

11 MAINTENANCE

11.1 INTRODUCTION

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

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

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

11.1.4 Required drafting for a maintenance Clause is as follows:

11.1 Maintenance¹

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

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

11.2 SINKING FUND

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

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

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

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

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

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

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

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

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

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

11.3 EXPIRY OF THE CONTRACT

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

11.4 TRANSFER OF ASSETS AT END OF CONTRACT

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

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

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

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

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

11.5 SURVEYS

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

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

11.5 Surveys

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

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

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

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

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

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

12 PAYMENTS AND SET-OFF

12.1 INTRODUCTION

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

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

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

12.2 SCOPE OF AUTHORITY'S RIGHT TO SET OFF

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

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

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

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

12.3 TIMING OF SET-OFF

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

Suitable drafting is as follows:

12 Set-off

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

12.4 VAT ON PAYMENTS

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

12.4 VAT

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

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

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

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

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

¹ This must be by definition an ascertained amount.

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

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

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

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

13 CHANGE IN SERVICE

13.1 INTRODUCTION

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

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

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

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

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

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

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

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

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

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

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

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

13.2 A TYPOLOGY OF CHANGES

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

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

13.2.3 Changes in Service can be classified:

By Origin

- Authority change
- Contractor change
- Changes in law

By Timing

- Construction
- Early operations
- Steady state operations

By Value

- Small
- Medium
- Large

By Impact

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

By Type

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

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

¹ Changes in Law are discussed in Section 14.

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

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

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

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

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

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

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

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

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

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

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

13.3 CHANGE PROTOCOLS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

13.3.8 Due Diligence

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

13.4 TRANSPARENCY OF PRICING AND VALUE FOR MONEY

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

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

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

13.4.3 Costing Issues

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

13.4.4 Pricing Issues

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

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

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

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

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

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

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

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

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

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

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

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

The terms of reference of the ITA could include:

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

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

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

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

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

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

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

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

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

13.4.5 Abortive Costs

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

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

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

13.5 INCENTIVISATION

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

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

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

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

¹⁵ See Section 7.2.6

14 CHANGE IN LAW

14.1 INTRODUCTION

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

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

14.2 CONTRACTOR'S AND AUTHORITY'S CONCERNS

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

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

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

14.3 DEFINITION OF CHANGE IN LAW

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

Required drafting for change in law is as follows:

14.3 “Change in Law”

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

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

“Legislation”

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

14.4 ALLOCATION OF RISK OF CHANGE IN LAW

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

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

14.5 MITIGATION

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

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

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

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

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

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

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

14.6 DISCRIMINATORY, SPECIFIC AND GENERAL CHANGES IN LAW

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

“Discriminatory Change in Law”

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

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

“Specific Change in Law”

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

14.6.2 Required drafting for a definition of General Change in Law is as follows:

“General Change in Law”

means a Change in Law which is not a Discriminatory Change in Law or a Specific Change in Law.⁶

14.6.3 Where a risk sharing approach is adopted in respect of Change in Law (as referred to in Section 14.4.2),⁷ any costs arising from Discriminatory Changes in Law and Specific Changes in Law should be at the Authority’s risk.

14.7 GENERAL CHANGE IN LAW AT CONTRACTOR’S RISK

14.7.1 Costs arising from changes in non-discriminatory/non-specific legislation (i.e. General Changes in Law) can either be for the account of the Contractor or shared between the Contractor and the Authority.

14.7.2 General Changes in Law are generally only at the Contractor’s sole risk in specific sectors where the length of the Contract is such that the Contractor is comfortable that the risk of General Changes in Law occurring is low, or where the relationship between the parties and the history of changes in the sector concerned is such that the Contractor is prepared to accept this risk. For example, in some MOD projects this risk is passed to the Contractor.

14.7.3 Although the Contractor may appear to bear all the risk of General Changes in Law, this approach will often involve some method of mitigating the effect on the Contractor. For example, market testing, benchmarking and/or indexation provisions will in fact lead to the sharing of some

⁵ In a Project involving construction, the “provision” of the Service will include the related construction of an asset to enable the Service to be provided. The Authority and its advisers will need to arrive at a definition of Specific Change in Law that gives protection in relation to Changes in Law which are targeted at companies delivering similar services to those being carried out by the Contractor (e.g. in NHS PFI Projects Specific Change in Law covers changes in law relating to the provision or operation of healthcare premises and changes in NHS requirements).

⁶ See Section 14.8.8 below.

⁷ The Authority should, accordingly, receive the full benefit of cost savings arising from Discriminatory Changes in Law and Specific Changes in Law. How such benefits are passed through to the Authority is a matter for discussion between the parties.

of this risk (see Section 15 (Price Variations)) in that additional operating costs may be reflected in increases to the Unitary Charge following a benchmarking or market testing and/or indexation, although the Contractor will bear such risk for the period up to benchmarking or market testing.

14.8 GENERAL CHANGE IN LAW AS A SHARED RISK

14.8.1 General Change in Law may affect the Project in a variety of ways. For example:

- the change may require alterations to the structure of a building or its fixtures (with an impact both on Capital Expenditure and, potentially, timetable); and
- the change may necessitate a change in the way a Service is delivered (e.g. the number of people required to deliver it or the rights of employees may change).

14.8.2 Costs arising from General Changes in Law should generally be for the account of the Contractor, as the Contractor is protected through the combined effects of benchmarking, market testing and indexation.⁸

14.8.3 This alternative approach recognises, however, that it may be more equitable for the Authority to share costs which are difficult for the Contractor to manage. An exception is therefore made of General Changes in Law which:

- require Capital Expenditure; and
- take effect during the Service Period (i.e. after construction is completed (but see Section 14.8.8)); and
- were not reasonably foreseeable at Contract signature.

Under this approach the costs of a General Change in Law falling within this exception are shared between the Contractor and the Authority. If the change was foreseeable during the construction period although not yet in effect, the Contractor's obligation to mitigate (see Section 14.5 (Mitigation)) would require it to have taken all reasonable action to minimise the eventual cost of implementing such change (e.g. by altering construction works prior to completion). This approach promotes a shared incentive to keep the costs of a change in law to a minimum without exposing the Contractor to excessive risk.

14.8.4 An appropriate approach to sharing the risk of the type of change in law described in Section 14.8.3 is to share such risk on a progressive scale so that, for example, the Contractor takes 100% of the first £x of Capital Expenditure, 75% of the next £y, 50% of the next £z and so on (see the table set out in Section 14.8.10). Once a certain amount is reached, the Authority takes 100% of any amounts above that amount.⁹ The threshold figures agreed and the number of graduated steps will take into account the size of the Project and the impact of other factors such as the likelihood of environmental and health and safety legislation. The levels of Cumulative Capital Expenditure (see Section 14.8.10) are not indexed (as the totals are cumulative, indexation can lead to unnecessary complication). The Contractor's total liability should generally be between 2% to 5% of the initial capital cost of the Project.¹⁰ A cap by reference to time is not recommended.

⁸ The Contractor should also receive the benefits of any cost savings resulting from General Changes in Law. Benchmarking, market testing and indexation should act to restrict the overall benefits received by the Contractor.

⁹ This will enable the Contractor and its financiers to quantify the Contractor's maximum exposure.

¹⁰ Bidders will price into their bid submissions any General Change in Law risk they are required to take. Both the Authority and bidders should seek to ensure that cost and adequate risk transfer are balanced as far as possible to achieve the best value for money.

14.8.5 The advantage of sharing the risk in the way described (as opposed to the Contractor simply being liable for the first £x of Capital Expenditure) is that it both incentivises the Contractor to minimise the cost of implementing the change (as opposed to the Contractor simply invoicing the Authority for whatever it costs) and reduces any concern the Contractor has that the Authority can take advantage of the situation.

14.8.6 Although it is the responsibility of the Contractor to manage the way in which it will fund any increases in capital costs which occur as a result of a General Change in Law occurring during the Service Period, if it is clear to the Authority from the winning bidder's Base Case that it has priced the risk at 100 percent,¹¹ the Authority may wish to retain the risk on value for money grounds. For example, if the Base Case shows amounts being drawn from Senior Debt to fund a so called "Change in Law Reserve Account", the Authority is paying for this account to be placed in-funds as if it were an expected cost of the Contractor.¹² Experience has shown however, that the competitive bidding process incentivises bidders to price the risk at less than 100 percent and Senior Lenders are typically comfortable that General Changes in Law can be managed either by: (i) standby finance (from Shareholders or Senior Lenders); (ii) undrawn revolving working capital facilities; or (iii) building up sums over time from free cashflow without the need for a pre-funded Change in Law Reserve Account because:

- changes in law are usually consulted well in advance;
- there is normally a grace period for implementation; and
- such changes rarely apply retrospectively.

14.8.7 The Authority should generally pay such Capital Expenditure in accordance with the principles set out in Section 13.3.7 (Funding and Payment). Any consequent operating cost increases are borne by the Contractor although these costs will be mitigated by the effects of market testing, benchmarking and/or indexation¹³ (see Section 15 (Price Variations)). The points made in Section 5.2.3 (Calculation of Compensation) are similarly relevant here.

14.8.8 All other General Changes in Law requiring Capital Expenditure (e.g. those which take effect during a typical construction period) should, with this approach, be at the risk of the Contractor in terms of time and money.

14.8.9 For projects which have unusually long construction periods, transferring the risk of General Changes in Law for the entire construction period (rather than adopting a sharing approach) may in fact be poor value for money and is likely to be difficult to achieve in practice (see in particular Department for Environment, Food and Rural Affairs' guidance for Waste PFI projects).¹⁴

14.8.10 Changes arising in operational costs as a result of a General Change in Law should also be borne by the Contractor (subject to Section 15 (Price Variations)). If a General Change of Law requires changes to the Service then either party should be entitled to require a variation to the project specifications to comply with a Change in Law and no breach of contract should arise while this is being done.¹⁵

Required drafting is as follows:¹⁶

¹¹ i.e. 100 pence in the pound.

¹² The cost of funding such an account is not likely to offer good value for money to the Authority.

¹³ Indexation is much less likely to have an effect here than market testing and benchmarking.

¹⁴ See Department for Environment, Food and Rural Affairs website at www.defra.gov.uk.

¹⁵ The required drafting that follows may be incorporated into a Change Protocol as described in Section 13 (Change in Service).

¹⁶ This will have to be adapted to the extent the approach in Section 14.7 (General Change in Law at Contractor's Risk) is taken. The

“Contractor’s Share”

means the percentage figure corresponding to that part of the Cumulative Capital Expenditure at the relevant time, shown in the first column of the table set out below.

Cumulative Capital Expenditure ¹⁷	Contractor’s Share ¹⁸
£0 – £ [a] million (inclusive)	100%
£[a] million to £ [b] million (inclusive)	80%
£[b] million to £ [c] million (inclusive)	60%
£[c] million to £ [d] million (inclusive)	40%
£[d] million to £ [e] million (inclusive)	20%
£[e] million to £ [f] million (inclusive)	10%
£[f] million and above	0%

“Cumulative Capital Expenditure”

means the aggregate of:

- (a) all Capital Expenditure that has been incurred as a result of each General Change in Law that has come into effect during the Service Period; and
- (b) the amount of Capital Expenditure that is agreed, or determined to be required, as a result of a General Change in Law under Clause 14.8 (Qualifying Change in Law).

“Qualifying Change in Law”¹⁹

means:

- (a) a Discriminatory Change in Law;
- (b) a Specific Change in Law; and/or
- (c) [a General Change in Law which comes into effect during the Service Period and which involves Capital Expenditure,²⁰

which was not foreseeable at the date of this Contract.²¹

14.8 Qualifying Change in Law

- (a) If a Qualifying Change in Law occurs or is shortly to occur, then either party may write to the other to express an opinion on its likely effects, giving details of its opinion of:
 - (i) any necessary change in Service,²²

“sharing” approach is set out as it includes both approaches.

¹⁷ These figures are to be bid as part of the bid submission. In each case they are not to be indexed.

¹⁸ These figures are illustrative only and it is open for the Authority or bidders to set the Contractor’s or Authority’s Share at zero or one hundred per cent with no incremental changes, or have only one or two stages in the graduation. This approach will help the Authority find the appropriate level.

