

PAYMENTS AND SET-OFF

II.1 INTRODUCTION

II.1.1 The Authority should ensure that the Contract contains an express right for the Authority to deduct liquidated amounts owed to it by the Contractor under the Contract from any payments it is obliged to make to the Contractor (whether during the Service Period or on termination). This applies to liquidated damages and all other debts or liabilities owed to the Authority (including amounts owed in respect of failure by the Contractor to comply with its maintenance obligations at the end of the Contract (see Section 22 (Surveys on Expiry and Termination)). Senior Debt service should not be insulated from set-off or deductions.

II.1.2 Set-off on termination is dealt with specifically in Section 21.4 (Set-off on Termination).

II.1.3 The right to set off being described here does not apply to deductions for non-availability or substandard performance of the Service (see Section 10 (Price and Payment Mechanism)) as these are contractual deductions which apply automatically if the relevant circumstances arise (e.g. if the availability or performance criteria are not met). Disputes relating to these are dealt with under Section 27 (Dispute Resolution).

II.2 SCOPE OF AUTHORITY'S RIGHT TO SET OFF

II.2.1 Standard practice in all fields of civil procurement has been for the Authority to have the right to set off amounts owed to it by the Contractor against amounts due to the Contractor under any contract between the Contractor and the Crown. In practice, there are not likely to be any other contracts between the Contractor and the Crown, as the Contractor will usually be a single purpose vehicle whose only business is the project in question.

II.2.2 If the Contractor does have other contracts with the Crown, its third party financiers would be highly unlikely to allow it to agree to a wide set-off clause which enabled amounts relating to other contracts (whether PFI or non-PFI contracts) to be set off against amounts due under the Contract. Generally, the financiers will only agree to the Authority having the right to set off any ascertained amount owed to it by the Contractor under the Contract and Project Documents (subject to any agreed restrictions) against amounts the Authority owes to the Contractor under such documents. The Authority should not usually seek to extend such right as many of the value for money benefits of PFI projects come from isolating the rights and obligations of the Project from more general rights and obligations.

II.2.3 Over payments, liquidated damages and amounts claimed under indemnities are the only liquidated claims that are likely to give rise to a set-off. Provided that any relevant criteria are fulfilled, as specified in the Contract (e.g. the Planned Service Commencement Date is missed due to the Contractor's fault or the Authority suffers a loss due to a breach covered by an indemnity), then the applicable amounts should be calculated by the Authority and set off against the next payment. The determination of any dispute as to whether such criteria were fulfilled or about the level of any indemnity amount set off will also determine whether or not any amounts should be repaid. Interest should be paid on any amounts which it is determined should be repaid with effect from the due date (see also Section 10.2.5 above).

II.2.4 To the extent an amount owed is disputed, the Authority should pay the undisputed amount, but be entitled to retain the disputed amount until the dispute is resolved (see Clause 27 (Dispute Resolution)).

II.3 TIMING OF SET-OFF

II.3.1 During the Service Period, any amount to be set off should generally be applied against the next payment of the Unitary Charge (or other payments) due after the amount owed by the Contractor has fallen due and payable (unless the Contractor has already paid the Authority the relevant amount).

Suitable drafting is as follows:

11 Set-off

- (a) The Contractor shall not be entitled to retain or set off any amount due to the Authority by it, but the Authority may retain or set off any amount owed to it by the Contractor under this Contract which has fallen due and payable¹ against any amount due to the Contractor under this Contract².
- (b) If the payment or deduction of any amount referred to in paragraph (a) above is disputed³ then any undisputed element of that amount shall be paid and the disputed element shall be dealt with in accordance with Clause 27 (Dispute Resolution).

II.4 VAT ON PAYMENTS

II.4.1 Standard required provisions for VAT on such payments are as follows⁴:

11.4 VAT

- (a) All amounts due under this Contract are exclusive of VAT.
- (b) If any supply made or referred to in this Contract is or becomes chargeable to VAT then the person receiving the supply (the “Recipient”) shall in addition pay the person making the supply (the “Supplier”) the amount of that VAT against receipt by the Recipient from the Supplier of a proper VAT invoice in respect of that supply⁵.

II.4.2 If amounts due under the Contract are calculated by reference to costs incurred by any person and VAT has been incurred on the costs, then VAT should not be included in the calculation of those costs (e.g. Section 12.3 (Authority Changes)) if the person concerned can recover the VAT from HM Customs and Excise. Required drafting for this would be as follows:

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

II.4.3 A provision as follows is also required for the above to work:

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

¹ This must be by definition an ascertained amount.

² The right to set off here is subject to the restriction in Clause 21.4 (Set-off on Termination).

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

⁴ For changes in law relating to VAT that qualify for compensation see Section 13.10.2 (Changes in VAT Scope).

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

12.1 INTRODUCTION

12.1.1 The service requirement which is set out in the Contract should take into account not only the Authority's current requirements but also its future requirements, to the extent these are identifiable and quantifiable.

12.1.2 Changes to the service requirement may, however, be necessary to cater for changes in the Authority's requirements which could not be anticipated or quantified at contract signature (e.g. in the case of aircraft simulator projects, changes to the relevant aircraft as it is developed or updated) or changes imposed by external factors for which the Authority has retained responsibility (e.g. a change of policy)¹.

12.1.3 The Contractor may also wish to propose changes either to the service requirement itself, or to the way in which it delivers the Service. Although the output specification should generally be flexible enough to allow the Contractor to make changes to its method of delivering the Service (e.g. by introducing technological developments) without formally consulting the Authority, there may be circumstances where aspects of the method of delivery impact on the service requirement and are therefore critically important to the Authority. In such circumstances, the Authority will wish to be formally consulted prior to the implementation of the changes.

12.1.4 The key issues regarding changes proposed by either party are whether such changes are mandatory and how the cost of implementing such changes (if any) is to be allocated. The Contract should therefore contain a comprehensive mechanism by which changes may be proposed by either party and evaluated and approved prior to implementation.

12.2 FACTORS TO CONSIDER

12.2.1 A proposed change may involve construction and/or operational changes. Depending on the nature of the change, costs may be incurred in implementing such change which were not originally anticipated. Changes to the service requirement which involve additional capital or operating costs may not be easily accommodated within the Contract where (in order to produce as competitive a bid as possible) the Contractor has only have set aside a small reserve in its budget to cover contingency requirements. Its financiers will be concerned that any changes will not have an adverse impact on the Project's economics. The Contractor should not in all cases be required to increase its contingency financing simply to cover possible changes as this is unlikely to prove value for money for the Authority if no changes are required.

12.2.2 Before seeking Authority Changes, the Authority should recognise that substantial changes are likely to involve a need for lengthy and possibly costly negotiations with the Contractor and its financiers. For a discussion of some of the issues that need to be dealt with see Section 5.2.3 (Calculation of Compensation). Significant changes are likely to require amendments to the Contract or supplementary financing which will be subject to the lending climate prevailing at that time or have to be financed by the Authority itself. While the

¹ Changes to the service requirement necessitated by changes in relevant legislation are reviewed in Section 13 (Change in Law).

Contract must cater for the flexibility required to meet major changes in the Authority's operating environment, such changes should be minimised where possible. The Authority may also need the flexibility to require the Contractor to carry out small works changes; if this flexibility is required, such changes should not necessitate significant amendments to the Contract and should be comparatively uncontroversial².

12.2.3 In some projects, the Authority may foresee changes being required to the Service during the term of the Contract but not be sufficiently well informed in respect of its future requirements to enable it to require pre-priced options from the Contractor. In such circumstances, although the change mechanism may enable the Authority to negotiate with the Contractor as and when it requires the change to the Service, the Authority may be unable to agree the solution and price for effecting that change and be left with no option but to terminate the Contract voluntarily in order to achieve its objective. The difficulty for the Authority in such circumstances is the cost attached to voluntary termination. If an Authority is concerned about the possibility of this situation arising it should ensure that it takes into account the costs associated with voluntary termination as part of the evaluation of each bid (i.e. breakage costs associated with Senior Debt and the method of calculating the equity element of the compensation³).

12.2.4 Some changes may, of course, involve no additional costs and may even reduce certain costs. The remainder of this Section assumes that changes in the service requirement (whether generated by the Authority or the Contractor) will lead to costs being incurred. Where, however, any such change results in the reduction of certain costs, the parties will need to agree upon the best way to pass through such savings to the Authority (in the case of Authority Changes) or to share such savings (in the case of Contractor generated changes).

