

## 16.1 INTRODUCTION

**16.1.1** 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.

## 16.2 RESTRICTIONS ON THE CONTRACTOR

**16.2.1** 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 30 (Direct Agreement)), the Contract should allow for the original Contractor's rights and obligations to be transferred.

## 16.3 RESTRICTIONS ON THE AUTHORITY

**16.3.1** 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.

**16.3.2** 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<sup>1</sup>. 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:

### **16.3(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) [other than in respect of the whole of the Contract]<sup>2</sup> to any public body other than any person (being a single entity) having the legal capacity, power and authority to become a party to and to perform the obligations of the Authority under this Contract being:

<sup>1</sup> 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).

<sup>2</sup> The Authority should not generally seek to retain the right to transfer part of the Contract.

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- (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.

### **16.3(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) [other than in respect of the whole of the Contract]<sup>3</sup> to any person other than any public body (being a single entity) 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 [Contract<sup>4</sup>];<sup>5</sup> 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.

## **16.4 RESTRICTIONS ON THE SENIOR LENDERS**

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**16.4.1** 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.

**16.4.2** 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 25 (Information and Confidentiality) and 30 (Direct Agreement)).

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<sup>3</sup> See footnote 2 above.

<sup>4</sup> This should also include any other Project Documents that the Authority is a party to (e.g. any direct agreements or leases).

<sup>5</sup> 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.

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**16.4.3** 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 list should be updated as and when appropriate. Restrictions of this type can be dealt with in the direct agreement, or in a separate confidential letter if there are particular sensitivities (see Section 30 (Direct Agreement)).

**16.4.4** 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.

**16.4.5** 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). Where bonds are privately placed and the Authority can justify imposing restrictions on financiers, a similar approach as under Section 16.4.3 may be adopted. The Authority should note that Stock Exchange rules on bond issues may require details of the Contract and underlying documents to be publicly displayed (there are some exceptions to such rules (e.g. if display would prejudice national security)<sup>6</sup>).

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<sup>6</sup> See Clause 25(b)(iv) (Information and Confidentiality) below.



### 17.1 INTRODUCTION

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**17.1.1** An Authority may be concerned about changes in the Contractor's shareholders, particularly where such changes lead to a change in ownership which gives cause for concern for particular, agreed reasons. 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 Service Commencement Date. 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.

**17.1.2** Suitable drafting is set out below:

- (a) The Contractor shall inform the Authority as soon as reasonably practicable and, in any event, within [30] days of any change in the ownership of the Contractor<sup>1</sup>.

### 17.2 AUTHORITY'S CONCERNS

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**17.2.1** Imposing a restriction on the 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 takes comfort from the original shareholders' continuing to retain their economic stake in the Project.

**17.2.2** The Authority should generally look to other provisions under the Contract to address its concerns about the effect 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.

**17.2.3** 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 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 shareholder (e.g. if technical support was provided in its capacity as a shareholder then equivalent support should be looked for before a transfer can occur). It is not unreasonable for the Authority to restrict equity transfers 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.

### 17.3 SHAREHOLDERS' CONCERNS

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**17.3.1** Holders of shares in Contractors will not want their ability to transfer their investment to be restricted. This is because 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.

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<sup>1</sup> Change of ownership is usually defined for this purpose as any material change to the direct or indirect legal or beneficial ownership of the Contractor. A change in the ownership is usually treated as material if it relates directly or indirectly to 5% or more of the Contractor's issued share capital although this is not always the most appropriate percentage.

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**17.3.2** The risk exposure of the Contractor also changes over time as most risks are concentrated in the period prior to Service Commencement. The optimal financing structure can therefore be expected to change over time to reflect this. Restrictions on transfers of equity would inhibit changes to the financing structure. For example, the Contractor may be able to offer the Authority a more competitive price, principally by relying on the fact that changes in the financing structure (e.g. through a refinancing) will allow it to reduce its costs and achieve its desired return.

## **17.4 EXCEPTIONS TO THE GENERAL RULE**

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**17.4.1** In some exceptional cases it may be reasonable for an Authority to impose some wider restriction on the transfer of ownership or investment in a Contractor (the precise restrictions will depend on the financing structure of the Project). Restrictions should address specific concerns and not be blanket restrictions. Certain limits are appropriate. 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. Political 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 and certainly no later than the ITN.

**17.4.2** In such exceptional 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.

**17.4.3** To the extent such matters are of a sensitive nature, they may be better dealt with outside the Contract (for example, in a confidential letter that does not form part of the Contract). If sensitive matters are to be in the Contract, the issues discussed in Section 25 (Information and Confidentiality) are relevant. In addition, any restrictions which are imposed need not last throughout the Contract.

**17.4.4** To the extent restrictions are needed, then there should be a focus on transfers of individual shares rather than necessarily changes of control, one way to do this is as follows:

- (b) The Contractor shall obtain the Authority's prior written consent (which may be given subject to conditions) to any Restricted Share Transfer<sup>2</sup> of the Contractor (other than where the Senior Lenders exercise their rights in respect of shares of the Contractor granted in any document conferring security over any of the shares of the Contractor)<sup>3</sup>.
- (c) For the purpose of paragraphs (a)<sup>4</sup> and (b) above:

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<sup>2</sup> 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 17.4.1 above), which may in turn be defined using generic descriptions of restricted (or permitted) classes of share transferees. The exercise by Senior Lenders of their security rights over shares of the Contractor should not be restricted.

<sup>3</sup> To the extent deferred equity commitments still exist, additional controls may be needed.

<sup>4</sup> See Section 17.1.2.

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- (i) any change in beneficial or legal ownership of any shares that are listed on a stock exchange shall be disregarded.
  - (ii) any transfer of shares or of any interest in shares by a person to its Affiliate shall be disregarded.

## **17.5 RELATED ISSUES**

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**17.5.1** 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 imperfect tool for controlling the substantive ownership of its counterpart.