¹⁹ It may of course be that there is a particular uncertainty attaching to a particular change in law (even if foreseeable), such as where, for example, its effects can vary by a significant factor. If this is so, then risk sharing can be agreed where the value for money impact is extremely difficult to assess. One example of such an issue is projects for energy from waste plants, given the Electricity Supply Industry Rateable Values Order, SI 1994/3282.

²⁰ This will depend on which option in Section 14.7 (General Change in Law at Contractor’s Risk) is adopted and the extent to which Capital Expenditure is at the risk of the Contractor (i.e. the extent to which such amounts have been included in the bid).

²¹ If any greater clarity can apply to this in a particular Project (such as concerns over particular envisaged changes in law) then this should be expanded upon.

²² For example, the contractual, financial, operational and/or construction implications of the change in Service. Any change in Service should be agreed and implemented in accordance with the Change Protocol described in Section 13 (Change in Service), with the costs of the change being shared as recommended in this Section 14.

- (ii) whether any changes are required to the terms of this Contract to deal with the Qualifying Change in Law;
- (iii) whether relief from compliance with obligations is required, including the obligation of the Contractor to achieve the Planned Service Commencement Date and/or meet the [performance regime] during the implementation of any relevant Qualifying Change in Law;
- (iv) any loss of revenue that will result from the relevant Qualifying Change in Law;
- (v) any Estimated Change in Project Costs that directly result from the Qualifying Change in Law; and
- (vi) any Capital Expenditure that is required or no longer required as a result of a Qualifying Change in Law taking effect during the Service Period,

in each case giving in full detail the procedure for implementing the change in Service. Responsibility for the costs of implementation (and any resulting variation to the Unitary Charge) shall be dealt with in accordance with paragraphs (b) to (f) below.

- (b) As soon as practicable after receipt of any notice from either party under paragraph (a) above, the parties shall discuss and agree the issues referred to in paragraph (a) above and any ways in which the Contractor can mitigate the effect of the Qualifying Change of Law, including:
 - (i) providing evidence that the Contractor has used reasonable endeavours (including (where practicable) the use of competitive quotes) to oblige its sub-contractors to minimise any increase in costs and maximise any reduction in costs;
 - (ii) demonstrating how any Capital Expenditure to be incurred or avoided is being measured in a cost effective manner, including showing that when such expenditure is incurred or would have been incurred, foreseeable Changes in Law at that time have been taken into account by the Contractor;
 - (iii) giving evidence as to how the Qualifying Change in Law has affected prices charged by any similar businesses to the Project, including similar businesses in which the Shareholders or their Affiliates carry on business; and
 - (iv) demonstrating that any expenditure that has been avoided, which was anticipated to be incurred to replace or maintain assets that have been affected by the Qualifying Change in Law concerned, has been taken into account in the amount which in its opinion has resulted or is required under paragraph (a) (v) and/or (vi) above.
- (c) If the parties agree or it is determined under Clause 28 (Dispute Resolution) that the Contractor is required to incur additional Capital Expenditure due to a Qualifying Change in Law (excluding the Contractor's Share of any Capital Expenditure agreed or determined to be required as a result of a General Change in Law under this paragraph), then the Contractor shall use its reasonable endeavours to obtain funding for such Capital Expenditure on terms reasonably satisfactory to it and the Senior Lenders.
- (d) The Contractor's Share shall be solely for the account of the Contractor.
- (e) If the Contractor has used reasonable endeavours to obtain funding for Capital Expenditure referred to in paragraph (c), but has been unable to do so within [60] days of the date that the agreement or determination in paragraph (c) occurred, then the Authority shall pay to the Contractor an amount equal to that Capital Expenditure on or before the date falling 30 days after the Capital Expenditure has been incurred.

- (f) Any compensation payable under this Clause by means of an adjustment to or reduction in the Unitary Charge²³ shall be [see Section 5.2.3 (Calculation of Compensation) above].²⁴

14.9 CHANGES IN TAX LAW

14.9.1 Discriminatory and specific changes in tax law should be dealt with in accordance with Section 14.6 (Discriminatory, Specific and General Changes in Law).

14.9.2 Whichever approach is adopted on General Changes in Law, all costs arising from changes in tax law that are general should be for the account of the Contractor, except as stated in Section 14.10 (Changes in VAT) in relation to changes in VAT legislation.

14.9.3 Save as otherwise expressly permitted by this guidance (e.g. gross up on certain termination payments or change in VAT regime), Authorities should not provide tax indemnities to the Contractor, and the Change of Law provisions should not be used as a device to transfer tax risk.²⁵

14.10 CHANGES IN VAT

14.10.1 Changes in the VAT Rate

14.10.1.1 The Contract should be explicit regarding the consequences of a change in the rate of VAT affecting the Service. Where the Service is within the scope of VAT, a change in the rate will affect the Unitary Charge paid by the Authority. This risk is borne by the Authority.

14.10.1.2 A change in the rate of VAT may also affect the gross costs borne by the Contractor if input VAT is not reclaimable (i.e. the Service supplied by the Contractor to the Authority is specifically disallowed or relates to “exempt supplies” as at the date of the Contract). If the rate changes in relation to supplies received by the Contractor, then the Contractor will benefit or not in the same way as if its general corporation tax bill changes. This risk should, therefore, be borne by the Contractor.

14.10.1.3 Changes in the rate of VAT can lead to a cashflow cost or advantage. There is always a difference in timing of VAT payments and their recovery. A Contractor should not increase its Unitary Charge to deal with any such disadvantage, but instead should take such timing differentials into account in structuring its financing.

14.10.2 Changes in VAT Scope

14.10.2.1 During the course of the Contract, changes in the scope of VAT may affect the Contractor’s ability to recover its input VAT. The Contract should make it clear that the Contractor bears this risk unless it results from a change in the VAT status of the Service e.g. the Service becomes exempt from VAT. In this exceptional case, the Contract should provide for an adjustment to the Unitary Charge.

²³ There will only be an adjustment to the Unitary Charge in respect of increased capital costs if the Contractor’s Share is less than 100% and the Authority does not make a lump sum payment to the Contractor (see Clause 14.8(e) above). Increased operational costs resulting from any General Change in Law are borne by the Contractor and will not result in an adjustment to or reduction to the Unitary Charge (see Section 14.8.7 above).

²⁴ See also Sections 14.6.3 and 14.8.2.

²⁵ If a change of tax law does however fall within the Discriminatory Change in Law or Specific Change in Law provisions, the normal protections available to the Contractor would apply. The loss of charitable status which a Contractor could suffer as a result of any General Change of Law would not fall within these categories.

Suitable drafting is as follows:

14.10 Payment of Irrecoverable VAT

The Authority shall pay to the Contractor from time to time as the same is incurred by the Contractor sums equal to any Irrecoverable VAT but only to the extent that it arises as a result of a Change in Law. Any such payment shall be made within 28 days of the delivery by the Contractor to the Authority of written details of the amount involved accompanied by details as to the grounds for and computation of the amount claimed. For the purposes of this Clause 14.10 "Irrecoverable VAT" means input VAT incurred by the Contractor on any supply which is made to it which is used or to be used exclusively in performing the Works or the Services or any of the obligations or provisions under the Contract (together with input VAT incurred as part of its overhead in relation to such activities) to the extent that the Contractor is not entitled to repayment or credit from HMRC in respect of such input VAT.

15 PRICE VARIATIONS

15.1 INTRODUCTION

15.1.1 The Contract will set out the Unitary Charge for the entire Contract term. However, due to the uncertainties of inflation rates and certain operating costs over a long-term contract, it is usually in the interests of both Authority and Contractor to set out provisions for varying the Unitary Charge in certain specified circumstances. The Contractor should always be encouraged to control its costs, but if there are mechanisms for addressing unforeseeable changes in costs, the Contractor can reduce the contingency in its bid price for such risk. Similarly, although the Authority should ensure it obtains a competitive price initially by holding a well-run competition, it will take additional comfort if there is some means of ensuring the price it has agreed to pay in future years will not be in excess of future market prices for such Services.

15.1.2 The Contract must achieve the right balance between the provisions for change in law (see Section 14 (Change in Law)), indexation and value testing; these are inherently interrelated, particularly in relation to the allocation of operating-cost risk. Contractors will be more willing to take risk in relation to certain changes in law, or in relation to cost increases above the relevant indexation rate, if they have some protection through the value testing provisions (i.e. they can bear certain risks for the period up to value testing as the extra costs are likely to be covered to an extent following value testing). The Authority should consider such inter-relationships when preparing its bid documents.

15.2 INFLATION INDEXATION

15.2.1 The Contractor will be concerned to protect itself against its costs inflating over the course of the Contract, rendering the Unitary Charge insufficient to meet its operating costs and financing obligations.¹ The payment mechanism should therefore usually include arrangements for indexing the Unitary Charge to this extent. If there is no indexation mechanism, the Contractor is likely to have to build a contingency into its price to cover operating-cost inflation risk and this is unlikely to give the Authority value for money (as the risk is outside the control of the Contractor and, historically, has been difficult to forecast accurately). It is highly unusual for prices to be fixed (i.e. without indexation) throughout the term of any Contract for periods for which PFI Contracts are typically let. Conversely, it is not usual for the whole Unitary Charge to be indexed, and such “over-indexation” should not be used as a method of artificially reducing the initial Unitary Charge.

15.2.2 The Authority should focus on the appropriate method of applying indexation to the payment stream at an early stage in Project development. By the time an ITPD is issued, the Contract should specify the index to be applied and how it applies (i.e. how the proportion of the Unitary Charge to be indexed is to be determined). Authorities should not leave the indexation proportion or choice of indices to the bidders, given the difficulties in comparing one bidder’s price and value for money with that of another bidder where different bidders use different proportions and methods of indexation.²

¹ See HMT’s Application Note—*Interest-Rate & Inflation Risks in PFI Contracts* (May 2006). The possible adjustment to Unitary Charges for movements in interest rates in the periods before or after contract signature are not considered here, but see Section 33.2.1 and HMT’s Application Note.

² It is open to the Authority, however, in the interests of value for money, to invite bidders to propose alternative indices, provided the choice of such alternates is supported in the bid with appropriate Models demonstrating their financial impact and the issues addressed in HMT’s Application Note referred in footnote 1 above are properly addressed.

15.2.3 Authorities should bear in mind that the use of benchmarking or market testing gives some protection to Contractors for the Services covered by these arrangements. In most cases value for money can be achieved through indexation of a proportion of the Unitary Charge which matches the proportion of total costs represented by any elements of the Contractor's underlying costs which are not fixed, using a general price index such as RPI or RPIX.

15.2.4 On certain projects, the use of a more focussed index such as a construction index for construction prices, a facilities management index, or a weighted basket of indices, may be preferable. In these cases, the Authority should take care with index selection. Choosing an index that may be short lived, or is not independently produced, is not a sensible approach.³ It is also not appropriate to have too narrow a focus on a particular industry or sector, as in specific sectors (such as the defence industry), Contractors or their Affiliates are themselves responsible to a significant extent for inflationary costs (that is, they can actually affect the index by increasing their price).⁴

15.2.5 Whilst choosing an index and weighting that reflect the underlying cost exposure of the Contractor has the effect of reducing its cost risk, amended forms of such indexation formulae can incentivise real cost savings over the life of the Contract.⁵

15.2.6 For more detailed guidance in this area, please see HMT *Application Note – Interest-Rate and Inflation Risks in PFI Contracts* (May 2006).

15.3 VALUE TESTING OF OPERATING COSTS

15.3.1 Introduction

15.3.1 As noted above, it may be beneficial to include within the Contract provisions for periodic value testing of certain Services provided by the Contractor. By "value testing", this guidance generally refers to either market testing or benchmarking, although other forms of value testing may sometimes be appropriate.

15.3.2 Market testing means the re-tendering by the Contractor of a relevant Service to ascertain the market price of that Service. This may lead to the replacement of the Sub-Contractor operating such Service by the winning bidder. Any increase or decrease in the cost of such Service following market testing should be reflected by an adjustment in the price charged to the Authority.