12.3 AUTHORITY CHANGES

12.3.1 Authority Changes should be limited to changes to the service requirement or to the specified constraints on inputs. In exceptional cases, there may be limits on the type of change the Authority may require. For example, it may be prevented from reducing its requirement for available places below a certain level or, as in some prisons projects, from requiring a male prison to accept female prisoners. The form of the variation should be a restatement of the original specification⁴.

12.3.2 In some projects, Authority Changes may be quite foreseeable (e.g. in street lighting projects, demographic projections of the Authority may make it quite foreseeable that the Authority will require new units to be brought into the scope of the Contract as housing increases in the region). In such circumstances, where the Authority's future requirements are reasonably well known, the Authority should consider the feasibility of requiring the Contractor to commit to pricing pre-specified changes as part of the Contract (e.g. unit prices for new lamp posts).

12.3.3 In all PFI Contracts, there is an inevitable tension between cost and flexibility. Stated simply, the cheapest Unitary Payment may provide the Authority with the least flexibility in managing the Contract, as the ability to absorb unforeseen changes and risks inevitably comes at a price. To preserve flexibility in managing the Contract, the Authority must think carefully whether or not it requires pre-priced options to vary scope, pre-priced unit rates for

² See Section 12.5 (Small Works Changes).

³ See Sections 20.5 (Voluntary Termination by the Authority).

⁴ Wherever possible, the Authority should outline the change required solely by reference to the Authority's output specifications. Any request made by the Authority for the Contractor to change its proposals may result in a compromise of the risk transfer achieved under the Contract by the Authority.

additional capacity of service delivery, comprehensive rights to insist on benchmarking market costs, open book accounting and cost transparency linked to prescribed margins for pre-agreed risk profiles.

12.3.4 Authority Changes during the construction or development phase should, where possible, be kept to a minimum and unless a long period of time is scheduled to elapse before the Service Commencement Date (e.g. three years or more) the Authority should not ordinarily reserve the right to change its construction requirements prior to Service Commencement⁵. In exceptional circumstances the Contractor may be able to incorporate such a change during the construction stage much more cheaply than after the Service has commenced. The Contract should incorporate provisions to reflect this possibility.

12.3.5 The drafting for Authority Change procedure, for all changes other than Small Works Changes, is set out in Clause 12.4 (Authority Changes) below. Initially, the Authority should serve a notice setting out the intended change and require the Contractor to provide an estimate of the technical, financial, contractual and timetable implications of the change within, say, 21 days. The Contractor should by this stage have been entitled to set out any reasons why the Authority was not entitled to seek such a change (or why and for what reason it resists such a change). The intention of this stage is for the Contractor to provide quickly an estimate of the implications of the change.

12.3.6 The Authority should recognise that the Contractor's financiers, in particular, are unlikely to allow the Contractor to agree to any change which would increase project risk, financing risk or reduce the rate of return. Such limits must be reasonable, however, and the financiers should not have an independent veto even if practically they will have a great deal of input and control over the ability of the Contractor to agree to any changes to the extent a right exists (see Clause 12.4 (Authority Changes)). If the Contractor is fully protected against the consequences of an Authority Change and how it is to be paid for, there should be no objection by its financiers.

12.3.7 In considering whether the Contractor's objections are reasonable, the Authority should take into account all relevant circumstances. For example, it would normally be reasonable for the Contractor to object to an Authority Change which would result in a change in the nature of the project⁶.

12.3.8 If the Authority still wishes to proceed with the change, the Contractor and the Authority should meet to discuss its implications. If the variation is sufficient to require the Contractor to seek additional finance, this may not be secured until after the Authority has committed fully to implementing the change. It is necessary therefore to seek "reasonable endeavours" commitments for the Contractor to put in place the finance. If the Contractor is unable to put in place the finance the Authority should reserve the right to fund the change through another method (e.g. by providing the necessary funding itself). The Authority must ensure that the finance provided represents good value for money (see Section 5.2.3 (Calculation of Compensation)).

⁵ During the competitive bidding process the Authority should ensure that the Service requirements are such that the bidders will be required to propose construction solutions that will meet the Authority's requirements for the immediate future, and accordingly the Authority should not be seeking to request changes that will significantly increase the Contractor's capital costs during the initial years of the Contract. The Contractor, the Sub-Contractors and the Senior Lenders will be concerned about interfacing issues if such changes are required, and the implications of having to obtain competitive tenders for works above a pre-agreed threshold. The Authority should not therefore seek to require significant capital works changes prior to Service Commencement.

⁶ See Clause 12.4(a) and footnote 10 below.

12.3.9 The estimates and quotation should be a fair estimate of the likely implications of the change. Nevertheless, the Authority should ensure that it is paying a reasonable price to implement the change by including provisions within the Contract that:

- make clear the duty on the Contractor to mitigate the costs;
- ensure that there is transparency of information on costings (see Section 29.7 (Contractor's Records));
- where the change is to be implemented by a Sub-contractor, provide, where practicable, for competitive quotes to be obtained and for the Authority to have the right to require competitive tendering in respect of any capital works required to implement the relevant change in Service; and
- where the change is to be implemented by the Contractor, that the cost is benchmarked against prevailing market rates.

If the parties disagree, the matter should be resolved by an independent third party (see Section 27 (Dispute Resolution))⁷. Once the price is agreed or determined, the Contractor should incorporate the relevant change.

12.3.10 If the Authority decides not to proceed with a change then this may have given rise to the Contractor incurring costs in estimating the cost of the Authority Change. On the other hand, the Contractor can, in practice, seek to resist changes by quoting unrealistically high prices. The Contractor should have no automatic right to recover all of its costs of preparing the bid as many of them will be internal costs which are already factored into its overhead provisions. If reimbursement is to be made it should only cover reasonable additional costs. The following factors are relevant in determining whether this is appropriate:

- the steps that have been undertaken by the Contractor (which is then a sole supplier) to produce a reasonable estimate;
- the extent to which the Authority has sight of the cost elements of the estimate (i.e. its component parts can be verified); and
- the extent to which changes are part of the original requirement (e.g. with training and simulator projects changes are inevitable, whereas in many accommodation projects they can often be avoided).

12.4 MEANS OF PAYMENT

12.4.1 If an Authority Change requires Capital Expenditure (i.e. expenditure that will have the effect of increasing the Contractor's financing costs for example, due to further construction work) or the Authority Change is required (where permitted) during the construction phase then generally the Authority should meet such costs by payment of a lump sum, staged payments or sums to pay for the reasonable and proper costs of the Contractor as they are incurred (on presentation of invoices) unless the Contractor is able to fund the costs itself and amortise them through the period of the Contract through an increase in the Unitary Charge in a way that is good value for money. The Contractor must, however, be incentivised to complete the changes necessary to ensure full compliance with the relevant change, so the payment mechanism should be structured accordingly (i.e. the Contractor should not receive payment in full before it has fully implemented the necessary

⁷ This process may not be appropriate in sectors where particular practices have been developed previously. For example, the MOD's approach is to market test the change or to refer any such dispute directly to binding arbitration.

changes as normal commercial practice would suggest). This should fit naturally with the Contractor's contract with its Sub-contractors carrying out the changes (as the Contractor will want similarly to incentivise its Sub-contractors to complete the changes). In this regard the points made in Section 5.2.3 (Calculation of Compensation) are equally applicable here.

12.4.2 Any increase in operating costs resulting from the Authority Change which is effected in the Service Period should normally be met by an increase in the Unitary Charge (see Section 5.2.3 (Calculation of Compensation)). The same approach should generally be used whether the change is required during the construction phase or the operational phase, as it is the cost effect of the change that is important here rather than the timing.

12.4.3 If the change will reduce the Contractor's costs (whether Capital Expenditure or operating costs), then an appropriate reduction should be made to the Unitary Charge (taking into account the fact that the Contractor's financial position should not be prejudiced). In the case of lower Capital Expenditure, the effect will be to reduce the amount of committed funding required by the Contractor, which excess may be released (again, see Section 5.2.3 (Calculation of Compensation)).

Required drafting is as follows:

12.4 Change in Service

Authority Changes

- (a) The Authority has the right to propose changes in Service (other than Small Works Changes⁸) in accordance with this Clause. The Authority shall not propose a change in Service which []⁹. If the Authority requires a change in Service, it must serve an Authority Notice of Change on the Contractor.
- (b) The Authority Notice of Change shall:
 - set out the change in Service required in sufficient detail to enable the Contractor to calculate and provide the Estimated Change in Project Costs in accordance with paragraph (c) below (the "Estimate");
 - in the event that the change will require Capital Expenditure, state whether the Authority intends to pay to the Contractor the costs involved in implementing the change or whether the Authority requires the Contractor to use its reasonable efforts to obtain funding in accordance with paragraph (i) below; and
 - (iii) require the Contractor to provide the Authority within [21] days of receipt of the Authority Notice of Change with the Estimate.

