

## CALCULATION AND PAYMENT OF EARLY TERMINATION PAYMENTS

### 21.1 INTRODUCTION

This section sets out the principles which should apply to termination payments.

### 21.2 GROSS UP OF TERMINATION PAYMENTS

**21.2.1** Compensation on early termination should be calculated on the basis that there is grossing-up of payments (for tax deductions), save in the case of Contractor Default where a market value payment makes grossing-up inappropriate as the Contractor is basically receiving the sale value of the outstanding Contract rather than receiving amounts designed to compensate specific elements of its financing<sup>1</sup>.

A grossing-up provision would typically be as follows:

If any amount of compensation payable by the Authority under Clauses 20.1.3 (Compensation on Authority Default), 20.3.2 (Compensation on Termination for Force Majeure), Section 20.4.4 (Compensation for Termination for Corrupt Gifts and Fraud), 20.5.2 (Voluntary Termination) and 20.6.2 (Compensation on Termination for Breach of the Refinancing Provisions) is subject to Tax payable to a Relevant Authority in the United Kingdom<sup>2</sup>, then the Authority shall pay to the Contractor such additional amount as will put the Contractor in the same after Tax position as it would have been had the payment not been subject to Tax, taking account of any relief, allowances deduction, setting off or credit in respect of Tax (whether available by choice or not) which may be available to the Contractor to reduce the Tax to which the payment is subject.

**21.2.2** With the approaches taken in Section 20 (Early Termination) to termination compensation, there is no need to deal in the drafting with the extent to which payments to replace the Unitary Charge should reflect tax deductions that would otherwise have occurred.

### 21.3 CERTAINTY OF COMPENSATION PAYMENT AMOUNTS

**21.3.1** Compensation payments where there has been a voluntary termination (see Section 20.5.2 (Compensation on Voluntary Termination)), a termination for Authority Default (see Section 20.1.3 (Compensation on Termination for Authority Default)), force majeure (see Section 20.3.2 (Compensation on Termination for Force Majeure)), corrupt gifts and fraud (see Section 20.4.3 (Compensation on Termination for Corrupt Gifts and Fraud)) or wilful breach of the refinancing provisions (see Section 20.6.2 (Compensation on Termination for Breach of the Refinancing Provisions)) are all calculated in whole or in part by reference to the level of the Contractor's Senior Debt outstanding at the time of the termination payment.

<sup>1</sup> The Authority will need to review carefully the tax implications of any market value payments upon termination for Contractor Default. A provision dealing with grossing up will be necessary for payments derived from the retendering process which are taxed as a result of the market value payment passing through the Authority's control.

<sup>2</sup> The Authority should ensure that UK tax only is relevant, so that no liability to foreign tax authorities is caught, as can occur if, for example, the Contractor's Affiliates are registered or located abroad. The Authority should also ensure that it retains the right to pay the amount of gross-up directly to the Inland Revenue or other Relevant Authority and to contest the Contractor's tax liability.

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**21.3.2** Authorities should be concerned to ensure that the level of Senior Debt outstanding at any time is not inflated in a way that will significantly and unexpectedly increase the Authority's liability on termination<sup>3</sup>. The Contract should always ensure that the amount of Senior Debt and Junior Debt cannot be artificially inflated.

**21.3.3** The Contractor may, during the course of the Contract, refinance or reschedule its debt obligations. This may be either to lower its financing costs and increase its return (see Section 35 (Refinancing)) or to attempt to save the Project if it is in difficulties due to construction delays, cost overruns or temporary poor performance. In the latter case, it is in the interests of all parties to ensure that a rescheduling of debt can take place as quickly as possible, without the need for the Contractor and/or Senior Lenders to obtain consents from the Authority. To reflect this principle, Section 35 (Refinancing) states that any Refinancing that does not increase the Equity IRR above that projected in the Base Case shall not require the prior consent of the Authority<sup>4</sup>. If the Project is in difficulty and in need of rescue, the Senior Lenders will also be reluctant to rescue the Project unless they know that any rescheduled or new Senior Debt required to rescue the Project will be compensated if the Authority chooses to terminate voluntarily, or termination occurs as a result of Authority Default, Force Majeure or Corrupt Gifts.

**21.3.4** The Senior Lenders will only agree to reschedule or commit new Senior Debt to the Project as a last resort. In recognition of this and to protect the Authority from Senior Debt levels being artificially inflated, the amount of compensation payable by the Authority in respect of Senior Debt on early termination should only include additional Senior Debt if it was incurred either under a "standby" facility committed at financial close or alternatively if this constitutes Additional Permitted Borrowing. This provision does not preclude Senior Lenders otherwise relying upon compensation payable to equity investors upon early termination for recovery of rescheduled or increased levels of Senior Debt.

**21.3.5** In certain termination scenarios, the amount payable will be adjusted for any Additional Permitted Borrowing advanced by Senior Lenders (on a rescue refinancing) – see Section 20.1.3 and definitions in Section 1.8.1 and Annex 4, "Permitted Borrowing".

**21.3.6** Following the making of any Additional Permitted Borrowing if the project terminates early on the grounds of Authority Voluntary Termination or Authority Default or Force Majeure, the Authority will pay to the Contractor:

- the Senior Debt, plus the Additional Permitted Borrowings less any Distribution made while the Additional Permitted Borrowing is outstanding (the "New Senior Debt Amount"). The Senior Lenders are protected even if the New Senior Debt Amount exceeds the aggregate amount which would have been payable (to both debt and equity) had no Additional Permitted Borrowing been made (the "Original Aggregate Compensation Amount");
- if the New Senior Debt Amount is greater than the Original Aggregate Compensation Amount, the Shareholders and Subordinated Lenders will receive no termination payment;

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<sup>3</sup> Consequently the Authority should also be concerned to capture increases in the Senior Debt profile caused by rescheduling of the Senior Debt (which may not include the provision of additional Senior Debt).

<sup>4</sup> If the Project is in difficulties and in need of rescue by the Senior Lenders, the Equity IRR should not increase above that projected in the Base Case.

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- (if the Original Aggregate Compensation Amount is greater than the New Senior Debt Amount, the Shareholders and Subordinated Lenders will, broadly, be paid the excess.<sup>5</sup>

**21.3.7** Distributions made while such Additional Permitted Borrowing is outstanding will reduce the amount payable to the Senior Lenders in various circumstances (and it may be that the Senior Lenders would therefore cash collateralise any such amount which would otherwise have been distributed until the Additional Permitted Borrowing is fully covered).<sup>6</sup> The amount of the Additional Permitted Borrowing which may be lent in this way is 10% of the initial principal commitment, reducing to 5% at such time as the initial principal senior debt is 50% paid down.

There is also a requirement in the Direct Agreement for the Authority to be notified of any such Additional Permitted Borrowing, and the reasons for it, and to be notified, on an ongoing basis, of Distributions then made.

**21.3.8** Senior Lenders, of course, remain able to advance new monies to the Contractor with the express consent of the Authority, but this Additional Permitted Borrowing provision will offer the Senior Lenders flexibility to rescue projects in difficulty without having to obtain the prior consent of the Authority and without having to step-in to the project. Authorities should not give their consent to other increases to their liabilities on termination (see Section 21.3) until such time as the Contractor/Senior Lenders have exhausted their rights to put more money into the project by way of Permitted Borrowing. See further Sections 20.1.3.8 to 20.1.3.11. The Authority should also consider the relationship between these provisions and Section 35 (refinancing) if a request is received to increase the Authority's termination liabilities beyond the extent permitted for Permitted Borrowings.

Required drafting is set out below:

### **21.3 Changes to Financing Agreements**

No amendment, waiver or exercise of a right under any Financing Agreement shall have the effect of increasing the Authority's liabilities on early termination of this Contract unless:

- (a) the Contractor has obtained the prior written consent of the Authority; or
- (b) it is a Permitted Borrowing.

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<sup>5</sup> But out of the total termination payment, the amount attributable to the senior banks will be increased and the amount attributable to the equity will be decreased, in order to reflect the increased debt levels. This follows the logic that applies to ordinary monthly payments of unitary charge. These do not increase following any Permitted Borrowing (although, as between the senior lenders and the equity, the equity's share of them may decrease).

<sup>6</sup> If no distributions are made during this period but monies are kept in reserved accounts, the Permitted Borrowings will not be reduced, however the amount of the Senior Debt payable by the Authority on an early termination of the project is reduced, under sub-paragraph (b) (i) of the definition of Base Senior Debt Termination Amount and Revised Senior Debt Termination Amount. It will be a matter for the Senior Lenders and the equity to decide whether surplus funds are used to repay Senior Debt, or are distributed or reserved.

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## 21.4 SET-OFF ON TERMINATION

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**21.4.1** The Authority should be fully entitled to set off any outstanding liabilities of the Contractor against the amounts it pays in compensation on a Contractor Default, but for the reasons set out in Section 21.4.2 this will in all likelihood not affect the termination payment concerned. There should be no ring-fencing of Senior Debt under these circumstances. In circumstances other than Contractor Default, however, it is acceptable for a limit on set-off to be introduced. To minimise the possible effects of not having the right to set off in other circumstances, the Authority should ensure that minimum amounts are outstanding from the Contractor.

Required drafting is as follows:

### 21.4 Set-off on Termination<sup>7</sup>

Except where expressly stated otherwise, the Authority is not entitled to set off any amount against any payment of termination compensation under Clauses 20.1.3 (Compensation on Authority Default), 20.3.4 (Compensation on Termination for Force Majeure), 20.4.3 (Compensation on Termination for Corrupt Gifts and Fraud), 20.5.2 (Compensation on Voluntary Termination) and 20.6.2 (Compensation on Termination for Breach of the Refinancing Provisions), save to the extent that after such an amount has been set off, the termination payment made would be in an amount greater than or equal to the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount, as the case may be, at that time.

**21.4.2** Claims against the Contractor by the Authority should be fully reflected in the “market value” based termination payment to the Contractor since bidders will discount the value of any claims (depending on the likelihood of their success) from the amount they are prepared to pay for a project retendered on the same terms (that is, subject to any outstanding claims which the Authority would set off against the future Unitary Charge if the outgoing Contractor did not meet them). This is the case, therefore, with the second valuation options for Authority Default and Voluntary Termination and also for termination for Contractor Default. There should be no double counting in these circumstances, so the Authority must make it clear to potential replacement contractors what claims they should take into account in their bids.

**21.4.3** Where termination has occurred for reasons other than Contractor Default, the Authority should be entitled to set off outstanding liabilities of the Contractor against all amounts it pays in compensation, except amounts paid to compensate Senior Debt (see above).

## 21.5 METHOD OF PAYMENT

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**21.5.1** Where an incoming Contractor pays market value on Contractor Default termination, or the Contract is terminated for Authority Default, the Authority should pay the Contractor by way of a lump sum.

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<sup>7</sup> Clause 11 (Set-Off) contains the right to set-off amounts.

