the Contract, such as in relation to termination. In any event, a change from corporate finance to project finance is *de facto* a refinancing albeit not one addressed specifically by the standard drafting of Section 34 (Refinancing) and so will be subject to negotiation as to Contract amendments and the sharing of the benefits between Authority and Contractor at the time. In order to help ensure that a project financing may not be effected without Authority consent, Authorities might consider including arrangements such as an absolute prohibition on charging the Contract or any of the Project Assets or project revenues.

37.6.2.2 If the Contractor builds-in a post-completion refinancing on a project finance basis (on reasonable market terms) as part of the Base Case (in accordance with 34.4.2 (Base Case Refinancings)), the financing package may offer the Authority good value for money (for example because the Contractor takes the Refinancing risk, while offering the full benefit of the Refinancing to the Authority rather than 50%). However, the Authority should compare such proposals with the alternative of using a standard project-finance structure from Financial Close.

37.6.2.3 If a specific project-finance Refinancing is not built into the Base Case, the Authority should not agree in advance to such a Refinancing.

37.6.2.4 If a Base Case project-finance Refinancing is agreed as part of the Contract structure, the original Contract should reflect the amendments to standard drafting set out in Section 37.5, and a 'Conversion Schedule' should be added to the Contract, reflecting the changes which will be needed when the switch to project finance takes place. This Conversion Schedule should:

- restore the standard Contract Clauses in lieu of the provisions set out in Section 37.5;
- require the Authority to sign a Direct Agreement as set out in Section 31 (Direct Agreement and Senior Lenders);
- require Authority consent to be obtained for any project finance refinancing which is on terms different to agreed minimum / maximum parameters, e.g. as to debt:equity ratio, lenders' cover ratios and reserve accounts, and credit margin;

- require that the maximum Compensation on Termination at any time shall not exceed amounts in a schedule agreed at Financial Close, i.e. based on the original Base Case (unless the Authority agrees otherwise at the time of the Refinancing);
- ensure that other than as set out in the Conversion Schedule, the Authority shall have no additional liabilities other than those set out in the original Contract; and
- provide the Authority with a 50% share of any net Refinancing Gain resulting from the terms of the project-finance Refinancing being better than the Base Case.

The normal refinancing provisions should apply to any subsequent refinancing.

37.7 VARIANT STRUCTURES

37.7.1 A variant structure is one which either: (i) has some of the features of project finance and some of corporate finance; or (ii) follows the standard approach to corporate finance (see 37.2.5) except on a few points which may be sector-specific. The question is not in which category – project or corporate – to place the structure as a matter of principle, but rather which treatments of the various evaluation and contractual issues are most appropriate to the structure in question, and consistent with the Authority obtaining the best value for money.

37.7.2 Variant structures will fail to meet one or all of the requirements of Section 37.2.5.

37.7.3 Some examples of issues which can arise with the use of such structures are given below. These are given by way of illustration of variant structures and do not necessarily reflect best practice, nor are they complete case studies on sector-specific issues.

- The Contractor may arrange leases, hire purchase agreements or similar for equipment forming part of the Project scope with the support of its balance sheet, in apparent compliance with corporate finance principles. However, the lessors or other finance counter-party may seek an acknowledgement of assignment from the Authority of payments its makes to the Contractor, or seek a security interest in the equipment, which breaches the corporate finance criteria (see Section 37.2.5).
- The Contractor may be a project-specific SPV, wholly owned by a company of substance, which has no capital resources of its own and relies on guarantees or on lending from its parent. In certain circumstances, the Authority may wish to have the right to require the parent to inject capital into the Contractor rather than rely solely on guarantees, under the terms of a direct agreement between Authority and parent.
- A loan arranged by the Contractor for a Project on a corporate-finance basis may be ring-fenced on its balance sheet, so that hedging instruments arranged for the loan will be project-specific despite their being supported by the Contractor's balance sheet.

37.7.4 Authorities should ensure that bidders using variant structures do not 'cherry-pick' between the benefits and drawbacks for Contractors and lenders of the provisions set out in this Section 37. Evaluation of variant structures should therefore always consider the issues set out in Section 37.4 (Corporate Finance – Evaluation Implications).