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## TERMINATION

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### 18.1 INTRODUCTION

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**18.1.1** A Contract will terminate either on the Expiry Date (see Section 19 (Termination on Expiry of Service Period)) or as a result of early termination. Early termination can be caused by Authority Default (see Section 20.1 (Termination on Authority Default)), Contractor Default (see Section 20.2 (Termination on Contractor Default)), force majeure (see Section 20.3 (Termination on Force Majeure)) and corrupt gifts (see Section 20.4 (Corrupt Gifts and Fraud)). It can also be caused by the Authority exercising a right to terminate the contract voluntarily (see Section 20.5 (Voluntary Termination by Authority)).

**18.1.2** The Contract should deal comprehensively with the consequences of all types of termination and, in particular, it must address what happens to the Assets and what level of termination payment (if any) is payable by the Authority. The level of compensation payable by the Authority should be determined by:

- the reason for the termination;
- which party retains the Assets; and
- whether those Assets have any alternative use.



## 19.1 INTRODUCTION

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**19.1.1** 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 19.2 (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 accommodation in areas where there is demand from other users, generic information technology systems and alternative land use). These are discussed in Section 19.4 (Transfer of Residual Value Risk).

**19.1.2** 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.

## 19.2 ASSETS WHERE THE AUTHORITY RETAINS RESIDUAL VALUE ON EXPIRY

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**19.2.1** In most PFI projects, the Authority’s long-term objectives will be best served by requiring either automatic transfer 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<sup>1</sup>.

**19.2.2** 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 Assets<sup>2</sup> at no cost;
- retendering the provision of the Service, with the outgoing Contractor making any Assets available to the new Contractor at no cost<sup>3</sup>; and
- removing any Assets.

**19.2.3** 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 22 (Surveys on 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).

**19.2.4** In some early PFI projects, a headlease was granted in favour of the Contractor in respect of the land on which the Assets (e.g. accommodation) were located which was longer than the initial Contract period. The Authority took a sublease from the Contractor for the duration of the Contract. This allowed the Authority to leave the land with the Contractor at the end of the initial Contract period for the remainder of the headlease<sup>4</sup>.

**19.2.5** These structures are not generally capable of transferring any real risk in relation to residual value, as in many such situations the Contractor will still seek the required return on its investment from the initial Contract period. Indeed, it may be counter-productive as it may also prevent the Authority from making use of the Assets after the Expiry Date. The Authority should be driven by its operational requirements and value for money rather than an attempt to create some residual value interest.

**19.2.6** Suitable drafting is as follows:

#### **19.2 Treatment of Assets at Expiry Date**

- (a) On or before a date falling no later than [12]<sup>5</sup> months prior to the Expiry Date, the Authority shall notify the Contractor in writing whether it wishes:
  - (i) to retender the provision of the Service; or

<sup>1</sup> In some cases, the land will have significant residual value in its own right, notwithstanding that the other Assets may not (see Sections 19.1.2 and 19.4 (Assets with an Alternative Use (Transfer of Residual Value Risk))).

<sup>2</sup> See Section 19.6.1.

<sup>3</sup> Any retendering of the Service should allow the incumbent Contractor to rebid for the Contract.

<sup>4</sup> This leasehold structure may also assist the parties in providing the Authority with an option to enter a secondary Service Period with the initial Contractor (i.e. by extending the Contract) which does not breach the rule against perpetuities in relation to the right to exercise options over land interests. See also Sections 2.2.1 and 19.3.2.

<sup>5</sup> This date should be consistent with Clause 22 (Surveys on 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).

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- (ii) the Contractor<sup>6</sup> to transfer all of its rights, title and interest in and to the Assets to the Authority; or
  - (b) If the Authority wishes to retender the provision of the Service then:
    - (i) the retendering shall be carried out on the basis that the Authority will contract with a successor contractor to provide the new service on and from the Expiry Date; and
    - (ii) 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
    - (iii) the Authority will bear all costs of any retendering of the Contract on expiry<sup>7</sup>.

**19.2.7** The parties may also wish the Contract to deal with a mandatory second term option with the existing Contractor (see Section 19.6.3) in conjunction with an open competition<sup>8</sup>. If this is the case, then the retendering would have to be on substantially the same terms as the original contract<sup>9</sup>, 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 22 (Surveys on Termination) are relevant in relation to assets with no alternative use.

## **19.3 PRESERVING THE CONDITION OF THE ASSETS ON EXPIRY**

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**19.3.1** Terminal Payments at the end of the Contract have been used (even where the Authority retains 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.

**19.3.2** 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.

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<sup>6</sup> The precise wording will depend on the specific circumstances e.g. if the Authority already owns part or all of relevant assets, it may choose to retain or transfer ownership.

<sup>7</sup> Costs of retendering of the Contract by the Authority following termination for Contractor Default should not be borne by the Authority. See Section 20.2 (Termination on Contractor Default).

<sup>8</sup> Such a competition may be subject to any procurement regulations applicable at the time.

<sup>9</sup> 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.

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**19.3.3** 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<sup>10</sup>. 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. 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.

## **19.4 HANDOVER PROVISIONS FOR ASSETS WHICH TRANSFER TO THE AUTHORITY**

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**19.4.1** 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 8 (Maintenance) and 22 (Surveys on Termination));
- any design life requirement after the Expiry Date;
- 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.

**19.4.2** Other relevant issues include how employees should be dealt with, as they will often transfer to any successor contractor or the Authority.

**19.4.3** 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).

**19.4.4** 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.

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<sup>10</sup> See also Sections 2.2.1 and 19.2.4, footnote 4.

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## 19.5 TRANSFER OF RESIDUAL VALUE RISK

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**19.5.1** 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. It is crucial that this issue is dealt with as part of the competitive bidding process if it is to deliver real value.

**19.5.2** 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.

**19.5.3** 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, financiers<sup>11</sup> 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.

**19.5.4** 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 Contract. Where this is the case it will be possible to have a much shorter contract length (see Section 2 (Duration of Contract)).