15.3.3 Benchmarking is a process by which the Contractor compares either its own costs or the cost of its Sub-Contractors for providing certain Services against the market price of such Services. This may lead to a price adjustment, but not to a change in the sub-contractor providing the Service.

15.3.4 The Services provided by the Contractor that are suitable for value testing are generally limited to soft services. By "soft services", this guidance means Services such as facilities management services for an accommodation project (e.g. catering, cleaning and security), to the extent they do not involve a significant capital outlay in their performance or affect the value of any capital asset under the Contract. These services are suitable as the prices charged by the

³ In any event, the Contract should include provisions dealing with circumstances where the specified index (or indices) is not published or the basis upon which it is calculated is changed – see Section 1, footnote 45.

⁴ Suggested drafting on indexation can be found in Clause 1.7.2(b) (Interpretation).

⁵ One such amended indexation formula of $x \times (1 + RPI \pm y)$ could be used by the Authority in its ITPD, with bidders required to bid values of x and y . Where future cost reductions are reasonably foreseeable and not reflected in the initial Unitary Charge these can be reflected in the value of y . The bidder can propose a value of x reflecting the percentage of any elements in its cost structure that are not fixed. The variable x will therefore be a number between 0 and 1.

incumbent sub-contractor and by various potential sub-contractors for such services from year to year should be comparable. Where an incumbent sub-contractor has incurred capital costs, its price cannot be expected to compete with the price of a bidder who was not required to incur those capital costs. Services such as building “re-fit” or lifecycle maintenance or “heavy maintenance” of equipment should not generally be market tested or benchmarked.⁶ These services are referred to as “hard services”.

15.3.5 Providing for periodic value testing of soft services in the Contract may benefit both the Authority and the Contractor. Testing against the market is an important mechanism for the Authority to ensure that the soft service costs remain value for money over the life of the Contract and that the Contractor does not become complacent in its pricing or delivery. In addition, if the Contractor was required to enter into a fixed price long-term contract for soft services (with a simple indexation mechanic and the assumption of operational change of law risk) without any form of periodic testing, significant risk reserves may need to be built into its price. This in turn would not offer value for money to the Authority. It is important that both the Authority and the Contractor understand the purpose of the value testing process and the results it may yield. In particular, if the Contractor has misjudged its original service delivery bid or is inefficient in its operation, value testing should not be viewed by it as a means of passing Service or delivery risk back to the Authority.

15.3.2 Choice of Value Test - Preference for Market Testing

15.3.2.1 It is now standard practice in most sectors of the PFI market to include some form of value testing. The recommended approach in Version 3 of this guidance was to adopt benchmarking as the preferred value testing mechanism and to use market testing only to the extent that the parties cannot agree on the outcome of benchmarking. This position has now changed.

15.3.2.2 Market testing allows a more flexible approach to the provision of Services than benchmarking because it ensures that the soft service provision for the Project can be re-assessed to match public sector requirements at the time the exercise takes place. Market testing also offers greater opportunity for transparency and competition. Accordingly, and because of a greater maturity in the soft services market, the recommended approach is to provide for market testing of soft services, as this is most likely to yield best value for money.

15.3.2.3 In certain limited circumstances however, it may not be appropriate to provide for market testing. For example:

- the Service may be specialised and only provided by one or two contractors, or it may require specific security clearance. In these cases neither market testing nor benchmarking may be appropriate but some alternative form of value testing such as profit-sharing may be considered,⁷ or
- there may be no competitive market for the relevant Service in the area, although Authorities should be expected to actively develop a market for the Service where possible. If no competitive market exists or can be developed and effective market testing would thus be impossible, benchmarking (perhaps against suppliers of a similar service operating in a different geographic region) or an alternative form of value testing may be used.

⁶ In some Contracts, it may nevertheless be possible for the Contractor to market test or benchmark “hard services” because they are of a standard nature (e.g. routine vehicle maintenance). The decision on the appropriateness and extent of market testing or benchmarking should be considered on a case by case basis in such Contracts.

⁷ See for instance Part 15 of the MOD PFI Standard Contract (August 2006) and related guidance, on the MOD website, www.mod.uk where, on these grounds, they provide for a value for money review instead of a benchmark or market test procedure.

Authorities should consult their relevant departmental Private Finance Units for guidance where benchmarking is proposed instead of market testing.

15.3.2.4 Whether the Authority determines market testing or benchmarking to be appropriate, it should consider whether it would be beneficial to include provisions in the Contract for an alternative method of value testing. Where market testing is selected as the primary value testing method, provisions could be included to allow the Authority to require a benchmarking process following the initial market test procedure if the market test fails, perhaps due to lack of any bidder other than the incumbent.

15.3.2.5 Similarly, where benchmarking is thought to be the most appropriate value test, it will usually be appropriate to include provisions in the Contract to allow the Authority to require a market test, at its discretion, with or without a prior benchmarking process. Benchmarking on its own is unlikely to produce best value for money results. Authorities should move to market testing following a benchmarking process where adequate benchmark data was not available, a robust benchmark process had not been achieved, or a price adjustment was not agreed. Further, it would be appropriate to move straight to a market test where benchmarking was selected due to a lack of competitive market, and a sufficiently competitive market has developed between Contract signature and the value testing date.

15.3.2.6 Different Services within the same Project may need different treatment (or possibly the same Service could have different treatment at different points in the Project). Authorities need therefore to consider their options carefully both at the outset and at any value testing point.

15.3.3 Planning and Management

15.3.3.1 At the outset of the Project, when developing its business case, the Authority should consider what Services it needs and whether it is appropriate to include soft services (see paragraph 4.25 and beyond of HMT's *"Value for Money Assessment Guidance"* November 2006). An Authority may decide that only those Services intimately connected with the design solution of the Project, such as hard services, should be included in the Project; a number of hospital projects have taken this route. If soft services are to be included in the Contract, the nature of the individual services and their degree of integration in the design solution and with each other needs to be considered.

15.3.3.2 The Authority should specify in the ITPD when the first value testing exercise will take place. Commonly the value testing exercise will occur at five to seven year intervals with a longer interval before the first exercise. The longer initial period (which should be well into the Service Period) should ensure that bidders do not set a deliberately low initial price that they then try to increase through the review. An excessively long initial period may, however, expose the Authority to an unreasonable price premium for transferring this risk. Where benchmarking is appropriate, the first benchmarking exercise could be limited such that it is capable of resulting in decrease in price only or a capped increase in price.

15.3.3.3 Some early projects have experienced practical difficulties in managing their benchmarking and market testing procedures and some early contracts lack detail on these processes. Contracts in any event are unlikely to provide a comprehensive blue print for such procedures. The Operational Taskforce has published guidance on this entitled "Operational Taskforce Note 1: *Benchmarking and market testing guidance*" (October 2006)⁸ which, in particular, sets out the relevant practical considerations to be taken into account. Any practitioners preparing for a market test or benchmark exercise should refer to this.

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

15.3.3.4 Benchmarking and market testing are the responsibility of the Contractor, from both a cost and management perspective. Depending on the Project, this may involve an independent tender manager being employed to manage the market testing and/or benchmarking processes. Having some independent management level (coupled with appropriate information barriers) would be essential where the current service provider, or any bidder, or any member of their respective groups, had a shareholding interest in the Contractor or relevant sub-contractor.

15.3.3.5 This guidance assumes that the person providing the soft services to be benchmarked or market tested is an operating Sub-Contractor who has a direct contractual relationship with the Contractor. If the relevant Services are instead being provided by a sub-contractor to such an operating Sub-Contractor, and thus there is no direct contract with the Contractor, the same principles apply. However, in these cases the calculation of pricing adjustments to the Unitary Charge following value testing may become more complicated, since the relationships between cost and price charged to the Contractor become more remote.⁹

15.4 MARKET TESTING

15.4.1 As outlined in Section 15.3.2, the recommended approach is to provide for market testing of soft services in the Contract, as this is most likely to yield best value for money. The procedure for market testing should be as follows:

- on certain fixed dates, the Contractor re-tenders the relevant Project Document and conducts a competition for potential replacement sub-contractors (and normally the existing sub-contractor would be allowed to bid).¹⁰ Care must be taken to avoid any conflict of interest issues, for instance where the Contractor may be part of the same corporate group as any bidder;¹¹
- if the competition shows that the Contractor can obtain better value for money with a new winning tenderer, then the Unitary Charge should be reduced (as described in Section 15.5.4) and the Contractor would obtain a reduction in cost by appointing the winning tenderer as a replacement sub-contractor; and
- if the competition shows that the Contractor's current sub-contractor is better value for money than any potential replacement, then the sub-contractor should continue, but with an appropriate change being made to the Unitary Charge to reflect the sub-contractor's bid price.

See further Operational Taskforce Note 1 referenced at footnote 8.

15.4.2 Information will need to be collected by the Contractor and made available to tenderers for the market testing to be effective. For example, information relating to the terms and conditions, job title, age, length of service and benefits of the employees of the service provider engaged wholly or mainly in the provision of the market tested services may be required.¹² The Contract should provide that this information is provided to the Authority (see Section 26, (Information and Confidentiality)).

15.4.3 The Contract should also make clear that the market testing of each Service is the responsibility of the Contractor who should ensure a smooth transition between sub-contractors.

⁹ See Chapter 5 of Operational Taskforce Note 1 "*Benchmarking and market testing guidance*", October 2006.

¹⁰ If, in unusual projects, the Authority is concerned that there may be a lack of bidders, the Authority could consider provisions whereby the incumbent was required to bid (if otherwise no bids might be made). If this is considered a possibility however, this may indicate that these are not actually suitable Services to be market tested. See Section 15.3.2.3.

¹¹ See Chapter 4 of Operational Taskforce Note 1 "*Benchmarking and market testing guidance*", October 2006. See also footnote 18 below.

¹² It may also be appropriate for the Contractor to make available to tenderers information relating to the relevant Service provider's shareholding in the Contractor (and/or Operating Sub-Contractor), including the terms of any associated shareholders' agreement.

The Authority may however wish to actively support the Contractor in encouraging bidders for the relevant Services, perhaps by the appointment of an independent tender manager, in order to ensure there are sufficient bidders willing to compete against an incumbent Service provider to provide an effective competition.

15.4.4 Suitable drafting for a market testing programme is as follows:

15.4.4 Market Testing

- (a) At least [40] weeks¹³ before each market testing date, the parties shall meet together as often as may be necessary in respect of all market tested services to be market tested on that date:
 - (i) to consider any changes required to the relevant services;
 - (ii) to discuss and seek to agree the appropriate manner of advertising the services required and the means of identifying prospective tenderers;¹⁴
 - (iii) to discuss and seek to agree the tender requirements which must include:
 - (A) a statement of the tender validity period;
 - (B) details of the tender evaluation criteria;¹⁵
 - (C) the terms and conditions under which the services will be contracted;
 - (D) information relating to employees and their conditions of employment;¹⁶
 - (E) the information that tenderers are required to provide;
 - (F) how many tenders are required for the market testing to be valid; and
 - (G) whether or not an independent tender manager needs to be appointed by the Contractor to manage the tender process.

15.4.5 Where a number of Services are being market tested, the question may arise as to whether bidders must tender for all such Services or whether they can select certain Services and tender in respect of those only (for example, some bidders may only want to take over the catering function, whereas others may want a wider role). One way of dealing with this is as follows:

Grouping of Services

Unless the Contractor can demonstrate to the Authority that best value for money is likely to be achieved for the Contractor if market tested services are tendered separately or in particular groupings, or if any market tested service is divided into separate parts, the grouping of any market tested services shall be left to the discretion of tenderers on the basis that the tender requirements shall specify that:

- (a) tenderers may submit tenders for all or any of the market tested services; and
- (b) if a tenderer submits a tender for a group or groups of market tested services, then it may be required to provide all or any of the services in such group or groups.¹⁷

¹³ Precise timing will depend on whether any prior benchmarking exercise is conducted. See Section 15.3.2.5 above.

¹⁴ This may include an OJEU notice. See further guidance at footnote 8.

¹⁵ These must be objective criteria.

¹⁶ This will deal with any exclusion required (such as retirement benefits and occupational pensions). Applicable TUPE regulations must be complied with.

¹⁷ The Authority should be aware of the danger of any less attractive services not being bid for and so may require these to be included in bids.