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**21.5.2** On other types of termination, the Contract should deal with how compensation is paid. Value for money issues should be taken into consideration which in most cases will mean that compensation payments by lump sum will be the appropriate position. Value for money is unlikely to be achieved if the Authority repays such amounts over time (i.e. in instalments), as interest will continue to accrue on the compensation amount to reflect the equity/Junior Debt providers' and Senior Lenders' loss of opportunity. Moreover, the Authority's choice between lump sum and instalments should not be influenced by arbitrage possibilities (i.e. it would be bad practice to choose the long term option just because it can earn higher interest on amounts on short term deposit than it pays the Contractor).

**21.5.3** While the above is the general position, local authorities may wish to reserve the option to pay over time due to affordability constraints, particularly as their ability to raise debt is restricted by statutory regulation. Therefore, where a local authority (or any other public body which has a valid value for money reason in accordance with 21.5.2) seeks the right to pay compensation by instalments it should follow the guidance set out below.

**21.5.3.1** The Contractor will require the Authority to pay interest on any outstanding balance at the Senior Debt rate<sup>8</sup>. If equity/Junior Debt compensation is payable on termination, the recommended approach for all Authorities is to restrict the Authority's right to pay by instalments to the Senior Debt related compensation.

**21.5.3.2** If the Contract is terminated for Contractor Default and the Adjusted Estimated Fair Value of the Contract is payable to the Contractor as compensation, the appropriate interest rate payable on the outstanding balance is again the Senior Debt rate<sup>9</sup>.

**21.5.3.3** If the Authority elects to pay compensation in instalments, the protections in the Contract in respect of payment default and unauthorised transfer of the Contract by the Authority should continue to operate<sup>10</sup> but the Contractor should only have the ability to declare all outstanding instalments immediately due and payable on the occurrence of these events. If the Authority elects to pay compensation in instalments the Senior Lenders should not require the Authority to enter into new funding arrangements with them as they will have fixed security over the instalments to be paid by the Authority which will be paid in accordance with the Senior Lenders' instructions.

Required drafting for Contracts in which the Authority has the right to pay by instalments is set out below<sup>11</sup>.

### **21.5 Method of Payment**

- (a) The Authority shall pay to the Contractor the Termination Sum on or before the date falling 60 days after the Notice Date unless it elects to pay in accordance with paragraph (b) below.
- (b) The Authority may elect to pay the Adjusted Estimated Fair Value of the Contract or the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant) element of the Termination Sum:

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<sup>8</sup> This is the non-default rate of interest payable under the Senior Financing Agreement.

<sup>9</sup> Although the Adjusted Estimated Fair Value of the Contract may be greater than amounts owing to the Senior Lenders, the Contract will have terminated for reasons that the Contractor can control. In such circumstances, it is equitable for the equity/Junior Debt providers to accept that to the extent that the Adjusted Estimated Fair Value of the Contract is greater than the outstanding Senior Debt, interest will accrue on all outstanding amounts at the Senior Debt rate.

<sup>10</sup> Clause 29.10 (Continuing Obligations) should provide that Clause 16.3 (Restrictions on Transfer of Contract by the Authority) survives termination of the Contract.

<sup>11</sup> These provisions will be kept under review in the context of the move to a prudential borrowing regime for local government.

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- (i) in instalments, on the dates (the “Instalment Dates”) and in the amounts that the Contractor would have been required to pay principal to the Senior Lenders (under the terms of the Senior Financing Agreements) had the Termination Date not occurred; or
  - (ii) as the parties may otherwise agree.
- (c) From the Notice Date until the date of payment, interest shall accrue on any unpaid element of the Termination Sum at the Senior Debt Rate and be payable on the next occurring Instalment Date.
- (d) If the Authority has elected to pay in accordance with paragraph (b) above, it may (on 28 days prior written notice to the Contractor) elect to pay the Adjusted Estimated Fair Value of the Contract or the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant) element of the Termination Sum in full on any Instalment Date.
- (e) If the Authority:
- (i) fails to make a payment to the Contractor in accordance with paragraphs (a) and/or (b) above; or
  - (ii) breaches Clause 16.3 (Restrictions on Transfer of Contract by the Authority),

the Contractor may issue a notice to the Authority declaring any unpaid and outstanding element of (as applicable) the Adjusted Estimated Fair Value of the Contract, the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant) element of the Termination Sum to be immediately due and payable<sup>12</sup>.

**“Notice Date”**

means the later of the Termination Date and (if applicable) the date that the Adjusted Estimated Fair Value of the Contract is agreed between the parties pursuant to Clause 20.2.9 (No Retendering).

**“Termination Sum”**

means any compensation payable by the Authority to the Contractor on an early termination of the Contract under [Section 20] (excluding the Adjusted Highest Compliant Tender Price<sup>13</sup> and any compensation payable as a result of a termination of the Contract under Clause 20.1.2 (Contractor’s Right to Terminate for Authority Default)).<sup>14</sup>

**“Senior Debt Rate”**

means [incorporate the non-default interest rate definition in the Senior Financing Agreement] or such other lower rate as the parties may agree.

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<sup>12</sup> Break costs arising should also be payable in respect of the Base Senior Debt Termination Amount or Revised Senior Debt Amount elements of the payment.

<sup>13</sup> See Clause 20.2.8 (Retendering Procedure) for the timing and manner of payment of the Adjusted Highest Compliant Tender Price.

<sup>14</sup> See Section 20.1.2.1 and the definition of “Authority Default”. If the Authority is in breach of its obligations and the Contract is terminated, the compensation payable by the Authority to the Contractor should be immediately due and payable (see clause 20.1). The Authority should be entitled to pay by instalments if there is a voluntary termination of the Contract.

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**21.5.4** To the extent that any compensation amounts are paid to Senior Lenders, a provision such as the following should be included:

The Authority shall be entitled to rely on the certificate of the Agent as conclusive as to the amount of the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount outstanding at any relevant time. The receipt of the Agent shall discharge the Authority's obligation to pay any element of compensation due to the Contractor that is equal to the Base Senior Debt Termination Amount or the Revised Senior Debt Termination Amount (as relevant).

## **21.6 RETENTION OF ASSETS BY CONTRACTOR ON TERMINATION**

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To the extent the Contractor retains Assets on a termination, then their value should be deducted from any compensation payments made. The value of the Assets will be close to zero in the case of Assets with no alternative use<sup>15</sup> and so there may be no need to deal with this issue in the Contract. Where residual value exists the Authority should, however, carefully consider likely residual value out-turns, as the commercial incentives can be different if the residual value were to be significant. In certain scenarios (e.g. if residual value could exceed the original return) residual value could distort the effect of any compensation payment (e.g. for Contractor Default) and reduce the incentives to perform that would otherwise exist.

## **21.7 EXCLUSIVITY OF REMEDY**

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**21.7.1** The Contractor should typically agree that termination compensation payments are its sole remedy, subject to certain exceptions. The Authority's agreement to a similar provision in this regard should depend on the issues set out in Section 23.6 (Damages Claims).

**21.7.2** Required drafting which deals with the Contractor's position is as follows:

Any payment of compensation shall be in full satisfaction of any claim which can be made against the Authority by the Contractor in relation to termination of this Contract or any Project Document. The compensation payable under Clauses 20.1.3 (Compensation on Authority Default), 20.3.4 (Compensation on Termination for Force Majeure), [Section 20.4.3 (Compensation for Termination for Corrupt Gifts and Fraud)] and 20.5 (Compensation on Voluntary Termination by the Authority) shall be the sole remedy of the Contractor against the Authority on termination of the Contract.

Specific exclusions will exist in most transactions and these should be on a project specific basis, based on the principle that any compensation payment does not reflect other claims. Examples would include claims under Clause 25 (Information and Confidentiality), certain types of claims for infringement of intellectual property rights and other claims not reflected, such as claims by third parties against the Authority or claims arising from damage to other property of the Authority.

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<sup>15</sup> Where land forms part of the Assets, it may be difficult to establish that there is no alternative use (see Section 19.1.2).



## 22.1 INTRODUCTION

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**22.1.1** If the Assets may be transferred to the Authority at no cost on the Expiry Date (i.e. no residual value risk has been transferred to the Contractor) (see Sections 19.2 (Assets where the Authority retains Residual Value Risk) and 19.6 (Valuation of Terminal Payments on Expiry where Residual Value Risk has been transferred)), the Contract should specify what condition the Assets should be in at such time. It should also specify the arrangements for a survey of the condition of Assets before the end of the Contract to assess whether such standards have been met. The costs of the final survey are normally borne by the Authority subject to recovery from the Contractor where the survey finds that rectification work is needed.

**22.1.2** Where there is a residual value payment to be made by the Authority to the Contractor reflecting the market value of the Assets at that time (see Section 19.5 (Valuation of Terminal Payments on Expiry)), then a survey will only be needed as part of a valuation, so that the condition of the assets<sup>1</sup> is reflected in any price paid on expiry.

## 22.2 TIMING OF SURVEY ON EXPIRY

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**22.2.1** The survey should usually be carried out one to two years prior to the end of the Contract, ideally by an independent party<sup>2</sup>.

**22.2.2** If no payment is to be made on expiry and the survey reveals that the Contractor has not complied with its obligations so that the assets will not be handed over to the Authority in the required condition, the Contract should contain a mechanism to ensure that the cost of carrying out the necessary works is recoverable from the Contractor. This may be as a debt or by way of set-off or withholding of the relevant amount from the Unitary Charge during the course of the Contract.

## 22.3 RETENTION FUND

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**22.3.1** Where the Authority elects to take possession of the Assets in accordance with Section 19.2.3 (i.e. where the Assets have no alternative use), the Contract may provide that the Authority pays a certain proportion of each Unitary Charge during the last few years of the Contract into a secured retention fund<sup>3</sup> to ensure that it can call on sufficient funds to carry out any maintenance identified as necessary by the survey. The period for and the size of payments into the retention fund should be set on a project specific basis, by reference to the amount likely to be needed to rectify defects in the assets<sup>4</sup>.

**22.3.2** If the Contractor carries out any maintenance identified as necessary by the survey, it can be reimbursed from the retention fund. Otherwise, the Authority can use such funds itself to carry out necessary maintenance. If the amount retained is insufficient to cover all required maintenance, the Authority will have to recover the balance from the Contractor as a debt. Any balance remaining in the fund belongs to the Contractor and should be paid to the Contractor together with accrued interest.

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<sup>1</sup> That is, the physical assets referred to in the definition of "Assets".

<sup>2</sup> The use of an independent party will not always be appropriate in defence projects particularly if the MOD is the only suitable surveyor.

<sup>3</sup> This may be achieved by establishing the account in the sole name of the Authority or charging the account to the Authority.

<sup>4</sup> See footnote 1 above.

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## 22.4 GUARANTEES OR BONDS

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A further alternative to the above is for the Contractor to procure a performance bond or alternative security in respect of the hand-back condition of the Assets. This would, for example, allow the release of any retention funds.