ANNEX Guidance Note

1 STANDARD REQUIRED INSURANCE SCHEDULE

Standard Required Insurance Schedule (Schedule [] Required Insurances)

This is Schedule [] comprising the Required Insurances referred to in the Contract for [] between:

[Authority/Trust]
-And-
[Contractor]

This Schedule [] comprises five Parts-

PART 1: Policies to be taken out by the Contractor and maintained during the [design and construction phase]

PART 2: Policies to be taken out by the Contractor and maintained during the Service Period

PART 3: Endorsements

PART 4: Broker's Letter of Undertaking

PART 5: Definitions

PART 1

Policies to be taken out by the Contractor and maintained during the [design and construction phase].

Common to each policy in Part 1 (unless stated otherwise):

Insureds:-

1. Authority/Trust.
2. Contractor.
3. Construction Sub-Contractor.
4. [Operating Sub-Contractor].
5. Construction sub-contractors of any tier.
6. Senior Lenders.
7. Subordinated Lenders.
8. Consultants - for their site activities only.

each for their respective rights and interests in the Project.

1. CONTRACTORS' 'ALL RISKS' INSURANCE (CAR)

1.1 Insured Property

The permanent and temporary works, materials [(including but not limited to equipment supplied by the Authority/Trust)]¹, goods, plant and equipment for incorporation in the works (other than constructional plant, tools, accommodation and equipment belonging to or the responsibility of the Construction Sub-Contractor or the Construction Sub-Contractor's sub-contractors) and all other property used or for use in connection with works associated with the Project.

1.2 Coverage

"All risks" of physical loss or damage to the Insured Property unless otherwise excluded.

1.3 Sum Insured

At all times an amount not less than the full reinstatement or replacement value of the Insured Property, but not less than the value specified in the building contract plus provision to include extensions as appropriate².

1.4 Maximum Deductible

£ []

1.5 Territorial Limits

¹ Include as appropriate as this is project specific.

² For certain projects where a total loss is inconceivable (e.g. road and rail) the sum insured could correspond to the Estimated Maximum Loss (ABI definition), rather than the full reinstatement value.

United Kingdom including offsite storage and during inland transit.

1.6 Period of Insurance

From the date of the Contract until the Service Commencement Date and thereafter in respect of defects liability until expiry of the [12] months defects liability period.

1.7 Cover Features & Extensions³

1. Terrorism.^{4 5}
2. Munitions of war clause.
3. Additional costs of completion clause.
4. Professional fees clause.
5. Debris removal clause.
6. 72 hour clause.
7. European Union local authorities clause.
8. Free issue materials clause.
9. [10]% escalation clause.
10. Automatic reinstatement of sum insured clause.
11. Loss minimisation.

1.8 Principal Exclusions

1. War and related perils (UK market agreed wording).
2. Nuclear/radioactive risks (UK market agreed wording).
3. Pressure waves caused by aircraft and other aerial devices traveling at sonic or supersonic speeds.
4. Wear, tear and gradual deterioration.
5. Consequential financial losses.
6. Cyber risks.
7. Inventory losses, fraud and employee dishonesty.

2 DELAY IN START UP INSURANCE (DSU)

2.1 Insureds

1. Contractor.
2. Senior Lenders.
3. Subordinated Lenders.

³ Additional Cover Features & Extensions may be appropriate for certain projects.

⁴ For certain projects where there is only a very remote likelihood of the risk materialising, and the probable impact of any such loss is perceived as being very low, e.g. street lighting projects, an Authority may elect not to include this extension as a Required Insurance.

⁵ For projects in England, Scotland and Wales the majority of this cover is *typically* provided by the Government-backed market mutual reinsurer: 'Pool RE'. Pool RE does not provide protection for projects in Northern Ireland. However under the provisions of the Criminal Damage (Compensation) Northern Ireland Order 1977, these projects will instead benefit from compensation provided by the Northern Ireland Office (see SoPCNI Section 24.3).(Note: This does not preclude use of commercial insurance should it become available).

4. Authority/Trust⁶.

each for their respective rights and interests in the Project.

2.2 Indemnity

In respect of:

1. loss of anticipated Revenue during at least the Minimum Indemnity Period arising from a delay in completion of the Project as a result of loss or damage covered under the Contractors' All Risks' Insurance effected in accordance with Item 1 of Part 1 of this Schedule, including physical loss or damage which would be indemnifiable but for the application of any deductible;

2. the economic additional expenditure necessarily and reasonably incurred for the purpose of avoiding or reducing the loss of Revenue of the Contractor which without such expenditure would have taken place, during the Minimum Indemnity Period.

2.3 Sum Insured

An amount sufficient to cover the sums the subject of the Indemnity for the Minimum Indemnity Period.⁷

2.4 Maximum Excess

[] days.