⁸ See Section 12.5 (Small Works Changes).

⁹ Limits on the Authority's ability to request changes to the Service may be appropriate in some circumstances. What is appropriate will depend on the Project, but there will be a point at which what is proposed is no longer the same Service (or incidental or ancillary to it) and the Authority should have no difficulty with the principle of limiting its ability to suggest changes in this way. Examples of appropriate limits include, in general terms changes that:

- (a) require the Service to be performed in a way that infringes any law or is inconsistent with good industry practice;
- (b) would cause any consent to be revoked (or a new consent required to implement the relevant change in Service to be obtainable);
- (c) would, if implemented, result in a change in the nature of the Project (e.g. as a prison or hospital);
- (d) would materially and adversely affect the health and safety of any person;
- (e) materially and adversely affect the health and safety of any person⁷
- (f) would increase the Contractor's capital costs by more than [10]% (in aggregate);
- (g) require the Contractor to implement the change in Service in an unreasonable period of time;
- (h) would (if implemented) materially and adversely change the nature of the Project (including its risk profile);
- (i) would represent a departure from good industry practice; and/or
- (j) the Authority does not have the legal power or capacity to require the implementation of.

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- (c) As soon as practicable and in any event within [21] days after having received the Authority Notice of Change, the Contractor shall deliver to the Authority the Estimate. The Estimate shall include the opinion of the Contractor on¹⁰:
- (i) whether relief from compliance with obligations is required, including the obligations of the Contractor to achieve the Planned Service Commencement Date and meet the [performance regime] during the implementation of the change in Service;
 - (ii) any impact on the provision of the Service;
 - (iii) any amendment required to this Contract and/or any Project Document as a result of the change in Service;
 - (iv) any Estimated Change in Project Costs¹¹ that result from the change in Service;
 - (v) any loss of revenue that results from the change in Service;
 - (vi) any Capital Expenditure that is required or no longer required as a result of the change in Service;
 - (vii) any regulatory approvals which are required; and
 - (viii) the proposed method of certification of any construction or operational aspects of the Service required by the change in Service if not covered by the procedures specified in [see Section 3 (Service Commencement)].
- (d) As soon as practicable after the Authority receives the Estimate, the parties shall discuss and agree the issues set out in the Estimate, including:
- (i) providing evidence that the Contractor has used reasonable endeavours (including (where practicable) the use of competitive quotes) to oblige its Sub-contractors to minimise any increase in costs and maximise any reduction in costs;
 - (ii) demonstrating how any Capital Expenditure to be incurred or avoided is being measured in a cost effective manner, including showing that when such expenditure is incurred, foreseeable Changes in Law at that time have been taken into account by the Contractor; and
 - (iii) demonstrating that any expenditure that has been avoided, which was anticipated to be incurred to replace or maintain assets that have been affected by the Authority Change concerned, has been taken into account in the amount which in its opinion has resulted or is required under paragraph (c) (iv) and/or (v) and/or (vi) above.

In such discussions the Authority may modify the Authority Notice of Change and (if the estimated increase in Capital Expenditure in respect of the change in Service is expected to exceed [£100,000¹²] (indexed) and it is practicable for the Contractor to do so), the Authority may require the Contractor to seek and evaluate competitive tenders for the relevant capital

¹⁰ Other information may be needed on certain projects (for example, to allow a certain level of security clearances).

¹¹ This Estimate should take into account any previously planned capital costs that will no longer be incurred due to the change (e.g. if a new type of roof is needed during the construction phase, then amounts can potentially be saved in not building the old roof (although ordering requirements may limit the ability to make savings)). The costs should also be broken down in accordance with a pre-agreed framework so that sufficient transparency exists. See Sections 5.2.3 (Calculation of Compensation) and 12.2.3.

¹² This threshold may vary from project to project.

works. In each case the Contractor shall, as soon as practicable, and in any event not more than [14] days after receipt of such modification, notify the Authority of any consequential changes to the Estimate.

- (e) If the Contractor does not intend to use its own resources to implement any change in Service it shall comply with good industry practice with the objective of ensuring that it obtains best value for money (taking into account all relevant circumstances including, in particular, the requirement that the Contractor should not be worse off as a result of the implementation of the change in Service) when procuring any work, services, supplies, materials or equipment required in relation to the change in Service.
- (f) If the parties cannot agree on the contents of the Estimate then the dispute will be determined in accordance with Clause 27 (Dispute Resolution)¹³.
- (g) As soon as practicable after the contents of the Estimate have been agreed or otherwise determined pursuant to Clause 27 (Dispute Resolution), the Authority shall:
 - (i) confirm in writing the Estimate (as modified); or
 - (ii) withdraw the Authority Notice of Change.
- (h) If the Authority does not confirm in writing the Estimate (as modified) within 30 days of the contents of the Estimate having been agreed in accordance with paragraph (d) above or determined pursuant to paragraph (e) above, then the Authority Notice of Change shall be deemed to have been withdrawn¹⁴.
- (i) In the event that the Estimate (as modified) involves estimated Capital Expenditure¹⁵ then (unless the Authority has elected to fund such costs in accordance paragraphs (b)(ii)) the Contractor shall use its reasonable endeavours to obtain funding for the whole of the estimated Capital Expenditure, on terms reasonably satisfactory to it and the Senior Lenders.
- (j) If the Contractor has used its reasonable endeavours to obtain funding for the whole of the estimated Capital Expenditure, but has been unable to do so within [60] days of the date that the Authority confirmed the Estimate, then the Contractor shall have no obligation to carry out the change in Service, unless the Authority agrees within [20] days of the end of such period to pay the costs for which funding is not available on the basis provided in paragraph (m) below.
- (k) The Authority may, at any time following the date on which the Estimate is confirmed, agree to meet all or, to the extent the Contractor has obtained funding for part of the Capital Expenditure, the remaining part of the estimated Capital Expenditure.

¹³ The MOD approach to all disputes as to price is to refer such disputes directly to binding arbitration rather than an adjudicator.

¹⁴ See Section 12.3.8.

¹⁵ It may be appropriate to introduce a threshold on the estimated increased Capital Expenditure below which it is not necessary for the Contractor to seek to obtain funding. This should ensure that the Contractor is not required to go through the effort of arranging funding for immaterial sums. Any such threshold should, however, be increased annually in line with an appropriate index.

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- (l) In the event that the Estimate has been confirmed by the Authority¹⁶, then the adjustment to the Unitary Charge shall be such as [see Section 5.2.3 (Calculation of Compensation) above¹⁷].
- (m) Where the Authority agrees to pay the costs for which funding is not available pursuant to paragraph (j) above:
- (i) the Authority and Contractor shall agree:
- (A) a payment schedule in respect of the payment of such sum reflecting the amount and timing of the costs to be incurred by Contractor in carrying out the change in Service to the extent borne by the Authority; and
- (B) where payment for part of the change in Service reflects the carrying out of, or specific progress towards, an element within the change in Service, an objective means of providing evidence confirming that the part of the change in Service corresponding to each occasion when payment is due under the payment schedule appears to have been duly carried out,
- (such payment schedule and evidence to be determined in accordance with Clause 27 (Dispute Resolution Procedure) in the event of the Authority and Contractor failing to agree as to its terms);
- (ii) the Authority shall make a payment to Contractor within fifteen (15) Business Days of receipt by the Authority of invoices presented to the Authority (in all material respects) in accordance with the agreed payment schedule (as the case may be, varied by agreement from time to time) accompanied by the relevant evidence (where applicable) that the relevant part of the change in Service has been carried out; and
- (iii) if payment is not made in accordance with sub-paragraph (ii) above, the Authority shall pay interest to Contractor on the amount unpaid from the date fifteen (15) Business Days after receipt of the relevant invoice until paid at the default rate set out in Clause [29.9].

12.5 SMALL WORKS CHANGES

12.5.1 To facilitate efficient management of the Contract, reduce costs for both parties and ensure continued delivery of the Service, the Contract should provide an efficient mechanism for dealing with requests by the Authority for small changes to the Service.

