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INFORMATION WARRANTIES

6.1 INTRODUCTION

6.1.1 Tenderers base their bids on information provided by the Authority in the ITN and the Authority should make it clear whether or not such information has been verified¹.

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

6.2 DUE DILIGENCE

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

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

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

6.3 AUTHORITY WARRANTIES

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

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

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

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

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

6.3 Exclusion from Warranty

- (a) The Contractor shall be deemed to have:
 - (i) satisfied itself as to the assets to which it will acquire rights and the nature and extent of the risks assumed by it under this Contract; and
 - (ii) gathered all information necessary to perform its obligations under this Contract and other obligations assumed, including:
 - (A) information as to the nature, location and condition of the land (including hydrological, geological, geo-technical and sub-surface conditions);
 - (B) information relating to archaeological finds, areas of archaeological scientific or natural interest², local conditions and facilities and the quality of existing structures; and
 - (iii) [other relevant information (e.g. environmental contamination³)].
- (b) The Contractor shall not in any way be relieved from any obligation under this Contract nor shall it be entitled to claim against the Authority on grounds that any information, whether obtained from the Authority or otherwise (including information made available by the Authority) is incorrect or insufficient and shall make its own enquiries as to the accuracy and adequacy of that information.

6.4 BENEFIT OF SURVEYS AND REPORTS

6.4.1 If the criteria listed in Section 6.3 (Authority Warranties) do not apply, there are other means by which the Authority can help reduce the Contractor's due diligence costs. It may, to the extent possible, disclose the contents of or assign the benefit of any reports or surveys it commissions from third party consultants direct to the Contractor (or the bidders) or share the benefit of such reports or surveys with them having reached an agreement on cost sharing. If the Authority wants to follow this route, it must ensure that when it appoints the relevant consultant that it agrees to take on the work on the basis of such assignment or sharing of the benefit. In addition, if this approach is to be of value to the Contractor, the relevant report or survey must be up-to-date and address the issues of particular concern to the Contractor and, where possible, its financiers.

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

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

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

6.5 LATENT DEFECTS RISK

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

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

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

Where land is concerned, however, ground conditions risk should be borne by the Contractor unless exceptional circumstances apply (e.g. the Contractor is prevented by the Authority from carrying out all relevant surveys).⁴

⁴ This is of general application in that it may not prove value for money for the Authority to seek to transfer this or latent defects risk in respect of any asset which the Contractor is not afforded the opportunity to survey (see Section 5.3.2.2). Fossils and antiquities are dealt with in Section 5.1.4 above.

7

SERVICE REQUIREMENTS AND AVAILABILITY

7.1 INTRODUCTION

7.1.1 The substance of a PFI deal should be the procurement of a service. Unavailability of the Service should therefore result in a reduced payment by the Authority or, in certain circumstances, no payment (see Section 10.2 (Features of the Payment Mechanism)).

7.1.2 The key issue in many projects is what constitutes availability. This is because, unless usage risk is transferred, the Authority is liable to pay for the Service if it is available, even if it is not used (see Section 10 (Price and Payment Mechanism)).

7.1.3 This Section focuses on projects in which payment depends on availability. One of the most obvious examples of such projects are those that involve the provision of a building based service (such as a hospital, school, prison or office accommodation). Such projects are looked at in particular detail as they give rise to many issues which do not occur in other sectors – see, for example, the issue of paying for space that is by definition unavailable, but which is still used by the Authority (see Section 7.8 (Service Unavailable but Used)).

7.1.4 In procuring services over long term PFI contracts, Authorities should have assessed not only their current requirements but also their requirements into the future. In many projects, demand or usage will be a key risk over the life of the Contract. In drawing up a specification for the services required, Authorities should be confident that there will be long-term demand for the Service and that any risk can be managed and mitigated.

7.2 DEFINITION OF UNAVAILABILITY

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

7.2.2 The definition of availability should therefore concentrate on the core functions of the Service and consist of objective, measurable criteria, so that it is clear to both parties whether or not those criteria have been satisfied. The criteria should not necessarily be limited to physical aspects (such as provision of a bed in a room), but should also include any “soft services” which are a core function of the Service. For example, services such as catering and delivery of meals are core requirements for prison and hospital accommodation to be usable and for the Authority to carry out its functions, but may not be in other projects. For such projects, the existence of a functioning catering service to an acceptable minimum standard may be appropriate to include in the definition of availability. Provided minimum standards are met, failure in performance of a catering service in such circumstances would not, however, make the whole Service unavailable, but rather would lead to performance deductions (see Section 10.3 (Direct Financial or Indirect Non-financial Incentives)).