**19.5.5** 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 19.5 (Valuation of Terminal Payments));
- 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 19.5 (Valuation of Terminal Payments)); 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.

**19.5.6** Each option has real economic value to the Authority, as the NPV of the total payments made 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).

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<sup>11</sup> Senior Debt is usually profiled to be repaid in advance of the Expiry Date.

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**19.5.7** Suitable drafting is as follows:

**19.5 Assets with an Alternative Use**

- (a) On or before the date falling [six] months<sup>12</sup> before the Expiry Date, the Authority shall notify the Contractor in writing whether it wishes to:<sup>13</sup>
  - (i) purchase the Assets by paying to the Contractor an amount equal to their market value;
  - (ii) retender the provision of the Service<sup>14</sup>; 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<sup>15</sup>.
- (d) If the Authority wishes to exercise its option under paragraph (a)(ii) above, then<sup>16</sup>:
  - (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<sup>17</sup>;
  - (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<sup>18</sup>; 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.

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<sup>12</sup> Any relevant procurement implications should be taken into account. To the extent option (a)(ii) is likely, the process may have to start earlier.

<sup>13</sup> The precise wording will depend on the specific circumstances e.g. if the Authority already owns part or all of a significant part of the assets used in the Project, or will do so automatically on termination, it may choose to retain or transfer ownership.

<sup>14</sup> The Authority will also need an option to purchase the Assets to allow any new Contractor to provide the Service.

<sup>15</sup> 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 its base case return. The meaning of "Terminal Payment" is explained in Section 19.5.1.

<sup>16</sup> 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.

<sup>17</sup> Any retendering would have to follow any applicable procurement rules.

<sup>18</sup> Again, 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.

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## **19.6 VALUATION OF TERMINAL PAYMENTS ON EXPIRY WHERE RESIDUAL VALUE RISK HAS BEEN TRANSFERRED**

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**19.6.1** The two main options for determining amounts payable at the expiry of the Contract in respect of Assets with an alternative use 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”.

**19.6.2** 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).

**19.6.3** 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.

**19.6.4** The alternative method referred to in Section 19.5.1 is inappropriate. 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.



The intention of the parties to the Contract should be that it will run its full course, 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.

## 20.1 TERMINATION ON AUTHORITY DEFAULT

### 20.1.1 Introduction

**20.1.1.1** 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.

### 20.1.2 Contractor's Right to Terminate for Authority Default

**20.1.2.1** 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.

Authority Default should be defined as follows:

**"Authority Default"**

means one of the following events:<sup>1</sup>

- (a) an expropriation, sequestration or requisition of a material part of the Assets and/or shares of the Contractor<sup>2</sup> 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<sup>3</sup>;
- (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<sup>4</sup>; or
- (d) a breach by the Authority of Clause 16 (Restrictions on Transfer of the Contract by the Authority) occurs.

<sup>1</sup> In certain cases, it may be appropriate to include additional events. See Section 20.1.2.2.

<sup>2</sup> 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.

<sup>3</sup> This provision assumes that interest on late payment is provided for in the Contract (see Section 10.2.5 and Clause 29.8 (Interest on Late Payments)).

<sup>4</sup> The periods triggering Authority Default in paragraphs (b) and (c) are subject to the further rectification periods set out in Clause 20.1.2 (Termination on Authority Default).

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**20.1.2.2** 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.

**20.1.2.3** 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.

**20.1.2.4** 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 (Compensation Events)). In addition, any failure by the Authority to pay sums when due should give rise to interest on late payment (see Section 10.2.5 and Clause 29.8 (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:

**20.1.2 Termination on Authority Default**

- (a) If an Authority Default has occurred and the Contractor wishes to terminate the Contract, it must serve a termination notice<sup>5</sup> on the Authority<sup>6</sup> 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.

**20.1.3 Compensation on Termination for Authority Default**

**20.1.3.1** The objective should be to ensure that the Contractor and its financiers are fully compensated<sup>7</sup> i.e. no worse off because of Authority Default than if the Contract had proceeded as expected.

**20.1.3.2** 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, the market value at the time of termination and the original base case return from the Termination Date (see Section 20.1.3.6).

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<sup>5</sup> This will contain detailed requirements and information on the Authority Default. See Section 5 (Supervening Events).

<sup>6</sup> In certain cases a third party (e.g. the relevant Secretary of State) should also receive notice.

<sup>7</sup> 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 21.6 (Exclusivity of Remedy)).

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**20.1.3.3** 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. Typically, Junior Debt has been repaid in full (together with interest) while compensation for equity has been based either on its market value or on a base case return. Mezzanine debt has not been specifically identified. If the project concerned does have an element of mezzanine debt then the Authority will have to consider the extent to which, for the purposes of Authority Default, it is more akin to Senior Debt or equity<sup>8</sup> and decide upon an appropriate approach for termination compensation.

**20.1.3.4** 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.

**20.1.3.5** 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.

**20.1.3.6** Bidders should 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).

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<sup>8</sup> Mezzanine debt will typically seek a much higher return than Senior Debt.

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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.

- 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 35 (Refinancing)) and the original equity and Junior Debt reduced, there is no double counting.

**20.1.3.7** 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.

**20.1.3.8** 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 21.6 (Retention of Assets by Contractor on Termination)).

**20.1.3.9** 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 21.3 and definitions in Section 1.8.1.

Required drafting is as follows:

#### **20.1.3 Compensation on Authority Default**

- (a) On termination of the Contract under Clause 20.1.2 (Termination on Authority Default) the Authority shall pay<sup>9</sup> the Contractor the “Authority Default Termination Sum” in accordance with [Section 21 (Calculation and Payment of Early Termination Payments)].

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<sup>10</sup>;

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<sup>9</sup> See Section 21 (Calculation of Compensation) for the rights of set-off against such payments.

<sup>10</sup> See Section 1.8.1 (Definitions).