## 22.5 SURVEYS ON EARLY TERMINATION

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Surveys will not generally be necessary on early termination of the Contract, except to the extent the condition of the Assets needs to be taken into account in calculating market value compensation payable on termination for Contractor Default (see Section 20.2 (Termination on Contractor Default)). This would only apply when the procedure referred to in Section 20.2.9 (No Retendering Procedure) is used. If a termination payment comes from a third party then it will be necessary for that third party to satisfy itself as to the condition of the Assets. If residual value has been transferred then any Assets may, of course, need to be valued.

Required drafting for this Section (where such a provision is needed<sup>5</sup>) is as follows:

### 22 Surveys on Termination

- (a) If the contractor has been notified under Clause 22(e)(i) that rectification and/or maintenance work is required, [12] months prior to the Expiry Date the Authority shall deduct the costs of that work as quantified by that survey from the Unitary Charge payable after such date and pay such amount into an interest bearing account (the “Retention Fund Account”) until the Contract has expired or terminated<sup>6</sup>.
- (b) [18] months prior to the Expiry Date, [the Authority<sup>7</sup>] shall be entitled to carry out a final survey of the assets<sup>8</sup> to assess whether they have been and are being maintained by the Contractor in accordance with its obligations under Clause 8.1 (Maintenance).
- (c) [The Authority] shall notify the Contractor in writing a minimum of [7] days in advance of the date it wishes to carry out the final survey. [The Authority] shall consider in good faith any reasonable request by the Contractor for the final survey to be carried out on a different date if such request is made at least [2] days prior to the notified date and the Contractor (acting reasonably) is able to demonstrate that carrying out the final survey on notified date would materially prejudice the Contractor’s ability to provide the Service<sup>9</sup>.
- (d) When carrying out the final survey, [the Authority] shall use reasonable endeavours to minimise any disruption caused to the provision of the Service by the Contractor. The Contractor shall afford [the Authority] (free of charge) any reasonable assistance required by [the Authority] during the carrying out of the final survey. The cost of the final survey shall be borne by the Authority.

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<sup>5</sup> The need for a survey will depend upon the option exercised by the Authority for Assets with no alternative use. See Section 19.2.7(a).

<sup>6</sup> Such an account will not normally be needed for early termination payments where residual value risk has been transferred (as the maintenance levels will be reflected in the market value of a termination payment).

<sup>7</sup> The drafting of this Clause may need to be amended if it is likely that an independent third party will carry out the final survey.

<sup>8</sup> See footnote 1 above.

<sup>9</sup> The parties will need to agree whether reimbursement will be made by staged payments during the course of the works or by a lump sum payment on completion of the works. One of the relevant considerations may be the size and nature of the rectification/maintenance works.

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- (e) If the final survey shows that the Contractor has not complied with or is not complying with its obligations under Clause 8.1 (Maintenance), the Authority shall:
- (i) notify the Contractor of the rectification and/or maintenance work which is required to bring the condition of the assets to the standard they would have been in if the Contractor had complied or was complying with its obligations under Clause 8 (Maintenance);
  - (ii) specify a reasonable period within which the Contractor must carry out such work; and
  - (iii) recover the cost of the survey from the Contractor by means of [a withdrawal from the Retention Fund Account] [a deduction from the next Unitary Charge] [other means of reimbursement].
- (f) The Contractor shall carry out such rectification and/or maintenance work to the Authority's reasonable satisfaction within the period specified and any costs it incurs in carrying out such rectification and/or maintenance work shall be at its own expense.
- (g) If and to the extent that the Contractor carries out the necessary rectification and/or maintenance work to the Authority's reasonable satisfaction within the specified period, the Authority shall reimburse the Contractor's costs of so doing by withdrawing amounts from the Retention Fund Account<sup>10</sup>. If the amount in the Retention Fund Account is insufficient to cover the Contractor's costs, the Contractor shall bear the balance of its costs itself.
- (h) If and to the extent that the Contractor fails to carry out the necessary rectification and/or maintenance work to the Authority's reasonable satisfaction within the specified period, the Authority shall be entitled to carry out itself, or procure, such rectification and/or maintenance work at the Contractor's expense and shall make withdrawals from the Retention Fund Account to pay for such work or, where there are insufficient funds in the Retention Fund Account, make deductions from the Unitary Charge to pay for such work<sup>11</sup>.
- (i) If:
- (i) all the rectification and/or maintenance work identified by [the Authority] has been carried out to the Authority's reasonable satisfaction; and
  - (ii) all such work has been paid for by the Contractor; and
  - (iii) no other Termination Notice is outstanding,
- then the Authority shall pay any credit balance on the Retention Fund Account to the Contractor as soon as practicable.

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<sup>10</sup> The parties will need to agree whether reimbursement will be made by staged payments during the course of the works or by a lump sum payment on completion of the works. One of the relevant considerations may be the size and nature of the rectification/maintenance works.

<sup>11</sup> If the balance standing to the credit of Retention Fund Account is not sufficient to cover the whole cost of the rectification and/or maintenance work carried out or procured by the Authority, the Authority can recover the balance from the Contractor either as a debt or through set off under Clause 11 (Set-off).



# 23

## INDEMNITIES, GUARANTEES AND CONTRACTUAL CLAIMS

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### 23.1 INTRODUCTION

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**23.1.1** The Authority will often be contracting with a Contractor which is a special purpose vehicle with no track record of service delivery and whose main asset is the Contract. The Authority will therefore require comfort that the SPV and its Sub-contractors will be able to meet their contractual obligations to provide the Service and any corresponding financial liabilities.

**23.1.2** In a traditional procurement, such comfort would normally take the form of guarantees, indemnities and collateral warranties to the Authority provided by the principal Contractor, its parent company and Sub-contractors. Under PFI, where the majority of projects are financed on a limited recourse basis and the Contractor is not paid if the Service is not delivered, such extensive direct comfort will not normally be necessary or appropriate.

**23.1.3** The Authority will, however, require certain types of comfort from the Contractor. This Section advises on the type of comfort the Authority should normally expect.

### 23.2 GUARANTEES

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**23.2.1** Authorities will have to be sure that continuity of service supply is maintained even if their counterparty is insolvent. In many service contracts this can be done by way of a guarantee by a parent company (whether this company is the ultimate parent company in a group or a sufficiently claim worthy person will be a matter for negotiation). In a Contract for the period of time that PFI contracts are typically provided for, such guarantees can be of much less value.

**23.2.2** A limited recourse structure is typically used in PFI projects as it isolates and limits the liabilities of the Project from those of the shareholders. Consequently, the obtaining of direct guarantees by the Authority is not normally appropriate. The Authority should generally not insist on receiving guarantees from the parent companies of a Sub-contractor or the Contractor's shareholders in respect of the obligations of the Contractor.

**23.2.3** A well-advised Authority can usually obtain sufficient comfort from a well structured limited recourse project, provided Sub-contractors have a suitable track record and financial standing; that the levels of equity are sufficient to demonstrate a commitment of shareholders to the Project and the rest of the financing structure is sufficiently robust. Appropriate levels of equity may well differ in the operating phase from the development or construction phase and will vary from project to project. This involves an analysis of the entirety of the structure (including the Contract, all Project Documents and any limits on liability of the Sub-contractors under their Sub-Contracts), any liability interfaces (such as which Sub-contractor is liable in the period between completion of construction and commencement of operation) and an understanding of the step-in rights of the Senior Lenders and other rights of the financiers (see Section 30 (Direct Agreement)).

**23.2.4** One of the advantages in structuring projects on a limited recourse basis is that it requires bidders to thoroughly investigate all risks relating to the Project and clearly allocate the risks in a manner that delivers a robust project<sup>1</sup>.

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<sup>1</sup> See Section 6.2 (Due Diligence).

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**23.2.5** If the Contractor is funding the project from its own internal resources and there is no third party Senior Debt being provided to the Contractor, the Authority should:

- assess the credit strength of the Contractor and consider whether or not it should require the Contractor to provide it with a guarantee from its parent or strongest credit within its group; and
- consider whether or not it should require the Contractor to maintain financial covenants throughout the term of the Contract.

## **23.3 INDEMNITIES**

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**23.3.1** The Authority will want to ensure the Contract requires the Contractor to indemnify the Authority against certain costs and the Contractor will make provision for such contingent liability in its bid price.

**23.3.2** The general principle in civil procurement is that there should be no limit on indemnities provided to the Authority. This principle can be overridden, however, if commercial necessities demand. In PFI projects there will be restricted instances where the Authority should consider limiting the scope or amount of the indemnity, as set out in paragraph 23.3.4 below.

**23.3.3** An analysis of the limits on liabilities under the Contract will be part of the assessment by the Authority of the strength of its counterparty. The existence and extent of any indemnity should be considered in conjunction with other obligations imposed on the Contractor and Sub-contractor (e.g. under collateral warranties). In this context Section 23.6 (Damages Claims) is relevant. The levels of insurance in respect of any likely claim are also relevant in the consideration of what an appropriate limit is.

**23.3.4** Broadly, there are four heads of liability that the Authority will be concerned to be indemnified against if the liability arises as a result of the Contractor's operations. These are:

- death and personal injury;
- property damage;
- breach of statutory duty; and
- third party claims.

The Contractor (and the Senior Lenders) will be particularly concerned with the potential scope of third party claims<sup>2</sup> or claims relating to Authority Property. Therefore the Authority should consider the value for money implications of seeking an uncapped indemnity from the Contractor in this respect<sup>3</sup> (particularly bearing in mind the extent or potential extent of Authority Property in the context of the project). The Contractor's liability in respect of the other heads of claim described above should, however, not generally be capped.

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<sup>2</sup> The Authority should consider whether or not it is appropriate to exclude consequential loss from the scope of the indemnity provisions. This approach has been adopted in the NHS sector, although in other sectors (e.g. transport) the potential for claims from third parties in relation to consequential loss may be greater.

<sup>3</sup> For example, liabilities relating to environmental risk will typically be capped for value for money reasons.

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**23.3.5** The Authority should not generally use the indemnity provisions in the Contract as an additional layer of protection for specific remedies set out in the Contract. For example, if the deductions being made to the Unitary Charge under the performance mechanism are a genuine reflection of the losses that the Authority will incur as a result of the Contractor's non-performance, the Authority should not generally seek to rely on the indemnity as an additional or alternative means of claiming against the Contractor in respect of that loss.

**23.3.6** Given the project specific nature of many of the employment issues that arise on projects no guidance can be given on either employment indemnities or issues arising out of the Transfer of Undertakings (Protection of Employment) Regulations 1981 SI No. 1794, save that they are appropriate in some cases.