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

7.2.4 In general terms, unavailability should be measured in as simple a way as possible. Accordingly, complex definitions that require excessive monitoring costs should be avoided, although definitions may have to be very specific. The precise measure will depend on the nature of the individual project, the particular times when the Service should be provided and the rectification periods allowed (see Section 7.7 (Rectification of Unavailability)). Possible examples of periods triggering unavailability include :

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

7.3 EXAMPLES OF UNAVAILABILITY

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

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

7.4 PAYMENT FOR AVAILABILITY AND WEIGHTING OF CRITICAL AREAS

7.4.1 Payment for availability of the Service will vary according to each project. In accommodation projects, for example, accommodation should be allocated into “units” (such as prisoner places, pupil places, office spaces). The availability test will be applied to each unit and payment of the Unitary Charge will vary according to the number of “units” available (see Section 10 (Price and Payment Mechanism)). In other types of project, this approach may not be feasible and there may be a single availability test applied to the whole Service.

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

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

7.4.4 In any event the aggregate of the maximum possible deductions should not total more than 100% of the full Unitary Charge payable at that time (but see Sections 4 (Protections Against Late Service Commencement) and 23 (Indemnities, Guaranties and Contractual Claims)).

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

7.5 WHEN DOES AVAILABILITY COMMENCE?

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

7.6 WHEN DOES UNAVAILABILITY COMMENCE?

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

- when the Contractor (e.g. the “Help Desk” provided by the Contractor) receives a notice of unavailability from the Authority. This may take the form of a simple telephone call, an e-mail that is activated when opened by the Help Desk¹ or a paper based pro-forma sent to the Help Desk. The key issue is that there must be formal recognition and recording of receipt of the notice so that the time taken for rectification can be measured; and
- when monitoring indicates that the availability criteria are not being met. The Contractor will need to verify the reported unavailability if it has not carried out the relevant monitoring.

7.6.2 If the Authority detects the unavailability but is unable to notify the Contractor because, for example, there is a failure in access to the Help Desk² then unavailability commences from the time when the failure is detected. If, however, the Authority fails to notify until later because of other duties (e.g. a teacher in a classroom), then unavailability and any applicable rectification period should not commence until the Contractor has been notified.

7.7 RECTIFICATION OF UNAVAILABILITY

7.7.1 The Contract should usually provide for a rectification period within which the Contractor has the opportunity to rectify the problem without triggering the start of a period of unavailability. How long the rectification period should be (e.g. one hour or twelve hours) will depend on the criticality of the area or function and the nature of the Project³. A failure to meet certain availability criteria may not be capable of rectification. For example, a rectification period may be appropriate in the case of a requirement for constant light in a room where the light fuses can be quickly repaired, but is not appropriate in the case of a requirement for meals to be served regularly three times daily and only two meals have been served. In the event that the Contractor is able to supply the Service by other means (e.g. alternative office space or hotel accommodation) and where the Contract recognises this option, availability payments should continue in full (although deductions to reflect standards of performance of the Service may be made and the effects of any disruption should be dealt with).

¹ To the extent such an e-mail is not opened within a certain time frame this will be dealt with through performance point deductions.

² Failure to provide a Help Desk Facility may give rise to deductions being made and performance points being awarded under the performance regime.

³ The Authority should consider carefully any requirement for rectification periods, taking into account tolerances already built in to the service levels and considering separately those events which lead to immediate unavailability and those which do not, but which provide an opportunity for rectification prior to failing to meet the availability criteria. When assessing whether or not to grant rectification periods to the Contractor, the Authority should ensure that the Contractor will continue to be incentivised to carry out maintenance during the planned maintenance periods and not as and when the Service becomes Unavailable.

7.7.2 If the Contractor rectifies the failure(s) within the relevant rectification period, the Service should be deemed to have been available throughout that period (i.e. from the commencement of unavailability determined in accordance with Section 7.6) and no availability deductions should be made. Any performance points should, however, still accrue in that period in respect of the relevant failure as the Authority has not received the full Service and the Contractor should be discouraged from relying on remedying failures at the last minute (see Section 10.3 (Direct Financial or Indirect Non- financial Incentives)).

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

7.8 SERVICE UNAVAILABLE BUT USED

7.8.1 The Contract should also specify what happens if the Authority continues to use the Service (e.g. a prison cell or classroom) despite the defects which would otherwise render that part of the Service unavailable. Various factors should be considered, such as:

- whether the Authority's continued use prevents the Contractor remedying the defect; and
- whether the Authority is able to use any alternative service (e.g. provided by the Contractor or a third party).