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- (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;
  - (2) interest paid and principal repaid by the Contractor under the Subordinated Financing Agreements on or before the Termination Date,<sup>11</sup>  
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<sup>12</sup>]

**or**

- [(iii)<sup>13</sup> 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

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<sup>11</sup> These amounts will take into account the initial investments of the shareholders.

<sup>12</sup> 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 and thought should be given to defining this in the Contract. 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. Suitable drafting for the relevant assumptions is set out in the definitions at Section 20.1.3.

<sup>13</sup> 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.

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- (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 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 20.1.3, 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 [•]%<sup>14</sup>;

**“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;

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<sup>14</sup> 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.

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### **“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
- (c) the Contractor and the relevant Sub-Contractor has each used its reasonable endeavours to mitigate the Losses;

**20.1.3.9** This is the same level of compensation as is appropriate on a voluntary termination by the Authority (see Section 20.5 (Voluntary Termination by Authority)). 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.

## **20.2 TERMINATION ON CONTRACTOR DEFAULT**

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### **20.2.1 Introduction**

**20.2.1.1** 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 20.2.4 (Rectification) and 30 (Direct Agreement)). It should be the Authority’s last resort to exercise rights of termination.

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## 20.2.2 Events Leading to Termination

**20.2.2.1** 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<sup>15</sup>, 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<sup>16</sup>;
- (c) a court makes an order that the Contractor be wound up or a resolution for a voluntary winding-up of the Contractor is passed<sup>17</sup>;
- (d) any receiver or manager in respect of the Contractor 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;
- (f) an administration order is made;
- (g) [a breach of Clause 15 (Sub-contractors and Employees)<sup>18</sup> occurs;]
- (h) [a breach by the Contractor of its obligations in Clause 16 (Assignment) occurs<sup>19</sup>;
- (i) [a breach of Clause 17 (Change of Ownership) occurs<sup>20</sup>;
- (j) the abandonment of the Contract by the Contractor<sup>21</sup>;
- (k) a failure to achieve the Service Commencement Date by [date]<sup>22</sup>;
- (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]<sup>23</sup>;

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<sup>15</sup> For example with performance points triggering termination.

<sup>16</sup> See Section 20.2.3 (Termination for Persistent Breach by the Contractor) as to whether this is appropriate.

<sup>17</sup> An exception can be made for reorganisations consented to by the Authority. As these can be done if the Authority consents, even if the Contract does not provide that this is the case, its inclusion is, however, unnecessary.

<sup>18</sup> This catches non-permitted replacement of Sub-Contractors. See Section 15 (Sub-Contractors and Employees) as to whether (and if so what) restrictions should be imposed.

<sup>19</sup> This catches non-permitted assignment by the Contractor of its rights and obligations under this Contract. See Section 16 (Assignment) as to whether (and if so what) restrictions should be imposed.

<sup>20</sup> This catches non-permitted transfers of shares in the Contractor. See Section 17 (Change of Ownership) as to whether such restrictions are appropriate.

<sup>21</sup> 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).

<sup>22</sup> 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)).

<sup>23</sup> Financial advisers may advise on suitable calibration.

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- (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<sup>24</sup>.

**20.2.2.2** Other events of default may be included on a project-specific basis<sup>25</sup>. If the exceptional circumstances of a particular project make it essential for the Authority to place 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 15 (Sub-contractors and Employees), 16 (Assignment) and 17 (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 11 (Payments and Set-off)), although particular projects may require this (e.g. where the Project has significant third party income).

**20.2.2.3** Generally, insolvency events of default should not be extended to include Sub-Contractors 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.

**20.2.2.4** Termination should be subject to any rectification procedures (see Section 20.2.4 (Rectification)) and the rights of the Senior Lenders under the Direct Agreement (see Section 30 (Direct Agreement)). Accrued performance points should not generally be altered on appointment of a replacement Sub-Contractor (but see Section 9.5 (Replacement of Sub-Contractors)).

**20.2.2.5** 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.

## **20.2.3 Termination for Persistent Breach by the Contractor**

**20.2.3.1** 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).

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<sup>24</sup> Not all failures to insure should lead to a termination event occurring. Only specified key insurances (such as construction all risks) should be caught. This approach goes hand in hand with the treatment of the issues relating to non-availability of certain insurances (see Section 24 (Insurance) and, in particular, Section 24.8 (Risks that Become Uninsurable)).

<sup>25</sup> For example, the NHS requires a right to terminate if the Contractor prevents the Authority from carrying out its retained activities.

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**20.2.3.2** 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. It may in fact be cheaper for the Contractor not to perform and suffer the (inaccurately calibrated) deductions. If such circumstances are likely to exist, the Authority should retain a right to terminate the Contract for Persistent Breach rather than trigger termination following accrual of a certain number of performance points<sup>26</sup>. 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. As payment and performance mechanisms develop and are seen to work well in established sectors, there will be less of a need for such a provision.

**20.2.3.3** 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 during the Service Period (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.

To the extent such a definition is needed, the following shall be used:

**“Persistent Breach”**

means a breach (other than any breach for which [performance points] could have been awarded and/or [deductions] could have been made<sup>27</sup>) which has continued or recurred [ ] or more times within [6] months after the date on which a final warning notice referred to in paragraph (b) of Clause 20.2.3 (Persistent Breach) is served on the Contractor<sup>28</sup>;

The mechanism shall be drafted as follows:

**20.2.3 Persistent Breach**

- (a) If a breach has 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;

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<sup>26</sup> A Persistent Breach default should complement, and not be a substitute for, a fully effective payment mechanism.

<sup>27</sup> To the extent that the provisions of the Contract give the Authority other specific rights against the Contractor for failure by it to provide the Service (e.g. step-in rights) the definition of “Persistent Breach” may need to be qualified accordingly.

