

Standardisation of PFI Contracts

Version 4

March 2007



HM TREASURY



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1 INTRODUCTION

1.1 BACKGROUND

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

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

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

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

1.2 PURPOSE

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

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

1.3 ASSUMPTIONS

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

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

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

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

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

1.4 APPLICATION AND IMPLEMENTATION

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

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

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

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

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

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

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

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

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

1.5 USE OF ADVISERS

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

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

1.6 TERMINOLOGY

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

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

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

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

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

HMRC: HM Revenue & Customs

HMT: HM Treasury

ISO: International Standards Organisation

IP: Intellectual Property

IPR: Intellectual Property Rights

IT: Information Technology

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

MOD: Ministry of Defence

NHS: National Health Service

NPV: Net Present Value

OGC: Office of Government Commerce

PUK: Partnerships UK plc

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

SPV: Special Purpose Vehicle

VfM: Value for Money

1.7 INTERPRETATION

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

1.7.1 Definitions⁴

In this Contract, unless the context otherwise requires:

"Additional Permitted Borrowing"

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

but only to the extent that:

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

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

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

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

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

“Additional Permitted Borrowings Limit”

means an amount equal to:

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

“Affiliate”

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

“Agent”⁵

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

“APB Distribution”

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

“Assets”⁶

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

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

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

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

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

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

“Associated Company”

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

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

“Base Case”

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

“Base Senior Debt Termination Amount”

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

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

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

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

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

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

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

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

“Business Day”

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

“Capital Expenditure”

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

“Consents”

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

“Construction Sub-Contractor”

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

“Contingent Funding Liabilities”

means []:¹⁸

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

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

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

¹⁴ See footnote 27.

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

¹⁶ These will include, for example, planning consents.

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

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

“Default Interest”

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

“Direct Agreement”¹⁹

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

“Effective Date”

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

“Estimated Change in Project Costs”

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

“Expiry Date”

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

“Financial Close”

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

“Financing Agreements”²¹

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

“Guidance”

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

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

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

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

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

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

“Holding Company”

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

“Holdco”

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

“Initial Financing Agreements”

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

[]

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

“Joint Insurance Account”

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

“Junior Debt”

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

“Operating Sub-Contractor”

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

“Original Senior Commitment”

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

“Permitted Borrowing”

means, without double-counting, any:

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

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

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

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

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

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

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

“PFI”

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

“PFI Contractor”

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

“Planned Service Commencement Date”²⁸

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

“Project”

means [];²⁹

“Project Documents”

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

“Qualifying Variation”³¹

means,

either:

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

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

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

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

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

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

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

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

³¹ See definition of Original Senior Commitment.

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

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

(b) a Qualifying Change in Law

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

“Relevant Authority”

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

“Revised Senior Debt Termination Amount”

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

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

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

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

³³ See footnote 27 above.

³⁴ See footnote 13 above.

“Senior Debt”

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

“Senior Financing Agreements”

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

“Senior Lender”

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

“Service”

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

“Service Commencement”

means the commencement of the Service;

“Service Commencement Date”

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

“Service Period”

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

“Shareholders”

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

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

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

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

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

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

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

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

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

“Sub-Contractors”

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

“Sub-Contracts”

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

“Subordinated Financing Agreements”

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

“Subordinated Lender”

means a person providing finance under a Subordinated Financing Agreement;

“Suitable Substitute Contractor”

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

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

“Tax”

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

“Termination Date”

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

“Unitary Charge”

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

“VAT”

means any value added taxes.

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

1.7.2 Interpretation

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

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

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

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

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

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

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

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

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

2 DURATION OF CONTRACT

2.1 INTRODUCTION

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

2.2 FACTORS TO CONSIDER

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

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

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

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

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

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

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

Required drafting is as follows:

2 Duration of Contract²

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

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

³ See footnote 2 above.