2.4 Minimum Indemnity Period

[12] months.

2.6 Period of Insurance

As per the Contractors' "All Risks" Insurance, excluding the defects liability period.

2.7 Cover Features & Extensions⁸

1. Denial of access.
2. Utilities.
3. Terrorism.^{9 10}
4. Automatic Reinstatement of sum insured.
5. Professional Fees.

2.8 Principal Exclusions

⁶ The Authority/Trust should be named as a co-insured party to the extent that it has a demonstrable insurable interest. This will be in connection with any additional cost of working insured against under the terms of the policy, and not with respect to any loss of anticipated Revenue.

⁷ For certain projects where a total interruption to the operation of the project is inconceivable (e.g. multiple sites), a sum insured which is lower than the theoretical maximum loss of Revenue may be appropriate.

⁸ For certain projects additional Cover Features & Extensions may be appropriate e.g. suppliers extension for the premises of specified suppliers.

⁹ For certain projects where there is only a very remote likelihood of the risk materialising, and the probable impact of any such loss is perceived as being very low, e.g. street lighting projects, an Authority may elect not to include this extension as a Required Insurance.

¹⁰ For projects in England, Scotland and Wales the majority of this cover is typically provided by the Government-backed market mutual reinsurer: 'Pool RE'. Pool RE does not provide protection for projects in Northern Ireland. However under the provisions of the Criminal Damage (Compensation) Northern Ireland Order 1977, these projects will instead benefit from compensation provided by the Northern Ireland Office (see SoPCNI Section 24.3). (Note: This does not preclude use of commercial insurance should it become available).

1. The exclusions under the Contractors' "All Risks" Insurance, other than for consequential financial losses.
2. Delayed response by a public body or state authority.

3. CONSTRUCTION THIRD PARTY LIABILITY INSURANCE¹¹

3.1 Interest

To indemnify the Insured in respect of all sums that they may become legally liable¹² to pay (including claimant's costs and expenses) as damages in respect of accidental:

- (a) death, or bodily injury, illness, death, disease contracted by any person;
- (b) loss or damage to property;
- (c) interference to property or any easement right of air, light, water or way or the enjoyment or use thereof by obstruction, trespass, nuisance, loss of amenities, or any like cause.

happening during the Period of Insurance and arising out of or in connection with the Project.

3.2 Limit of Indemnity

Not less than £[]m¹³ in respect of any one occurrence, the number of occurrences being unlimited, but in the aggregate in respect of pollution liability.

3.3 Maximum Deductible £[] for each and every occurrence of property damage. (Personal injury claims will be paid in full¹⁴).

3.4 Territorial Limits

UK [and elsewhere in the world in respect of non manual visits].

3.5 Jurisdiction

UK [and elsewhere in the world in respect of non manual visits].

3.6 Period of Insurance

As per the Contractors' "All Risks" Insurance, including the defects liability period.

3.7 Cover Features & Extensions¹⁵

1. *Munitions of war.*
2. *Cross liability clause.*
3. *Contingent motor.*

¹¹ If possible, insurance should be placed on a losses occurring basis.

¹² Cover should be for contractual liability, statutory liability and liability in tort.

¹³ Limit should be determined by the Authority, in conjunction with its insurance adviser, taking into account the relevant circumstances of the project.

¹⁴ For certain projects an excess may apply to personal injury claims.

¹⁵ For certain projects, additional Cover Features & Extensions may need to be noted e.g. terrorism, legionella (for schools and hospitals) and liabilities arising from maintenance of site helipad (for hospitals).

4. Legal defense costs.

3.8 Principal Exclusions

1. Liability for death, illness, disease or bodily injury sustained by employees of the insured.
2. Liability arising out of the use of mechanically propelled vehicles whilst required to be compulsorily insured by legislation in respect of such vehicles.
3. Liability in respect of predetermined penalties or liquidated damages imposed under any contract entered into by the Insured.
4. Liability in respect of loss or damage to property in the care, custody and control of the insured but this exclusion is not to apply to all property belonging to the Authority/Trust which is in the care, custody and control of another Insured.
5. Events more properly covered under a professional indemnity policy.
6. Liability arising from the ownership, possession or use of any aircraft or marine vessel.
7. Liability arising from seepage and pollution unless caused by a sudden, unintended and unexpected occurrence.
8. Losses indemnified under the CAR policy or DSU policy.