Depending on these factors, the parties may agree that:

- the Service is deemed available if the Authority does not stop using it within a specified time period and the Contractor would otherwise be able to remedy the defect;
- a proportion of the availability fee is paid, based on what part of the Service is available;
- an appropriate number of performance points could accrue in respect of the relevant failure; or
- in exceptional cases (e.g. certain defence establishments), if the Service is unavailable but used (for example because operational reasons require it to be used even though the Service is significantly below what either party regards as adequate) then no payment is made.

It does not matter whether this situation is dealt with by availability deductions or performance measures, provided that the effect is the same. The Contractor should not receive a full Unitary Charge (with no availability or performance deductions) as it has not provided the Service at the required standard. The deduction should reflect the degradation in Service⁴.

⁴ See also Sections 7.4.4 and 9.11 (Consequences of Poor Performance).

7.8.2 Unavailability should be excused if it is caused by Authority step-in (see Section 28 (Authority Step-In)). The effects of a Compensation Event on availability are set out in Section 5.2 (Compensation Events).

7.8.3 As availability is the factor in determining payment, the dispute resolution procedure should contain a mechanism to ensure a quick solution to any disagreements (see Section 27 (Dispute Resolution)).

7.9 RESTORATION OF AVAILABILITY

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

7.10 PLANNED MAINTENANCE

7.10.1 Maintenance is required in order to allow the Contractor to keep any facility at the appropriate standard in order to meet the output specification throughout the life of the Contract (see Section 8 (Maintenance)). The programme for planned preventative maintenance should be planned and agreed in advance in the Contract between the parties so that the extent to which units or areas will be affected by the Contractor undertaking such maintenance is clear.

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

7.10.3 The Authority's technical adviser should help ensure that the planned preventative maintenance periods are reasonable by undertaking discussions with the Contractor. What is reasonable will depend on the nature of the activities undertaken by the Contractor. For example, the maintenance of a school should be capable of being planned around holiday periods or outside school hours so there should, in most projects, be no maintenance planned during school hours or in term time.

8

MAINTENANCE

8.1 INTRODUCTION

8.1.1 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.

8.1.2 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.

8.1.3 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 7.10 (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).

8.1.4 Required drafting for a maintenance clause is as follows:

8.1 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 life⁴; and
- (c) [the Assets are handed back to the Authority on the Expiry Date in a condition complying with the requirements of this Clause⁵].

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 intellectual property rights.

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).

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 19 (Termination on Expiry of Service Period)).

8.2 SINKING FUND

8.2.1 The Unitary Charge will usually be made on a broadly level basis in accordance with the Authority's budget, whereas the need for capital replacement will only occur at intervals (although exceptional payments may be sculpted to give a non-level profile to the Unitary Charge). 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.

8.2.2 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.

8.2.3 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 fund⁶. 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 provisions⁷. The Authority will wish to ensure that the Contractor is as equally incentivised to maintain the Assets in the latter 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 standard⁸.

8.2.4 To protect themselves in the event of Contractor Default, the Senior Lenders will have a charge over the sinking fund as security (see Section 23.5 (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 21 (Calculation and Payment of Termination Payments) and the definitions of "Base Senior Debt Termination Amount" and "Revised Senior Debt Termination Amount" in Clause 1.8.1 (Definitions)). The Authority should not need any additional rights over the sinking fund.

8.3 EXPIRY OF THE CONTRACT

8.3.1 As the Expiry Date approaches, the Authority's interest in the maintenance of any Asset will become most acute where full 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 22 (Surveys on Expiry and Termination).

⁶ The Contractor may, however, be required to provide the Authority with details of the balance of the sinking fund in accordance with Clause 29.7 (Contractor's Records).

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 22 (Surveys on Expiry and Termination).

8.4 TRANSFER OF ASSETS AT END OF CONTRACT

8.4.1 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.

8.4.2 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 22 (Surveys on Termination)).

8.5 SURVEYS

8.5.1 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 9.3 (Monitoring)) and a mechanism needs to be agreed whereby this can be done in as non-intrusive a manner as possible.

8.5.2 The following is the required drafting for a clause dealing with surveys:

8.5 Surveys

- (a) If the Authority reasonably believes that the Contractor is in breach of its obligations under Clause 8.1 (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 8.1 (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 Service¹¹.
- (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)(iii) 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.

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.

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- (d) If the survey shows that the Contractor has not complied or is not complying with its obligations under Clause 8.1 (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 8.1 (Maintenance);
 - (ii) specify a reasonable period within which the Contractor must carry out such rectification and/or maintenance work; and
 - (iii) be entitled to be reimbursed by the Contractor for the cost of the survey¹².
 - (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 This can be set-off under Clause 11 (Set-Off).

9.1 INTRODUCTION

9.1.1 Availability of the Service to the required standards determines the maximum possible level of the Unitary Charge (see Section 7 (Service Requirements and Availability)). Payment of such maximum level is conditional upon the quality of the performance of the Service (see Section 10 (Price and Payment Mechanism)).