12.5.2 In any Contract Year the Authority may have to make several requests to the Contractor in respect of minor changes to the Service. Provided that the threshold is low enough for the Contractor to manage, there is no reason why the Contractor should not be able to provide a schedule of rates to the Authority at the beginning of each Contract year,

¹⁶ If the Authority Change simply has a cost consequence (and no change is made either in the timetable for completion or increase in costs of operation), then it can be dealt with as a one-off payment, without an adjustment to the Unitary Charge or timetable.

¹⁷ The adjustment to the Unitary Charge would take account of any increased operational costs of the Contractor and any increased capital costs funded by the Contractor. Any increased capital costs funded by the Authority or loss of revenue caused by the Authority Change should be paid to the Contractor by way of direct payments from the Authority and not through an increase in the Unitary Charge. To the extent that the Authority Change will prevent the Contractor from delivering the Service, the Contractor should be relieved from the accrual of performance points and/ or deductions.

which (when agreed) shall apply in respect of all requests from the Authority for small works changes to be implemented by the Contractor. The Contractor should provide the Authority with a rate in respect of labour costs and the materials element of any small works change should be charged at cost plus a pre-agreed margin.

Required drafting is set out below:

12.5 Small Works Changes

- (a) 28 days prior to the Service Commencement Date and the commencement of each subsequent Contract Year for the first [x] years and within [y] days of any request in any subsequent Contract Year, the Contractor shall propose a schedule of rates to be agreed with the Authority (the “**Small Works Rates**”), such agreed rates to be applied in respect of any request from the Authority for Small Works to be completed during that Contract Year. The value of any Small Works shall be calculated on the basis that:
 - (i) the labour element shall be calculated in accordance with the Small Works Rates or, where such rates are not applicable, in accordance with rates which are fair and reasonable; and
 - (ii) the materials element shall be charged at the cost of the materials to the Contractor or to the contractor carrying out the work (net of all discounts) plus [7.5]%.¹⁸
- (b) The Contractor and the Authority shall agree the timing of any Small Works, so as to minimise any inconvenience to the Authority. The Contractor shall take all reasonable steps to minimise the duration of any Small Works.
- (c) Any dispute between the parties relating to Small Works shall be determined in accordance with Clause 27 (Dispute Resolution).

“Small Works”

means any change to the [Works]¹⁹ requested by the Authority having an individual cost not exceeding £[1,000] (indexed), or as otherwise agreed from time to time, except for any request which will (if implemented) increase the likelihood of the Service not complying with the [performance regime] or materially and adversely affect the Contractor’s ability to perform its obligations under this Contract.

12.6 CONTRACTOR CHANGES IN SERVICE

12.6.1 Notwithstanding the recommendation given in Section 3.4 (Submission of Designs and Information to the Authority) the Contractor should be encouraged to find ways of delivering the Service more cheaply and efficiently. If quality is maintained, then the Authority should not object and both parties should share in the benefits.

12.6.2 It may, however, be appropriate for the Authority to reserve the right to object to certain changes in the means of delivery. In such cases, a procedure should be built into the Contract providing for the Contractor to serve a notice of a change (including any consequent amendments required to the Contract and other Project Documents) on the Authority, giving

¹⁸ To be determined on a project by project basis.

¹⁹ The small works procedure should only be used for the purposes of requiring additional capital works. Due to the complexity of requiring changes to the service element, the Contractor will not be able to provide the Authority with annual rates relating to such changes, and such changes will need to be requested in accordance with Clause 12.4 (Change in Service).

the Authority an opportunity to object on reasonable grounds within a reasonable time period. If the Authority objects, the change should not be made or should be amended and presented again.

12.6.3 In all Contracts, however, the Authority will need a similar procedure to be followed if the Contractor proposed a change in the actual service requirement although in this case the Authority should not be under any obligation to give reasons for any refusal to agree a change.

12.6.4 The Authority should generally object only if the primary tenets of the deal are likely to be compromised. This might be the case if:

- the change will not provide the Authority with the Service it requires;
- the change diminishes the quality of the Service to be delivered by the Contractor or the likelihood of successful delivery;
- the change will interfere with the Authority's relationship with third parties;
- the change threatens the Contractor's financial robustness;
- the residual value of the assets is likely to be reduced materially (depending, of course, on who bears this risk); or
- the change materially affects the risks or costs to which the Authority is exposed.

12.6.5 A Contractor generated change will not normally be expected to result in an increase in the Unitary Charge, but to allow the same Service to be delivered more cheaply (so improving the return of the Contractor); a better service to be delivered at the same price; or a combination of the two. If the Contractor's costs will be reduced by the Contractor generated change, a reduction in the Unitary Charge can be agreed as part of the procedure. This should not, however, be a full pass through, as the Contractor should be incentivised to make cost savings and the Authority is more likely to benefit from innovation by the Contractor than suffer.

Required drafting is as follows:

12.6 Contractor Changes in Service

- (a) If the Contractor wishes to introduce a change in Service²⁰, it must serve a Contractor Notice of Change on the Authority.
- (b) The Contractor Notice of Change must:
 - (i) set out the proposed change in Service in sufficient detail to enable the Authority to evaluate it in full;
 - (ii) specify the Contractor's reasons for proposing the change in Service²¹;
 - (iii) request the Authority to consult with the Contractor with a view to deciding whether to agree to the change in Service and, if so, what consequential changes the Authority requires as a result;

²⁰ It is likely that a change in the means of delivery will, for the purposes of the Contract, result in a change of Service.

²¹ For example, if it is required as a result of a Change in Law and if so what type (see Section 13 (Change in Law)).

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- (iv) indicate any implications of the change in Service²²;
 - (v) indicate, in particular, whether a variation to the Unitary Charge is proposed (and, if so, give a detailed cost estimate of such proposed change); and
 - (vi) indicate if there are any dates by which a decision by the Authority is critical.
- (c) The Authority shall evaluate the Contractor's proposed change in Service in good faith, taking into account all relevant issues, including whether:
- (i) a change in the Unitary Charge will occur;
 - (ii) the change affects the quality of the Service or the likelihood of successful delivery of the Service;
 - (iii) the change will interfere with the relationship of the Authority with third parties;
 - (iv) the financial strength of the Contractor is sufficient to perform the changed Service;
 - (v) [the residual value of the Assets is reduced²³]; or
 - (vi) the change materially affects the risks or costs to which the Authority is exposed.
- (d) As soon as practicable after receiving the Contractor Notice of Change, the parties shall meet and discuss the matter referred to in it. During their discussions the Authority may propose modifications or accept or reject the Contractor Notice of Change.
- (e) If the Authority accepts the Contractor Notice of Change (with or without modification), the relevant change in Service shall be implemented within [7] days of the Authority's acceptance²⁴. Within this period, the parties shall consult and agree the remaining details as soon as practicable and shall enter into any documents to amend this Contract or any relevant Project Document which are necessary to give effect to the change in Service.
- (f) If the Authority rejects the Contractor Notice of Change, it shall not be obliged to give its reasons for such a rejection.
- (g) Unless the Authority's acceptance specifically agrees to an increase in the Unitary Charge, there shall be no increase in the Unitary Charge as a result of a change in Service proposed by the Contractor.
- (h) If the change in Service proposed by the Contractor causes or will cause the Contractor's costs or those of a Sub-contractor to decrease, there shall be a decrease in the Unitary Charge such that []²⁵.

²² For example, the contractual, financial, operational and/or construction implications of the change in Service.

²³ This will be relevant in projects in which the Authority bears all or part of this risk.

²⁴ This means that all aspects of the change must be agreed prior to implementation, including the availability of funding where appropriate.

²⁵ A mechanism can be agreed such that any savings are shared, having deducted from any savings the costs the Contractor has incurred in implementing such a change. See Section 12.2.3. A mechanism should be included in the Contract for identifying and agreeing decreases in costs arising out of the proposed change in service.

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- (i) The Authority cannot reject a change in Service which is required in order to conform to a Change in Law. The costs of introducing a change in Service resulting from a Qualifying Change in Law (including any resulting variation in the Unitary Charge) shall be dealt with in accordance with Clause 13 (Change in Law) and to the extent not dealt with shall be borne by the Contractor.

13.1 INTRODUCTION

13.1.1 The Contractor must comply with all applicable legislation. A failure to comply could give rise to termination for Contractor Default (see Section 20.2 (Termination on Contractor Default)). The cost of complying with legislation which is current or foreseen at the time of the Contract should be built into the price the Contractor bids to provide the Service. Nevertheless, the Contractor may not, for example, be capable of including in the price specific costs arising from changes in law which are not foreseeable prior to contract signature. Accordingly, the issues concern who should be responsible for the costs arising from changes in law and how such costs should be funded.