**23.3.7** The Authority may be faced with a request for a reciprocal indemnity from the Contractor. A general indemnity from the Authority should not be offered in response to such a request. If the request relates to possible breach of the Authority's obligations under the Contract, this should be dealt with under Compensation Events (see Section 5.2.1.4); and if the request relates to acts of the Authority during a Step-In this is dealt with separately as part of any Step-In arrangements (see Section 28.5.1). Exceptionally an Authority may be faced with project specific issues which require it to offer a reciprocal indemnity, in which case the Authority should ensure that the indemnity is limited to the specific issue.

**23.3.8** Appropriate drafting for a general form of indemnity from the Contractor is as follows:

### **23.3 Indemnity**

- (a) The Contractor shall, subject to paragraph (b), be responsible for, and shall release and indemnify the Authority, its employees, agents and contractors on demand from and against, all liability<sup>4</sup> for:
  - (i) death or personal injury;
  - (ii) loss of or damage to property (including property belonging to the Authority or for which it is responsible "Authority Property");
  - (iii) breach of statutory duty; and
  - (iv) actions, claims, demands, costs, charges and expenses (including legal expenses on an indemnity basis)<sup>5</sup>,

which may arise out of, or in consequence of, the design, construction, operation or maintenance of the assets or the performance<sup>6</sup> or non-performance by the Contractor of its obligations under this Contract or the presence on the Authority's property of the Contractor, a Sub-contractor, their employees or agents.

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<sup>4</sup> See footnote 2 above.

<sup>5</sup> See Section 23.6.3.

<sup>6</sup> The Contractor will perform its obligations under the Contract in accordance with the solution it offers as part of its bid and in putting together such solution should have regard to the indemnity provisions. Accordingly, the Contractor should take account of the potential liability under the indemnity provisions in developing its methodology and pricing its bid. Some Contractors may try to argue that the indemnity provisions should only be triggered if the relevant liability arises as a result of (a) the Contractor being in breach of or not performing its obligations under the Contract; or (b) the Contractor being negligent. Such requests are unacceptable as they bring the risk of the Contractor's delivery plan (to meet the output specification) back on to the Authority. The only exception to this will be if the Authority has specified input requirements or is providing a degree of design sign-off (see Section 3.4) in which case the indemnity may need to acknowledge this.

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- (b) The Contractor shall not be responsible or be obliged to indemnify the Authority for:
- (i) any of the matters referred to in paragraphs (a)(i) to (iv) above which arises as a direct result of the Contractor acting on the instruction of the Authority;
  - (ii) any injury, loss, damage, cost and expense caused by the negligence or wilful misconduct of the Authority, its employees, agents or contractors or by the breach by the Authority of its obligations under this Contract; or
  - (iii) any claims made under Clause 23.3(a)(ii) in respect of Authority Property or 23.3(a)(iv) in excess of [ ]<sup>7</sup>.
- (c) An indemnity by either party under any provision of this Contract shall be without limitation to any indemnity by that party under any other provision of this Contract<sup>8</sup>.

**23.3.9** This clause will also need to deal with:

- giving notice of claims (stating in reasonable detail the nature of the matter and the amount claimed). This will enable the proceedings to be contested before any judgment in respect of such proceedings is given;
- taking any action insurers may request to dispute the matter or enforce rights against any person;
- the exclusive conduct of the proceedings by the party giving the indemnity although it may be that certain politically sensitive issues would require the Authority to control proceedings which will require specific agreement; and
- there being no admission of liability or settlement of the matter without the consent of the indemnifying party.

## **23.4 COLLATERAL WARRANTIES**

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**23.4.1** An Authority may seek a collateral warranty (i.e. a direct contractual undertaking) from each of the Sub-contractors giving direct claims in some circumstances. This does not undermine the limited recourse nature of the Project, provided that the content of any undertakings requested dovetail with the overall approach to the Project structure. That is:

- they should not be used to increase levels of liability or impose obligations where none would otherwise exist (see Sections 23.3 (Indemnities) and 23.6 (Claim for Damages));
- they should not be used to undermine the rights of Senior Lenders (see Section 23.5 (Financiers' Security)); and
- they should not grant rights to the Authority prior to early termination (see Section 20 (Early Termination)).

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<sup>7</sup> This will often involve both a limit on an annual basis and in total. Alternatively, it may be more appropriate to specify two caps on indemnity claims: one for insured losses (e.g. third party liability), the other for uninsured losses. This approach has been adopted in the prison sector. Another approach would be to specify caps for particular types of indemnity claim (e.g. environmental claims).

<sup>8</sup> See Section 23.6 (Damages Claims).

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**23.4.2** In the event that such undertakings are required and sought, the Authority should consider the strength of the covenant of the counterparty in the light of the obligation in the warranty. It may be that they are required to be guaranteed by the parent companies (or other companies of substance within the group) of the relevant Sub-contractors. Except in the case of rights that exist to protect the position of the Authority<sup>9</sup>, the rights of the Authority to bring an action under these collateral warranties should, however, be exercisable on an early termination and then only after the Senior Lenders have exercised any direct rights they have against the Sub-contractors concerned. This should not be objectionable to the Authority as any recovery made by the Senior Lenders in such a situation will often result in a direct reduction from any termination compensation to be paid.

## **23.5 FINANCIERS' SECURITY**

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**23.5.1** Although the interests of the Authority are not necessarily the same as those of the Senior Lenders, the Authority can take some comfort from the fact that Senior Lenders will usually insist on a security package from the Contractor and its consortium in return for providing the necessary debt finance. In the event of a default by the Contractor under the Senior Financing Agreements, Senior Lenders will be able to enforce their security and put the proceeds towards repaying Senior Debt. Such security may consist of an assignment of the Contractor's rights under the Project Documents, collateral warranties and performance bonds from the Construction Sub-contractor, guarantees from the shareholders in the Contractor and shareholders of the Sub-contractors. The Contractor and its consortium will, therefore, be under a great incentive to perform their obligations under the Contract to ensure that the security is never called.

**23.5.2** Any such comfort that is taken should be qualified by the fact that the Senior Lenders will in many cases be repaid prior to the Expiry Date and so the Authority should be careful in placing undue reliance on such comfort.

## **23.6 DAMAGES CLAIMS**

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**23.6.1** It is common practice to limit the ability of the Authority and the Contractor to make claims against each other for breach of obligation under the Contract. The rationale for limiting this ability is that the Contract payment mechanism is structured to ensure that there is an incentive to perform and that any deduction as a result of the payment mechanism reflects the loss to the Authority and so should usually be the exclusive remedy of the Authority.

**23.6.2** The issues here are similar to those in Section 4.2 (Liquidated Damages). This is because the issue of when liquidated damages and general damages claims are appropriate are closely connected. The Authority should strive to ensure that the performance payment mechanism works in such a way as to ensure that during the term of the Contract the absence of the Service reflects the costs the Authority incurs in not receiving the Service.

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<sup>9</sup> For example, liquidated damages under Section 4.2 (Liquidated Damages).

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**23.6.3** There will, as described in Section 4.2 (Liquidated Damages), be circumstances in which relying on the non-payment of the Unitary Charge is insufficient to compensate the Authority for its loss. For the reasons given in that Section, liquidated damages may be appropriate. A general damages claim is not something that the Authority should seek to obtain or preserve.<sup>10</sup> A combination of the payment mechanism and market value assessment should deal with issues that are required to be covered. To the extent particular categories of claim need special treatment, they should explicitly be dealt with in Clause 23.3 (Indemnity).

**23.6.4** On a termination for Contractor Default, the Contractor will have an ability to pursue claims against Sub-contractors (this right will be taken as security by the Senior Lenders). This can lead to the Authority reasoning that it should have a right to claim in such a situation too. This may be the case in some situations (as described above), but in many cases (and probably most cases) the deductions from termination compensation payments will reflect any amount which, in traditional procurement, the Authority would normally expect to claim from the Contractor.

**23.6.5** On termination for Contractor Default, not all amounts which the Authority could claim on a termination are reflected in a reduced market value compensation payment. Examples would include claims under Clauses 23.3 (Indemnity), 25 (Information and Confidentiality) and 26 (Intellectual Property Rights) and claims against the Authority by third parties. To the extent these claims are not deducted from the market value payment (for example for reasons set out in Section 11 (Set-off)), they should continue to be exercisable after termination. Such rights should therefore if relevant be included in any collateral warranties.

**23.6.6** The limits on liability within collateral warranties should be within the overall required limits on indemnities within the Contract (and, by implication, the sub-contracts) (see Sections 23.3 (Indemnities) and 23.4.1 (Collateral Warranties)). Accordingly, claims against indemnities which reduce the capped liability within the Contract should have the same effect on the maximum liabilities under the collateral warranties and vice-versa. The Authority should assess the optimum level of such a limit, taking into account all circumstances, such as value for money, consideration of specific rules and the issues referred to above.

**23.6.7** Care should be taken to ensure that amounts dealt with under the payment mechanism or market value compensation on termination payment are not capable of being claimed, as this could result in double counting.

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<sup>10</sup> The Authority should recognise the importance of the relationship between its right to claim damages for breach of Contract, its ability to make deductions from the Unitary Charge and the scope of the indemnity provisions. For example, if the majority of the Contractor's income is generated through third party use or through charging the public for use of the Services, the Unitary Charge may be insufficient to allow the Authority to make deductions that are a realistic reflection of its loss. In such circumstances the Authority should not limit its right of recourse to deductions in the Unitary Charge.

# 24 INSURANCE

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## 24.1 INTRODUCTION

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**24.1.1** Traditionally, central government has chosen not to take out commercial insurance against most risks retained under conventional procurement techniques as the premiums payable have not been seen to represent good value for money compared to self-insurance.

**24.1.2** Under PFI a greater range of risks is transferred to the private sector. The financing arrangements behind most Contracts and the need to ensure continuity of service means that self-insurance for the full range of risks is not a practical option for the Contractor. Indeed insurance requirements of the Senior Lenders will usually be extensive, although the Authority should not rely on them. It is essential for the Authority to seek professional insurance advice on what requirements should be imposed on the Contractor at an early stage in the procurement process (before issuing the ITN) and during negotiations.

**24.1.3** The main issues are whether and the extent to which the Authority should require the Contractor to take out and maintain certain insurances as a means of managing particular risks, what should happen if any required insurance becomes unavailable and ensuring that the proceeds of any claim under any required insurance are used correctly by the Contractor.

## 24.2 AUTHORITY'S REQUIREMENTS

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**24.2.1** In order to optimise risk transfer, the Authority should allow the Contractor to manage its insurance arrangements as far as possible. In general terms, the Contractor will be expected to insure in accordance with good industry practice<sup>1</sup>.

**24.2.2** There will be a number of required insurances, however, which the Authority will want to know are being taken out and maintained by the Contractor, to ensure that insurance proceeds are available to cover certain types of claims. Such required insurances should include: third party liability claims, construction all risks, material damage claims and employer's liability insurance.