PART 2

Policies to be taken out by the Contractor and maintained during the Service Period.

Common to all policies in Part 2 (unless stated otherwise):

Insureds:-

1. Authority/Trust.
2. Contractor.
3. Operating Subcontractor.
4. Operating Sub-subcontractors.¹⁶
5. Senior Lenders.
6. Subordinated Lenders.

each for their respective rights and interests in the Project.

1. PROPERTY DAMAGE INSURANCE

1.1 Insured Property

The project assets which are the property of the Contractor or for which the Contractor may be responsible including but not limited to the new facilities.

1.2 Coverage

“All risks” of physical loss or damage to the Insured Property from any cause not excluded, including machinery breakdown and computer breakdown in respect of appropriate equipment¹⁷.

1.3 Sum Insured

At all times an amount not less than the total reinstatement or replacement value of the Insured Property¹⁸ plus provision to include other Principal Extensions as appropriate. (escalated periodically as appropriate)¹⁹

1.4 Maximum Deductible

£[] each and every claim. (escalated periodically as appropriate)

1.5 Territorial Limits

United Kingdom

1.6 Period of Insurance

¹⁶ To the extent that their activities are required to be insured under contract.

¹⁷ For projects with large and expensive equipment/machinery (e.g. large hospital projects) a separate engineering policy may be required.

¹⁸ For certain projects, where a total loss is inconceivable (e.g. road and rail) the sum insured could correspond to the Estimated Maximum Loss, rather than the full reinstatement value.

¹⁹ It will be important for the parties to agree an appropriate method of escalation.

From the Service Commencement Date or as otherwise specified in the Contract for the duration of the Contract and renewable on an annual basis unless agreed otherwise by the Parties.

1.7 Cover Features & Extensions²⁰

1. Terrorism^{21 22}
2. Automatic reinstatement of sum insured.
3. Capital additions clause.
4. 72 hour clause.
5. European Union local authorities clause.
6. Professional fees.
7. Debris removal.
8. Pollution and contamination to the Insured Property arising from an event which itself is not otherwise excluded.
9. Repair/reinstatement basis of claims settlement with cash option for non-reinstatement.

1.8 Principal Exclusions

1. War and related perils (UK market agreed wording).
2. Nuclear/radioactive risks (UK market agreed wording).
3. Pressure waves caused by aircraft and other aerial devices traveling at sonic or supersonic speeds.
4. Wear, tear and gradual deterioration.
5. Consequential financial losses.
6. Cyber risks.
7. Losses recovered under the CAR policy.

2. BUSINESS INTERRUPTION INSURANCE²³

2.1 Insureds

1. Contractor.
2. Senior Lenders.
3. Subordinated Lenders.
4. Authority/Trust.²⁴

²⁰ For certain hospital projects additional Cover Features & Extensions should be noted, including cover for clean up costs necessarily incurred by the Insured as a result of the outbreak of any infectious or contagious disease, including but not limited to MRSA and Legionella.

²¹ For certain projects where there is only a very remote likelihood of the risk materialising, and the probable impact of any such loss is perceived as being very low, e.g. street lighting projects, an Authority may elect not to include this extension as a Required Insurance.

²² For projects in England, Scotland and Wales the majority of this cover is typically provided by the Government-backed market mutual reinsurer: 'Pool RE'. Pool RE does not provide protection for projects in Northern Ireland. However under the provisions of the Criminal Damage (Compensation) Northern Ireland Order 1977, these projects will instead benefit from compensation provided by the Northern Ireland Office (see SoPCNI Section 24.3). (Note: This does not preclude use of commercial insurance should it become available).

²³ Not typically required for street-lighting projects.

²⁴ The Authority/Trust should be named as a co-insured party to the extent that it has a demonstrable insurable interest. This will be in connection with any additional cost of working insured against under the terms of the policy, and not with respect to any loss of

each for their respective rights and interests in the Project.

2.2 Indemnity

In respect of:

1. loss of anticipated Revenue during at least the Minimum Indemnity Period arising from an interruption or interference in the operation of the Project as a result of loss or damage covered under Property Damage Insurance effected in accordance with paragraph 1 of Part 2 of this Schedule including physical loss or damage which would be indemnifiable but for the application of any deductible;
2. the economic additional expenditure necessarily and reasonably incurred for the purpose of avoiding or reducing the loss of Revenue of the Contractor which without such expenditure would have taken place, during the Indemnity Period.