13.1.2 The treatment of changes in law relates very closely to the issues of indexation, benchmarking and market testing (see Section 14 (Price Variations)), particularly in relation to the risk of increases in operating costs. These provisions must be developed in conjunction with each other when negotiating the overall level of change in law risk to be transferred by the Authority. For example, the more often a Contract provides for benchmarking and market testing to occur (allowing upward revisions of price), then the more likely an apparently tougher change in law provision can be achieved by the Authority. It is recognised, however, that benchmarking, market testing and indexation provisions are not likely to have a significant bearing on the risk transfer position in relation to increases in capital costs due to a change in law.

13.2 CONTRACTOR'S AND AUTHORITY'S CONCERNS

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

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

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

13.3 DEFINITION OF CHANGE IN LAW

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

“Change in Law”

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

- (a) Legislation, other than any Legislation which on the date of this Contract has been published:
 - (i) in a draft Bill as part of a Government Departmental Consultation Paper;
 - (ii) in a Bill;
 - (iii) in a draft statutory instrument; or
 - (iv) published as a proposal in the Official Journal of the European Communities¹;
- (b) any Guidance²; or
- (c) any applicable judgment of a relevant court of law which changes a binding precedent³.

“Legislation”

means any Act of Parliament or subordinate legislation within the meaning of Section 21(1) of the Interpretation Act 1978, any exercise of the Royal Prerogative, and any enforceable community right within the meaning of Section 2 of the European Communities Act 1972, in each case in the United Kingdom⁴.

13.4 ALLOCATION OF RISK OF CHANGE IN LAW

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

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

13.5 MITIGATION

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

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

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

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

⁴ See Clause 1.8.2(a)(v) (Interpretation) – Legislation includes any re-enactment, amendment, consolidation or replacement of legislation.

13.5.2 This duty to mitigate can be measured, in part, by reference to the extent to which price increases in comparable sectors are experienced. It will also require the Contractor to foresee and anticipate the effect of changes in law, particularly in relation to expenditure which it has planned to incur anyway in the ordinary course of the Contract. For example, a Contractor cannot on one day change a boiler under its normal maintenance programme and then argue that it immediately has to replace it due to a subsequent change in law which the Contractor should have anticipated at the time of replacement (and for which the Authority bears the cost in whole or in part). For that reason, any compensation should reflect any anticipated future saved maintenance costs.

13.6 DISCRIMINATORY, SPECIFIC AND GENERAL CHANGES IN LAW

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

“Discriminatory Change in Law”

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

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

“Specific Change in Law”

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

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

“General Change in Law”

means a Change in Law which is not a Discriminatory Change in Law or a Specific Change in Law⁶.

13.6.3 Where a risk sharing approach is adopted in respect of Change in Law (as referred to in Section 13.4.2)⁷, any costs arising from Discriminatory Changes in Law and Specific Changes in Law should be at the Authority’s risk.

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

⁶ See Section 13.8.8 below.

⁷ The Authority should, accordingly, receive the full benefit of cost savings arising from Discriminatory Changes in Law and Specific Changes in Law. How such benefits are passed through to the Authority is a matter for discussion between the parties. See also Section 12.2.3.

13.7 GENERAL CHANGE IN LAW AT CONTRACTOR'S RISK

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

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

13.7.3 Although the Contractor may appear to bear all the risk of General Changes in Law, this approach will often involve some method of mitigating the effect on the Contractor. For example, market testing, benchmarking and/or indexation provisions will in fact lead to the sharing of some of this risk (see Section 14 (Price Variations)) in that additional operating costs may be reflected in increases to the Unitary Charge following a benchmarking or market testing and/or indexation, although the Contractor will bear such risk for the period up to benchmarking or market testing.

13.8 GENERAL CHANGE IN LAW AS A SHARED RISK

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

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

13.8.2 Costs arising from General Changes in Law should generally be for the account of the Contractor, as the Contractor is protected through the combined effects of benchmarking, market testing and indexation⁸.

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

- require Capital Expenditure; and
- take effect during the Service Period (i.e. after construction is completed (but see Section 13.8.8)); and
- were not reasonably foreseeable at contract signature.

Under this approach the costs of a General Change in Law falling within this exception are shared between the Contractor and the Authority. If the change was reasonably foreseeable during the construction period although not yet in effect, the Contractor's obligation to mitigate (see Section 13.5 (Mitigation)) would require it to have taken all reasonable action to minimise the eventual cost of implementing such change (e.g. by altering construction works prior to completion). This approach promotes a shared incentive to keep the costs of a change in law to a minimum without exposing the Contractor to excessive risk.

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

13.8.4 An appropriate approach to sharing the risk of the type of change in law described in Section 13.8.3 is to share such risk on a progressive scale so that, for example, the Contractor takes 100% of the first £x of Capital Expenditure, 75% of the next £y, 50% of the next £z and so on (see the table set out in Section 13.8.9). Once a certain amount is reached, the Authority takes 100% of any amounts above that amount⁹. The threshold figures agreed and the number of graduated steps will take into account the size of the Project and the impact of other factors such as the likelihood of environmental and health and safety legislation. The levels of Cumulative Capital Expenditure (see Section 13.8.9) are not indexed (as the totals are cumulative, indexation can lead to unnecessary complication). The Contractor's total liability should generally be between 2% to 5% of the initial capital cost of the Project¹⁰. A cap by reference to time is not recommended.

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

13.8.6 Although it is the responsibility of the Contractor to manage the way in which it will fund any increases in capital costs which occur as a result of a General Change in Law occurring during the Service Period, if it is clear to the Authority from the Preferred Bidder's Base Case that it has priced the risk at 100 percent¹¹, the Authority may wish to retain the risk on value for money grounds. For example, if the Base Case shows amounts being drawn from Senior Debt to fund a so called "Change in Law Reserve Account", the Authority is paying for this account to be placed in-funds as if it were an expected cost of the Contractor¹². Experience has shown however, that the competitive bidding process incentivises bidders to price the risk at less than 100 percent And Senior Lenders are typically comfortable that General Changes in Law can be managed either by: (i) standby finance; (ii) undrawn revolving working capital facilities; or (iii) building up sums over time from free cashflow without the need for a pre-funded Change in Law Reserve Account because:

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

13.8.7 The Authority should generally pay such Capital Expenditure in accordance with the principles set out in Sections 12.4 (Means of Payment). Any consequent operating cost increases are borne by the Contractor although these costs will be mitigated by the effects of market testing, benchmarking and/or indexation¹³ (see Section 14 (Price Variations)). The points made in Section 5.2.3 (Calculation of Compensation) are similarly relevant here.

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

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

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

¹¹ I.e. 100 pence in the pound.

¹² The cost of funding such an account will be at the Senior Debt rates and is not likely to offer good value for money to the Authority.

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

13.8.9 For projects which have unusually long construction periods, transferring the risk of General Changes in Law for the entire construction period (rather than adopting a sharing approach) may in fact be poor value for money and is likely to be difficult to achieve in practice.

13.8.10 Changes arising in operational costs as a result of a General Change in Law should also be borne by the Contractor (subject to Section 14 (Price Variations)). If a General Change of Law requires changes to the Service then either party should be entitled to require a variation to the project specifications to comply with a Change in Law and no breach of contract should arise while this is being done¹⁴.

Required drafting is as follows:¹⁵

“Contractor’s Share”

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

Cumulative Capital Expenditure¹⁶	Contractor’s Share¹⁷
£0 [a] million (inclusive)	100%
£[a] million to [b] million (inclusive)	80%
£[b] million to [c] million (inclusive)	60%
£[c] million to [d] million (inclusive)	40%
£[d] million to [e] million (inclusive)	20%
£[e] million to [f] million (inclusive)	10%
£[f] million and above	0%

“Cumulative Capital Expenditure”

means the aggregate of:

- (a) all Capital Expenditure that has been incurred as a result of each General Change in Law that has come into effect during the Service Period; and
- (b) the amount of Capital Expenditure that is agreed, or determined to be required, as a result of a General Change in Law under Clause 13.8 (Qualifying Change in Law).

¹⁴ See Clause 12.6 (Contractor Changes in Service).

¹⁵ This will have to be adapted to the extent the approach in Section 13.7 (General Change in Law at Contractor’s Risk) is taken. The “sharing” approach is set out as it includes both approaches.

¹⁶ These figures are to be bid as part of the bid submission. In each case they are not to be indexed.

¹⁷ These figures are illustrative only and it is open for the Authority or bidders to set the Contractor’s Authority’s Share at zero or one hundred per cent with no incremental changes, or have only one or two stages in the graduation. This approach will help the Authority find the appropriate level.