<sup>28</sup> 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 the Service in full. This does not address 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 20.2.3 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 Agreement for Persistent Breach, is acting in a “reasonable and proportionate manner”. Again, the detailed mechanism in Clause 20.2.3 is itself sufficient in ensuring that this right to terminate is only exercised for repeated failures following service of a series of warnings, and final warning notices, to the Contractor.

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- (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 [ ] or more times<sup>29</sup> 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] month<sup>30</sup> period prior to the date of service of the final warning notice; and
  - (iii) stating that if such failure continues or recurs [ ] or more times within the [six] month<sup>31</sup> 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 in respect of which a separate warning notice has already been served until a period of 12 months has elapsed since the date of service of the previous warning notice or final warning notice.

**20.2.3.4** 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 30 (Direct Agreement)).

## 20.2.4 Rectification

**20.2.4.1** 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 20.2.1 (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:

### 20.2.4 Rectification

- (a) If a Contractor Default has occurred and the Authority wishes to terminate the Contract, it must serve a termination notice<sup>32</sup> on the Contractor.

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<sup>29</sup> This will depend on the particular breach concerned, but a certain number of recurrences should be specified.

<sup>30</sup> The time periods should be fixed by reference to the nature of the Project.

<sup>31</sup> See footnote 30 above.

<sup>32</sup> This notice will specify at least the information in paragraph (b). For the Direct Agreement to work effectively, a similar notice should be delivered to the Agent containing the information required by the Senior Lenders (see Section 30 (Direct Agreement)).

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- (b) The termination notice must specify:
- (i) the type and nature of Contractor Default that has occurred, giving reasonable details; and
  - (ii) that the Contract will terminate on the day falling [60]<sup>33</sup> days after the date the Contractor receives the termination notice, unless the Contractor puts forward an acceptable rectification programme within [30] days<sup>34</sup> (and implements such programme in accordance with its terms and rectifies the Contractor Default in accordance with the Programme) or rectifies the Contractor Default within [60] days or the provisions of the Direct Agreement apply to prevent termination<sup>35</sup>.
- (c) If the Contractor either rectifies<sup>36</sup> 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 the Contractor fails to rectify the Contractor Default within the time period specified in the termination notice (or in accordance with any accepted rectification programme), the Contract will, subject to the terms of the Direct Agreement, terminate on the date falling [60] days after the date of receipt of the termination notice.
- (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 [60] days after the date of notification to the Contractor.

**20.2.4.2** The rectification procedure should allow the Contractor to propose a rectification programme on which the Authority may comment. 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.

**20.2.4.3** 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))<sup>37</sup>. 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.

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<sup>33</sup> This will depend on the project concerned (and as stated in Section 20.2.4.1, the breach concerned).

<sup>34</sup> See footnote 36 below.

<sup>35</sup> See Section 30 (Direct Agreement). This gives the Senior Lenders an opportunity to rectify or "sell" the unexpired terms of the Contract themselves.

<sup>36</sup> It is possible to provide either for actual rectification or for an agreed rectification programme to be introduced, during which termination will not occur provided that the rectification programme is followed. Paragraphs (a), (b), (g), (h), (i) and (o) of the definition of Contractor Default can be rectified, but only in the case of paragraphs (a) and (b) is a rectification programme a suitable way of dealing with the breach.

<sup>37</sup> It may be appropriate in the light of these concerns to extend the exceptions to the definition of Relief Events to cover the wilful acts and defaults of other concerned parties.

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## 20.2.5 Compensation on Termination for Contractor Default

**20.2.5.1** 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.

**20.2.5.2** 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 recommended approach for all PFI projects outside of the roads and prisons sectors.

**20.2.5.3** 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 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.

**20.2.5.4** 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 30 (Direct Agreement)).

**20.2.5.5** 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 a conservative approach to risk pricing, liquidated damages and the limits on liability they require from their sub-contractors.

**20.2.5.6** 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.

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## 20.2.6 Market Value

**20.2.6.1** The recommended approach follows the principle set out in Section 20.2.5.4. 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.

**20.2.6.2** The recommended 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 30 (Direct Agreement));
- 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 hits 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.

**20.2.6.3** 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<sup>38</sup>. 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 20.2.7 (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 recommended 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 20.2.9 (No Retendering Procedure) should be used to determine the compensation payable to the Contractor<sup>39</sup>.

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<sup>38</sup> See Section 30 (Direct Agreement).

<sup>39</sup> See Clause 4 (No Liquid Market) of the direct agreement set out at Section 30 (Direct Agreement).

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## 20.2.7 Retendering Election and Liquid Market

**20.2.7.1** Clause 20.2.7 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 20.2.8 (Retendering Procedure) and Clause 20.2.9 (No Retendering Procedure) applies) (e.g. if Senior Lenders decide not to step-in).

**20.2.7.2** If there is no liquid market for the Contract or similar contracts, and the Contract terminates then the procedure set out in Clause 20.2.9 (No Retendering Procedure) should be used.

**20.2.7.3** 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)<sup>40</sup> to ensure that the price that a contractor will offer for the Contract is reasonably likely to represent a fair value.

**20.2.7.4** 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 Authority<sup>41</sup> to ensure greater control by means of retendering of the Contract.

**20.2.7.5** 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 30 (Direct Agreement)). 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.

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<sup>40</sup> 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.

<sup>41</sup> See Section 30 (Direct Agreement).

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**20.2.7.6** Any dispute as to the existence of a liquid market for the Contract should be dealt with through the dispute resolution procedure (see Section 27 (Dispute Resolution)).

Required drafting (including definitions) is as follows:

**“Fair Value”**

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 Agreement may be novated shall be discounted in assessing whether there are sufficient willing bidders in the market for such purposes.