15.4.6 The next step in the market testing provisions will be to specify how tenderers are selected.¹⁸ A suggested way of doing this is set out below:

Selection of Tenderers

- (a) The Contractor shall be responsible for compiling the list of prospective tenderers and selecting the tenderers from the list of prospective tenderers on the basis of their:
 - (i) financial standing; and
 - (ii) technical and managerial experience and ability (taking into account any relevant references).
- (b) The Authority shall have a right to prevent the selection of any person as a prospective tenderer if it reasonably believes that such person does not (or could not reasonably be considered to) comply with any of the criteria referred to in Clause 15.4.4 (a)(iii) above.
- (c) The Authority shall, in its absolute discretion, have the right to prevent the selection of any person as a tenderer on the grounds that the prospective tenderer has committed a Prohibited Act.¹⁹
- (d) The Authority shall have a right to review the list of prospective tenderers. The Contractor shall provide the Authority with an explanation of the reasons behind the non-inclusion on the list of prospective tenderers of any person identified as suitable by the Authority, if so requested by the Authority.
- (e) The Contractor shall provide any prospective tenderer which is unsuccessful in being selected with an explanation of the reasons behind its non-selection, if so requested by the person in question.

15.4.7 Once the period for submission of tenders has ended, the Contractor must determine the best tender. The following drafting deals with this issue:

- (a) The Contractor shall determine which compliant tender in respect of any market tested service represents the best value for money.²⁰
- (b) On making this determination, the Contractor shall supply to the Authority a copy of its tender evaluation, together with sufficient supporting information concerning the tender evaluation to enable the Authority to analyse and understand the basis for the Contractor's determination.
- (c) If the Authority does not agree with the Contractor's determination, the Authority may, within 15 Business Days of being provided with the tender evaluation, dispute such determination and, if the parties do not resolve such dispute within a further 15 Business Days, the dispute shall be dealt with in accordance with Clause 28 (Dispute Resolution).

¹⁸ The Contract will also have to deal with the extent to which any person is disqualified from selection as a tenderer merely by virtue of its connection with any other person in the Project. Typically, no such connection should disqualify a tenderer provided an independent tender manager is appointed and appropriate information barriers are put in place. See Section 15.3.3.4.

¹⁹ This may also include breach of security requirements in certain sectors. See Section 21.4 (Termination on Corrupt Gifts and Fraud) for the definition of "Prohibited Act".

²⁰ If only one compliant tender is submitted in respect of some or all of the market tested services, the Authority is at risk of being obliged to pay an uncompetitive price for that part or all of the Service. Accordingly, the Contract may provide a right for the Authority to prevent the Contractor appointing a single bidder and passing those costs onto the Authority through the Unitary Charge without its approval. The risks of only one such bid being received in practice should be remote and capable of assessment by the Contractor (unless there are project specific reasons to the contrary) which should enable the Contractor to accept the inclusion of a provision of this nature. If the parties wish to specify what would happen in those circumstances, the provision should be amended on a project specific basis.

15.4.8 On selection, the winning tenderer will take over the provision of the Service and the Unitary Charge should be adjusted on the basis agreed in the Contract. As the Contractor is responsible for the market testing, the Authority should be indemnified against any claims brought against it (for example, from a losing tenderer) as a result of any market testing (for example, for a breach of the agreed market testing procedures).

15.5 BENCHMARKING

15.5.1 The following provisions of this Section 15.5 are relevant if a benchmarking process is included in the Contract, either as the sole value test or included along with market test provisions (as outlined in Section 15.4).

15.5.2 To ensure any benchmarking exercise provides a good comparison with the costs of a Sub-Contractor, the Contractor will have to ensure the following issues are addressed:

- that the cost comparison encompasses only the services being benchmarked;
- that the cost comparison includes factors relating to risks inherent in a change of service provider (such as mobilisation costs);²¹
- that Contractors' own costs are not used as a benchmark;
- whether individual services are to be benchmarked separately, in clusters, or all together;
- whether it is possible to rely on the information being provided by those persons contacted for benchmarking information;
- whether it is possible to verify the appropriateness of the benchmarking information as a comparator for the service being benchmarked; and
- whether there is any other reason or factor that would make benchmarking unrealistic or impracticable.

See further Operational Taskforce guidance referenced at Section 15.3.3.3 above.

15.5.3 The procedure for carrying out a benchmarking exercise is as follows:

- on certain fixed dates, the Contractor compares certain of its costs (e.g. what it pays its Sub-Contractors providing soft services) with equivalent prevailing market costs (e.g. what it would have to pay other Sub-Contractors to provide the equivalent service) and, if appropriate, proposes a variation to the Unitary Charge;
- the Authority and the Contractor should generally begin planning 40 weeks ahead of the benchmark adjustment date in order to allow sufficient time to complete the benchmarking process (and allow a market testing to occur, should this be needed and provided for in the Contract), though this period could be longer or shorter depending on the scale and nature of the relevant services;
- if the market cost is higher than the Contractor's current costs and the current Sub-Contractor is still obliged to provide the Service at the lower price, there is no need to adjust the Unitary Charge (it may be that the Sub-Contractor concerned is simply more efficient than the rest of the market);

²¹ Another relevant consideration may be the credit standing of a replacement service provider. This will depend upon the particular service being benchmarked (or market tested) but will be of specific application where the particular service involves significant capital outlay over a long term.

- if the market cost is higher than the Contractor's current costs and the current Sub-Contractor is contractually entitled to review its price, the Unitary Charge may be adjusted (although this will not necessarily be the case - see Section 15.5.4);
- if the market cost is lower than the Contractor's current costs, there should be an adjustment to the Unitary Charge (see Section 15.5.4). It could be that the Sub-Contractor is not as efficient as its competitors. The price decrease should encourage the Contractor to take appropriate steps to reduce its costs (for example by replacing the sub-contractor, taking into account the costs of such replacement). The Authority should encourage efficiency, for example by comparing the Contractor's costs to those of the most efficient quartile of the market, rather than the median;
- the Authority must have the right to inspect the Contractor's and sub-contractor's cost information to confirm cost details. Full transparency of cost information is needed for benchmarking to function properly (see Clause 26.2 (Contractor's Records and Provision of Information) and
- if the Authority and the Contractor cannot agree on any price adjustment or the Authority is not satisfied that there has been a robust benchmark process, then if the Contract so provides the Service concerned should be market tested (see Section 15.4 (Market Testing)).

15.5.4 The outcome of the review should not necessarily be a direct pass-through to the Authority of the benefit or burden of all the cost change. There should instead be a formulaic adjustment that shares any cost increase or decrease in a way that incentivises the Contractor to control its costs. The sharing ratios need not be symmetrical on an upwards and downwards price variation, and the Authority should assess the likely value for money impact of a greater sharing in a price reduction than a price increase when deciding on such an approach.

16 SUB-CONTRACTING, EMPLOYEES AND DOCUMENTARY CHANGES

16.1 CONTROL OVER SUB-CONTRACTORS

16.1.1 The Authority often has the perception that it must retain a large degree of control of a subjective nature over Sub-Contractors. This perceived need for control applies both to the performance of the Sub-Contractors and to any procedure for appointing replacement Sub-Contractors. The Contractor's stated view is often that as it originally selected these Sub-Contractors and has taken risk on their performance, it should be entitled to change them at will (for example, if they are not performing) whilst recognising the legitimate interest of the Authority in the identity of key sub-contractors (as provided for in Section 16.1.5).¹

16.1.2 In general, attempts by the Authority to control Sub-Contractors are to be discouraged as it is in most cases unnecessary and may dilute the level of risk transfer achievable by the Authority (see also Section 9.4 (Monitoring of Sub-Contractors)). The Authority should in any event (if control is needed) generally only seek a degree of control in relation to Sub-Contractors and not in relation to sub-contractors of Sub-Contractors, though the ability to engage directly with the service provider on-site may also be needed (see further Section 13.5.3).

16.1.3 In certain limited cases, there may be overriding reasons why the Authority should have a degree of control over sub-contractors. For example, there may be national security issues (particularly in some defence projects), other public interest issues (e.g. regarding who should be allowed to be involved in schools), or the Authority may have a statutory duty that it needs to carry out.

16.1.4 In such cases, the criteria that a replacement sub-contractor must satisfy should be reasonable (for example, they should require that the potential sub-contractor is not a threat to national security or other relevant aspect of the public interest). Any judgment that the potential sub-contractor does not satisfy the criteria should be based on objective evidence. For example, a judgment that employment of a certain sub-contractor would represent a threat to national security or the public interest should be made on the basis of concrete information received from a relevant legal, financial or other authority demonstrating that the national interests would be detrimentally affected. In the majority of cases, criteria of this nature will not be needed.

16.1.5 In cases in which there is no specific reason to control sub-contractors, the Authority may still want some control on the basis that it placed reliance on the original sub-contractor's identity and ability to perform in awarding the Contract to the Contractor. In such cases, satisfaction of a limited set of objective criteria should prove an acceptable level of control to the Authority and the Contractor. Any such criteria should include:

- technical ability and competence; and
- financial strength (including any willingness to give guarantees to the Contractor).

16.1.6 If in the circumstances described the Authority retains some control over replacement Sub-Contractors or sub-contractors of Sub-Contractors, these controls will also apply to any substitute Sub-Contractors or sub-contractors whom the financiers wish to appoint in accordance

¹ Controls over the performance and identity of Sub-Contractors will be expected by Senior Lenders. These controls will be set out in the Senior Financing Agreements.

with their rights under the Direct Agreement (see Section 31 (Direct Agreement and Senior Lenders)).

16.2 CONTROL OVER EMPLOYEES²

16.2.1 The Authority should not generally seek to control whom the Contractor (or its sub-contractors) employs, except where there are valid reasons to do so (e.g. overriding public policy considerations, national security issues, security clearances or statutory duties).

16.2.2 The Authority's concerns are likely to be focussed on preventing or terminating the employment of persons with a criminal conviction relevant to their employment. This is unlikely to be an issue for the Contractor where the concern relates to a matter which is also of concern to the Contractor (e.g. dishonesty convictions). The Contractor will be equally keen to build in safeguards into its employment procedures to take action against dishonest employees.

16.2.3 Examples where a degree of Authority control is required include prison and defence projects, where the Authority retains a need to approve all staff because of statutory duties relating to sensitive security considerations. The Authority has the right to prevent the employment, or require the removal, of any staff. Similarly, public policy considerations may mean that an Authority involved in school projects, for example, does not want employees with convictions of a certain nature (but, again, the Authority and Contractor are likely to have a common interest on such issues).

16.2.4 In the cases in which the Authority is justified in retaining a degree of control over the Contractor's employees, the Authority should agree the relevant restrictions with the Contractor as part of the bidding process. The Contractor's personnel and employment policy will need to reflect the Authority's requirements and this may have a cost implication. The Contract provisions should be reasonable and allow the Authority to veto or require the removal of staff, with the Contractor bearing the risk of the consequences of such action. Any judgment that an employee does not satisfy certain relevant criteria should, to the extent within the Authority's control, be made on the basis of objective evidence. Contractors should note that certain security clearance procedures may be outside the control of the Authority.

16.2.5 Controls need to be exercised over employees at the end of the Service Period, where the considerations referred to in Section 20.4 (Handover Provisions for Assets which transfer to the Authority) apply. Other statutory restrictions will still apply after the end of the Service Period (for example, the Official Secrets Acts 1911, 1920, 1939 and 1989).

16.3 CONSEQUENCES OF CONTROL

16.3.1 If the Authority does retain some control over sub-contractors and/or employees then the Contract should contain a procedure to be followed to confirm whether the Authority has any objections to a particular party. Any failure by the Authority to respond within the specified time limit should be dealt with in accordance with Section 5.2 (Compensation Events). Authorities should consider carefully whether their "approval" can be deemed to be given if they fail to respond.

² For more general guidance on TUPE issues, please see the 4ps Guidance "*Code of Practice on Workforce Matters in Local Authority Service Contracts*" on the 4ps website and please see "*Standardisation of PFI Contracts for Local Authorities*", published on the HMT website and the TUPE provisions contained in the BSF standard form schools PFI contract.