2.3 Sum Insured

An amount sufficient to cover the sums the subject of the Indemnity for the Minimum Indemnity Period.

2.4 Maximum Excess

[] days.

2.5 Minimum Indemnity Period

[12] months.

2.6 Period of Insurance

From the Service Commencement Date for the duration of the Contract and renewable on an annual basis unless agreed otherwise.

2.7 Cover Features & Extensions²⁵

1. Denial of access.
2. Terrorism.^{26 27}
3. Utilities.
4. Accountants Clause.
5. Automatic reinstatement of sum insured.

2.8 Principal Exclusions

1. financial losses.
2. Delayed response by a public body or state authority.

anticipated Revenue.

²⁵ For certain projects additional Cover Features & Extensions may be required: infectious disease, specified suppliers.

²⁶ For projects in England, Scotland and Wales the majority of this cover is typically provided by the Government-backed market mutual reinsurer: 'Pool RE'. Pool RE does not provide protection for projects in Northern Ireland. However under the provisions of the Criminal Damage (Compensation) Northern Ireland Order 1977, these projects will instead benefit from compensation provided by the Northern Ireland Office (see SoPCNI Section 24.3). (Note: This does not preclude use of commercial insurance should it become available).

²⁷ For certain projects where there is only a very remote likelihood of the risk materialising, and the probable impact of any such loss is perceived as being very low, e.g. street lighting projects, an Authority may elect not to include this extension as a Required Insurance.

3. THIRD PARTY PUBLIC AND PRODUCTS LIABILITY INSURANCE²⁸

3.1 Interest

To indemnify the Insured in respect of all sums that they may become legally liable²⁹ to pay (including claimant's costs and expenses) as damages in respect of accidental:

1. death, or bodily injury, illness, death, disease contracted by any person;
2. loss or damage to property;
3. interference to property or any easement right of air, light, water or way or the enjoyment or use thereof by obstruction, trespass, nuisance, loss of amenities, or any like cause.

happening during the period of insurance and arising out of or in connection with the Project and the provision of the Services.

3.2 Limit of Indemnity

Not less than £[]m³⁰ (*escalated periodically as appropriate*)³¹ in respect of any one occurrence, the number of occurrences being unlimited, but in the aggregate in respect of pollution and products liability.

3.3 Maximum Deductible

£[] for each and every occurrence of property damage (escalated periodically as appropriate). (Personal injury claims will be paid in full).³²

3.4 Territorial Limits

UK [and elsewhere in the world in respect of non manual visits].

3.5 Jurisdiction

UK [and elsewhere in the world in respect of non manual visits].

3.6 Period of Insurance

From Service Commencement Date or as otherwise specified in the Contract for the duration of the Contract and renewable on an annual basis unless agreed otherwise.

3.7 Cover Features & Extensions³³

1. Munitions of war.
2. Cross liability clause.
3. Contingent motor.

²⁸ Insurance should be maintained on a losses occurring basis.

²⁹ Cover should be for contractual liability, statutory liability and liability in tort.

³⁰ Limit should be determined by the Authority in conjunction with its insurance adviser, taking into account the relevant circumstances of the project.

³¹ It will be important for the parties to agree an appropriate method of escalation.

³² For certain projects an excess may apply to personal injury claims.

³³ For certain projects, additional Cover Features & Extensions may be required e.g. legionella (for schools and hospitals), liabilities arising from maintenance of site helipad (for hospitals) and terrorism.

4. legal defense costs.

3.8 Principal Exclusions

1. Liability for death, illness, disease or bodily injury sustained by employees of the insured.
2. Liability arising out of the use of mechanically propelled vehicles whilst required to be compulsorily insured by legislation in respect of such vehicles.
3. Liability in respect of predetermined penalties or liquidated damages imposed under any contract entered into by the insured.
4. Liability in respect of loss or damage to property in the care, custody and control of the insured but this exclusion is not to apply to all property belonging to the Authority/Trust which is in the care, custody and control of another Insured Party.
5. Liability arising out of technical or professional advice (given for a fee) other than in respect of death or bodily injury to persons or damage to third party property.
6. Liability arising from the ownership, possession or use of any aircraft or marine vessel.
7. Liability arising from seepage and pollution unless caused by a sudden, unintended and unexpected occurrence.
8. Losses under the property damage policy or business interruption policy.

PART 3

Endorsements³⁴

Unless the context otherwise requires defined terms set out in the following endorsements shall have the meaning set out in the Contract.