9.1.2 The Contract should therefore set out:

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

9.2 SETTING THE PERFORMANCE LEVEL

9.2.1 In order to encourage innovation and optimise risk transfer, the Contract should specify the required performance level through output requirements (i.e. the service standard required), rather than through prescriptive inputs (i.e. how the Service will be delivered). In some cases there may be no appropriate comparators or benchmarks available. In such circumstances a suitable performance regime will need to be carefully worked out by the Authority and the bidders during the competitive stages of the procurement. The negotiated performance regime will form a key element of the risk transfer mechanism. The Authority should pay due attention to the principles set out in Sections 9.2.5 and 9.2.6 in constructing such a regime.

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

9.2.3 An alternative method is to set the performance level by reference to the average performance level of a comparator group made up of other providers of the same or similar Service to the Authority (e.g. if the Authority is letting a number of Contracts to various Contractors). For example, in prisons, the comparator group includes a number of similar establishments and the levels of performance by the service providers in those establishments is monitored and compared, and an appropriate benchmark thereby obtained.

9.2.4 The danger with both of these approaches should be recognised, in that if there were a reduction in quality of service elsewhere, then the Contractor would benefit in that it would (even if perfectly able to perform, unaffected by the reason for a wider deterioration) have an opportunity to perform the Service at a lower level.

9.2.5 Benchmarking against a comparator group may be particularly useful where the Service to be delivered has not been measured before in the manner required by the performance monitoring regime in the Contract. An untested performance measurement system may by itself result in performance deductions being too high or too low, so a mechanism for setting the level by comparing similar services should avoid this problem (see Section 20.2.3 (Termination for Persistent Breach by the Contractor)).

9.2.6 As with availability (see Section 7 (Service Requirements and Availability)), financiers will be concerned that the performance level required is reasonable and objectively measurable. They will seek to establish that Unitary Charge will not, save in circumstances which they have satisfied themselves are unlikely to occur, drop below a level that allows Senior Debt to be serviced and an equity return to be paid. In considering what a reasonable level is, the Authority should decide what the optimum 100% performance standard would be and whether it is achievable and essential (taking into account the nature of the Service), to set the required standard in the Contract at this level. For example, in some cases such as operating theatres in hospitals and custody suites in police stations, the optimum 100% standard will always be required and should always be achievable.

9.2.7 In other cases, however, the Authority may recognise that the optimum 100% standard is not, in practice, always essential (or necessarily always achievable). In such cases, the Authority may retain the optimum 100% level, but allow a certain leeway before the Contractor suffers for performing below such 100% level. For example, it may be acceptable for the Contractor to incur a certain number of performance points in any specified period before suffering financially where the Service provided is adequate without being excellent and the under-performance does not materially affect the operation in that area (see Section 9.11 (Consequences of Poor Performance)).

9.3 MONITORING

9.3.1 There must be a mechanism under the Contract which enables the Authority to monitor the Contractor's performance against the outputs specified by the Authority under the Contract so that the performance measurement system can operate effectively.

9.3.2 The monitoring requirement should be set out in the ITN¹ and a full methodology included in the bid. The methodology will normally include a substantial element of monitoring by the Contractor, subject to periodic Authority audits². Additional Authority monitoring will also take place on an exceptional basis, for example, teachers or medical staff identifying and reporting performance failures. The reports relied upon will be key to the management of the Contract, and to the payment mechanisms, and should be specifically tailored to meet these requirements.

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

¹ Including an indication of who should bear the costs associated with performance monitoring (see Section 9.7 (Who pays for the monitoring?)).

² See Section 9.6.3 (Who does the monitoring?).

9.4 COMMENCEMENT OF PERFORMANCE MONITORING

9.4.1 The Contract must specify whether the performance regime applies in full from the Service Commencement Date³. In some projects, such as prisons, it is recognised that problems are inevitable in the settling in period, and the Contractor can be afforded a degree of flexibility. In other projects such as roads (where the safety element is crucial), it is essential that the Contractor ensures there are no settling in problems, and the Authority requires the full performance regime from day one⁴, even if the road is opened in phases.

9.4.2 One approach which gives flexibility in the settling in period is to allow the Contractor to accrue a higher number of performance points during that period before financial penalties are triggered than is allowed during the remainder of the Contract. Some Contracts (e.g. where the Service involves a relocation from existing facilities into new facilities) have alternatively made successful use of a regime where the Contractors are allowed a 3 to 6 month settling in period. During this time, monitoring takes place, but any financial deductions imposed on the Contractor for poor performance are set at a lower level than is the case once operations are fully established (but, in such cases, this does not affect the Authority's rights to terminate for Contractor Default)⁵. A third approach is to award performance points at the normal Contractual rate so that the Authority only pays for the services which it receives but to apply a more lenient mechanism in counting the points which trigger the right to terminate for Contractor Default.