16.4 CHANGES TO PROJECT DOCUMENTS AND FINANCING AGREEMENTS

16.4.1 The Contractor will want to retain flexibility in case its sub-contracting or financing arrangements need updating, but the Authority will want to ensure that this does not prejudice the Project, and that the Project Documents and Financing Agreements reviewed by it prior to Financial Close, as part of its due diligence, are not simply rewritten. Section 22.3.8 ensures that the Authority's own exposure to liability on termination of the Contract is not increased without the Authority's consent, despite any changes being made to the Project Documents or Financing Agreements. Section 34 (Refinancing) contains further provisions relating to the amendment of Financing Agreements. If, however, an Authority feels that this protection is insufficient and that any Project Document or Financing Agreement entered into by the Contractor is sufficiently important to require ongoing oversight, provision for this may be made in the Contract. Authorities should not use this as a device to micro-manage delivery of the Service. Suitable drafting is as follows:

16.4.1 Delivery of Initial and Changed Project Documents and Financing Agreements

- (a) The Contractor has provided to the Authority copies of the Project Documents³ [(as listed in Part 1 of Schedule [])] and of the Initial Financing Agreements [(as listed in Part 2 of Schedule [])].
- (b) Without prejudice to the provisions of Clauses 16.4.2 or 16.4.3, or to the definition of Senior Financing Agreements in Clause 1, if at any time an amendment is made to any Project Document or Financing Agreement, or the Contractor enters into a new Project Document or Financing Agreement (or any agreement which affects the interpretation or application of any Project Document or Financing Agreement), the Contractor shall deliver to the Authority a conformed copy of each such amendment or agreement within ten (10) Business Days of the date of its execution or creation (as the case may be), certified as a true copy by an officer of the Contractor.

16.4.2 Changes to Project Documents

The Contractor shall perform its obligations under, and observe all of the provisions of, the Project Documents and shall not:

- (a) terminate or agree to the termination of all or part of any Project Document;
- (b) make or agree to any material variation of any Project Document;
- (c) in any material respect depart from its obligations, (or waive or allow to lapse any rights it may have in a material respect), or procure that any counterparty to a Project Document in any material respect departs from its obligations (or waives or allows to lapse any rights they may have in a material respect), under any Project Document; or
- (d) enter into (or permit the entry into by any other person of) any agreement replacing all or part of (or otherwise materially and adversely affecting the interpretation of) any Project Document, unless the proposed course of action (and any relevant documentation) has been submitted to the Authority for review and there has been no objection made by the Authority within [] Business Days of receipt by the Authority of such submission, or such shorter period as may be agreed by the parties, [and provided, in the circumstances specified in Clause 16.4.2 (a), that the Contractor has complied with the provisions of [Section 16 (Sub-Contracting,

³ If there are any key second tier sub-contracts (beneath the main construction Sub-Contract or operating Sub-Contract) these could also be listed here and additionally referenced, as appropriate, in Clauses 16.4.1 (b) and 16.4.2.

Employees and Documentary Changes)].⁴ The Authority may only make objection on the following reasonable grounds [].⁵

16.4.3 Changes to Financing Agreements

Without prejudice to the provisions of Clauses 16.4.1 (Delivery of Initial and Changed Project Documents and Financing Agreements), 22.3 (Changes to Financing Agreements and Project Documents), and 34 (Refinancing), the Contractor shall not, without the prior written consent of the Authority, enter into new Financing Agreements or terminate, amend, waive its rights or otherwise deal with its Financing Agreements if the same may reasonably be expected to have a material adverse effect on the ability of the Contractor to perform its obligations under the Project Documents or this Agreement.

⁴ Reference to control over Sub-Contractors is only relevant if the Authority has decided to take approval rights as described in Section 16.1. If so, the relevant clause should be cross referenced.

⁵ The Authority should list out its possible grounds of objection, which may be based around any adverse consequences to the Contractor, the Authority or the Services. If the Contract makes provision for a formal Review Procedure, proposed changes pursuant to this Clause 16.4.2 could be put through this rather more detailed procedure and this provision amended accordingly (see for example the March 2006 BSF School Standard Form on the PfS web site at Clause 7 and Schedule 8 and in particular paragraph 3.1.2 "Grounds of Objection").

17 ASSIGNMENT

17.1 INTRODUCTION

17.1.1 Over the course of a long-term contract, the identity of the Authority, the Contractor or its financiers may change to some extent. This should be recognised at the time of negotiating the Contract and an appropriate balance struck which allows some flexibility for change where appropriate but gives the parties sufficient comfort about the identity and/or creditworthiness of their counterparties.

17.2 RESTRICTIONS ON THE CONTRACTOR

17.2.1 The Contract should not allow the Contractor to assign, novate or transfer its rights under the Contract, except as part of its Senior Lenders' security package. If a replacement Contractor is appointed by the Senior Lenders in accordance with their rights under the Direct Agreement (see Section 31 (Direct Agreement and Senior Lenders)), the Contract should allow for the original Contractor's rights and obligations to be transferred. Senior Lenders may also, in accordance with security rights which they may take over the shares in the Contractor, transfer these shares as allowed by Section 18.4 (Transfer of Interest: Flexibility and Restrictions).

17.3 RESTRICTIONS ON THE AUTHORITY

17.3.1 The Contract should generally not allow the Authority to assign or transfer its rights or obligations under the Contract without the consent of the Contractor.

17.3.2 The main exceptions to the above are where transfer either takes place under statute or is required to facilitate a public sector reorganisation. Specific exceptions may also have to be provided for in a particular project if a transfer is anticipated (e.g. the London Underground project which was, under statute, transferred to Transport for London) or particular sectors (e.g. the local authority sector where transfers may be required due to boundary changes). Authorities should recognise that financiers will be concerned to ensure that any transferee's covenant is as strong as that of the original Authority and that the transfer could not prejudice their security.¹ If this is not the case, appropriate credit enhancement (e.g. in the form of a guarantee) may be required so that the Contractor's position is not prejudiced. Where such a right is required by the Authority, appropriate drafting for both central and non-central government projects is set out below.

Required drafting is as follows:

17.3(A) Restrictions on Transfer of the Contract by the Authority in Central Government Projects

The rights and obligations of the Authority under this Contract shall not be assigned, novated or otherwise transferred (whether by virtue of any Legislation or any scheme pursuant to any Legislation or otherwise) to any person other than to any public body (being a single entity) [acquiring the whole of the Contract and] having the legal capacity, power and authority to become a party to and to perform the obligations of the Authority under this Contract being:

¹ Pursuant to the Enterprise Act 2003 (the "Act"), lenders to PFI transactions can benefit from exemption from the effect of the changes to the Insolvency Act made by the Act. This exemption may only be available to the extent that the PFI Contract is between the Contractor and a public body; accordingly, financiers will be concerned to ensure that the Contract cannot be transferred to a non-public body (whether or not any proposed non-public body transferee's obligations are guaranteed by a public body).

- (a) a Minister of the Crown pursuant to an Order under the Ministers of the Crown Act 1975; or
- (b) any other public body whose obligations under this Contract are unconditionally and irrevocably guaranteed (in a form reasonably acceptable to the Contractor) by the Authority or a Minister of the Crown having the legal capacity, power and authority to perform the obligations under the guarantee and the obligations of the Authority under this Contract.

17.3(B) Restrictions on Transfer of the Contract by the Authority in Non-Central Government Projects

The rights and obligations of the Authority under this Contract shall not be assigned, novated or otherwise transferred (whether by virtue of any Legislation or any scheme pursuant to any Legislation or otherwise) to any person other than to any public body (being a single entity) [acquiring the whole of the Contract and] having the legal capacity, power and authority to become a party to and to perform the obligations of the Authority under this Contract being:

- (a) a Minister of the Crown pursuant to an Order under the Ministers of the Crown Act 1975;
- (b) any [local authority] which has sufficient financial standing or financial resources to perform the obligations of the Authority under this [Contract²];³ or
- (c) any other public body whose obligations under this Contract are unconditionally and irrevocably guaranteed (in a form reasonably acceptable to the Contractor) by the Authority or a Minister of the Crown having the legal capacity, power and authority to perform the obligations under the guarantee and the obligations of the Authority under this Contract.

17.4 RESTRICTIONS ON THE SENIOR LENDERS

17.4.1 The Authority may be tempted to seek to limit the ability of Senior Lenders to transfer their rights. This is due in part to a perceived need to have the original Senior Lenders involved who understand the deal negotiated, but is primarily a confidentiality and national security/public policy issue. The Authority may be concerned, for example, about whose hands project information may be in and to whom the Authority may end up owing money. The Authority does not want to become embroiled in national security issues.

17.4.2 The Authority should not attempt to put restrictions on the identity of the Senior Lenders unless exceptional circumstances apply. The appropriate way to deal with confidentiality issues, for example, is to impose confidentiality obligations in either the Contract (as against the Contractor) and the Direct Agreement (as against the Senior Lenders) (see Section 26 (Information and Confidentiality) and Section 31 (Direct Agreement and Senior Lenders)).

17.4.3 To the extent that transfer restrictions against financiers can be justified, however, they should focus on objective categories (e.g. credit ratings or EU/OECD banks) or should prescribe a list of acceptable transferees rather than adopting the clumsy, all encompassing approach of a general right of veto (which, in any event, is unlikely to work). Such a list should be updated as and when appropriate. Restrictions of this type can be dealt with in the Direct Agreement, or in a

² This should also include any other Project Documents that the Authority is a party to (e.g. any direct agreements or leases).

³ This Sub-Clause will only be applicable in non-central government projects. A transfer pursuant to this Sub-Clause should only be to an authority with the same status as the procuring authority. For example, on a local authority Project, the transfer must be to a local authority.

separate confidential letter if there are particular sensitivities (see Section 31 (Direct Agreement and Senior Lenders)).

17.4.4 Restrictions are often more cosmetic than real, as they can usually be circumvented through assignment or sub-participation and so reliance should not be placed on such arrangements being effective or meeting the Authority's concerns. However, structures in which the interests of the Senior Lenders are assigned or transferred to entities in which or with which the shareholders (or Junior Lenders) have an economic interest are likely to be linked to a Refinancing and, if so, may require Authority consent on those grounds (see Section 34 (Refinancing)).

17.4.5 Where projects are financed by bond issues, it is likely to be particularly difficult to identify the bondholders at any one time. The Authority should not seek to impose or rely on any restrictions on such Senior Lenders either (this is particularly impractical where bondholders are not registered e.g. holders of bearer bonds or where bonds are cleared through a clearing system, as is commonly the case). Where bonds are privately placed and the Authority can justify imposing restrictions on financiers, a similar approach as under Section 17.4.3 may be adopted. The Authority should note that Stock Exchange or listing authority rules on bond issues may require details of the Contract and underlying documents to be publicly displayed (although there are some exceptions to such rules (e.g. if display would prejudice national security)).⁴

⁴ See Clause 26(b)(iv) (Confidentiality) below.

18 CHANGE OF OWNERSHIP

18.1 INTRODUCTION

18.1.1 Having formed a relationship with bidders in the procurement phase, an Authority may be concerned about changes in the Contractor's shareholders thereafter. If this is the case then it may seek to impose restrictions on the ability of shareholders to transfer their shareholdings in the Contractor. Shareholders will usually object to such restrictions other than restrictions on transfers of equity prior to the end of the defects liability period (at the end of the construction phase). As a general rule, it should not be necessary for the Contract to contain other restrictions on the transferability of equity, other than a need to inform the Authority, except perhaps where the Authority would object to particular classes of shareholder being involved in the Project for particular reasons.¹

18.1.2 Suitable drafting is set out below:

18.1 Ownership Information

- (a) The Contractor represents and warrants to the Authority that at the date of the Contract the legal and beneficial ownership of the Contractor [and Holdco] is as set out in Schedule [] and that [, other than any Shareholder pre-emption rights,] no arrangements are in place that have or may have or result in any sale, transfer or disposal of any legal, beneficial, equitable or other interest in any or all of the shares in the Contractor [or Holdco].
- (b) The Contractor shall inform the Authority as soon as reasonably practicable (and in any event, within [30] days) of any Change of Ownership occurring.
- (c) The Authority may, not more than [twice] in any Contract Year, or at any time when a Contractor Default is outstanding, require the Contractor to inform it, as soon as reasonably practicable and in any event within 30 days of receipt of the Authority's request for details, of any Change of Ownership.
- (d) The Contractor's obligations under (b) and (c) above shall, except where a legal transfer of shares has occurred, be limited to the extent of the Contractor's awareness having made all reasonable enquiry.