Endorsement 1

Cancellation

This policy shall not be cancelled or terminated before the original expiry date is to take effect except in respect of non-payment of premium.

The insurer shall by written notice advise the Authority:

- (a) at least 30 days before any such cancellation or termination is to take effect;
- (b) at least 30 days before any reduction in limits or coverage or any increase in deductibles is to take effect; and
- (c) of any act or omission or any event of which the insurer has knowledge and which might invalidate or render unenforceable in whole or in part this policy.

Endorsement 2

Multiple Insured/Non-Vitiation Clause

Each of the parties comprising the insured shall for the purpose of this policy be considered a separate co-insured entity, insured on a composite basis, with the words "the insured" applying to each as if they were separately and individually insured provided that the total liability of the insurers under each Section of this policy to the insured collectively shall not (unless the policy specifically permits otherwise) exceed the limit of indemnity or amount stated to be insured under that Section or policy. Accordingly, the liability of the insurers under this policy to any one insured shall not be conditional upon the due observance and fulfilment by any other insured party of the terms and conditions of this policy or of any duties imposed upon that insured party relating thereto, and shall not be affected by any failure in such observance or fulfilment by any such other insured party.

It is understood and agreed that any payment or payments by insurers to any one or more of the insureds shall reduce, to the extent of that payment, insurers' liability to all such parties arising from any one event giving rise to a claim under this policy and (if applicable) in the aggregate.

Insurers shall be entitled to avoid liability to or (as may be appropriate) claim damages from any insured party in circumstances of fraud misrepresentation non-disclosure or material breach of warranty or condition of this policy (each referred to in this clause as a "Vitiating Act") committed

³⁴ The endorsements in this Part 3 of Annex 1 is recommended drafting. Whilst the parties should endeavour to obtain cover in accordance with these wordings, if these are not in practice available, the parties should obtain the best terms reasonably available in the market at the time.

by that insured party save where such misrepresentation non-disclosure or breach of warranty or condition was committed innocently and in good faith.

For the avoidance of doubt it is however agreed that a Vitiating Act committed by one insured party shall not prejudice the right to indemnity of any other insured who has an insurable interest and who has not committed the Vitiating Act.

Insurers hereby agree to waive all rights of subrogation and/or recourse which they may have or acquire against any insured party (together with their employees and agents) except where the rights of subrogation or recourse are acquired in consequence of a Vitiating Act in which circumstances insurers may enforce such rights against the insured responsible for the Vitiating Act notwithstanding the continuing or former status of the vitiating party as an insured.

Notwithstanding any other provision of this policy or any other document or any act and/or omission by any insured party insurers agree that:

(1) no party other than the Authority has any authority to make any warranty, disclosure or representation in connection with this policy on behalf of the Authority;

(2) where any warranty, disclosure or representation is required from the Authority in connection with this policy insurers will contact the Authority in writing (in accordance with Endorsement 3 to the Contract) and set out expressly the warranty, disclosure and/or representation required within a reasonable period of time from the Authority (regarding itself); and

(3) save as set out in a request from insurers to the Authority in accordance with (2) above, the Authority shall have no duty to disclose any fact or matter to insurers in connection with this policy save to the extent that for the Authority not to disclose a fact or matter would constitute fraudulent misrepresentation and/or fraudulent non-disclosure.

Endorsement 3

Communications

All notices or other communications under or in connection with this policy shall be given to each insured (and the Authority) in writing or by facsimile. Any such notice will be deemed to be given as follows:

- (a) if in writing, when delivered;
- (b) if by facsimile, when transmitted but only if, immediately after transmission, the sender's facsimile machine records a successful transmission has occurred.

The address and facsimile number of the Authority for all notices under or in connection with this policy are those notified from time to time by the Authority for this purpose to the Contractor at the relevant time. The initial address and facsimile number of the Authority are as follows:

1. The Authority:
Address:

Facsimile No: []

Attention: The Chief Executive from time to

time of the Authority

It is further agreed that a notice of claim given by the Authority or any other insured shall in the absence of any manifest error be accepted by the insurer as a valid notification of a claim on behalf of all insureds.

Endorsement 4

Loss Payee (applicable only to the Physical Damage Policies)

Subject to the provision of Clause [24.5(b)] all proceeds of this policy shall be payable without deduction or set-off to the Joint Insurance Account.