9.5 REPLACEMENT OF SUB-CONTRACTORS

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

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

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

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

³ This will be more complicated where the Project has more than one Service Commencement Date (see Section 3.6 (Acceptance and Service Commencement)).

⁴ See also Section 3.6 (Acceptance and Service Commencement).

⁵ See Section 3.7.4.

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- cancel any performance points accrued by the Contractor under the Contract in relation to the relevant Services provided by the replaced Sub-Contractor on the appointment of the replacement Sub-Contractor.

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

9.5.5 As mentioned above, the Authority should not be disadvantaged by the replacement of any Sub-Contractor. Accordingly, the Authority should consider allowing itself the opportunity to approve the identify of any replacement Sub-Contractor if a request is made by the Contractor for temporary relief under the performance regime following the replacement of a Sub-Contractor. This approval right is consistent with the approach taken in the Direct Agreement (see Section 30 (Direct Agreement) and similarly, any such approval rights should be limited to matters of technical competence and financial standing.

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

9.6 WHO DOES THE MONITORING?

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

9.6.2 Monitoring should occur at three levels:

- a systematic monitoring by the Contractor through a quality management system measuring performances (see Section 3.5 (Quality Management Systems));
- a review of the quality management system of the Contractor by the Authority with certain planned and random spot checks (with an ability to increase monitoring on repeated failure or poor performance) (see Section 9.9.2); and
- the ability for users to report failures (e.g. doctors, teachers and service personnel).
- A failure to agree such a system can cause difficulties, particularly if disputes arise on the issue of whether a payment is due.

9.6.3 Monitoring is ultimately the responsibility of the Authority but in many cases it requires the use of information that can only be gathered with co-operation from the Contractor. This will usually be dealt with as part of the quality management systems run by the Contractor (see Section 3.5 (Quality Management Systems)). Mechanisms must be in place to ensure the Contractor provides data accurately⁶. The right approach depends on the particular project but will always call for co-operation between the parties as benefits will accrue to the Contractor as well as the Authority. Where a Contractor is providing the information, the Authority should obtain a right of audit to verify the information.

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

⁶ Failure to provide data should give rise to deductions and/or the award of performance points under the performance regime.

9.7 WHO PAYS FOR THE MONITORING?

9.7.1 Monitoring arrangements impose obligations on the Contractor and may cause the Contractor natural concern about any exposure to onerous obligations. It is therefore sensible for each party to bear its own costs of monitoring and this should reassure the Contractor that the Authority will not act with too heavy a hand and avoid any possible conflict of interest⁷.

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

9.8 ADDRESSING QUALITATIVE FACTORS

9.8.1 Objective performance criteria should always be used as far as practicable, but other methods of measuring performance may be appropriate in some specific projects⁸. For example, in some projects there may be qualitative aspects of performance to which it may be difficult to apply performance points objectively but which are nevertheless important to the users of the Service such as the helpfulness of staff or the quality of catering. Three possible approaches for measuring these type of performance aspects are the use of customer satisfaction surveys, the use of "mystery shoppers" and sampling.

9.8.2 Customer satisfaction surveys – it is difficult to base financial compensation on customer satisfaction surveys because they are based on individuals' perception rather than hard measurable facts and so the results of an individual survey may be variable. Over time they are, however, a useful way of monitoring performance and have been used successfully in a number of projects in a variety of sectors. The railway franchise contracts require customer satisfaction monitoring to be undertaken by an independent company twice a year with the results published. Operators are under an obligation to improve customer satisfaction and where a particular aspect of the survey falls below the benchmark level, they have to propose an action plan to remedy the problem which has to be agreed by the Authority. The advantage of such a system is that if the customers clearly understand the quality of service contracted for, the feedback obtained can be very useful.

9.8.3 Mystery shoppers – a similar approach could be adopted with "mystery shopper" surveys (i.e. the use of qualified individuals to test aspects of the Service). This removes the perception aspect of testing as the relevant individuals will apply the same objective standards to all aspects of the businesses tested.

9.8.4 Sampling – where monitoring is to be done on a sampled basis, the methodology for sampling, including sample size and frequency, should be agreed prior to signing the Contract.

9.8.5 Certain projects do not lend themselves particularly to any of these approaches. Regardless of which method is used, the quality of service aspects must be considered in detail by both parties and included in the Contract.

⁷ The Authority's cost of additional monitoring or audit required due to the poor performance of the Contractor should be for the account of the Contractor.

⁸ The alternative approaches to performance measurement set out in Section 9.8 are intended to complement rather than replace objective performance criteria.