18.1.3 Authorities will wish to adopt a suitable definition of change of ownership to use with the above provisions and to apply where restrictions on changes of ownership are required in the Contract. Any such definition should cover any transfers (whether by sale or otherwise) of any interest (legal, beneficial or equitable) in shares, and transfers of economic interest in shares (such as dividend or voting rights) should also be covered. Furthermore, Authorities should consider whether subordinated debt has characteristics that would usually be associated solely with shares (e.g. voting rights) or whether the subordinated debt may be converted to equity in certain circumstances. Where this is the case then the transfer of subordinated debt should also be restricted.² Suitable drafting is set out below:

“Change of Ownership”

means

¹ See section 18.4.5.

² The transfer of shares and subordinated debt are usually “stapled” i.e. the transfer of one would compel the transfer of the other. Where shares and subordinated debt are not stapled it may be appropriate to restrict the transfer of subordinated debt where, for example, shareholder contributions to project costs are to be made at a time other than Contract signature.

- (a) any sale, transfer or disposal of any legal, beneficial or equitable interest in any or all of the shares³ in the Contractor and/or [Holdco] [and/or []] (including the control over exercise of voting rights conferred on those shares, control over the right to appoint or remove directors or the rights to dividends); and/or
- (b) any other arrangements that have or may have or which result in the same effect as paragraph (a) above.

18.1.4 Authorities will need to consider the above definition carefully in the light of each Project's particular ownership structure; issues that should be considered include how far up the ownership chain the Authority would require the change of ownership provisions to extend and whether limited partnerships or other non-corporate entities are used in the Contractor's ownership structure.

18.1.5 Where unincorporated entities form part of the ownership structure, additional considerations will apply. Authorities will want to ensure, for example, that any lock-in requirement covers transfers of relevant interests in any relevant unincorporated entity (e.g. limited partnerships) and Authorities may wish to consider requiring that the unincorporated entity is at all times during the lock-in period managed and advised by a member of the relevant investor's or Sub-Contractor's group (if the identity of the group is important to the Authority).

18.1.6 The Contractor may request that the Authority consent to a change of ownership during the period when restrictions to changes of ownership apply (see Section 18.4). The Authority should consider whether to agree to such a request at its sole discretion. Where the Authority agrees to any such request it should consider whether any amendments to the change of ownership restrictions will need to be made so that they continue to apply to any transferee (for example, amendments should be considered where a non-corporate entity, such as a limited partnership, joins the Contractor's ownership structure).

18.2 AUTHORITY'S CONCERNS

18.2.1 Imposing a restriction on shareholders' ability to transfer their interests in the Contractor is partly to prevent any party the Authority views as unsuitable from being involved in the Project (or in control of the Contractor) and partly because the Authority may take comfort from the original shareholders continuing to retain their economic stake in the Project.

18.2.2 The Authority should generally look to other provisions under the Contract to address its concerns about the effect which a change in shareholders may have on the Contractor. For example, any concerns relating to the ability of the Contractor to perform the Contract without the support of the original shareholders should be addressed by the payment mechanism and termination rights.

18.2.3 The Authority may seek to restrict equity transfers if it is concerned that the original shareholders may leave the Project before all their equity commitments have been fulfilled. There should be no reason to prevent transfers of equity (at least following the end of the defects liability period, post Service Commencement), provided that any such deferred equity commitments are fully supported (e.g. by suitable letters of credit) and a substantially similar overall package is available from the proposed new shareholder (e.g. if technical support was provided by a shareholder in its capacity as a shareholder then, if still required, equivalent support should be put in place before a transfer can occur). It is not unreasonable for the Authority to restrict equity

³ Where limited partnerships are used then a reference to the general partner and/or manger should be made here. See Section 1 footnote 2.

transfers in the Contractor by the Construction Sub-Contractor (or any of its Affiliates) until Service Commencement or by the Operating Sub-Contractor (or any of its Affiliates) until Service delivery is established.

18.3 SHAREHOLDERS' CONCERNS

18.3.1 Holders of shares in Contractors will not want their ability to transfer their investment to be unnecessarily restricted. Allowing them to transfer their investments in Contractors extends the availability of capital for projects, makes the market more liquid and, as a consequence, can help improve value for money.

18.4 TRANSFER OF INTERESTS: FLEXIBILITY AND RESTRICTIONS

18.4.1 Practice concerning change of ownership provisions across PFI sectors has developed so that a lock-in period (usually up to the Service Commencement Date plus the defects liability period) is provided for, during which no Change of Ownership is permitted. In limited circumstances, however, transfers will be permitted during such lock-in period.

18.4.2 Circumstances where transfers are permitted during a lock-in period are usually restricted to (i) transfers that arise as a consequence of the enforcement by Senior Lenders of security over or in connection with shares to which the Change of Ownership provisions apply, (ii) any shares that are dealt in a recognised investment exchange, and (iii) intra-Affiliate transfers (although in such cases the Authority should be careful to ensure that where an Affiliate that has had shares transferred to it subsequently leaves the group, the shares are transferred back to a member of that group).

18.4.3 Suitable drafting is set out below:

18.4 Change of Ownership

- (a) No Change of Ownership may occur during the [lock-in period⁴].
- (b) Any Change of Ownership arising as a consequence of:
 - (i) the grant or enforcement of security in favour of the Senior Lenders over or in relation to any of the shares of the Contractor [or Holdco], provided that any document conferring security over any shares has been approved by the Authority (such approval not to be unreasonably withheld or delayed); or
 - (ii) any change in legal or beneficial ownership of any shares that are listed on a recognised investment exchange (as defined in [Section 285 of the Financial Services and Markets Act 2000]); [or]
 - [(iii) any transfer by a Shareholder [or []]⁵ to an Affiliate of such transferor,]

shall be disregarded for the purpose of paragraph (a) above.

[Where sub-paragraph (iii) applies and subsequent to any such transfer (the "Original Transfer") the transferee ceases to be an Affiliate of the original transferor, it shall be a breach of this Clause 18.4 if the shares or interests which were the subject of the Original

⁴ This is usually defined by reference to the Service commencement date plus the defects liability period.

⁵ Reference should be made to the owner of each entity to which the lock-in provisions apply. See definition of Change of Ownership at paragraph (a). See also Section 18.1.4 and footnote 3.

Transfer are not within [20 days] of the transferee ceasing to be an Affiliate of the original transferor transferred to that original transferor or any Affiliate of such transferor.]⁶

18.4.4 It is important to ensure that the flexibility afforded above should not operate so as to disapply the notification provisions set out in Section 18.1.2 or to circumvent any provisions preventing transfers to any particular category of shareholder (as envisaged in Section 18.4.5).

18.4.5 As well as restrictions on transfers during the lock-in period an Authority may wish to impose some wider restriction on the transfer of ownership or investment in a Contractor (and the precise restrictions will depend on the financing structure of the Project). Restrictions should address specific concerns and not be blanket restrictions, and legal advice should be sought. For example, in certain defence projects, the Authority may be concerned that national security may be threatened by unsuitable shareholders and for that reason restrictions will exist. Similar public interest concerns will exist in prison projects. Other considerations may also apply – for example, an Authority may not wish to have tobacco companies holding shares in schools. The Authority should ensure bidders are made aware of such concerns and restrictions as early as possible.

18.4.6 In such cases the Contract should either seek to set out in an objective manner the grounds on which a transfer is not permitted or, if necessary and practical, set out a list of unacceptable holders of equity. A less attractive option for all concerned is to include a provision requiring the investor to seek the prior written consent of the Authority before transferring its shareholding (or other investment). If this latter course of action is taken, it should be made clear in the Contract that any such consent should not be unreasonably withheld (nor a response delayed). The Authority should be obliged, unless there are public policy reasons to withhold reasons, to specify the reason for any refusal.

18.4.7 Suitable drafting is set out below

Restricted Share Transfer

The Contractor shall obtain the Authority's prior written consent (which may be given subject to conditions) to any [Restricted Share Transfer].⁷

18.5 RELATED ISSUES

It is not always possible to ascertain who holds an interest or beneficial interest in shares and it may not be possible in any event to police more remote changes in ownership. The use of nominees means the Authority may not even be aware of changes. The protection offered by change of ownership provisions should therefore be seen by the Authority as an important but imperfect tool for controlling the substantive ownership of its counterpart.

18.6 OWNERSHIP DEFAULT

Paragraph (i) of the definition of Contractor Default at Section 21.2.2.1 applies where a restriction on the transfer of shares is included in the Contract, and any transfer of a shares or a beneficial or economic interest in a share in breach of any transfer restrictions is a Contractor Default. The Authority and the Contractor should agree whether or not to extend this Contractor Default event to breach of the notification provisions as set out in Section 18.1.2 above.

⁶ Not required where sub-paragraph (iii) is not used.

⁷ This term will need to be defined in the Contract but should generally relate to any proposed share transfer to any party on a restricted (or not on a permitted) list (see Section 18.4.5 above).

19 LAND, EQUIPMENT AND OTHER PROPERTY INTERESTS

19.1 INTRODUCTION

19.1.1 In the majority of PFI projects involving buildings, the Authority will own the land and grant a licence or lease to the Contractor. Occasionally, however, the Contractor will procure land itself. On PFI projects involving equipment, the Contractor will commonly procure the equipment itself. During the life of the Project the Contractor will manage the operation and maintenance of the relevant assets.

19.1.2 Consideration should be given to the nature of the interest that the Contractor should have in the asset during the life of the Project and, in the context of procurement of assets for the purpose of delivering the Project, consideration should be given to whether or not the Authority or the Contractor would be best placed to manage such procurement.

19.1.3 On equipment projects, where the Contractor will commonly own or procure the equipment¹ and the equipment is important to the ability of the Authority to fulfil its statutory duties, it is vital that the arrangements are structured so that the Authority can always obtain use and, if necessary, ownership of the equipment, and that no insolvency or receivership of the Contractor will disturb this. The Authority should seek appropriate legal advice and ensure that the Direct Agreement, and the Authority's broader relationship with the Senior Lenders (who may have security rights in the equipment), is structured accordingly. Similar considerations apply on PFI projects involving land where the Contractor procures the land².

19.1.4 On property projects, commonly the Authority will own the land (and buildings built on it). The Authority must, in these circumstances, ensure that it conducts due diligence over its property rights early in the procurement process³ to ensure that the Project will not be jeopardised during the procurement due to a late discovery of a problem relating to the nature of the Authority's interest in the property.

19.2 PROPERTY TRANSFER

19.2.1 As part of the Authority's feasibility study for a proposed Project, and prior to preparation of the Authority's Outline Business Case, the Authority should consider:

- the extent to which it will be required to transfer assets, or grant a licence or lease, to the Contractor (so as to allow the Contractor to carry out and perform the Service);
- its ability to transfer such assets⁴ or grant such a licence or lease to the Contractor; and
- the extent to which the Authority requires control over, and/or access to the assets during the life of the Project.

¹ This has been the case in certain MOD equipment projects.

² In this connection, where it is important for the Authority to be able to take back control of the property, it is more secure for the Authority to take a freehold interest in the property (and grant a lease or licence) rather than taking a mere option.

³ The Authority should ensure legal due diligence is conducted to verify the legal interest and also that the condition of the asset is verified.

⁴ The nature of the Authority's interest in the relevant asset will dictate the extent to which, and manner in which, the Authority can transfer the benefit of the relevant asset to the Contractor. Legal due diligence over the Authority's interest in the asset will highlight any restrictive covenants, conditions of transfer and /or claims over the relevant asset. See also footnote 1 above.

19.2.2 If the Project will involve both the Authority and the Contractor accessing and using the asset (for example, school teachers or hospital clinicians accessing a building managed and maintained by the Contractor), then the Authority should seek advice from its legal advisers as to the best way of ensuring that the Authority's rights of use are maintained following transfer of the asset, or grant of licence.