Endorsement 5

Primary Insurance

It is expressly understood and agreed that this policy provides primary cover for the insured parties and that in the event of loss destruction damage or liability covered by this policy which is covered either in whole or in part under any other policy or policies of insurance effected by or on behalf of any of the insured parties the insurers will indemnify the insured parties as if such other policy or policies of insurance were not in force and the insurers waive their rights of recourse if any against the insurers of such other policy or policies of insurance.

Endorsement 6

Ringfencing

The level of any indemnity available to an insured party under this policy in relation to any claim(s) concerning the Project shall not be affected and/or reduced by any claim(s) unrelated to the Project.

PART 4

Chapter 2 Broker's Letter of Undertaking³⁵

To: The Authority

Dear Sirs

Agreement dated [] entered into between [] Limited (the "Contractor") and [] (the "Authority") (the "Agreement")

We refer to the Agreement. Unless the context otherwise requires, terms defined in the Agreement shall have the same meaning in this letter.

We act as insurance broker to the Contractor in respect of the Required Insurances and in that capacity we confirm that the Required Insurances which are required to be procured pursuant to clause [] and schedule [] of the Agreement:

- where appropriate name you and such other persons as are required to be named pursuant to the Agreement for their respective interests;
- are, in our reasonable opinion as insurance brokers, as at today's date, in full force and effect in respect of all the matters specified in the Agreement; and that all premiums due to date in respect of the Required Insurances are paid and the Required Insurances are, to the best of our knowledge and belief, placed with insurers which, as at the time of placement, are reputable and financially sound. We do not, however, make any representations regarding such insurers' current or future solvency or ability to pay claims; and that
- the endorsements set out in **Part 3 to Schedule []** of the Agreement are as at today's date in full force and effect in respect of the Required Insurances.

We further confirm that the attached cover notes confirm this position.

Pursuant to instructions received from the Contractor and in consideration of your approving our appointment [or continuing appointment] as brokers in connection with the Required Insurances, we hereby undertake in respect of the interests of the Authority in relation to the Required Insurances:

Notification Obligations

- to notify you at least 30 (thirty) days prior to the expiry of any of the Required Insurances if we have not received instructions from the Contractor to negotiate renewal and in the event of our receiving instructions to renew, to advise you promptly of the details thereof;

³⁵ The wording in this Part 4 of Annex 1 is recommended drafting. If agreement to this wording is not in practice achievable, then the parties should agree the best terms reasonably available in the market at the time.

- to notify you at least 30 (thirty) days prior to ceasing to act as brokers to the Contractor unless, due to circumstances beyond our control, we are unable to do so in which case we shall notify you as soon as practicable; and
- to pay into the Joint Insurance Account without set off or deduction of any kind for any reason all payments in respect of claims received by us from insurers in relation to the Required Insurances specified in **Clause [25.5]** of the Agreement.

Advisory Obligations

- to notify you promptly of any default in the payment of any premium for any of the Required Insurances;
- to notify you if any insurer cancels or gives notification of cancellation of any of the Required Insurances, at least 30 (thirty) days before such cancellation is to take effect or as soon as reasonably practicable in the event that notification of cancellation takes place less than 30 (thirty) days before it is to take effect;
- to notify you of any act or omission, breach or default of which we have knowledge which in our reasonable opinion may either invalidate or render unenforceable in whole or in part any of the Required Insurances or which may otherwise materially impact on the extent of cover provided under the Required Insurances; and
- to advise the Contractor of its duties of disclosure to insurers and to specifically advise upon:

the facts, circumstances and beliefs that should generally be disclosed to insurers; and

the obligation not to misrepresent any facts, matters or beliefs to insurers.

Disclosure Obligations

- to disclose to insurers all information made available to us from any source and any fact, change of circumstances or occurrence made known to us from any source which in our reasonable opinion is material to the risks insured against under the Required Insurances and which properly should be disclosed to insurers as soon as practicable after we become aware of such information, fact, change of circumstance or occurrence whether prior to inception or renewal or otherwise; and
- to treat as confidential all information so marked or otherwise stated to be confidential and supplied to us by or on behalf of the Contractor or the Authority and not to disclose such information, without the prior written consent of the supplier, to any third party other than those persons who, in our reasonable opinion have a need to have access to such information from time to time, and for the purpose of disclosure to the insurers or their agents in respect of the Required Insurances in discharge of our obligation set out at Clause 4.3.1 of this letter. Our obligations of confidentiality shall not conflict with our duties owed to the Contractor and shall not apply to disclosure required by an order of a court of competent jurisdiction, or pursuant to any

applicable law, governmental or regulatory authority having the force of law or to information which is in the public domain.

