

From: Geoffrey Spence, HM Treasury

To: Heads of PFU's; Project Review Group; NAO; PUK; 4ps; CEO's of Local Authorities

Standardisation of PFI Contracts ("SoPC")

I refer to Justin Slater's letter of 21 March relating to implementation of SoPC and the possibility of further changes to that document.

The discussions with public and private sector bodies on SoPC referred to in that letter have now come to an end. HM Treasury has decided to make a small number of changes to SoPC in light of these discussions. The purpose of this letter is to specify what these changes will be.

Contractor Default/Retendering Election

HMT have, in consultation with the NHS Private Finance Unit (the "NHS PFU") and Partnerships UK ("PUK"), undertaken a review of the relevant provisions of both SoPC and the NHS standard form contract (as published on the NHS website: www.doh.gov.uk/pfi). This includes the amendment made by the NHS PFU which has been agreed on a number of recent transactions and which is appended to this paper at Appendix 1.

The key differences between the SoPC drafting and the NHS drafting are:

- Although both contracts require the lenders to have used reasonable efforts to transfer the Contract as a prerequisite to preventing the Authority from retendering the Contract, the NHS drafting does not require the lenders to demonstrate that the reason why the Contract could not be transferred was because there was no Liquid Market;
- The SoPC drafting (in Clause 4 of the Direct Agreement) allows the lenders to call for a "Liquid Market" test to be run before commencing to use its reasonable efforts to transfer the Contract. This gives the lenders the comfort of knowing that they do not have to commit resource to a retendering of the Contract that will in any event end in nobody bidding for the Contract;
- The SoPC drafting does not place any restrictions on the amount of time that the lenders can step-in under the Direct Agreement, whereas the NHS standard form Direct Agreement limits the lenders Step-in Period to two years; and

- The definition of Liquid Market.

SoPC will be changed so that the NHS standard form re-tendering election (attached as Appendix 1) will be incorporated into the SoPC wording in paragraph 20.2.7.

The NHS standard form Project Agreement will be amended so that the definition of Liquid Market is the same as that in SoPC.

The NHS standard form Direct Agreement will also be amended so that:

- Clause 4 (No Liquid Market) of the SoPC Direct Agreement will be included in the NHS standard form Direct Agreement; and
- The two year long-stop date on the Step-in Period in the NHS standard form Direct Agreement shall be removed.

Replacement of Sub-Contractors

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

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.

However, where there is a single sub-contractor, or a very small number of sub-contractors (i.e. two) then the SPV may find it impossible to find a replacement sub-contractor where the performance points accrued at Project Agreement level are such that a further very minor default under the sub-contract could trigger termination of the Project Agreement. In these circumstances the Authority should consider whether it should:

- give relief from termination of the Project Agreement 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 Project Agreement. Financial deductions under the Project Agreement 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 accrued by the Contractor under the Project Agreement in relation to the relevant Services provided by the replaced Sub-Contractor on the appointment of the replacement Sub-Contractor.

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

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 identity of any replacement Sub-Contractor if a request is made by the Contractor for temporary relief under the performance regime following the replacement of a Sub-Contractor. This approval right is consistent with the approach taken in the Direct Agreement (see Section 30 of SoPC (Direct Agreement)) and similarly, any such approval rights should be limited to matters of technical competence and financial standing.

For Projects where there are a number of sub-contractors the Authority should not give this relief as failures attributable to a single sub-contractor in these circumstances will not cause accrued penalty points under the Project Agreement to approach termination thresholds.

Permitted Borrowing

The definition of Permitted Borrowing will be amended to permit re-scheduling of interest payments under the Senior Financing Agreements. No further changes will be made to this definition.

Refinancing

Exempt Refinancing sub-paragraph (c): Concerns have been expressed that this definition does not cover a number of day to day administrative matters undertaken by banks in administering many PFI Projects. PUK/HMT are considering whether the drafting can be amended to accommodate these concerns.

Definition of Qualifying Bank: The definition will be amended to include a list of named “Qualifying Lenders” which will include both monolines, building societies and other lending institutions. This list will be maintained centrally on behalf of HMT.

Payment by Instalments

4ps are currently considering issues relating to the costs associated with and processes involved in the continued existence of the Project Company after termination if payments on termination are made by instalments pursuant to paragraph 21.5 of SoPC.

Unavailability of third party liability cover

A number of contractors have expressed their concern that the Contractor could be obliged to continue to provide the Services under the Project Agreement when third party liability has ceased to become insurable.

To address this concern SoPC will be amended so that, if:

- (a) third party liability cover becomes Uninsurable; and
- (b) Uninsurability is not caused by the actions of the Contractor or the Sub-Contractor; and
- (c) the Contractor has demonstrated to the Authority that the Contractor and third parties operating the same or substantially similar businesses in the United Kingdom would, if faced with the same Uninsurable third party risk in similar circumstances, cease to operate such business as a result of that risk becoming Uninsurable,

then the parties shall meet to discuss how this risk should be managed.

If the parties cannot agree as to how the risk should be managed, then the Authority should consider if it is prepared to make a payment equivalent to the insurance proceeds that would have been available under the Project Agreement under the third party liability cover, in the event that the uninsured third party liability occurs. The Authority will notify the Contractor within a specified timeframe whether it is prepared to accept this risk. If it is, then the Contract will continue. If it is not prepared to accept this risk then the Agreement will terminate and an amount payable on termination for Force Majeure will be payable to the Contractor.

If the Contract continues and a risk covered by the third party liability cover required under the Project Agreement occurs, then provided the Contractor still meets the requirements set out in (a) to (c) above, the Authority will pay either the Contractor and/or the third party claimant the insurance proceeds that would have been available under the third party liability cover required by the Project Agreement. If the Authority wishes to terminate this Agreement then, in addition to this payment, the Authority will pay the Contractor an amount equal to the amount it would pay on termination of the Agreement for Force Majeure. This does not affect the rights of the Contractor where other risks are covered by Uninsurability provisions.

Amendments to SoPC

These changes will be published in due course and sent to all existing and future subscribers of SoPC. In the meantime please refer any queries to either Simon Moore or Sian Dunstan at PUK (tel: 0207 273 8383)

END

ANNEX 1

Retendering Election:

The Authority shall be entitled to retender the provision of the Project Operations in accordance with paragraph [] [*Retendering Procedure*] and the provisions of paragraph [] [*Retendering Procedure*] shall apply if:

- (a) the Authority notifies Project Co on or before the date falling twenty (20) Business Days after the Termination Date; and
- (b) there is a Liquid Market; and either
- (c) the Senior Funders have not exercised their rights to step-in under Clause [4] [*Representatives*] of the Funders' Direct Agreement; or
- (d) Project Co or the Senior Funders have not procured the transfer of Project Co's rights and liabilities under this Agreement to a Suitable Substitute Contractor and have failed to use all reasonable efforts to do so,

but otherwise the Trust shall require a determination in accordance with paragraph [] (*No Retendering Procedure*) and the provisions of that paragraph shall apply.

END