**24.2.3** The Contractor should only be required to take out insurances from which the Authority derives a benefit. In respect of those risks that the Contractor is required to insure against, the Authority should ensure that the uninsurability protection<sup>2</sup> does not extend to cover risks if it would have the effect of undermining the essence of the commercial principle that the risk being covered is a risk that the Contractor is required to manage. For example, if the Contractor is given uninsurability protection in respect of professional indemnity or non-vitiation<sup>3</sup> insurance and cover subsequently becomes uninsurable, the Authority may be required to insure the Contractor against claims relating to the Contractor's (or its sub-contractors') negligence. Authorities should therefore ensure that any professional indemnity and non-vitiation insurances are carved out from the uninsurability protection provided under Clause 24.8 (Risks that become Uninsurable).

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<sup>1</sup> What constitutes good industry practice should be part of the advice sought by the Authority from its professional insurance adviser (see Section 24.1.2 above).

<sup>2</sup> See Section 24.8 (Risks that become Uninsurable).

<sup>3</sup> See Section 24.2.8 below.

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**24.2.4** The Senior Lenders will require the Contractor to take out delay in start-up and business interruption insurance. The effect of these insurances is to ensure that during any period of reinstatement of the Project the Contractor will be able to fund its debt service obligations under the Senior Financing Agreements. If such insurances become unavailable in the market and material damage to the Project subsequently arises, the Contractor may (depending on the period of reinstatement) default under the terms of the Senior Financing Agreements. Without the benefit of uninsurability protection for delay in start-up and business interruption insurances, Senior Lenders are likely to require contingencies to be put in place by the Contractor to cover such eventualities. In such circumstances the Authority should, on value for money grounds, extend uninsurability protection in the Contract to cover business interruption insurance<sup>4</sup> and, in limited circumstances, delay in start-up insurance<sup>5</sup>. The Authority should not, however, allow uninsurability protection to be given in respect of any advance loss of profits insurance that the Contractor may take out.

**24.2.5** Insurance requirements should reflect the degree of risk transfer, the ability of the Contractor to make the premium payments (relative to the size of the risks), value for money considerations and the specifics of the Project. There are, of course, standard insurances that are required during the construction and operating phases of all projects although the sums insured and deductibles will clearly be different. The scope of insurances (the risks, the exclusions, the endorsements, the amounts of cover and the deductibles) will vary from project to project and sector to sector<sup>6</sup>. The Authority and its advisers must focus on the value of the risks to be insured when assessing what is the appropriate level of insurance to require.

**24.2.6** If the Authority wishes to increase the limits or scope of the insurances during the life of the Contract, then this should be treated as an Authority Change (see Section 12.3 (Authority Changes)).

**24.2.7** As central Government often self-insures, there should be no requirement for any insurance to cover those risks retained under the Project by a central Government Authority. It is, however, reasonable to seek third party public liability insurance where appropriate (this should be checked with the relevant policy unit within the Authority). The Authority should protect its position by being a co-insured for its own interests (where it has an insurable interest) and requiring its interests to be noted as appropriate on the insurances taken out by the Contractor. This should be acceptable to the Contractor<sup>7</sup>.

**24.2.8** The Authority should consider the value for money benefits of requiring the Contractor to take out “non-vitiation” protection in respect of certain required insurances. Non-vitiation protection allows the Authority to claim as a co-insured under a policy even if the insurer would be able to avoid a claim made by the Contractor on the basis that the Contractor, for example, withheld material or information from the insurer (e.g. the Contractor does not make the insurer aware that it is intending to use highly flammable substances during the construction period). The Senior Lenders may also require non-vitiation cover. However, absence of such cover should not be covered by the protection given to the Contractor in respect of unavailability of insurance cover<sup>8</sup>.

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<sup>4</sup> See footnote 35 below.

<sup>5</sup> Generally, the delay in start-up policy (as distinct from business interruption insurance) will be placed at financial close, will be non-cancellable by the insurers and will cover the entire construction period. In some projects, however, the construction period may be so long that the Contractor is unable to place a delay in start-up policy at financial close that covers the entire construction period. Only in such rare circumstances is it appropriate for delay in start-up insurance to benefit from the uninsurability protection.

<sup>6</sup> Salient information as to the scope of the required insurances specified in Section 24.2.2 should be included within the schedules to the Contract referred to in paragraphs (a) and (b) of Clause 24.2 (Insurance).

<sup>7</sup> Where possible, the Authority should be a co-insured on the Contractor’s insurance policies. This is a much stronger position for the Authority than being named as “loss payee” under the policy, as a co-insured can make the claim itself and is not (as in the case of a “loss payee”) reliant on the insured party making the claim.

<sup>8</sup> See Section 24.8 (Risks that become Uninsurable).

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Suitable drafting is as follows:

## 24.2 Insurance

- (a) The Contractor shall, prior to the Service Commencement Date, take out and maintain or procure the maintenance of the insurances described in [Schedule] and any other insurances as may be required by law. These insurance must be effective in each case not later than the date on which the relevant risk commences<sup>9</sup>.
- (b) The Contractor shall during the Service Period take out and maintain or procure the maintenance of the insurances described in Schedule [•] (Required Insurances) and any other insurances as may be required by law<sup>10</sup>.
- (c) No party to this Contract shall take any action or fail to take any reasonable action, or (insofar as it is reasonably within its power) permit anything to occur in relation to it, which would entitle any insurer to refuse to pay any claim under any insurance policy in which that party is an insured, a co-insured or additional insured person.
- (d) The insurances referred to in paragraphs (a) and (b) shall:
  - (i) subject to paragraph (e) below, name the Contractor as co-insured with any other party maintaining the insurance;
  - (ii) [provide for non-vitiation protection in respect of any claim made by the Authority as co-insured];
  - (iii) contain a clause waiving the insurers' subrogation rights against the Authority, its employees and agents;
  - (iv) provide for 30 days prior written notice of their cancellation, non-renewal or amendment to be given to the Authority; and
  - (v) provide for payment of any proceeds to be made by insurers in accordance with Clause 24.6 (Reinstatement).
- (e) Wherever possible, the insurances referred to in paragraphs (a) and (b) shall name the Authority as a co-insured for its separate interest<sup>11</sup>.
- (f) The Contractor shall provide to the Authority:
  - (i) copies on request of all insurance policies referred to in paragraphs (a) and (b) (together with any other information reasonably requested by the Authority relating to such insurance policies) and the Authority shall be entitled to inspect them during ordinary business hours; and
  - (ii) evidence that the premiums payable under all insurance policies have been paid and that the insurances are in full force and effect in accordance with the requirements of this Clause 24.2 (Insurance) and Schedule [ ] (Required Insurances).

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<sup>9</sup> These are the construction or development phase insurances and must be required insurances only. The insurance schedule should specify the dates these insurances should be effective by.

<sup>10</sup> These are the operational insurances and must be required insurances only. In some projects the operational phase may overlap with the construction phase (e.g. a grouped schools project) and insurance requirements will need to be tailored accordingly.

<sup>11</sup> This will only be possible on policies for which the Authority has an insurable interest (not, for example, employer's liability or professional indemnity insurance).

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- (g) Renewal certificates in relation to the insurances referred to in paragraphs (a) and (b) shall be obtained as and when necessary and copies (certified in a manner acceptable to the Authority) shall be forwarded to the Authority as soon as possible but in any event on or before the renewal date.
  - (h) If the Contractor is in breach of paragraphs (a) or (b) above, the Authority may pay any premiums required to keep such insurance in force or itself procure such insurance<sup>12</sup> and may in either case recover such amounts from the Contractor on written demand<sup>13</sup>.
  - (i) The Contractor shall give the Authority notification within 30 days after any claim in excess of £[ ] on any of the insurance policies referred to in this Clause accompanied by full details of the incident giving rise to the claim<sup>14</sup>.
  - (j) Neither failure to comply nor full compliance with the insurance provisions of this Contract shall limit or relieve the Contractor of its liabilities and obligations under this Contract.
  - (k) The insurance premiums referred to in paragraphs (a) and (b) shall be the responsibility of the Contractor.

## 24.3 MECHANISM TO INCREASE INSURED AMOUNTS

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**24.3.1** It is difficult to place insurance to cover the full life of a Contract. Aside from the construction phase, policies are often renewable annually. There must be a mechanism to ensure that the insured amount increases over the duration of the Contract in order to keep pace with inflation<sup>15</sup>. This is commonly done through an index linking mechanism. Alternatively it may be by agreement on expiry of policies.

**24.3.2** Index-linking can cause a problem for liability insurance if it cannot be bought in odd amounts (i.e. £50, £51.15, £52.53 etc) although this is normally dealt with by rounding up annually to the nearest whole insurable amount.

**24.3.3** The risk of increases in insurance costs should be borne by the Contractor<sup>16</sup>. Whilst there may ultimately be an indirect partial pass-through (e.g. via indexation and benchmarking (see Section 14.2 (Indexation) and Section 14.4 (Benchmarking)), the Contract should not include any provisions which expose the Authority to direct pass-through of such extra costs (save as described in Section 24.8 (Risks That Become Uninsurable)). Increases in insurance premiums which result from Authority Changes (see Section 12.3 (Authority Changes)) should be taken into account in any price variations resulting from the change in Service. The Contractor should bear any premium increases resulting from any change in Service it proposes (see Section 12.5 (Contractor Generated Changes in Service)).

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<sup>12</sup> This will not be possible for insurances in respect of which the Authority has no insurable interest.

<sup>13</sup> These amounts can be set off under Clause 11 (Set-Off).

<sup>14</sup> On projects on which many claims are expected, the Authority can agree a minimum amount below which is not notified. If this is done, it may be necessary for the Authority to be notified of important claims (e.g. accident and injury based claims).

<sup>15</sup> This will not be necessary where the insured amount is an unspecified amount (e.g. the reinstatement cost of a property) rather than a specific sum (as is usually the case for third party liability cover).

<sup>16</sup> This risk relates not only to increased premia but also to increased levels of deductibles. See Section 24.8.1.

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**24.3.4** Notwithstanding the principles stated in Section 24.3.3 above, it does not represent best value for money if bidders price worst case scenarios for future insurance premium levels into their bids. HMT is currently considering ways in which this can be addressed and is working with consultees from the public and private sector to agree an appropriate mechanism for dealing with increases in insurance costs over the term of the Contract that are attributable to market movements. In the meantime, Authorities should refer to HMT Guidance on Insurance Issues and should contact HMT or PUK if they are facing requests from bidders for price protection in respect of insurances to be included in the Contract. In no circumstances should the Authority introduce benchmarking of insurance provisions into the Contract. It is intended that the proposed price protection mechanism will operate in addition to the uninsurability protection set out in the Contract<sup>17</sup> and that the uninsurability provisions will be amended to allow the Authority to claim that a risk has become uninsurable.

## **24.4 ENSURING THE QUALITY OF THE INSURANCES**

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**24.4.1** The Contract should require that all insurances are placed through a reputable insurer of good standing. In practice financiers will ensure that insurances will be arranged by and placed with brokers and insurers approved by them (or that fall within a particular category) and on terms acceptable to them.