Administrative Obligations

- to hold copies of all documents relating to or evidencing the Required Insurances, including but without prejudice to the generality of the foregoing, insurance slips, contracts, policies, endorsements and copies of all documents evidencing renewal of the Required Insurances, payment of premiums and presentation and receipt of claims;
- to supply to the Authority and/or its insurance advisers (or the Authority's or its insurance advisers' authorised representatives) promptly on written request copies of the documents set out in Clause 4.4.1 of this letter, and to the extent available, to make available to such persons promptly upon the Authority's request the originals of such documents;
- to administer the payment of premiums due pursuant to the Required Insurances such that, in so far as we hold appropriate funds, all such premiums shall be paid to insurers in accordance with the terms of the Required Insurances;
- to administer the payment of claims from insurers in respect of the Insurances (the "Insurance Claims") including:
 - negotiating settlement of Insurance Claims presented in respect of the Required Insurances;
 - collating and presenting all information required by insurers in relation to Insurance Claims presented in respect of the Required Insurances, and
 - insofar as it is relevant and practicable, liaising with and reporting to each Authority throughout the settlement, payment and administration of such Insurance Claims.
- to advise the Authority promptly upon receipt of notice of any material changes which we are instructed to make in the terms of the Required Insurances and which, if effected, in our opinion as Insurance Brokers would result in any material reduction in limits or coverage or in any increase in deductibles, exclusions or exceptions;
- to advise the Authority in advance of any change to the terms of, or any lapse, non-renewal and/or cancellation of any policy maintained in respect of the Required Insurances; and
- to use our reasonable endeavours to have endorsed on each and every policy evidencing the Required Insurances (when the same is issued) endorsements substantially in the form set out in Part 3 to Schedule [] of the Agreement.

Insurance Cost Reporting Procedures

- to prepare following request, at the expense of the Contractor, a Joint Insurance Cost Report on behalf of both the Contractor and the Authority in

accordance with the Insurance Review Procedure as set forth in [Section 24.8] of the Agreement. We shall ensure that the information in the Joint Insurance Cost Report is fairly represented, based on the information available to us.³⁶

Notification Details

Our obligations at Clause 4 of this letter to notify or inform you shall be discharged by providing the requisite information in hard copy to:

[] Authority

We shall supply further letters substantially in this form on renewal of each of the Required Insurances and shall supply copies of such letters to those parties identified to us by the Authority for such purposes.

Yours faithfully

For and on behalf of [Contractor's broker]³⁷

³⁶ This provision under Clause 4.5 is Required Drafting and may not be altered.

³⁷ The Contractor's broker may wish to limit its liability and include additional liability wording in the Broker's Letter of Undertaking. Whilst this is in principle acceptable, the Authority will need to check that (i) the scope of such additional wording is appropriate (e.g. does not extend to a limitation of liability for fraudulent acts), and (ii) the capped amount is set at a sufficiently high level.

PART 5

Definitions

“Revenue” is defined as the projected Unavoidable Fixed Costs and Senior Debt Service Costs of the Contractor.

“Senior Debt Service Costs” shall mean interest and debt service costs incurred in respect of the Senior Financing Agreements less

- (a) sums which are in arrears;
- (b) all sums reserved by the Contractor and which the Contractor is entitled to use to make such payments, without breaching the Senior Financing Agreements.

“Unavoidable Fixed Costs” should mean the fixed costs incurred by the Contractor which first fall due for payment by the Contractor during the period of indemnity but excluding:-

- (a) costs which could have reasonably been mitigated or avoided by the Contractor;
- (b) payments to the Contractor’s Associated Companies;
- (c) payments which are not entirely at arm’s length;
- (d) payments to holders of equity in the Contractor, Subordinated Lenders and any other financing costs other than Senior Debt Service Costs;
- (e) indirect losses suffered or allegedly suffered by any person;
- (f) fines, penalties or damages for unlawful acts, breaches of contract or other legal obligations;
- (g) payments the Contractor can recover under contract or in respect of which the Contractor has a remedy against another person in respect of the same liability;
- (h) payments to the extent that the Contractor has available to it
 - (i) reserves which the Contractor can draw upon without breaching the Senior Financing Agreement;
 - (ii) standby or contingent facilities or funds of Senior Debt or equity which the Contractor is entitled to have available;
- (i) payments representing any profits of the Project (to the extent not already excluded in (e) above).

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