9.9 MONITORING OF SUB-CONTRACTORS

9.9.1 An Authority may feel it needs to use the Contract to allow it to intervene at Sub-contractor level to protect its interest if a Sub-contractor is underperforming (e.g. the Authority may want the right to direct or require the replacement of the Sub-contractor). This approach is not recommended as it should be for the Contractor to manage its Sub-contractors and intervention by the Authority will affect the degree of risk transfer achieved (see Section 15 (Sub-contractors and Employees)). The Authority should instead rely on the payment mechanism and its termination rights to address sub-standard performance.

9.9.2 Deductions under the payment mechanism and, ultimately, the risk of the Authority terminating the Contract for under performance, should be a sufficient incentive on the Contractor to manage its Sub-contractors' performance. The Contractor will typically ensure it has the right under the Project Documents to replace its Sub-contractors before the Authority's right to terminate arises under the Contract. Concerns regarding Sub-Contractors' performance may be further addressed in the Contract by requiring a temporary increase of monitoring at the Contractor's expense in specified circumstances as well as requiring the Contractor to provide an acceptable plan outlining how any defects in the Service will be put right. Both of these measures impose costs on the Contractor and are only acceptable if there has been a persistent and verifiable period of under-performance. If the Contractor elects to replace any of its Sub-Contractors to improve performance, the Contractor should not be entitled to a relaxation of the performance regime, but it is recognised that this will be a factor to be taken into account in the initial development of the performance regime.

9.10 REPORTING THE RESULTS OF PERFORMANCE MONITORING

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

- what reports are required by whom? How frequently? Are different reports required by different people in the organisation, e.g. contract manager, chief executive?
- is there to be a standard monitoring form or an IT compatible format to present results?
- how soon after a monitoring period is the report to be received?
- how often are meetings required between the Authority and the Contractor? Who is required to attend from the Contractor?

9.10.2 As further discussed in Section 23.6 (Damages Claims), performance points imposed in respect of a specific failure should be the Authority's exclusive remedy in respect of that failure (except to the extent that any termination rights depend on levels of accrued points).

9.II CONSEQUENCES OF POOR PERFORMANCE

9.II.1 The Contract must set out clearly the consequences of any failure by the Contractor to perform to the standard required by the output specification.

9.II.2 A common approach is for the Contractor to incur a specified number of performance points for each failure, with the number of points incurred varying according to the seriousness of the failure. The Contract would in this case include a schedule setting out in detail the level of points imposed for each failure to meet a specified performance output. There should be a clear link between the seriousness of the failure, the number of points accrued and the potential financial impact on the Contractor. For example, a failure to cut the grass outside a prison should not accrue as many points as a failure to carry out security checks. Similarly, the same type of failure may also incur different deductions depending upon the nature of the area in which it arises. For example, a failure to empty bins in a hospital ward is a more serious failure than a failure to empty bins in the hospital's office accommodation.

9.II.3 The accumulation of performance points does not usually have an immediate financial impact on the Unitary Charge. Generally, deductions only start once a certain threshold level of points is exceeded. Once performance deteriorates below a particular level then a range of other non- financial mechanisms can be implemented to encourage the Contractor to improve performance – these range from formal warnings to eventual termination for breach of the Contract (see Section 20.2.2.1 (Events Leading to Termination)).

9.II.4 In some Contracts, it will be appropriate to have a ratchet mechanism to encourage the Contractor to improve performance (as opposed to availability) if it is consistently poor in relation to a particular part of the Service or a particular failure is not rectified. This can be particularly useful where the financial cost of performance points which accrue is insufficient to provide an appropriate incentive on the Contractor to rectify the fault. Too complicated a regime can, however, be difficult to manage and including onerous measures in the pricing mechanism can lead to poor value for money. A key advantage of a ratchet mechanism, however, is that poor performance that continues for a significant period will be more difficult for others interested in the Contract (e.g. Sub-contractors and financiers) to ignore, encouraging early action by the Contractor.

9.II.5 A simple ratchet mechanism will work by increasing the number of penalty points awarded for a particular failure in the Service which recurs too often within a specified period. For example, if x points are awarded for a failure to achieve a particular output then $(x+3)$ points may be awarded for each failure over and above a specified maximum number of failures within a pre-defined period⁹. It is of vital importance to tailor the ratchet mechanism to a particular project in a way that produces best value for money so as not to introduce perverse incentives. In establishing a suitable system, the Authority will have to be aware of the effects a particular system has on the solution offered by a bidder. For example, a bid solution that is capital intensive up front with reduced consequential life cycle cost will have one optimum approach, whereas one with lower up front capital costs but with higher life cycle costs will have a different optimum approach (i.e. they bite at different points in the respective financing plans). It is crucial for the Authority to understand what level of commercial “pain” will best achieve the result desired by the Authority. An over rigid approach during negotiations will reduce the scope for innovation by the bidders and so reduce the potential for best value for money to be achieved.