The way this is normally done is as follows:

The insurances referred to in this Clause shall be effected with insurers approved by the Authority, such approval not to be unreasonably withheld or delayed.

**24.4.2** There is usually no need to limit the market within which the Contractor must insure the relevant risks (e.g. the worldwide market is not unusual).

## **24.5 CHANGES IN THE TERMS OF INSURANCE POLICIES**

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Insurers should inform the Authority of changes in the policy (see Clause 24.2(d) above).

## **24.6 REINSTATEMENT AND CHANGE OF REQUIREMENT AFTER INSURED EVENT**

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**24.6.1** If an insured event occurs and certain Assets require replacement or reinstatement<sup>18</sup>, the Authority may decide to change the service requirement. If it does so, the cost of reinstatement may be more or less than the cost of exact replacement. Clearly there is no problem where the cost is less. Where insurance proceeds do not cover the full reinstatement, and the additional cost is due to an Authority Change (and not under-insurance by the Contractor of the original asset), then the extra cost must be funded by the Authority in accordance with the change in Service mechanism (see Section 12.3 (Authority Change)).

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<sup>17</sup> See Section 24.8 (Risks that Become Uninsurable).

<sup>18</sup> See Clause 24.6(c)(ii)(D).

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**24.6.2** Insurance should be available for full reinstatement and the Contractor should be required to negotiate insurance to reflect the fact that the Authority's requirements may change after an insurance events occurs and that it is possible that there will be a requirement for something other than full or exact reinstatement<sup>19</sup>.

**24.6.3** In practice, the parties are likely to discuss and negotiate whether (and how) to reinstate the Project after the occurrence of an insured event. Accordingly, the Contract should set out provisions regarding how the parties will agree a plan for the reinstatement of the project. The Contract must be clear as to the remedy in the event of disputes over reinstatement.

**24.6.4** The Authority has a clear interest in the application of any insurance proceeds received by the Contractor under the physical damage policies that are to be applied in reinstatement of the project. Although the Authority agrees a Reinstatement Plan with the Contractor, the Authority should also be concerned to ensure that that any insurance proceeds are utilised in accordance with the agreed Reinstatement Plan. Additionally, the Authority must ensure that upon termination of the Contract (either through natural expiry or early termination) the Authority receives the benefit of any insurance proceeds so that it can continue with the reinstatement of the project<sup>20</sup>.

Required drafting is as follows:

#### **24.6 Reinstatement**

- (a) Subject to Clause 24.7 (Economic Test), all insurance proceeds received under any policy referred to in Section [ ] of the Schedule (the Physical Damage Policies)<sup>21</sup> shall be applied to repair, reinstate and replace each part or parts of the Assets in respect of which the proceeds were received.
- (b) All insurance proceeds paid under any Physical Damage Policy in respect of a single event (or a series of related events) in an amount in excess of £[minimum level] (indexed) shall be paid into the Joint Insurance Account<sup>22</sup>.
- (c) Subject to Clause 24.7 (Economic Test), where a claim is made or proceeds of insurance are received or are receivable under any Physical Damage Policy in respect of a single event (or a series of related events) (the ("Relevant Incident") in an amount in excess of £ [the same figure as in paragraph (b) above ] (indexed):
  - (i) the Contractor shall deliver as soon as practicable and in any event within [28] days after the making of the claim a plan prepared by the Contractor for the carrying out of the works necessary (the "**Reinstatement Works**") to repair, reinstate or replace (the "**Reinstatement Plan**") the assets which are the subject of the relevant claim or claims in accordance with paragraph (d) below. The Reinstatement Plan shall set out:
    - (A) if not the Construction Sub-contractor, the identity of the person proposed to effect the Reinstatement Works, which shall be subject to the prior written approval of the Authority; and

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<sup>19</sup> If the Authority decides to reinstate with a lower level of service requirement following an insured event, the Unitary Charge should remain the same unless compensation is paid to the Contractor. The Authority should also be aware of the fact that a decision not to reinstate fully may impact upon the amount of insurance proceeds recoverable.

<sup>20</sup> This is particularly important if the Contract is terminated for Contractor Default and the Authority elects (and is able) to retender the Contract.

<sup>21</sup> This will not include, for example, third party liability, employers' liability, business interruption or advance loss of profits insurance.

<sup>22</sup> See Section 1.8 (Interpretation) for definition.

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- (B) the proposed terms and timetable upon which the Reinstatement Works are to be effected (including the date that the Project will become fully operational), the final terms of which shall be subject to the prior written approval of the Authority;
- (ii) provided that the Authority is satisfied<sup>23</sup> that the Reinstatement Plan will enable the Contractor to comply with paragraph (d) below within a reasonable timescale:
- (A) the Reinstatement Plan will be adopted;
- (B) the Contractor shall enter into contractual arrangements to effect the Reinstatement Works with the person identified in the approved Reinstatement Plan approved by the Authority;
- (C) prior to the earlier to occur of the Termination Date or the Expiry Date, any amounts standing to the credit of the Joint Insurance Account (the “**Relevant Proceeds**”) (together with any interest accrued) may be withdrawn by the Contractor from Joint Insurance Account as required to enable it to make payments in accordance with the terms of the contractual arrangements referred to in paragraph (ii)(B) above, and to meet any other reasonable costs and expenses of the Contractor for the sole purposes of funding the Reinstatement Works. Following the earlier to occur of the Termination Date and the Expiry Date, the Authority may withdraw amounts standing to the credit of the Joint Insurance Account for the purposes of funding any Reinstatement Works;
- (D) the Authority agrees and undertakes that, subject to compliance by the Contractor with its obligations under this clause, and provided that the Contractor procures that the Reinstatement Works are carried out and completed in accordance with the contractual arrangements referred to in paragraph (ii) (B), it shall not exercise any right which it might otherwise have to terminate this Contract by virtue of the event which gave rise to the claim for the Relevant Proceeds<sup>24</sup>;
- (E) the Authority undertakes to use reasonable endeavours to assist the Contractor in the carrying out of the Reinstatement Plan; and
- (F) after the Reinstatement Plan has been implemented to the reasonable satisfaction of the Authority and in accordance with paragraph (d) below the Authority shall permit withdrawal by the Contractor of any Relevant Proceeds then held in the Joint Insurance Account that have not been paid under paragraph (ii)(C) above, in respect of the Relevant Incident, together with any interest accrued.

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<sup>23</sup> The Authority should be aware that following any physical damage to the project, the Contractor will only be permitted to claim under any business interruption or advance loss of profits insurance if the insurer is satisfied that the Contractor is using its reasonable endeavours to reinstate. Accordingly, the Authority’s response to the proposed Reinstatement Plan should be reviewed by the Authority as a matter of priority and the Authority should respond to the Contractor within a reasonable period of time.

<sup>24</sup> This would apply if the definition of Relief Events (see Section 5.3.2 (Scope of Relief Events)) did not cover the insured event giving rise to the issue of reinstatement. If this is the case then the Contract should confirm that the concepts of Compensation Events and Relief Events (see Section 5 (Delays)) will apply during the period of carrying out the Reinstatement Works so that, for example, any Authority Change (see Section 12.3 (Authority Changes)) will be treated as a Compensation Event (see Section 5.2.1.2) during this period.

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- (d) Where insurance proceeds are to be used, in accordance with this agreement, to repair, reinstate or replace any Asset, the Contractor shall carry out the work in accordance with the [Construction Specification] so that on completion of the work, the provisions of the Contract are complied with.

## **24.7 APPLICATION OF INSURANCE PROCEEDS**

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**24.7.1** The Contractor should always be obliged to reinstate the asset and the Service if an insurance event occurs. If the Authority does not require reinstatement, then any insurance proceeds should go to the Contractor but the Authority should be aware that this effectively results in a voluntary termination and the Authority will be obliged to make a full payout to the Contractor (see Section 20.5 (Voluntary Termination)), but deducting such amounts from the payment.

**24.7.2** In some projects, Senior Lenders want to impose a project economic test to determine whether reinstatement will enable them to recover their outstanding debt in full. If the economic test shows that this is not possible, Senior Lenders prefer to “head for the hills” and appropriate the insurance proceeds instead of allowing reinstatement. This should not be a first resort for the Senior Lenders and there should be good reasons for the Authority to agree to the inclusion of an economic reinstatement test in the Contract. Senior Lenders should focus instead on ensuring that the amount insured under the advance loss of profits and business interruption insurances is sufficiently high or that there is sufficient contingency in the Contractor to deal with their concerns.

**24.7.3** A project economic test should not be necessary where there is a low risk of total destruction of the asset (such as with a road or rail project, or a project that has a large number of geographically diverse sites). Where the risk exists (e.g. a single site project), the Authority may have to accept a project economic test but this should be based on a default senior loan life cover ratio so that Senior Lenders cannot abandon the Project if the test shows that debt service is achievable (even if there is a minimal amount of headroom). Certain projects include debt service cover ratios in an economic test. This is not recommended for inclusion in an economic test (as the debt service cover ratio contains only an annual “snapshot” of performance, which is not relevant here). There should be no need to specify a threshold amount of insurance proceeds below which the economic test should not be applied because the test should in any event only be applied in cases of total or near total destruction.

**24.7.4** If the result of the project economic test allows the Senior Lenders to take the insurance proceeds or an amount equal to the outstanding Senior Debt (whichever is the lesser), the Contractor remains under an obligation to reinstate the asset. If, as is likely, it is not financially able to do so, it will be in breach of contract and the Authority will terminate for Contractor Default in the usual way (see Section 20.2 (Termination for Contractor Default)). The Authority can then rebuild the asset through a new competition.

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Required drafting is as follows:

#### 24.7 Economic Test

- (a) If all of the Assets are destroyed or substantially destroyed in a single event and the insurance proceeds (when taken together with any other funds available to the Contractor<sup>25</sup>) are equal to or greater than the amount required to repair or reinstate the Assets, then the Contractor<sup>26</sup> shall calculate<sup>27</sup> the senior debt loan life cover ratio<sup>28</sup> (on the assumption that the Assets are repaired or reinstated in accordance with Clause 24.6 (c)).
- (b) If the calculation referred to in paragraph (a) above shows that the senior debt loan life cover ratio is greater than or equal to [event of default level] then the Contractor shall be subject to the procedure set out in Clause 24.6 (Reinstatement).
- (c) If the calculation referred to in paragraph (a) above shows that the senior debt loan life cover ratio is less than [event of default level] then an amount equal to the lesser of:
  - (i) the insurance proceeds; and
  - (ii) the Base Senior Debt Termination Amount, or, if any Additional Permitted Borrowing has been advanced, the Revised Senior Debt Termination Amount<sup>29</sup>, shall be released from the Joint Insurance Account to the Contractor<sup>30</sup>.
- (d) If, pursuant to paragraph (c) above, insurance proceeds are released from the Joint Insurance Account the Contractor shall be in breach of its obligations under this Contract (and shall not be relieved of its obligations pursuant to clause 5.3) unless it can demonstrate, to the satisfaction of the Authority, that it can carry out the works necessary to repair, reinstate or replace the assets which are subject to the relevant claims in accordance with Clause 24.6(d) (Reinstatement) and within a reasonable timescale.