19.2.3 The Authority may already own the freehold to the land and property. In this case, it can transfer an interest in the land and property (freehold or long leasehold/headlease) to the Contractor, whilst at the same time securing for itself a sub-lease or licence, which allows it to access and use the land and property for the term of the Contract. More commonly, however, Authorities now merely grant a licence in respect of such property (see Section 19.3 below).

19.2.4 If the Authority only has a leasehold interest in the land and property, and a lease structure is used, it is likely that the consent of the freeholder will be required before the Authority can grant any interest in the land and property to the Contractor.

19.3 PROPERTY PURCHASE AND DISPOSAL AND RESIDUAL VALUE

19.3.1 In some Projects it may be necessary for a new site to be secured for the purposes of the Project. Historically, where there has not been a requirement for the Project to be operated from a certain site, Authorities have required bidders to price the cost of the land acquisition into bids with a view to making the acquisition after selection of the winning bidder. However, such an approach should not be taken on Projects where the location of the site is critical to the success of the Project for the following reasons:

- deliverability of the Project should be demonstrated at the time the Outline Business Case is prepared by the Authority. This may be best achieved if the Authority secures the site prior to, or at the time of, the Outline Business Case being prepared;
- where the Project is being procured using the Competitive Dialogue procedure, the availability and pricing of the land would need to be determined prior to the close of the dialogue;
- requiring bidders to commit to pricing of land acquisition prior to making the acquisition is unlikely to offer best value for money to the Authority, as bidders are likely to include a contingency in their bid to allow for difficult negotiations with the owner of the site or future variability in the purchase price. Furthermore, delay in Contract award may arise if the owner of the site realises that the winning bidder has priced its bid on the assumption that the Project will be delivered on that site, therefore giving the owner a strong negotiating position against the winning bidder; and
- the result of competition could effectively be determined not by the best value for money bid, but by the best property deal available.

19.3.2 Where the location of the site is not critical to the success of the Project, bidders should be encouraged to offer innovative solutions in respect of land acquisition.

19.3.3 Where land and property owned by the Authority becomes surplus as a result of the Project and this surplus land is dealt with as part of the procurement, the Authority must ensure that it receives market value⁵ for such land from the Contractor. When surplus land and property features as an integral part of a bid, it can be difficult for the Authority to reach clear judgements about market value. However, this does not relieve an Authority from its obligation to demonstrate that it has achieved market value. The risks involved in surplus property development are different to those within a PFI Contract and Authorities should consider in advance of procurement:

⁵ See section 24.2 (General Principles, Disposal of Surplus Property) of Government Accounting 2000.

- how best value can be extracted from surplus land assets to the benefit of the public sector (including whether it should form part of the Contract or be sold separately), taking account of the town planning status and market risks;
- if land is to be included in the Contract, how mandatory and variant bids will be evaluated to take account of differing approaches by bidders to the treatment of land receipts within the PFI; and
- whether it is appropriate to introduce competitive market testing of the surplus land proceeds and/or gain sharing mechanisms within the Contract.

19.3.4 Where the Authority cannot satisfy itself that market value has been achieved it should consider seeking bids that remove the financial benefit of the surplus land and property. Where the Authority intends to release property to the Contractor, it must consider carefully how best this is done, over time, in order to achieve best value for money. For example, transfer of surplus property at Financial Close prior to it receiving detailed planning permission, is unlikely to prove good value for money. Care should be taken in evaluating proposals that combine the realisations from sale and/or development of surplus land with the construction of operational property and provision of services.

19.3.5 The Authority needs to take care that the inter-relationship between the realisation of proceeds from the sale of surplus land, and the property and the facilities from which services will be delivered during the term of the Contract, supports the overall objectives of the Project and also does not prejudice the Authority's position should an event of early termination arise.⁶

19.3.6 Residual value interests may form an important part of some projects.⁷ Such projects require very careful structuring. In addition to financial and legal advice, Authorities should seek early guidance from their Private Finance Unit on such schemes. In addition to value for money, balance sheet, termination payment and other derogation issues, the relevant property and security interests would need attention. Commonly in such Projects, the Contractor would assume a certain residual value for the relevant asset at the end of the Project term (which would be bid as part of the tendering process and appear in the bidder's financial model) and, in the light of this, the amount of Unitary Charge bid by the bidder would be reduced. Authorities must however be clear as to:

- who is taking the residual value risk in the Project (i.e. the risk of the actual value of the asset being greater or less than the assumed value either at expiry of the Term or on early termination in any of the early termination scenarios);
- how this may impact the balance of risk and incentive in the project;
- how this is best and most securely structured (in terms of property interests and options and possible value sharing arrangements);⁸ and
- the precise basis on which the residual value is valued at expiry or termination.⁹

On a facilities Project (where the assumption is that the underlying value of land will go up) Authorities will want to ensure that they have a proper interest in increased land values. On an equipment Project (where the assumption is that the value of equipment will go down) Authorities

⁶ Where the Contractor takes the market movement risk, it may be exposed in the event of a termination at a down-cycle in the property market.

⁷ This has been the case in certain housing projects and certain MOD equipment projects.

⁸ See section 19.1.3 above.

⁹ Any definition of Market Value used should be as precise as possible to avoid future disputes. See footnote 5 above. See generally Section 20.5 (Transfer of Residual Value Risk).

may want to ensure access to the equipment at a value for money price should they continue to need it at expiry or early termination of the Contract.

19.3.7 On the Department of Health LIFT programme,¹⁰ the LIFT companies bought the properties at the start of the Contract and took the residual value risk on them. Public sector gain sharing provisions applied on disposal of surplus property, and the public sector had to pay open market rates if it wanted continued use of the properties at the end of the term.

19.4 CAPITAL ALLOWANCES ACT, 2001

19.4.1 The effect of Chapter 14 of the Capital Allowances Act, 2001 (the “CAA”) is to draw a distinction between the treatment of licences and leases for the purposes of assessing whether or not a party with any such interest in land can claim capital allowances in respect of expenditure incurred on the provision of fixtures to the relevant land and/or buildings.

19.4.2 For the purposes of any PFI contract, the Contractor can currently only claim capital allowances in respect of expenditure on fixtures if it has a qualifying interest in the land to which the fixtures are attached. Whether or not the Contractor has a qualifying interest turns on the meaning of “interest in land” in Chapter 175(1) of the CAA and, very often, whether it has a licence to occupy land. HMRC considers that a licence is a “licence to occupy land” for the purposes of Chapter 175(1) of the CAA if the licence itself gives the licensee an exclusive right to occupy the land.

19.4.3 By way of example, if under a PFI Schools Contract the Authority grants the Contractor a right of access to enter the school for the purposes of providing certain services, such a right of access is unlikely to be sufficient for the Contractor to claim capital allowances under Chapter 14 of the CAA as the right will not be exclusive. The Authority will also be ensuring that the school’s staff and pupils can access the site for the purposes of delivery of the education service. However, in the context of any Project, issues surrounding the Contractor’s ability to claim relief under Chapter 14 of the CAA should be considered by both Parties and their respective legal and tax advisers.

19.4.4 Whether the Contractor claims capital allowances or pursues alternative taxation treatments, such as composite trader status, could have material impact on the Project’s economics and the level of Unitary Charge bid by bidders. Distinctions between licences and leases may well therefore be significant commercial issues affecting the financial model for the Project, as well as being technical legal points. Accordingly, the Authority and its advisers should satisfy themselves that the taxation assumptions within the bidders’ financial models are realistic, consistent with the proposed contractual structures and fully anticipated within the Unitary Charge bid (see further Section 34.4.5 (Taxation and Accounting Policies)).

19.5 COMPOSITE TRADER

19.5.1 Early PFI projects were often structured by way of lease and lease back with the Contractor, such that construction expenditure in the Contractor would be capital, qualifying, where appropriate, for capital allowances tax relief. Under this treatment, part of the Unitary Charge is treated as rental income in the Contractor. Typically, as much of the expenditure by the Contractor is on buildings not qualifying for capital allowances, tax relief is limited.

19.5.2 PFI projects are now commonly structured by way of licence, rather than lease and lease back, with a view to allowing the Contractor to become eligible for composite trade tax treatment.

¹⁰ See standard LIFT documents on the Partnerships for Health website: www.partnershipsforhealth.co.uk.

Under composite trade tax treatment all Contractor expenditure on the Project may be treated as being trading expenditure and thereby, in principle, wholly eligible for tax relief. This may give tax relief to design and construction expenditure that would not otherwise qualify.

19.5.3 The facts of each case must of course be considered, but as a general guide, in order for composite trade tax treatment to apply, the Contractor must show that it has a trade of design and construction services (as well as the Services it provides once the Project is up and running). The Contractor must have no lease in the Project land (only a lesser right of access) and no rental income derived from the land, as such an interest in the land would give the Contractor a capital asset from which it was deriving an income and would disqualify the Contractor from composite trade tax treatment.

20 TREATMENT OF ASSETS ON EXPIRY OF SERVICE PERIOD

20.1 INTRODUCTION

20.1.1 A distinction can be drawn between:

- Contracts where it represents best value for money for the Authority to take control of the Assets on Expiry. This includes Assets where the long-term public sector demand is clear or for which there is no practical alternative use (for example, schools, hospitals, prisons, specialist information technology systems and office accommodation that, due to its location or nature, is only of value to the public sector client). These are dealt with in Section 20.2 (Assets where the Authority Retains Residual Value on Expiry); and
- Contracts where residual value of the Assets is best transferred to the Contractor. These are generally generic Assets which have alternative use outside the public sector and for which there is no clear long-term public sector need (for example, office or housing accommodation in areas where there is demand from other users, generic information technology systems and alternative land use). These are discussed in Section 20.5 (Transfer of Residual Value Risk).

20.1.2 By “residual value” this guidance means, in the context of a Contract, the market value of the Assets associated with the Contract at the time it expires. When the Contract is signed, the residual value of the Assets is not known. “Residual Value Risk” refers to the uncertainty as to what the residual value will prove to be. There will usually be some estimate of the approximate residual value to be expected, which may be factored into the overall financing structure of the Contract.

20.1.3 The Contract should deal comprehensively with the treatment of Assets on all types of terminations. Which party retains the Assets on termination, and whether those Assets have any alternative use, will affect the level of termination payment (if any) payable by the Authority.

20.2 ASSETS WHERE THE AUTHORITY RETAINS RESIDUAL VALUE ON EXPIRY

20.2.1 In most PFI projects, the Authority’s long-term objectives will be best served by requiring either automatic transfer or reversion of the Assets to itself on expiry of the Contract or at a minimum an option to purchase the assets at nominal cost. This may be because:

- legal constraints prevent any practical alternative option, for example, the private sector cannot be a highway authority so roads must revert to the public sector Authority;
- contracts which involve Assets, such as hospitals and schools are specifically designed to cater for a particular service. In these sectors, the Assets have a useful economic life if retained by the Authority but there is no realistic alternative use for the Assets. There may be only limited scope for alternative use on expiry of the Contract and conversion is likely to be costly;

- the Authority requires long-term use of the Asset for the continued provision of its services;
- bidders are likely to discount the residual value of the Assets; or
- the expiry of the useful economic life of the Asset means it has no value but there is a separate reason for the Asset, such as any freehold of the land, to revert to the Authority.¹

20.2.2 The Contract must, however, protect the Authority's interest by not restricting the options exercisable at or immediately before the end of the Contract. These may include:

- taking possession of any Assets² at no cost;
- retendering the provision of the Service, with the outgoing Contractor making any Assets available to the new Contractor at no cost;³ and
- removing any Assets.

20.2.3 In most cases in which the Authority retains Assets at no cost, the Authority should consider the extent to which it should have recourse to the Contractor if the condition of the Assets reveals that the Contractor has not carried out all its contractual (for example, maintenance) obligations (this issue is dealt with in Section 23 (Surveys on Expiry and Termination)). This would not be necessary if such Assets had reached the end of their useful economic life (as may be the case, for example, in equipment based projects). The Authority should be driven by its operational requirements and value for money rather than by an attempt to create some residual value interest.