⁹ Alternatively, the number of points may increase for each failure over and above *de minimis* level.

9.11.6 Performance points should generally not be capable of being “earned back” retrospectively by the Contractor performing above the standard required¹⁰. The required performance level should be set at what is considered reasonable and achievable, so if the Contractor is capable of performing at a consistently higher level then the level will either be too low (e.g. if the higher level does not offer any additional benefit to the Authority) or the Contractor may simply be performing very well and delivering a standard of service at a much higher level than the Authority expected. If the higher level of performance is of additional benefit to the Authority then it may be appropriate for the Contractor to receive additional consideration over and above the usual Unitary Charge.

9.11.7 The performance points regime should as far as possible cover every aspect of the Service. Where an all-encompassing performance regime is not feasible or does not sufficiently address persistent failures (as described in Section 9.11.4), the Authority should consider what recourse it has against the Contractor for sub-standard performance which is not covered under the performance regime (see Section 20.2.3 (Termination for Persistent Breach by the Contractor)).

¹⁰ The performance points mechanism should after a certain time, however, disregard points accrued in circumstances where the relevant thresholds for warnings, deductions etc. have not been reached or, if reached, have been dealt with in accordance with the Contract. This is often achieved by using periodic test periods or rolling points accrual periods.

10.1 INTRODUCTION

10.1.1 The payment mechanism is at the heart of the Contract, as it puts into financial effect the allocation of risk and responsibility between the Authority and the Contractor. It determines the payments the Authority makes to the Contractor and establishes the incentives for the Contractor to deliver exactly the Service required in a manner that gives value for money. It is vital that this Section is considered in conjunction with Sections 7 (Service Requirements and Availability) and 9 (Performance Monitoring).

10.1.2 This Section focuses primarily on projects in which payment is made by the Authority and depends on availability of the Service and performance of the available Service rather than on usage (see Section 10.2.3 which refers to projects where aggregate payment is dictated largely by demand).

10.2 FEATURES OF THE PAYMENT MECHANISM

10.2.1 In general terms, the key features of a payment mechanism must be:

- no payments should be made until the Service is available (but see Section 3.6.4);
- there should be a single Unitary Charge for the Service which is not made up of separate independent elements relating to availability or performance;
- the single Unitary Charge should only be paid to the extent that the Service is available (e.g. proportionate to the number of available places or units); and
- the payment mechanism should seek to make deductions for substandard performance so that the Contractor is worse off than if the required Service had been delivered, but deductions should reflect the severity of failure, so that no service should lead to no payment, but a minor failure should only cause at most a minor deduction except in the case of persistent failure where ratchet mechanisms may increase the level of deduction (see Section 9.11 (Consequences of Poor Performance)).

10.2.2 The basis of PFI (i.e. the specification of outputs and services) requires that the Unitary Charge should not be made up of sub-elements which relate to delivery of any inputs (e.g. completion of stages of construction, cost of materials or labour). In particular, the payment mechanism should never contain a fixed element which the Contractor always receives irrespective of performance (e.g. which covers the Contractor's debt service obligations). The Senior Lenders should have confidence (taking into account, where relevant, the advice from their technical adviser) in the Contractor's (i.e. their borrower's) ability to perform and/or remedy defective performance.

10.2.3 The Unitary Charge may in some cases be determined by usage (or volume). Complete transfer of usage risk is only appropriate in cases in which the Contractor can forecast or influence future usage. This may be the case where the Contractor is satisfied with

predictions of level of demand for the Service or there is significant third party revenue which the Contractor's performance can affect (either during the life of the Contract or scope for it following a termination). In many projects, demand or scope for generating significant third party revenue is not possible to predict and so it is unlikely to offer value for money to transfer any volume risk. A part of usage risk can, however, be transferred, but only in some Contracts. Transfer of a degree of usage risk does, of course, bring advantages of simplicity as customers "vote with their feet" on the availability and quality of the Service. Of course, some projects cannot transfer any usage risk (even where catering facilities are being provided) and transferring usage risk in inappropriate cases is likely to result in poor value for money.

10.2.4 The payment mechanism will often include provisions relating to changes in the general price level (i.e. as a result of inflation) during the Contract. The related issues are addressed in Section 14.2 (Indexation).