**20.2.7 Retendering Election**

- (a) Subject to paragraph (b), the Authority shall be entitled<sup>42</sup> either to:
  - (i) retender the provision of the Service in accordance with Clause 20.2.8 (Retendering Procedure); or
  - (ii) require an expert determination in accordance with Clause 20.2.9 (No Retendering Procedure).
- (b) The Authority shall be entitled to retender the provision of the Service in accordance with Clause 20.2.8 (Retendering Procedure) if:
  - (i) the Authority notifies the Contractor on or before the date falling 20 Business Days after the Termination Date; and
  - (ii) there is a Liquid Market; and either:
    - (A) the Senior Lenders have not exercised their rights to step-in under Clause 4 of the Direct Agreement<sup>43</sup>; or
    - (B) the Contractor or Senior Lenders have not procured the transfer of the Company’s rights and liabilities under this Contract to a Suitable Substitute Contractor<sup>44</sup> and have failed to use all reasonable efforts to do so<sup>45</sup>.

but otherwise the Authority shall not be entitled to re-tender the provision of the Services and Clause 20.2.9 shall apply.

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<sup>42</sup> The presumption should be in favour of a retender.

<sup>43</sup> See Section 30 (Direct Agreement).

<sup>44</sup> As defined in Section 30 (Direct Agreement).

<sup>45</sup> The Retendering Procedure should apply during both the construction and operational period.

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## 20.2.8 Retendering Procedure

**20.2.8.1** The Authority will in the circumstances referred to in Clause 20.2.7 (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.

**20.2.8.2** 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 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.

**20.2.8.3** 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.

**20.2.8.4** 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 recommended 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).

**20.2.8.5** 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.

**20.2.8.6** 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<sup>46</sup>.

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<sup>46</sup> If this is the case then the parties will have to fix a date for the new Contract coming into effect, so that tenderers can bid for a fixed term.

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**20.2.8.7** 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).

**20.2.8.8** 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.

**20.2.8.9** 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 20.2.7(c), 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"<sup>47</sup>**

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 11 (Set-off),

**plus** an amount equal to the aggregate of:

- (i) all credit balances<sup>48</sup> 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),

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<sup>47</sup> This definition sets out the adjustments which should be made to the Highest Compliant Tender Price before it is paid by the Authority.

<sup>48</sup> See footnote 21 in Section 1.8 (Interpretation).

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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 20.2.8 (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 20.2.9 (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 20.2.8(c).

**“Compliant Tenderer”**

means a tenderer who is a Suitable Substitute Contractor<sup>49</sup>.

**“Highest Compliant Tender Price”**

means the price offered by the Compliant Tenderer (if any) with the highest tender price<sup>50</sup> and, if no Compliant Tenders are received, zero.

**“Market Value Availability Deduction Amount”<sup>51</sup>**

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 (Service Requirements and Availability)] 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<sup>52</sup>.

**“Maximum<sup>53</sup> Unitary Charge”**

means, in respect of a month, the unitary charge payable during that month before any deductions under [see Section 10 (Price and Payment Mechanism)] but allowing for indexation under the [indexation provisions (see Clause 1.8.2(c) (Interpretation) and Section 14.2 (Indexation))].

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<sup>49</sup> As defined in Section 30 (Direct Agreement).

<sup>50</sup> 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.

<sup>51</sup> See Section 20.2.8.8 above.

<sup>52</sup> 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.

<sup>53</sup> This will require careful consideration if significant third party income or usage payments exist.

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**“New Contract”**

means an agreement on the same terms and conditions<sup>54</sup> as this Contract<sup>55</sup> 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 Contractor<sup>56</sup> to achieve Service Commencement;
- (b) any accrued Performance Points and/or Warning Notices shall be cancelled;
- (c) the term of such agreement shall be equal to the term from the [Termination Date]<sup>57</sup> until the Expiry Date; and
- (d) any other amendments which do not adversely affect the Contractor.

**“New Contractor”**

means the person who has entered or who will enter into the New Contract with the Authority.

**“Post Termination Service Amount”<sup>58</sup>**

means for the purposes of Clause 20.2.8 (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.<sup>59</sup>

**“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 Service<sup>60</sup> is available.

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<sup>54</sup> 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.

<sup>55</sup> This should also include other documents entered into between the parties, where appropriate.

<sup>56</sup> 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.

<sup>57</sup> 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).

<sup>58</sup> 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. It is recommended that their effects are, where possible, stripped out.

<sup>59</sup> 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.

<sup>60</sup> That is, in accordance with the output specification under the Contract.

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**“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 20.2.8 (Retendering Procedure).

**“Tender Process Monitor”**

means a third party appointed by the Contractor under Clause 20.2.8(e).

**20.2.8 Retendering Procedure**

If the Authority elects to retender the provision of the Service under Clause 20.2.7 (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 criteria 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<sup>61</sup>.
- (d) The Contractor authorises the release of any information by the Authority under the Tender Process which would otherwise be prevented under Clause 25 (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 information<sup>62</sup> 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.

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<sup>61</sup> The Authority may wish to define qualification criteria. See the Department of Health standard form PFI Agreement.

<sup>62</sup> The parties will agree what constitutes “confidential information” when the Tender Process Monitor is appointed.

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- (f) The Tender Process Monitor shall enter into a confidentially 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 27 (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 27 (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 27 (Disputes Resolution) and the Authority shall pay interest to the Contractor at the 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)<sup>63</sup>.
- (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.<sup>64</sup>

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<sup>63</sup> If there is an agreed amount and a disputed amount then the Authority should only be entitled to retain the disputed amount.

<sup>64</sup> 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).

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- (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 Documents<sup>65</sup> 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 20.2.9 (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 Document<sup>66</sup> 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<sup>67</sup>.
  - (q) The Authority may elect at any time prior to the receipt of a Compliant Tender to follow the no retendering procedure under Clause 20.2.9 (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.

## 20.2.9 No Retendering

**20.2.9.1** Alternatively, either the Authority may elect (for example, for operational reasons<sup>68</sup>) 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 20.2.8 (Retendering Procedure)) that is, if a Liquid Market had existed (the “**Estimated Fair Value of the Contract**”).

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<sup>65</sup> Any other relevant contract should also be included here.