20.2.4 Suitable drafting (where no residual value risk has been transferred) is as follows:

20.2 Treatment of Assets at Expiry Date

- (a) On or before a date falling no later than [12]⁴ months prior to the Expiry Date, the Authority shall notify the Contractor in writing whether it wishes to retender the provision of the Service.
- (b) If the Authority wishes to retender the provision of the Service then:
 - (i) the Contractor shall do all necessary acts (including entering into any contracts) to ensure that the successor contractor obtains all of its rights, title and interest in and to the Assets with effect on and from the Expiry Date; and
 - (ii) the Authority will bear all costs of any retendering of the Contract on expiry.⁵
- (c) If the Authority does not wish to retender the Service then the Assets shall transfer to the Authority on the Expiry Date and the Contractor shall do any necessary acts (including entering into any contracts) to ensure that the Authority obtains all of its rights, title and interest in the Assets with effect on and from the Expiry Date.

¹ In some cases, the land will have significant residual value in its own right, notwithstanding that the other Assets may not (see Sections 20.1.1 and 20.5 (Transfer of Residual Value Risk)).

² See Section 20.6.1.

³ Any retendering of the Service should usually allow the incumbent Contractor to rebid for the Contract.

⁴ This date should be consistent with Clause 23 (Surveys on Expiry and Termination) to enable a decision to be made in sufficient time to facilitate the build-up of an adequate retention fund where the Authority requires the transfer of the Assets to itself in accordance with paragraph (a)(ii). See Section 23.3.1.

⁵ Costs of retendering of the Contract by the Authority following termination for Contractor Default should not be borne by the Authority. See Section 21.2 (Termination on Contractor Default).

20.2.5 The parties may also wish the Contract to deal with a mandatory second term option with the existing Contractor (see Section 20.6.3) in conjunction with an open competition.⁶ If this is the case, then the retendering would have to be on substantially the same terms as the original Contract,⁷ so that this can be evaluated against other bids. The Authority must also consider what the effect will be on the Authority's option if it wants to retender on different terms. The effect of this may then be to transfer some residual value risk.

The provisions of Clause 23 (Surveys on Termination) are relevant in relation to assets with no alternative use.

20.3 PRESERVING THE CONDITION OF THE ASSETS ON EXPIRY

20.3.1 Some early Contracts used Terminal Payments at the end of the Contract (even where the Authority retained control of the Assets on Expiry) as a means of incentivising the Contractor to maintain high standards of Service throughout the Service Period. The argument here is that if there is a Terminal Payment related to the value of the Assets at the end of the Contract then the Contractor will ensure high Service standards are maintained to the end. This argument confuses the purpose of payments for Services and payments for Asset transfer, as service standards can still be low, even if the Assets are very well maintained. Terminal Payments are not therefore recommended (except for any residual value transfer arrangement – see Section 20.6 and see generally Section 19 (Land, Equipment and other Property Interests)).

20.3.2 The payment mechanism should be the main method by which the Contract incentivises the Contractor to maintain service standards at all stages of the Contract. If there will be a re-competition of the Service, this provides further incentive on the Contractor to continue to meet the Authority's requirements until the Expiry Date.

20.3.3 One means of incentivising the Contractor to maintain Service standards where there is no alternative use for the Assets would be to structure the Contract to give the Authority an option to enter a secondary Contract period with the initial Contractor.⁸ This will increase the incentive for the Contractor to maintain standards through to the Expiry Date, in addition to the payment mechanism incentives, without the need for a Terminal Payment. The Contractor is obliged to enter into a second term if the Authority decides to exercise its option, but such decision will be taken in the context of an open competition with other bidders. One drawback of this is that the prices for such a second term (if it is added to the typical term for a PFI contract) are very difficult to bid in advance. The likelihood is that at best only a mechanism for calculating the price for the second period can be set out and such a mechanism is of questionable value. The Authority may, of course, instead opt to contract with another contractor if this offers better value for money. If this happens, the new contractor will have to bid to take over the use of the Assets.

20.4 HANDOVER PROVISIONS FOR ASSETS WHICH TRANSFER TO THE AUTHORITY

20.4.1 Provisions dealing with the transfer of the Assets will need to be set out in the Contract. These will have to deal with:

- the condition of the Assets, any rectification works, their cost and how they are paid for (see Sections 11 (Maintenance) and 23 (Surveys on Expiry and Termination));
- any design life requirement after the Expiry Date;

⁶ Such a competition may be subject to any procurement regulations applicable at the time.

⁷ That is, the Unitary Charge may be substantially different, particularly if the incumbent or incoming Contractor is not, as part of the competition, purchasing any Assets, but is taking over existing Assets.

⁸ See also Section 2.2.1.

- inspection prior to handover;
- checking any rectification works have been done;
- provision for any assignment of warranties, contracts and other rights relating to the Project; and
- any disputes in connection with the above.

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

20.4.3 To the extent that employees are being transferred, then the Contract should contain restrictions on the ability of the Contractor to alter either the number of employees or their terms and conditions as the end of the Contract approaches (such as in the last 2 to 3 years of the Contract).

20.4.4 A general further assurance provision is usually included in relation to termination, such as the following:

The Contractor shall take all reasonable steps and co-operate fully with the Authority and any successor contractor so that any continuation in the Service is achieved with the minimum of disruption and so as to prevent or mitigate any inconvenience or risk to health or safety of the employees of the Authority and members of public.

20.5 TRANSFER OF RESIDUAL VALUE RISK

20.5.1 Where there is the potential for alternative use, and hence alternative users, of the Service or any Assets, there may be scope for the Contract to include provisions that transfer some residual value risk to the Contractor.⁹ It is crucial that this issue is dealt with as part of the competitive bidding process if it is to deliver real value.

20.5.2 There are a number of issues for an Authority to consider. First, is it likely to require long-term use of the Assets? If so, it is unlikely to derive best value from transferring residual value risk. Second, if the Authority has no clear long-term requirement for the Assets, is it possible for the Authority to pass on any residual value risk to the Contractor? Third, will transfer of residual value risk provide value for money? Finally, how will transfer of residual value impact on any payment on termination on expiry of the Contract.

20.5.3 It will not be possible in all cases to leave the residual value risk of the Assets with the Contractor, even if there is some potential for alternative use. The difficulty of estimating value and the required length of the initial Contract may make it uneconomic for the Contractor to estimate the residual value of the Asset at anything other than an insignificant amount. In such circumstances, financiers¹⁰ are unlikely to accept being exposed to significant residual value risk. It will in such circumstances generally not represent value for money for the Authority to transfer this risk as the Contractor will expect to obtain its return over the life of the Contract.

20.5.4 If transfer of residual value risk will enhance value for money, the Authority can pay a Unitary Charge which does not enable the Contractor to cover the complete cost of financing its investment through the service payments it receives during the Contract. The Contractor instead has to rely on value being left in the Assets remaining on the Expiry Date to recover all such cost. This leaves some real risk with the Contractor in relation to the residual value at the end of the

⁹ See for instance the social housing sector and see Section 19.3.

¹⁰ Senior Debt is usually profiled to be repaid in advance of the Expiry Date. This may not however be the case on a corporately financed housing project.

Contract. Where this is the case it will be possible to have a shorter Contract length (see Section 2 (Duration of Contract)). When residual value is to be transferred, an appropriate leasehold (or freehold) structure should be used and the definition of Assets amended accordingly. Authorities should also consider Residual Value Risk when setting any capital expenditure contribution limits or liabilities (for example on a Qualifying Change of Law – see Sections 14.6 to 14.8).

20.5.5 The options exercisable by the Authority on the Expiry Date in relation to Assets with an alternative use where the Contractor is taking the residual value risk are:

- to take over the Asset, in which case a payment should be made to the Contractor (see Section 20.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been Transferred));
- to re-tender the Service, in which case the successful Contractor in the re-tendering exercise should make a payment to the previous Contractor reflecting the value of the Assets (see Section 20.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been Transferred)); or
- if the Authority has no further use for the Assets, to walk away at no further cost, leaving the Contractor to realise their value.

20.5.6 Each of these options affords the Contractor the ability to realise the value of the Assets upon expiry of the Contract, and accordingly the NPV of the total Unitary Charges payable under the Contract should be lower than if the Residual Value Risk had been retained (subject, of course, to there having been a well run competition).

20.5.7 Suitable drafting (where residual value risk has been transferred) is as follows:

20.5 Assets with an Alternative Use

- (a) On or before the date falling [six] months¹¹ before the Expiry Date, the Authority shall notify the Contractor in writing whether it wishes to:¹²
- (i) purchase the Assets by paying to the Contractor an amount equal to the Terminal Payment;
 - (ii) retender the provision of the Service;¹³ or
 - (iii) do neither (i) nor (ii) above.
- (b) If no notice is given under paragraph (a) above, then the Authority shall be deemed to have exercised its option under paragraph (a)(iii) and the Assets shall remain with the Contractor.
- (c) If the Authority wishes to exercise its option under paragraph (a)(i) above, then:
- (i) the Contractor and the Authority shall do all necessary acts (including entering into any contracts) to ensure that on the Expiry Date, the Assets are transferred to the Authority;
 - (ii) Within [30] days of effective transfer of ownership of the Assets to the Authority, the Authority shall pay to the Contractor the Terminal Payment.¹⁴

¹¹ The precise wording will depend on the specific circumstances. This wording assumes that effective ownership of the Assets is already with the Contractor and that, if the Authority wishes to continue to use the Assets, the Authority will need to make a payment or hold a new tender competition. If the Authority already owns part or all of the Asset (or will do so at the end of the Contract) these provisions would need amending accordingly.

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

¹³ The Authority will also need an option to purchase the Assets to allow any new Contractor to provide the Service.

- (d) If the Authority wishes to exercise its option under paragraph (a)(ii) above, then:¹⁵
- (i) it shall carry out the retendering with the aim of entering into a new contract with a successor contractor to provide the Service on and from the Expiry Date;¹⁶
 - (ii) a condition of any retendering shall be that the successor contractor must pay the Contractor the Terminal Payment on transfer of ownership of the Assets to the successor contractor; and
 - (iii) the Contractor and the Authority shall do all necessary acts (including entering into any Contracts) to ensure that ownership of the Assets is transferred to the successor contractor with effect on and from the Expiry Date.

20.5.8 The Contract will also need to take account of Assets retained by the Contractor in the various scenarios where the Contract may be terminated prior to its expiry date. See Section 22.6 (Retention of Assets by Contractor on Termination).

20.6 VALUATION OF TERMINAL PAYMENTS ON EXPIRY WHERE RESIDUAL VALUE RISK HAS BEEN TRANSFERRED

20.6.1 The two main options for determining amounts payable by the Authority at the expiry of the Contract in respect of Assets with an alternative use (and which are owned by the Contractor) are:

- the market value of the Assets in their existing use; and
- an amount bid by the Contractor when negotiating the original Contract, indexed through the duration of the Contract.

These amounts are referred to as “Terminal Payments”.

20.6.2 The market value of the Assets is the more valid basis for a payment to be made at the end of the Contract. If, however, there is a possibility of an extraordinary increase in market value during the duration of the Project and the Assets are critical to the Authority’s needs (i.e. the Service cannot be obtained without them) then a cap on the amount payable may be prudent (for example, to guard against excessively inflated property prices).

20.6.3 The mechanism for arriving at the market value must be specified in the Contract to avoid a dispute over the valuation. The final amount will reflect the condition of the Assets.

20.6.4 The alternative method (bid amount) referred to in Section 20.6.1 is unlikely to be appropriate. The value paid should reflect the actual value of the Assets (for example, their condition) and a fixed sum transfers no risk in this regard.

¹⁴ This Clause should not be used and no payment should be made by the Authority if the Contractor did not accept any residual value risk during the term of the Contract so that the Authority paid a Unitary Charge which was capable of providing the Contractor with sufficient funds to fully amortise its capital debt and equity in accordance with its base case financial model. The meaning of “Terminal Payment” is explained in Section 20.6.1.

¹⁵ If the incumbent Contractor wins a retender then it should still be entitled to receive a Terminal Payment, reflecting the market value of the Assets unless such value has been included within the incumbent Contractor’s tender price.

¹⁶ Any retendering would have to follow any applicable procurement rules.