“Qualifying Change in Law”¹⁸

means:

- (a) a Discriminatory Change in Law;
- (b) a Specific Change in Law; and/or
- (c) [a General Change in Law which comes into effect during the Service Period and which involves Capital Expenditure¹⁹.]

which was not foreseeable at the date of this Contract²⁰.

13.8 Qualifying Change in Law

- (a) If a Qualifying Change in Law occurs or is shortly to occur, then either party may write to the other to express an opinion on its likely effects, giving details of its opinion of:
 - (i) any necessary change in Service²¹;
 - (ii) whether any changes are required to the terms of this Contract to deal with the Qualifying Change in Law;
 - (iii) whether relief from compliance with obligations is required, including the obligation of the Contractor to achieve the Planned Service Commencement Date and/or meet the [performance regime] during the implementation of any relevant Qualifying Change in Law;
 - (iv) any loss of revenue that will result from the relevant Qualifying Change in Law;
 - (v) any Estimated Change in Project Costs that directly result from the Qualifying Change in Law; and
 - (vi) any Capital Expenditure that is required or no longer required as a result of a Qualifying Change in Law taking effect during the Service Period,

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

- (b) As soon as practicable after receipt of any notice from either party under paragraph (a) above, the parties shall discuss and agree the issues referred to in paragraph (a) above and any ways in which the Contractor can mitigate the effect of the Qualifying Change of Law, including:

¹⁸ It may of course be that if there is a particular uncertainty attaching to a particular change in law (even if foreseeable), such as where, for example, its effects can vary by a significant factor. If this is so, then risk sharing can be agreed where the value for money impact is extremely difficult to assess. One example of such an issue are projects for refuse incinerators, given the Electricity Supply Industry Rateable Values Order, SI 1994/3282.

¹⁹ This will depend on which option in Clause 13.7 (General Change in Law at Contractor’s Risk) is adopted and the extent to which Capital Expenditure is at the risk of the Contractor (i.e. the extent to which such amounts have been included in the bid).

²⁰ If any greater clarity can apply to this in a particular project (such as concerns over particular envisaged changes in law) then this should be expanded upon.

²¹ See footnote 22 in Section 12 (Change in Service).

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- (i) providing evidence that the Contractor has used reasonable endeavours (including (where practicable) the use of competitive quotes) to oblige its Sub-contractors to minimise any increase in costs and maximise any reduction in costs;
 - (ii) demonstrating how any Capital Expenditure to be incurred or avoided is being measured in a cost effective manner, including showing that when such expenditure is incurred or would have been incurred, foreseeable Changes in Law at that time have been taken into account by the Contractor;
 - (iii) giving evidence as to how the Qualifying Change in Law has affected prices charged by any similar businesses to the Project, including similar businesses in which the shareholders or their Affiliates carry on business; and
 - (iv) demonstrating that any expenditure that has been avoided, which was anticipated to be incurred to replace or maintain assets that have been affected by the Qualifying Change in Law concerned, has been taken into account in the amount which in its opinion has resulted or is required under paragraph (a) (v) and/or (vi) above.
- (c) If the parties agree or it is determined under Clause 27 (Dispute Resolution) that the Contractor is required to incur additional Capital Expenditure due to a Qualifying Change in Law (excluding the Contractor's Share of any Capital Expenditure agreed or determined to be required as a result of a General Change in Law under this paragraph), then the Contractor shall use its reasonable endeavours to obtain funding for such Capital Expenditure on terms reasonably satisfactory to it and the Senior Lenders.
- (d) The Contractor's Share shall be solely for the account of the Contractor.
- (e) If the Contractor has used reasonable endeavours to obtain funding for Capital Expenditure referred to in paragraph (c), but has been unable to do so within [60] days of the date that the agreement or determination in paragraph (c) occurred, then the Authority shall pay to the Contractor an amount equal to that Capital Expenditure on or before the date falling 30 days after the Capital Expenditure has been incurred.
- (f) Any compensation payable under this clause by means of an adjustment to or reduction in the Unitary Charge²² shall be [see Section 5.2.3 (Calculation of Compensation) above²³].

13.9 CHANGES IN TAX LAW

13.9.1 Discriminatory and specific changes in tax law should be dealt with in accordance with Section 13.6 (Discriminatory, Specific and General Changes in Law).

13.9.2 Whichever approach is adopted on General Changes in Law, all costs arising from changes in tax law that are general should be for the account of the Contractor, except as stated in Section 13.10 (Changes in VAT) in relation to changes in VAT legislation.

²² There will only be an adjustment to the Unitary Charge in respect of increased capital costs if the Contractor's Share is less than 100% and the Authority is not required to make a lump sum payment to the Contractor (see Clause 13.8(e) above). Increased operational costs resulting from any General Change in Law are borne by the Contractor and will not result in an adjustment to or reduction to the Unitary Charge (see Section 13.8.7 above).

²³ See also Sections 12.2.3, 13.6.3 and 13.8.2.

13.10 CHANGES IN VAT

13.10.1 Changes in the VAT Rate

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

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

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

13.10.2 Changes in VAT Scope

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

Suitable drafting is as follows:

13.10 Payment of Irrecoverable VAT

The Authority shall pay to the Contractor from time to time as the same is incurred by the Contractor sums equal to any Irrecoverable VAT but only to the extent that it arises as a result of a Change in Law. Any such payment shall be made within 28 days of the delivery by the Contractor to the Authority of written details of the amount involved accompanied by details as to the grounds for and computation of the amount claimed. For the purposes of this Clause 13.10 “**Irrecoverable VAT**” means input VAT incurred by the Contractor on any supply which is made to it which is used or to be used exclusively in performing the Works or the Services or any of the obligations or provisions under the Contract (together with input VAT incurred as part of its overhead in relation to such activities) to the extent that the Contractor is not entitled to repayment or credit from HM Customs & Excise in respect of such input VAT.

14

PRICE VARIATIONS

14.1 INTRODUCTION

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

14.1.2 The Contract must achieve the right balance between the provisions for change in law (see Section 13 (Change in Law)), indexation, benchmarking and market testing as these are inherently interrelated, particularly in relation to the allocation of operating cost risk. For example, if indexation is based on RPI, the Contractor must either bear any cost increases in excess of RPI or pass these costs to Sub-contractors either directly or by managing them (e.g. through market testing). Also, Contractors will be more willing to take risk in relation to certain changes in law if they have some protection through the benchmarking or market testing provisions (i.e. they can bear certain risks for the period up to benchmarking or market testing as the extra costs are likely to be covered to an extent following benchmarking or market testing). The Authority should ensure that it considers such inter-relationship in preparing its bid documents.

14.2 INDEXATION

14.2.1 The Contractor will be concerned to protect itself against inflation rates increasing over the course of the Contract and rendering the prices initially set out in the Contract insufficient to meet its operating costs and financing obligations¹. The payment mechanism should therefore usually include arrangements for indexing the Unitary Charge agreed at Contract signature. If there is no indexation mechanism², the Contractor is likely to have to build in contingency into its price to cover inflation risk and this is unlikely to give the Authority value for money (as the risk is outside the control of the Contractor and, historically, has been difficult to forecast accurately). It is highly unusual for prices to be fixed (i.e. without indexation) throughout the term of any contract for periods for which PFI contracts are typically let or, conversely, for the whole Unitary Charge to be indexed.

14.2.2 The Authority should focus on the appropriate method of applying indexations to the payment stream at an early stage in project development. By the time an ITN is issued, the Contract should specify the type of index to be applied and how it applies (e.g. whether it applies to the whole Unitary Charge and whether it is part of a formula). The Authority should, in deciding what indexation to include in its ITN or what percentage of the Unitary Charge this applies to, give full consideration to indices other than RPI, although the factors

¹ The possible adjustment to Unitary Charges for movements in interest rates in the periods before or after contract signature are not considered here, but see Section 33.3.1.

² The Contract will also need to include provisions dealing with circumstances where the particular index (or indices) specified in the Contract is not published or the basis upon which it is calculated is changed – see Section 1, footnote 37.

referred to below are very important in reaching this decision. Leaving the choice of indices to the bidders is not the answer here given the difficulties in comparing one bidder's price and value for money, with that of another bidder where different bidders use different indices³.

14.2.3 The Authority must take into account its affordability constraints in deciding upon the appropriate index. The Authority should also be aware, however, that the Contractor may charge a higher price if asked to bear significant inflation risk, so the use of a particular long term index, such as a construction index for construction prices or a facilities management index on others (as an alternative to market testing), or a weighted basket of indices may be preferable on certain projects. The price impacts should be weighed against the greater level of protection for cost risks that is being given to the Contractor.