3 SERVICE COMMENCEMENT

3.1 INTRODUCTION

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

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

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

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

3.2 AUTHORITY'S ROLE – GENERAL

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

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

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

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

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

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

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

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

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

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

3.3 CRITICAL DATES

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

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

3.4 SUBMISSION OF DESIGNS AND INFORMATION TO THE AUTHORITY

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

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

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

3.4.4 The Contract should therefore set out a mechanism for:

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

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

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

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

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

3.5 QUALITY MANAGEMENT SYSTEMS

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

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

3.6 ACCEPTANCE AND SERVICE COMMENCEMENT

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

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

3.6.2 The Contract should set out in detail:

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

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

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

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

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

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

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

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

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

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

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

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

3.7 EXISTING SERVICES

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

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

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

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

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

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

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

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

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

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

3.8 RANGE OF SERVICES TO BE PROVIDED

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

3.9 CAPITAL CONTRIBUTIONS¹⁰

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

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

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

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

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

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

3.10 EARLY WORKS AGREEMENTS

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

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

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

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

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

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

4 PROTECTIONS AGAINST LATE SERVICE COMMENCEMENT

4.1 INTRODUCTION

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

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

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

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

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

4.2 LIQUIDATED DAMAGES

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

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

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

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

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

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

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

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

² A cap will be a key issue for financiers.

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

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

4.3 PERFORMANCE BONDS

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

4.4 PARENT COMPANY GUARANTEES

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

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

4.5 LONG-STOP DATE

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

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

4.6 BONUS PAYMENTS FOR EARLY SERVICE COMMENCEMENT

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

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

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

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

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

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

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

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

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

5 SUPERVENING EVENTS

5.1 INTRODUCTION

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

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

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

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

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

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

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

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

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

5.2 COMPENSATION EVENTS

5.2.1 Purpose and Scope

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

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

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

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

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

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

⁴ See Section 6 (Warranties).

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

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

“Compensation Event”

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

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

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

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

5.2.2 Consequences

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

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

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

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

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

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

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

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

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

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

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

5.2.3 Calculation of Compensation

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

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

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

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

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

by

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Required drafting is as follows:

5.2 Delays in Service Commencement Due to a Compensation Event

- (a) If, on or before the Service Commencement Date,¹⁸ as a direct result of the occurrence of a Compensation Event:¹⁹
- (i) the Contractor is unable to achieve Service Commencement on or before the Planned Service Commencement Date, or, following the Planned Service Commencement Date, the Long Stop Date;
 - (ii) the Contractor is unable to comply with its obligations under this Contract; and/or
 - (iii) the Contractor incurs costs or loses revenue,²⁰
- then the Contractor is entitled to apply for relief from its obligations and/or claim compensation under this Contract.
- (b) Subject to sub clause (d) below, to obtain relief and/or claim compensation the Contractor must:
- (i) as soon as practicable, and in any event within [21] days after it became aware that the Compensation Event has caused or is likely to cause delay, breach of an obligation under this Contract and/or the Contractor to incur costs or lose revenue, give to the Authority a notice of its claim for an extension of time for Service Commencement, payment of compensation and/or relief from its obligations under the Contract;
 - (ii) within [14] days of receipt by the Authority of the notice referred to in paragraph (b)(i) above, give full details²¹ of the Compensation Event and the extension of time and/or any Estimated Change in Project Costs and/or loss of revenue claimed;²² and
 - (iii) demonstrate to the reasonable satisfaction of the Authority that:
 - (A) the Compensation Event was the direct cause of the Estimated Change in Project Costs and/or loss of revenue and/or any delay in the

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

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

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

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

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

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

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

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

²³ This will depend on the industry concerned.

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

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

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

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

5.3 RELIEF EVENTS

5.3.1 Purpose

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

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

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

5.3.2 Scope of Relief Events

5.3.2.1 The required drafting for Relief Events is as follows:

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

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

“Relief Event”

means:²⁹

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

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

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

5.3.3 Consequences

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

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

³⁰ Force Majeure Events are defined in Section 5.4.

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

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

³³ See footnote 30 above.

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

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

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

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

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

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

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

Required drafting to deal with Relief Events is as follows:

5.3 Consequences of a Relief Event

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

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

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

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

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

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

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

³⁸ See footnote 36 above.

³⁹ This will depend on the industry concerned.

⁴⁰ See Section 21.2 (Termination on Contractor Default).

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

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

⁴³ See footnote 36 above.

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

5.4 FORCE MAJEURE EVENTS

5.4.1 Scope of Force Majeure

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

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

“Force Majeure Event”⁴⁵

means the occurrence after the date of Contract of:

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

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

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

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

⁴⁴ See footnote 36.