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

10.3 DIRECT FINANCIAL OR INDIRECT NON-FINANCIAL INCENTIVES

10.3.1 If the Contractor fails to perform there can be both direct and indirect incentives to remedy the failure.

10.3.2 The direct approach involves immediate deductions from the Unitary Charge and depends on availability of the Service (see Section 7 (Service Requirements and Availability)). For example, if certain prison cells or classroom space do not meet the relevant availability definition, then a deduction is made from the Unitary Charge. The Contract should contain sufficient incentives for the Contractor to rectify the default itself. Unavailability for a prolonged period will trigger a termination event (see Section 20.2 (Termination on Contractor Default)).

10.3.3 The indirect approach depends on the level of performance of the available Service (see Section 9 (Performance Monitoring)) and involves substandard performance being addressed by the award of performance points which will vary according to the severity and regularity (if a ratchet mechanism is used) of the breach (see Section 9.11 (Consequences of Poor Performance)). When the Contractor accumulates a certain level of performance points, the consequence is a deduction from the Unitary Charge. Once performance deteriorates below a certain level (whether for a single failure or for persistent failure under a ratchet mechanism), or a certain number of performance points are accumulated, then a range of other incentives can be imposed, from formal warnings to, in extreme cases, eventual termination for a breach of the Contract.

10.3.4 A combination of deductions for unavailability and under-performance may be used to address failure by the Contractor. Care should be taken, however, to avoid unintended deductions of both types in respect of the same failure.

10.4 STRUCTURING THE PAYMENT MECHANISM

10.4.1 In practice, a variety of payment mechanism structures have been used across various sectors and project types (from availability based mechanisms to service based and usage based mechanisms). For many projects, Model A (referred to below) will most accurately reflect the Service that the Authority wishes to purchase (being places or units available, to a defined standard, for delivery of a public service) and is therefore the recommended approach.

- Model A – this follows the principles set out in Sections 7 (Service Requirements and Availability) and 9 (Performance Monitoring). The Unitary Charge is based on the number of available places or units – so only places or units that are available are paid for. The definition of available places or units incorporates ongoing services that are core to the requirements of the Authority to carry out its functions, and the performance points regime is only used to address levels of performance that do not impact on the availability of places and/or services that are outside the definition of the core Service. Substandard performance leads initially to “performance points” accruing and, only indirectly, to deductions from the Unitary Charge once a certain level of points has accrued.

10.4.2 Model B also provides a Unitary Charge structure, focussing on broad accommodation areas, rather than individual places, for the Service required:

- Model B – the Unitary Charge is based on a full provision of the overall accommodation requirement and the payment mechanism simply determines the deductions for unavailability and/or substandard performance. Availability is defined in terms of being usable and accessible and different deductions are made depending on which area is unavailable. For example, in an accommodation project, each section of the accommodation is divided into units and is given a weighting depending on its importance. For each failure to provide an available unit there is initially a payment deduction equal to the Unitary Charge multiplied by the relevant weighting. The deduction can be based on an escalating tariff so that subsequent days of unavailability of the same space may lead to progressively higher deductions. There are no separate payment streams for each of the non-core services, but as with Model A, substandard performance leads initially to performance points and to payment deductions once a certain level of points has accrued. As the definition of availability here may omit certain key service requirements of the Authority, it may also be appropriate for poor performance of key services to lead to direct payment deductions.

10.4.3 Structures where the Unitary Charge is in fact a combination of a separate availability payment and a separate performance-related facilities management payment are not appropriate as they move away from the basic principles set out in Section 10.2 (Features of the Payment Mechanism), i.e. that the Authority should enter into a single Contract involving a Unitary Charge for a range of services. In particular, availability payments which are completely separable from payments for the on-going services (in terms of the build up of the Unitary Charges) do not sit comfortably with the aim of getting best value for money as the inter-relationship between the availability of accommodation and the provision of associated services is lost.

10.4.4 For those projects relying on usage based payment mechanisms (such as some transport and water treatment projects) neither Model A nor Model B are appropriate approaches (for obvious reasons).

10.5 FINANCEABILITY

10.5.1 A payment mechanism should not ring fence or guarantee the Contractor's finance charges. The relatively weak risk transfer created by such a structure will not usually give good value for money and the Authority will often be taking the risk of the interfaces between the service elements. The structure of the payment mechanism should meet the requirements of the Authority, the solution offered by the Contractor and then the financing should be structured to fit with this. Clearly an unfinanceable proposition should be avoided, but the Authority should not effectively accept all the risk of the financing.

Experience has shown that Unitary Charge systems based on Model A are perfectly capable of being financed provided the payment mechanism is objective, reasonable rectification periods are included and deductions are appropriately weighted. Financiers will typically expect the reductions for availability payments, performance deductions or (with usage being an element of the payment) likely downside usage outturns to be accommodated within their financial model runs which show the sensitivity of the financing to various events (so that their assessment is that the risk of losing the whole payment is minimised).