## 24.8 RISKS THAT BECOME UNINSURABLE

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**24.8.1** The Contract must address the situation where a risk required to be insured against (i.e. a risk covered by a required insurance) and which was previously insurable becomes uninsurable. The approach adopted concentrates upon the availability of insurance cover for a particular risk rather than the availability of cover upon particular terms or with particular levels of deductibles. The consequences of uninsurability (ranging from Contractor Default to the Authority accepting liability for occurrence of the event) will depend on the type of risk involved and whether either party was responsible for the uninsurability.

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<sup>25</sup> Such funds could, for example, include sums made available to the Contractor by the Authority to ensure that the test in paragraph (b) is passed and that, as a result, reinstatement occurs in accordance with Clause 24.6 (Reinstatement).

<sup>26</sup> The calculation will be controlled by the Senior Lenders in the Financing Agreements, and checks will need to be made by the Authority that this calculation allows reinstatement.

<sup>27</sup> There will be a debate as to how this should be done. Since the Senior Lenders are those whose interests are being protected, the formulae set out in the banking financial model should be used, having agreed exactly how the formula will work and memorialised this in the Contract (see footnote 26 above).

<sup>28</sup> For the meaning of this ratio see Section 5.2.3 (Calculation of Compensation).

<sup>29</sup> Excluded from this will be amounts standing to the credit of the account into which the insurance proceeds are paid.

<sup>30</sup> This will mean the amounts are released to the accounts secured to Senior Lenders and the Senior Lenders will apply such amounts as a prepayment against Senior Debt.

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The required definition of “Uninsurable” for these purposes is as follows:

**“Uninsurable”**

means, in relation to a risk, either that:

- (a) insurance<sup>31</sup> is not available to the Contractor in respect of the Project in the world-wide insurance market with reputable insurers of good standing in respect of that risk; or
- (b) [the insurance premium payable for insuring that risk is at such a level that the risk<sup>32</sup> is not generally being insured against in the worldwide insurance<sup>33</sup> market<sup>34</sup> with reputable insurers of good standing by contractors in the United Kingdom.]<sup>35</sup>

**24.8.2** The Contractor should not be required to insure risks which become Uninsurable. The following clause should be included to reflect this principle.

Nothing in this clause shall oblige the Contractor to take out insurance in respect of a risk which is Uninsurable.

If, however, a key insurance risk becomes Uninsurable, the Contractor will be in breach of Contract where it has caused the relevant insurance to be unavailable, which will give rise to a termination right for Contractor Default (see Section 20.2.2 (Events Leading to Termination)).

**24.8.3** Unavailability of insurance should not be at the sole risk of the Authority. If either:

- insurance becomes unavailable in respect of a risk which is a particular defined sector specific risk; or
- a particular risk usually covered by construction all risks, material damage business interruption (but not loss of profits)<sup>36</sup> or statutory insurances (including employer’s liability insurance) becomes uninsurable to the extent that the Contractor and other contractors operating in similar sectors shut down their operations as the means of managing the particular risk,

then neither party should be entitled to terminate the Contract. If (in respect of the risk concerned) insurance becomes unavailable for reasons outside the control of the Contractor, then the parties should consider alternative approaches to the risk to consider if they can agree a means by which it can be managed. If, however, no agreement is reached and the risk reverts to the Authority then (subject to Section 24.8.4 below) the amount of the premium previously paid is deducted from the Unitary Charge. If the risk then occurs, the Authority can choose either to pay an amount equal to the insurance proceeds that would have been payable (in which case termination will not occur) or terminate the Contract and pay compensation equivalent to the amount payable on a force majeure termination to the

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<sup>31</sup> This should be expanded further to cross-refer to the principles set out in Section 24.4 (Ensuring the Quality of the Insurances), i.e. for insurances to be considered available, the relevant insurer should be reputable and of good standing. This will, *inter alia*, assist the Contractor in demonstrating any unavailability of insurance.

<sup>32</sup> The effect of this provision should not be to give the Contractor protection against changes in terms of insurance or levels of deductibles, but to only give protection if the cost of insurance (on any terms) is at such a level that the market is not generally insuring against that risk.

<sup>33</sup> To the extent relevant, the wider risk transfer market (rather than just the insurance market) should be referred to. Insurance advice should be taken on this.

<sup>34</sup> This approach is preferable to one dealing with the extent to which prices of premiums have increased.

<sup>35</sup> In projects where the Contractor retains end user risk, the Authority should consider whether it should give the Contractor any price protection in relation to increases in insurance premia (i.e. paragraph (b) of the definition of Uninsurable) as the Contractor can manage such increases by increasing the price that the end user pays for the Services to reflect any increase in insurance premia for the Project.

<sup>36</sup> See Section 24.2.4

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Contractor. As sector specific risks should not apply to most projects, this approach will be limited to the second scenario outlined above in the majority of projects.

**24.8.4** The Contractor should not be obliged to continue to provide services under the Contract where third party liability cover has ceased to become insurable and the Authority and the Contractor are unable to agree how to manage that risk. In the event that third party liability insurance becomes unavailable for reasons that are outside of the control of the Contractor and the parties are unable to agree the means by which the risk should be managed by the Contractor, the Authority should be able to elect to either self-insure the risk or terminate the Contract and pay compensation to the Contractor equivalent to the amount payable on a Force Majeure termination. If it is agreed that the Contract should continue then the amount of the premium previously paid should be deducted from the Unitary Charge.

**24.8.5** The following is the required approach (assuming such sector specific insurances exist):

#### **24.8 Uninsurable Risks**

(a) If either:

- (i) a Specific Risk<sup>37</sup>; or
- (ii) a risk usually covered by [construction all risks, material damage, third party liability, business interruption (but excluding loss of profit) or statutory insurances]<sup>38</sup>,

becomes Uninsurable then:

- (iii) the Contractor shall notify the Authority within [5] days of the risk becoming Uninsurable; and
- (iv) if both parties agree, or it is determined in accordance with Clause 27 (Dispute Resolution) that the risk is Uninsurable and that:
  - (A) the risk being Uninsurable is not caused by the actions of the Contractor or a Sub-contractor; and
  - (B) in respect of paragraph (a)(ii), the Contractor has demonstrated to the Authority that the Contractor and a prudent board of directors of a company operating the same or substantially similar PFI businesses in the United Kingdom to that operated by the Contractor would in similar circumstances (in the absence of the type of relief envisaged by this clause) be acting reasonably and in the best interests of the company if they resolved to cease to operate such businesses as a result of that risk becoming Uninsurable, taking into account inter alia (and without limitation) the likelihood of the uninsurable risk occurring (if it has not already occurred) , the financial consequences for such company if such uninsurable risk did occur (or has occurred) and other mitigants against such consequences which may be available to such company the parties shall meet to discuss the means by which the risk should be managed (including considering the issue of self-insurance by either party)<sup>39</sup>.

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<sup>37</sup> This risk will be defined on a project specific basis and identified separately from the other insurances. Examples of risks for which insurance cover has ceased to be available at some point in the past include: terrorism and unrestricted pollution liability, although these risks will often not be insured against in a PFI project.

<sup>38</sup> That is, the insurances referred to in Clause 24.2(a) and Clause 24.2(b). See Section 24.2.2 for discussion.

<sup>39</sup> In the event that a risk becomes Uninsurable and the parties are required to meet to discuss how to manage the relevant risk, the Authority should take into consideration the extent to which it may be deemed to be carrying out insurance business in the event that the parties are unable to agree and the provisions of Clause 24.8(b) apply. In the event that the Authority believes that it would be conducting insurance business, it should consider whether it has the necessary powers and authorisations to do so.

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- (b) If the requirements of paragraph (a) are satisfied, but the parties cannot agree as to how to manage the risk, then:
- (i) in respect of third party liability insurance only the Authority shall (at the Authority's option) either pay to the Contractor an amount equal to the amount set out in Clause 20.3.2 (Compensation on Termination for Force Majeure) and the Contract will terminate, or elect to allow the Contract to continue and paragraph (ii) below shall thereafter apply in respect of such risk; and
  - (ii) in respect of [construction all risks, material damage, third party liability (if relevant) business interruption (but not loss of profits) or statutory insurances] the Contract shall continue and on the occurrence of the risk (but only for as long as such risk remains Uninsurable) the Authority shall (at the Authority's option) either pay to the Contractor an amount equal to insurance proceeds that would have been payable had the relevant insurance continued to be available and the Contract will continue, or an amount equal to the amount set out in Clause 20.3.2 (Compensation on Termination for Force Majeure) plus (in relation to third party liability insurance only) the amount of insurance proceeds that would have been payable to the Contractor whereupon the Contract will terminate.

## **24.9 CONTROL OF THE DEFENCE ON LITIGATION OF AN INSURED EVENT**

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**24.9.1** The Authority may wish to control the defence of any litigation against the Contractor which is likely to have implications for the Authority itself or wider Government. If the Authority is likely to become a co-defendant in the relevant litigation or a defendant in a number of similar litigations which will be based on the precedent in law set by the relevant litigation, it is likely to want to control the litigation from an early stage. This may involve prolonging litigation in order to establish a clear precedent instead of settling out of court. Alternatively, the Authority may wish to settle the litigation as soon as possible for public policy reasons and, in such cases, these will override commercial considerations (this may be the case, for example, in prison and hospital projects).

**24.9.2** The Contractor's insurer will usually expect to be in control of any litigation which may lead to a claim under one of its policies. It will be reluctant to pay out for claims over which it has had no control of the defence. This might include claims which the Authority has settled out of court where the courts may have awarded a lesser amount had the action been fully pursued or claims which the insurer believes it could have settled out of court for a lesser amount than is awarded by the courts. The degree of control by the Authority which the insurer will accept should be examined on a project specific basis.

**24.9.3** Generally, the Authority should expect to take back some liability for litigation costs if it wishes to insist on controlling such litigation. In practice, it is extremely difficult to determine what such liability should be. In principle, the Authority should be liable for any difference between what the insurer would have paid and the final amount settled or decided. It would be very hard to establish, however, what amount would have been an acceptable settlement to all parties (including the plaintiff) in either case outlined in Section 24.9.2. In practice, the Authority may find it is obliged to take on the majority, or even all, the relevant litigation costs in return for the right to control the defence.

## 25.1 INTRODUCTION

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The Contract should determine whether information provided by the Authority to the Contractor and vice versa is to be treated as confidential. It should also specify the extent to which details in the Contract itself are confidential.