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

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

5.4.2 Consequences of Force Majeure

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

5.4.3 Relief Events, Force Majeure Events and Insurance

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

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

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

6 WARRANTIES

6.1 INTRODUCTION

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

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

6.2 DUE DILIGENCE

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

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

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

6.3 AUTHORITY WARRANTIES

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

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

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

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

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

6.3 Exclusion from Warranty

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

6.4 BENEFIT OF SURVEYS AND REPORTS

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

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

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

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

⁴ See, for instance, the BSF schools programme.

6.5 LATENT DEFECTS RISK

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

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

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

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

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

7 PRICE AND PAYMENT MECHANISM

7.1 INTRODUCTION

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

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

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

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

7.2 FEATURES OF THE PAYMENT MECHANISM

7.2.1 The key features of a payment mechanism are:

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

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

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

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

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

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

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

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

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

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

7.3 STRUCTURING THE PAYMENT MECHANISM

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

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

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

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

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

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

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

7.4 USAGE-BASED SYSTEMS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Evaluation and other implications of transferring usage risk

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

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

7.5 CALIBRATION

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

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

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

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

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

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

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

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

Calibration methodology

7.5.6 Authorities should consider the following calibration issues:

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

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

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

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

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

Standards

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

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

Time periods for repair/rectification

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

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

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

“Unavailable but used”

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

Weightings

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

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

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

the potential for unnecessary risk-pricing.

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

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

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

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

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

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

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

Ratchet mechanisms

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

Performance deduction caps

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

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

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

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

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

7.6 FINANCEABILITY

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

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

7.7 FLEXIBILITY

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

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

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

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

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

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

7.8 OTHER REMEDIES FOR POOR PERFORMANCE

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

7.8.2 Suitable drafting is as follows:

7.8 Payment Mechanism: No double remedy

(a) Subject to:

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

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

²⁴ See further Section 24.6 (Damages Claims).

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

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

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

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

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

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

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

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

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

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

7.9 QUALITATIVE FACTORS AND USER SATISFACTION

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

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

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

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

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

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

²⁷ See the Local Government Act 1999.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

8 AVAILABILITY REQUIREMENTS

8.1 INTRODUCTION

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

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

8.2 DEFINITION OF AVAILABILITY

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

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

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

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

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

8.3 EXAMPLES OF UNAVAILABILITY

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

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

8.4 PAYMENT FOR AVAILABILITY AND WEIGHTING OF CRITICAL AREAS

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

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

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

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

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

8.5 WHEN DOES AVAILABILITY COMMENCE?

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

8.6 WHEN DOES UNAVAILABILITY COMMENCE?

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

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

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

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

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

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

8.7 RECTIFICATION OF UNAVAILABILITY

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

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

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

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

8.8 SERVICE UNAVAILABLE BUT USED

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

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

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

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

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

8.9 RESTORATION OF AVAILABILITY

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

8.10 PLANNED MAINTENANCE

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

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

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

9 PERFORMANCE REQUIREMENTS

9.1 INTRODUCTION

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

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

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

9.2 SETTING THE PERFORMANCE LEVEL

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

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

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

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

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

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

9.3 REPLACEMENT OF SUB-CONTRACTORS

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

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

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

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

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

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

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

9.4 MONITORING OF SUB-CONTRACTORS

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

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

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

9.5 CONSEQUENCES OF POOR PERFORMANCE

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

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

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

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

Ratchet mechanisms

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

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

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

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

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

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

10 PAYMENT MECHANISM MANAGEMENT AND MONITORING

10.1 CONTRACT MANAGEMENT

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

10.1.2 The following issues must be considered:

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

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

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

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

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

10.2 MONITORING AGAINST THE PAYMENT MECHANISM

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

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

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

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

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

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

10.3 COMMENCEMENT OF MONITORING

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

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

10.4 WHO DOES THE MONITORING?

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

10.4.2 Monitoring should occur at three levels:

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

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

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

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

⁶ See Section 3.7.4 (Existing Services).

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

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

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

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

10.5 WHO PAYS FOR THE MONITORING?

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

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

10.6 REPORTING THE RESULTS OF MONITORING

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

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

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

- who is required to attend from the Contractor?