<sup>66</sup> See footnote 65 above.

<sup>67</sup> 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.

<sup>68</sup> 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.

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**20.2.9.2** 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.

**20.2.9.3** 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 Payment 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.

**20.2.9.4** 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 suggested drafting below.

**20.2.9.5** The Authority and the Contractor will need to agree a forecast rate of inflation to be applied to the RPI index to make the nominal computations. It is recommended that the agreed assumed rate of inflation should be an easily observable and transparent figure such as the Bank of England's target long term inflation rate as published in the Bank of England Quarterly Bulletins.

**20.2.9.6** 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.

**20.2.9.7** 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.

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**20.2.9.8** 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. It is therefore recommended that an adjustment should be made as suggested in the drafting below to reflect the impact on the Estimated Fair Value Discount Rate of changes to underlying market rates.

**20.2.9.9** An adjustment as proposed 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.

**20.2.9.10** From the point of view of Authorities, it is also beneficial to consider adjustments as suggested 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.

**20.2.9.11** Any dispute as to the assessed value of the terminated Contract should be dealt with through the dispute resolution procedure (see Section 27 (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) [the Post Termination Service Amounts<sup>69</sup> (if a positive number)<sup>70</sup>];
- (b) the Tender Costs; and
- (c) amounts that the Authority is entitled to set off or deduct under Clause 11 (Set-Off),

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<sup>69</sup> 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.

<sup>70</sup> 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 (rather than the Termination Date to the original Expiry Date)).

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**plus** an amount equal to the aggregate of:

- (i) all credit balances<sup>71</sup> 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<sup>72</sup>;
- (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)<sup>73</sup>,

to the extent that:

- (1) (i), (ii) and (iii) have not been directly taken into account in calculating the Estimated Fair Value; 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 Contractor<sup>74</sup> to achieve Service Commencement;
- (b) any accrued Performance Points shall be cancelled; and
- (c) the term of such agreement shall be for a period equal to the term from the Termination Date<sup>75</sup> to the Expiry Date.

**“Estimated Fair Value of the Contract”**

means the amount determined in accordance with Clause 20.2.9 (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<sup>76</sup>;

**“i”** is the agreed assumed forecast rate of increase in the Inflation Index set out in the Contract which, for the avoidance of doubt, is equal to the Bank of England’s prevailing long term inflation target;

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<sup>71</sup> See footnote 21 in Section 1.8 (Interpretation).

<sup>72</sup> In reality on Contractor Default (i) and (ii) are likely to be the same amounts.

<sup>73</sup> See footnote 59 above.

<sup>74</sup> 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.

<sup>75</sup> The Termination Date here is the relevant date as no New Contract is actually being entered into.

<sup>76</sup> Parties should not agree a discount rate other than this (this is the discount rate contained in the Base Case (see Clause 35 (Refinancing) for definition).

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“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 Financial Model at Financial close; and

“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 Financial Model as on the date of Termination.

#### 20.2.9 No Retendering Procedure

If either the Authority is not entitled to retender the provision of the Services under Clause 20.2.7 (Retendering Election) or the Authority elects to require an expert determination in accordance with this Clause 20.2.9 (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 20.2.9 (No Retendering Procedure) after it has elected to follow the procedure under Clause 20.2.8 (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 20.2.8 (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 sub-paragraph (ii) above, such costs to include (without double counting):
    - (A) a reasonable risk assessment of any cost overruns that will arise<sup>77</sup>, whether or not forecast in the relevant base case;
    - (B) the costs of the service forecast to be incurred by the Authority to the standard required<sup>78</sup>; and
    - (C) any rectification costs required to deliver the service 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.

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<sup>77</sup> A methodology can be agreed in advance for agreeing what constitutes a reasonable risk assessment.

<sup>78</sup> This includes both the every day running costs and the costs of the service and life cycle maintenance costs. Forecasts are determined by agreement or, in the event of disputes, by an expert.

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- (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 20.2.9 (No Retendering Procedure), then the Estimated Fair Value of the Contract shall be determined in accordance with Clause 27 (Dispute Resolution).
  - (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 20.2.9 (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 Document<sup>79</sup> 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 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<sup>80</sup>.

## 20.3 TERMINATION ON FORCE MAJEURE

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### 20.3.1 Failure to agree

**20.3.1.1** 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 20.3.4 (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:

#### 20.3 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.
- (b) Nothing in paragraph (a) above shall affect any entitlement to make deductions or any deductions made as a result of [Section 9 (Performance and Payment Mechanism)] in the period during which the Force Majeure Event is subsisting.<sup>81</sup>

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<sup>79</sup> See footnote 70 above.

<sup>80</sup> See footnote 67 above.

<sup>81</sup> During the period which a Force Majeure Event is subsisting, the payment mechanism should operate to ensure that the Contractor is paid only for such of the Service that it performs.

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- (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.<sup>82</sup>
- (e) If no such terms are agreed on or before the date falling [120<sup>83</sup>] 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 20.3.4 (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 Charge<sup>84</sup> from the day after the date on which the Contract would have terminated under paragraph (e) as if the Service was being fully provided;<sup>85</sup> 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.

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<sup>82</sup> 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.

<sup>83</sup> These timings are indicative only.

<sup>84</sup> 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.

<sup>85</sup> This will be subject to general mitigation obligations.

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- (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 terms<sup>86</sup> existing immediately prior to the occurrence of the Force Majeure Event.

## 20.3.2 Compensation on Termination for Force Majeure

**20.3.2.1** 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.

**20.3.2.2** 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 20.3.4 (Compensation on Termination for Force Majeure) should be made (see also paragraph 20.1.3.9 above for explanation where there has been Additional Permitted Borrowing).

Required drafting is as follows:

### 20.3.2 Compensation on Termination for Force Majeure

- (a) On termination of the Contract under Clause 20.3 (Termination on Force Majeure), the Authority shall pay<sup>87</sup> to the Contractor the "Force Majeure Termination Sum" in accordance with [Section 21 (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 and principal made by the Contractor under the Subordinated Financing Agreements;<sup>88</sup>
  - (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)<sup>89</sup>; and
  - (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.