## 25.2 GOVERNMENT OPENNESS

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**25.2.1** The “Code of Practice on Access to Government Information” (published by the Cabinet Office) provides that: “the approach to release of information should in all cases be based on the assumption that information should be released”.

**25.2.2** The requirements of Open Government suggest that PFI Contracts should be placed in the public domain as far as possible. Only “commercially sensitive” information, information the dissemination of which is contrary to the public interest or information which is personally private should be withheld. In the PFI context the key concern relates generally to “commercially sensitive” information and (for defence related projects particularly) issues of national security.<sup>1</sup>

## 25.3 RECOMMENDED APPROACH

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**25.3.1** The recommended approach is that as much information in the Contract as possible should be placed in the public domain and only information which is specifically identified as commercially sensitive by the Contractor or identified and justified by the Authority as sensitive for public interest (including national security) reasons should be excluded. The parties should aim to achieve a pragmatic balance between the public sector’s interest in transparency and the need for commercial confidentiality.

**25.3.2** The Authority should make it clear at the start of a procurement that it is its intention to make the final Contract available to any relevant public sector body (e.g. the NHS Executive) in accordance with the Code of Practice on Access to Government Information (see Section 25.2 (Government Openness)). Access, however, to commercially sensitive information will be restricted in line with the particular confidentiality restrictions within the final Contract.

**25.3.3** After short-listing, the Authority should negotiate with bidders as early as possible to define the scope of the information to be treated as commercially sensitive. If possible, the Authority should also agree with bidders when commercially sensitive matters will become non-sensitive to ensure maximum disclosure. Contracts should be structured if possible to facilitate easy removal of commercially sensitive elements.

**25.3.4** The focus for whether information should be agreed to be “commercially sensitive” should be of disclosure causing real prejudice to the interests (legal and/or commercial) of the parties<sup>2</sup>.

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<sup>1</sup> See also the Freedom of Information Act 2000 (c.36) and the Lord Chancellor’s Implementation Timetable (published on 15th November, 2001). The Act will be fully implemented by January 2005. Further details can be found at [www.dataprotection.gov.uk](http://www.dataprotection.gov.uk).

<sup>2</sup> The current proposals for future freedom of information legislation suggest that this approach will be developed further.

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## 25.4 NATURE OF COMMERCIALLY SENSITIVE INFORMATION

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**25.4.1** The commercially sensitive aspects of Contracts differ greatly from sector to sector, depending on the maturity of the market. What may be commercially sensitive in one context may not be in another and sensitivity may also decline over time.

**25.4.2** For example, for some types of contract, the only commercially sensitive information may be the financial provisions (e.g. the price and payment mechanism). Certain signed contracts have been lodged in the House of Commons library with only the money values blanked out and the Central IT Unit released copies of certain contracts on the same basis. In other contexts, however, the balance of risk transfer, some innovative construction or operational method and the payment mechanisms may be commercially sensitive (i.e. its disclosure may cause commercial harm), at least for a short period.

A suitable definition is as follows:

**“Commercially Sensitive Information”**

means any information which is agreed by the parties at the time of the Contract as being commercially sensitive<sup>3</sup>.

**25.4.3** Contractors are usually keen to ensure that proprietary information and details of pricing are kept confidential, so that their competitors cannot obtain any commercial advantage over them, for example, in any future competition. Financiers are likely to want to ensure details of the financing (such as the structure and pricing) are kept confidential from rivals and future borrowers and both of these interests are legitimate.

**25.4.4** In some sectors, such as defence, the Authority may wish to keep certain contract details confidential to avoid prejudicing national security or other public interests. Other sectors may have their own particular sensitivities and certain information may need to be treated as confidential to avoid third party interference in the smooth running of the Contract.

## 25.5 RELATED MATTERS

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**25.5.1** Stock Exchanges have publicity requirements with which listed companies are required to comply. Companies raising finance through capital markets (e.g. through bond issues), in particular, must disclose details of Contracts and related documents. There are some exceptions to disclosure requirements, for example, where national security would be prejudiced. These type of disclosure requirements should be taken into account in negotiating the confidentiality obligations in the Contract, particularly if it is anticipated that a bond issue will take place to refinance the Project after contract signature.

**25.5.2** Authorities should recognise that attempts to keep contractual terms confidential amongst the private sector and financial community are to some extent cosmetic, as details of signed contracts will often become known over time. The advantage of greater openness on the public sector side is that Authorities planning projects should benefit similarly from gaining knowledge of positions agreed by Contractors and financiers on projects similar to those planned and to gain the benefits of competition, there is some advantage in making positions known. If there is a public offering or wide syndication, the prospectus or information memorandum will usually contain a great deal of detail on the contents of the Contract and other documents.

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<sup>3</sup> This could also include, for example, information relating to detailed costings, design and other issues that give a particular bidder a competitive edge in a sector.

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**25.5.3** Contractors should note that the National Audit Office will require access to all relevant information from the Contracts which it requires for its audit purposes, irrespective of whether it is confidential or sensitive. The National Audit Office may also publish any information (including key contract terms, the contract price and results of bid evaluations) in its reports to Parliament. The Contract should ensure that the Comptroller and Auditor General is entitled to examine the Contractor's records.

Required drafting is as follows:

### **25 Information and Confidentiality**

- (a) The parties shall keep confidential all matters relating to this Contract and Project Documents and shall use all reasonable endeavours to prevent their employees and agents from making any disclosure to any person of any matter relating to the Contract.
- (b) Paragraph (a), shall not apply to:
  - (i) any disclosure of information that is reasonably required by persons engaged in the performance of its obligations under the Contract;
  - (ii) any matter which a party can demonstrate is already generally available and in the public domain otherwise than as a result of a breach of this Clause;
  - (iii) any disclosure to enable a determination to be made under Clause 27 (Dispute Resolution);
  - (iv) any disclosure which is required by any law (including any order of a court of competent jurisdiction), any Parliamentary obligation or the rules of any stock exchange or governmental or regulatory authority having the force of law<sup>4</sup>;
  - (v) any disclosure of information which is already lawfully in the possession of the receiving party, prior to its disclosure by the disclosing party;
  - (vi) any provision of information to the Senior Lenders or the Senior Lenders' professional advisers or insurance advisers or, where it is proposed that a person should or may provide funds (whether directly or indirectly and whether by loan, equity participation or otherwise) to the Contractor to enable it to carry out its obligations under the Contract, to that person but only to the extent reasonably necessary to enable a decision to be taken on the proposal;
  - (vii) any disclosure by the Authority of information relating to the design, construction, operation and maintenance of the Project and such other information as may be reasonably required for the purpose of conducting a due diligence exercise to:
    - (A) any proposed new contractor, its advisers and lenders, should the Authority decide to retender the Contract<sup>5</sup>; or
    - (B) any person in connection with [Section 14.4 (Benchmarking)] or Clause 14.5 (Market Testing);

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<sup>4</sup> It may be that certain regulatory authorities involved may not have the benefit of legal compulsion. If this is the case then the following can be added: "If not having the force of law, compliance with which is in accordance with the general practice of persons subject to the stock exchange or governmental or regulatory authority concerned."

<sup>5</sup> See for example, Section 20.2 (Termination on Contractor Default).

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- (viii) any registration or recording of the Consents<sup>6</sup> and property registration required;
  - (ix) any disclosure of information by the Authority to any other department, office or agency of the Government<sup>7</sup>;
  - (x) any disclosure by the Authority of any document related to the Contract to which it is a party and which the Contractor (acting reasonably) has agreed with the Authority contains no Commercially Sensitive Information; and
  - (xi) any disclosure for the purpose of
    - (A) the examination and certification of the Authority's or the Contractor's accounts; or
    - (B) any examination pursuant to [Section 6(1) of the National Audit Act 1983<sup>8</sup>] of the economy, efficiency and effectiveness with which the Authority has used its resources.
  - (c) Where disclosure is permitted under paragraph (b), other than paragraphs (iv), (vi), (viii), (x) and (xi), the recipient of the information shall be subject to the same obligation of confidentiality as that contained in this Contract<sup>9</sup>.
  - (d) For the purposes of the [National Audit Act 1983 the Comptroller and Auditor General] may examine such documents as he may reasonably require which are owned, held or otherwise within the control of the Contractor and any Sub-contractor and may require the Contractor and any Sub-contractor to produce such oral or written explanations as he considers necessary. For the avoidance of doubt it is hereby declared that the carrying out of an examination under [Section 6(3)(d) of the National Audit Act 1983] in relation to the Contractor is not a function exercisable under this Agreement.
  - (e) The Contractor shall not make use of the Contract or any information issued or provided by or on behalf of the Authority in connection with the Contract otherwise than for the purpose of the Contract, except with the written consent of the Authority.

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<sup>6</sup> For example, any planning permission application.

<sup>7</sup> PUK is currently assembling information in relation to all PFI projects in the UK for the purposes of compiling a comprehensive PFI projects database.

<sup>8</sup> The National Audit Office are the auditors for central government. The Audit Commission appoint auditors for local authorities and NHS Trusts in England and Wales (with the Accounts Commission performing the equivalent role to the Audit Commission in Scotland). Where the National Audit Office is not the appropriate auditor, all references to the National Audit Office in Clause 25 should be substituted with a reference to the appropriate auditor.

<sup>9</sup> This will require delivery or evidence of confidentiality agreements based on this Clause.

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- (f) Where the Contractor, in carrying out its obligations under the Contract, is provided with information relating to [people/users e.g. prisoners, patients, pupils], the Contractor shall not disclose or make use of any such information otherwise than for the purpose for which it was provided, unless the Contractor has sought the prior written consent of that [person/user e.g. prisoner, pupil, patient] and has obtained the prior written consent of the Authority<sup>10</sup>.
  - (g) On or before the Expiry Date, the Contractor shall ensure that all documents or computer records in its possession, custody or control, which contain information relating to [people/users e.g. prisoners/patients/pupils] including any documents in the possession, custody or control of a Sub-Contractor, are delivered up to the Authority.
  - (h) The Contractor will note and facilitate the Authority's compliance with the Code of Practice on Access to Government Information (1994). In the event that the Authority is required to provide information to a person as a result of a request made to it under the Code, the Authority shall adhere to the requirements of the Code in disclosing information relating to the Contract and the Contractor.<sup>11</sup>
  - (i) The parties acknowledge that [the National Audit Office] has the right to publish details of the Contract (including Commercially Sensitive Information) in its relevant reports to Parliament.

**25.5.4** The Authority should make it a condition of it becoming involved in the underlying financing (such as entering into the Direct Agreement) that the Authority is entitled to receive from the Contractor a copy of any information memorandum, prospectus or other similar financial information relating to the Project. Such information, where necessary, will be treated as Commercially Sensitive Information.

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<sup>10</sup> See also Clause 29.1 (Data Protection).

<sup>11</sup> Amendment may be necessary to refer to the Freedom of Information Act, 2001 (c.36) when and where it is in force.