14.2.4 Care should be taken by the Authority with selection of appropriate indices. Choosing an index that may be short lived, or is not independently produced, is not a sensible approach, nor does it make sense to have too narrow a focus on a particular industry or sector. This is because, in specific sectors (such as the defence industry), Contractors or their Affiliates are themselves responsible to a significant extent for inflationary costs (that is, they can actually affect the index by increasing their price)⁴.

14.2.5 Whilst choosing an index and weighting that reflect the underlying cost exposure of the Contractor has the effect of reducing its cost risk, amended forms of such indexation formulae can incentivise real cost savings over the life of the Contract⁵.

14.3 BENCHMARKING AND MARKET TESTING OF OPERATING COSTS – GENERAL

14.3.1 In some Contracts, it may not be appropriate to have any price variation mechanism (other than, for example, indexation) to address unforeseen changes in operating costs. This may be because all of the Contractor's costs are either fixed or are appropriately protected from changes in general price levels by the indexation provisions. Although it is in theory sensible to compare costs to ensure that value for money continues, the practice of benchmarking and market testing are much more difficult, and sometimes impossible, in some Contracts due to the inter-related nature of the services being purchased and the absence of ready comparators. Sections 14.4 (Benchmarking) and 14.5 (Market Testing) assume, notwithstanding the practical difficulties, that benchmarking and/or market testing are possible in certain types of contract. Given the potential disruptions and practical difficulties which market testing may cause, this guidance suggests that benchmarking is adopted as the preferred price review mechanism and that market testing is used only to the extent that the parties cannot agree upon the outcome of benchmarking⁶. The terms "benchmarking" and "market testing" are defined in Sections 14.4.1 and 14.5.1.

³ It is open to the Authority, however, in the interests of value for money, to invite bidders to propose alternative indices, provided the choice of such alternates is supported in the bid with appropriate models demonstrating their financial impact.

⁴ Suggested drafting on indexation can be found in Clause 1.8.2(b) (Interpretation).

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

⁶ The NHS approach is to view benchmarking and market testing as equally valid alternatives or complementary solutions.

14.3.2 Benchmarking and market testing are the responsibility of the Contractor, both from a cost and management perspective. Depending on the Project, the existence of either will often lead to a contract manager being employed to manage actively the benchmarking and market testing processes to keep Sub-contractor costs to a minimum. The sharing mechanism referred to in Section 14.4.4 below should therefore be structured in such a way as to ensure that such an approach is encouraged.

14.3.3 Generally, only soft services are appropriate for either benchmarking or market testing⁷. By “soft services”, this guidance means the services such as facilities management services in an accommodation project (typically those such as catering, cleaning and security) to the extent they do not involve a significant capital outlay in their performance or affect the value of any capital asset under the Contract. This definition is used because the prices charged must be comparable with those of a potential alternative Sub-contractor and, to the extent capital costs have been incurred by a Sub-contractor it is not realistic to expect a price including those capital costs to be competitive with a bidder whose costs do not include those costs. Services such as building “re-fit” or life-cycle maintenance should not be benchmarked or market tested.

14.3.4 With both benchmarking and market testing, the Authority will have to consider whether the contractual structure adopted by a bidder makes either approach realistic. In what follows, the assumption is made that the person providing the soft services to be benchmarked or market tested is the Operating Sub-contractor in accordance with its sub-contract with the Contractor. The same logic also applies where the particular service is provided by a sub-contractor to the Operating Sub-contractor.

14.3.5 If, however, the soft services concerned are provided directly by the Operating Sub-Contractor as part of a fully integrated Service, then it is unlikely that a benchmarking or market testing can successfully be conducted. Also, if the soft services are provided at a level of sub-contractor distantly removed from the Operating Sub-contractor, then both benchmarking and market testing are more difficult, as the relationships between cost and price charged to the Contractor become more remote.

14.3.6 Many Contracts already provide for soft services to be benchmarked and/or market tested. These Contracts have adopted a number of different arrangements, including the following:

- no obligatory benchmarking, but either side can trigger a review of the Unitary Charge after 10 and 15 years of the Service Period if it believes that there has been a change of more than, say, 5% in certain aggregate costs beyond the Contractor’s control affecting the original level of return (see Section 12 (Change in Service));
- a five yearly benchmarking exercise of the full range of soft services, on a basis to be agreed between the parties (adjustments to the Unitary Charge or service requirement will only occur if there is a more than, say, 5% variation between cost and benchmark cost);

⁷ In some Contracts, it may be possible for the Contractor to benchmark or market test “hard services” because they are of a standard nature (e.g. routine vehicle maintenance). The decision on the appropriateness and extent of benchmarking and market testing should not be imposed on the Contractor but should be considered on a case by case basis in such Contracts.

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- performance related facilities management payments being subject to a benchmarking exercise every five years in some projects, irrespective of the percentage cost change (the availability payment is not subject to benchmarking in such projects); and
 - market testing where the parties fail to agree on the appropriate price variation under any of the benchmarking methods above.

14.4 BENCHMARKING

14.4.1 In this guidance, the term “benchmarking” is used to mean the process by which the Contractor compares either its own costs or the cost of its Sub-contractors providing soft services against the market cost of such services. If the relevant costs are higher than market costs, a reduction in the price charged to the Authority should be made on an agreed cost-sharing basis to reflect the differential. If costs are lower than market costs, any price increase must be justified by the Contractor. For example, an increase may be required to restore the Contractor’s base case return.

14.4.2 To ensure the benchmarking exercise is as valid a comparison with the costs of a Sub-Contractor as possible, the Contractor will have to ensure that the following issues are addressed:

- how to ensure that the cost comparison encompasses only the services being benchmarked;
- how to ensure the cost comparison includes factors relating to risks inherent in a change of service provider (such as mobilisation costs⁸);
- whether individual services are to be benchmarked separately or whether all soft services must be benchmarked together;
- whether it is possible to rely on the information being provided by those persons contacted for benchmarking information; and
- whether there is any other reason or factor that would make benchmarking unrealistic or impracticable (e.g. would it require a Contractor to contract directly with a competitor, or a competition would so disrupt the Service that it is not realistic to complete it).

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

- on certain fixed dates, the Contractor compares certain of its costs (e.g. what it pays its Sub-contractors providing soft services) with equivalent prevailing market costs (e.g. what it would have to pay other sub-contractors to provide the relevant service) and, if appropriate, proposes a variation to the Unitary Charge;
- these fixed dates should be 12 months prior to the date on which any changes in the Unitary Charge are proposed to take effect and the exercise should last no more than 6 months (to allow a market testing to occur, should this be needed);

⁸ Another relevant consideration may be the credit standing of a replacement service provider. This will depend upon the particular service being benchmarked (or market tested) but will be of specific application where the particular service involves significant capital outlay over a long term.

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- if the market cost is higher than the Contractor's current costs, there is no need to adjust the Unitary Charge if the current Sub-contractor is still obliged to provide the service at the lower price (it may be that the Sub-contractor concerned is simply more efficient than the rest of the market);
 - if the market cost is higher than the Contractor's current costs, and the current Sub-contractor is contractually entitled to review its price then the Unitary Charge may be adjusted (although this will not necessarily be the case) (see Section 14.4.4);
 - if the market cost is lower than the Contractor's current costs, then there should be an adjustment to the Unitary Charge (see Section 14.4.4). This could be that the Sub-contractor is clearly not as efficient as its competitors. The price decrease should encourage the Contractor to take appropriate steps to reduce its price (for example by replacing the Sub-contractor, taking into account the costs of such replacement);
 - if the Authority and the Contractor cannot agree on any cost increase or reduction then the soft service concerned should be market tested (see Section 14.5 (Market Testing)); and
 - the Authority should have the right to inspect the Contractor's and Sub- Contractor's cost information to confirm cost details. Full transparency of cost information is needed for benchmarking to function properly (see Clause 29.7(b)).

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

14.4.5 The Authority should specify in the ITN when the first benchmarking exercise will take place. There should be a longer initial period (well into the Service Period) before such provisions are implemented, to ensure that bidders do not set a deliberately low initial price which they then try to increase through the review. An excessively long initial period may, however, expose the Authority to an unreasonable price premium for transferring this risk for a longer term. Alternatively, the first benchmarking exercise should be capable of resulting in decrease in price only or a capped increase in price.