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<sup>86</sup> Taking into account the time that has elapsed, when an extension has been agreed.

<sup>87</sup> See Section 21 (Calculation and Payment of Early Termination Payment) for the rights of set-off against such payments.

<sup>88</sup> This excludes interest accrued but unpaid but the Junior Debt documentation should, of course, be checked to ensure this is the way it works. Repayment of principal is caught through the definition of Junior Debt.

<sup>89</sup> The effect of this paragraph is to ensure that there are no circumstances in which a refund to the Authority is required.

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- (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 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 20.3.2, 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 21 (Calculation and Payment of Early Termination Payments)].

## **20.4 TERMINATION ON CORRUPT GIFTS AND FRAUD**

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### **20.4.1 Introduction**

**20.4.1.1** 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.

**20.4.1.2** 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.

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**20.4.1.3** The required drafting for the corruption and fraud that should be dealt with in such a clause is as follows:

**“Prohibited Act”**

means<sup>90</sup>:

- (a) offering giving or agreeing to give to [any servant of the Crown<sup>91</sup>] any gift or consideration of any kind as an inducement or reward:
  - (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.

## **20.4.2 Scope of Corrupt Gifts and Fraud**

**20.4.2.1** 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.

**20.4.2.2** 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.

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<sup>90</sup> The MOD deals with “National Security” in a similar way.

<sup>91</sup> 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”.

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**20.4.2.3** 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:

**20.4.2 Corrupt Gifts and Fraud**

The Contractor warrants that in entering the Contract it has not committed any Prohibited Act.

**20.4.3 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 shareholders<sup>92</sup> 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,<sup>93</sup> then the Authority may terminate the Contract by giving notice to the Contractor.

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<sup>92</sup> 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”.

<sup>93</sup> 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).

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- (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 Service by another person.<sup>94</sup>
  - (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<sup>95</sup>, 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 Service by another person.<sup>96</sup>
  - (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 Service by another person.
  - (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 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<sup>97</sup>; and
    - (iv) the Authority's chosen option under Clause 20.4.4 (Compensation on Termination for Corrupt Gifts and Fraud).

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<sup>94</sup> 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.

<sup>95</sup> 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).

<sup>96</sup> This must comply with the provisions of replacement Sub-Contractors – see Section 15 (Sub-Contractors and Employees).

<sup>97</sup> Either immediately or following the 30 day period specified.

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### **20.4.3 Compensation on Termination for Corrupt Gifts and Fraud**

**20.4.3.1** 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.

**20.4.3.2** 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.

**20.4.3.3** 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).

**20.4.3.4** 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:

#### **20.4.4 Compensation on Termination for Corrupt Gifts and Fraud**

- (a) On termination of the Contract in accordance with Clause 20.4.3 (Termination for Corrupt Gifts and Fraud), then the Authority shall pay<sup>98</sup> the Contractor an amount equal to the Revised Senior Debt Termination Amount.
- (b) Such amount shall be determined and paid in accordance with [Section 21 (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.<sup>99</sup>

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## **20.5 VOLUNTARY TERMINATION BY AUTHORITY**

### **20.5.1 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.

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<sup>98</sup> See Section 21 (Calculation and Payment of Early Termination Payments) for the right of set-off against such payments.

<sup>99</sup> The Contract must provide that any charges are released by the financiers in this circumstance. See Section 30.3.8 also.

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## 20.5.2 Consequences of Voluntary Termination

**20.5.2.1** The Contractor should not object to the Authority having such a right provided that it is compensated in full if such right is exercised.

## 20.5.3 Compensation for Voluntary Termination

**20.5.3.1** 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.<sup>100</sup>

**20.5.3.2** 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 20.1.2 (Compensation on Termination for Authority Default) and 20.1.3.9).

**20.5.3.3** 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:

### 20.5.1 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.<sup>101</sup>
- (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 20.5.1 (Voluntary Termination by Authority);
  - (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;

### 20.5.2 Compensation on Voluntary Termination

On termination under Clause 20.5.1(d) above, the Authority shall pay the Contractor an amount equal to the amount payable under Clause 20.1 (Authority Default) in accordance with [Section 21 (Calculation and Payment of Early Termination Payments)].

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<sup>100</sup> In projects where a significant change to the Service is foreseeable, the Authority should consider the value for money of requiring the Contractor to bid on the basis that if the Contract is terminated voluntarily, a lesser amount of equity related compensation will be paid to the Contractor. See Sections 12.2.4 (Authority Changes).

<sup>101</sup> This could arise, for example, if the Authority did not wish the Project to continue for reasons unconnected with the Contractor.

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## 20.6 TERMINATION FOR BREACH OF THE REFINANCING PROVISIONS

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### 20.6.1 Introduction

**20.6.1.1** The Contract must deal comprehensively with termination as a result of a breach of the refinancing provisions<sup>102</sup> by the Contractor.

**20.6.1.2** 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.

### 20.6.2 Compensation on Termination for Breach of the Refinancing Provisions

**20.6.2.1** 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.

**20.6.2.2** 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 Section 20.4.4 (Compensation on Termination for Corrupt Gifts and Fraud)).

Required drafting is as follows:

#### 20.6.1 Termination by the Authority for Breach of the Refinancing Provisions

- (a) If the Contractor wilfully breaches Clause 35.1 (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 20.6.1 (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;

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<sup>102</sup> See Section 35 (Refinancing).

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### **20.6.2 Compensation on Termination for Breach of the Refinancing Provisions**

On termination under Clause 20.6.1(d) above, the Authority shall pay the Contractor an amount equal to the amount payable under Clause 20.4 (Termination on Corrupt Gifts and Fraud) in accordance with [Section 21 (Calculation and Payment of Early Termination Payments)].