14.5 MARKET TESTING

14.5.1 In this guidance, "market testing" means the re-tendering on the market by the Contractor of the relevant Sub-contractor's soft service to test the value for money of that service. Any increase or decrease in the cost of such service as a result of market testing requirements in the Contract which result in the replacement of a Sub-contractor should be reflected by an adjustment in the price charged to the Authority (calculated on an agreed cost-sharing basis).

14.5.2 As stated above, this should generally only be undertaken where the parties have failed to agree on the results of a benchmarking exercise and there is a real prospect of a competition (see Section 14.3.1 above). Market testing is likely to be more disruptive to the Contractor (and, therefore, possibly the Authority) than benchmarking as it may require replacement of a Sub-contractor. The procedure for market testing would be as follows:

- on certain fixed dates, following a failure to agree the outcome of a benchmarking exercise, the Contractor retenders the relevant Project Document and conducts a competition for potential replacement Sub-contractors (the existing Sub-contractor is allowed to bid);
- if the competition shows that the Contractor can obtain better value for money, then the Unitary Charge must be reduced (as described in Section 14.4.4) with the result that the Contractor could therefore obtain a reduction in price by appointing a replacement Sub-contractor in order to minimise its costs; and
- if the competition shows that the Contractor's current Sub-contractor is cheaper and better value for money than any potential replacement, then the Sub-contractor should continue with an increase in price to the extent this follows the agreed sharing principles.

14.5.3 A great deal of information will need to be collected by the Contractor and made available to tenderers for the market test to be effective. For example, information relating to the terms and conditions, job title, age, length of service and benefits of the employees of the service provider engaged wholly or mainly in the provision of the market tested services may be required⁹. The Contract should provide that this information can be provided to the Authority (see Section 25 (Information and Confidentiality) and Clause 29.7 (Contractor's Records)).

14.5.4 The Contract should also make clear that the market testing of each service is the responsibility of the Contractor and should be carried out so that the person selected to provide the particular service following the market test shall commence provision of the relevant services to ensure a smooth transition between Sub-contractors.

14.5.5 Suitable drafting for a market testing programme provision is as follows:

14.5 Market Testing

- (a) At least [6] months¹⁰ before each market testing date, the parties shall meet together as often as may be necessary in respect of all market tested services to be market tested on that date:
 - (i) to consider any changes required to the relevant services;
 - (ii) to discuss and seek to agree the appropriate manner of advertising the services required and the means of identifying prospective tenderers¹¹;
 - (iii) to discuss and seek to agree the tender requirements which must include:

⁹ It may also be appropriate for the Contractor to make available to tenderers information relating to the relevant service provider's shareholding in the Contractor (and/or Operating Sub-Contractor), including the terms of any associated shareholders' agreement.

¹⁰ This will allow the benchmarking exercise to have been completed.

¹¹ This may include an OJEC notice.

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- (A) a statement of the tender validity period;
 - (B) details of the tender evaluation criteria¹²;
 - (C) the terms and conditions under which the services will be contracted;
 - (D) information relating to employees and their conditions of employment¹³;
 - (E) the information that tenderers are required to provide; and
 - (F) how many tenders are required for the market testing to be valid.

14.5.6 One of the major difficulties that arises with market testing is the question of which potential bidders can bid for which of the soft services being market tested (as some bidders may only want to take over, for example, the catering function, whereas others may want a wider role). One way of dealing with this is as follows:

Grouping of Services

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

- (a) tenderers may submit tenders for all or any of the market tested services; and
- (b) if a tenderer submits a tender for a group or groups of market tested services, then it may be required to provide all or any of the services in such group or groups¹⁴.

14.5.7 The next step in the market testing provisions will be for the means by which tenderers are selected to be dealt with¹⁵. A suggested way of doing this is set out below:

Selection of Tenderers

- (a) The Contractor shall be responsible for compiling the list of prospective tenderers and selecting the tenderers from the list of prospective tenderers on the basis of their:
 - (i) financial standing; and
 - (ii) technical and managerial experience and ability (taking into account any relevant references).
- (b) The Authority shall have a right to prevent the selection of any person as a prospective tenderer if it reasonably believes that such person does not (or could not reasonably be considered to) comply with any of the criteria referred to in Clause 14.5(a)(iii) above.

¹² These must be objective criteria.

¹³ This will deal with any exclusion required (such as retirement benefits and occupational pensions).

¹⁴ The Authority should be aware of the danger of any less attractive services not being bid for and so may require these to be included in bids.

¹⁵ The Contract will also have to deal with the extent to which any person is disqualified from selection as a tenderer merely by virtue of its connection with any other person in the Project. Typically, no such connection should disqualify a tenderer.

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- (c) The Authority shall, in its absolute discretion, have the right to prevent the selection of any person as a tenderer on the grounds that the prospective tenderer has committed a Prohibited Act¹⁶.
 - (d) The Contractor shall provide any prospective tenderer which is unsuccessful in being selected with an explanation of the reasons behind its non-selection, if so requested by the person in question.

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

- (a) The Contractor shall determine which compliant tender in respect of any market tested service represents the best value for money¹⁷.
- (b) On making this determination, the Contractor shall supply to the Authority a copy of its tender evaluation, together with sufficient supporting information concerning the tender evaluation to enable the Authority to analyse and understand the basis for the Contractor's determination.
- (c) If the Authority does not agree with the Contractor's determination, the Authority may, within 15 Business Days of being provided with the tender evaluation, dispute such determination and, if the parties do not resolve such dispute within a further 15 Business Days, the dispute shall be dealt with in accordance with Clause 27 (Dispute Resolution).

14.5.9 On selection, the alteration to the Unitary Charge can occur on the basis agreed in the Contract, bearing in mind the need to incentivise the Contractor to manage the market testing programme efficiently.

As the Contractor is responsible for the market testing and is the principal beneficiary the Authority should be indemnified against any claims brought against it (for example, from a losing tenderer) as a result of any market testing (for example, for a breach of the market testing procedures agreed).

¹⁶ This may also include breach of security requirements in certain sectors. See Section 20.4 (Termination for Corrupt Gifts and Fraud) for the definition of Prohibited Act.

¹⁷ If only one compliant tender is submitted in respect of some or all of the market tested services, the Authority is at risk of being obliged to pay an uncompetitive price for that part or all of the Service. Accordingly, the Contract may provide a right for the Authority to prevent the Contractor appointing a single bidder and passing those costs onto the Authority through the Unitary Charge without its approval. The risks of only one such bid being received in practice should be remote and capable of assessment by the Contractor (unless there are project specific reasons to the contrary) which should enable the Contractor to accept the inclusion of a provision of this nature. If the parties wish to specify what would happen in those circumstances, the provision should be amended on a project specific basis.

15.1.1 CONTROL OVER SUB-CONTRACTORS

15.1.1 The Authority often has the perception that it must retain a large degree of control of a subjective nature over Sub-contractors. This perceived need for control applies both to the performance of the Sub-contractors and to any procedure for appointing replacement Sub-contractors. The Contractor's stated view is often that as it originally selected these Sub-contractors and has taken risk on their performance, it should be entitled to change them at will (for example, if they are not performing) whilst recognising the legitimate interest of the Authority in the identity of key Sub-contractors (as provided for in Section 15.1.5)¹.

15.1.2 In general, any attempt by the Authority to control Sub-contractors is to be discouraged as it is in most cases unnecessary and may dilute the level of risk transfer achievable by the Authority (see also Section 9.9 (Monitoring of Sub-contractors)). The Authority should in any event (if control is needed) only seek a degree of control in relation to Sub-contractors and not in relation to sub-contractors of Sub-contractors.

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

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

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

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

Rarely will further criteria be needed.

15.1.6 If in the exceptional circumstances described the Authority retains some control over replacement Sub-contractors, these controls will also apply to any substitute Sub-Contractors whom the financiers wish to appoint in accordance with their rights under the direct agreement (see Section 30 (Direct Agreement)).

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

15.2 CONTROL OVER EMPLOYEES²

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

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

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

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

15.2.5 Controls need to be exercised over employees at the end of the Service Period, where the considerations referred to in Section 19.3 (Handover Provisions for Assets with No Alternative Use) apply. Other statutory restrictions will still apply after the end of the Service Period (for example, the Official Secrets Acts 1911, 1920, 1939 and 1989).

15.3 CONSEQUENCES OF CONTROL

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

² For more general guidance on TUPE issues, please see the 4ps Guidance "Code of Practice on Workforce Matters in Local Authority Service Contracts" and please see "Standardisation of PFI Contracts for Local Authorities", due to be published on HM Treasury website in May 2004.